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The future of transfer pricing

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Discussion Leader: Luís Eduardo Schoueri (Brazil)
The General Council and General Assembly of IFA decided at its Mumbai meeting in October 2014 to change its publication format from 2016 onwards. The printed publication of the Cahiers consists of the General Reports of both Subject 1 and Subject 2, together with short biographies of all branch reporters. The digital publication consists of the General Reports as well as all branch reports including the biographies and directives.

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*Sdu Uitgevers, The Hague, The Netherlands*
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The inauguration of IFA took place in the Peace Palace of The Hague, the Netherlands, on 12 February 1938.

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* The views expressed are those of the reporters and not necessarily those of the respective IFA branches or the International Fiscal Association

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* Tenured professor of tax and finance law at the Rio de Janeiro State University; master’s degree and PhD in law; in 2016 founded Sergio André Rocha Advocacia & Consultoria Tributária
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Summary and conclusions

At the heart of the base erosion and profit shifting (BEPS) project are discussions regarding the control of transfer pricing in transactions involving related entities. Not only is transfer pricing the direct object of no fewer than four BEPS actions – 8–10 and 13 – it is also indirectly linked to several others.

The analysis of the branch reports demonstrated that the OECD transfer pricing guidelines are the most influential transfer pricing standard in the participating IFA branches. Even developing jurisdictions refer to the OECD standard as the basis for their transfer pricing, or as a secondary support document. Few branch reports refer to diverging practices: the only example of significantly divergent practice is the case of Brazil.

Most jurisdictions are committed to the adoption of the BEPS project outcomes, at least to some extent. However, some branch reporters stated that the reaction to the BEPS project from the business community had not been as positive as that from government, tax authorities and academia.

Regarding transactions with intangibles, most branches reported that their jurisdictions did not have specific rules for defining intangibles or transactions with intangibles. Similarly, most branch reporters commented that their jurisdictions apply a substance-over-form approach to transfer pricing – even though very few have specific rules on the matter. Even jurisdictions that are generally formalistic make an exception for transfer pricing. Across the board, there have not been any significant developments in the fields of hard-to-value intangibles and cost contribution agreements (CCAs). Some jurisdictions mentioned their experience with the analysis of group synergies. However, there have been no significant advances in this area.

In respect of the provision of low value-adding services, even though jurisdictions may move in the direction of applying a simplified, fixed margin methodology in this case, there is no indication that this may lead to the application of simplified methodologies in other areas.

Even though a substance-over-form approach is part of the future of transfer pricing, there has not been a massive turn in the direction of the functional and risk analysis proposed by the OECD.

In relation to transactions with commodities, only a few jurisdictions have enacted the “sixth method” – mostly in Latin America. Most jurisdictions use the comparable uncontrolled price (CUP) as the applicable methodology for transactions with commodities.

In reviewing the branch reports, it is possible to state that, even though the use of profit splits is possible in several jurisdictions, there are only a few that use the method customarily. On the other hand, there is a perception that the increase in the use of the profit split method will also increase litigation, and potentially double taxation.

Considering transfer pricing documentation requirements, it is possible to state that:

- Country-by-country reporting will be a reality. In most cases jurisdictions will also implement – or already have in place – the master and local file requirements.
In general, there is a concern that the new transfer pricing documentation package will increase the compliance costs for multinational companies (MNEs), even though a few branch reporters mentioned that this would only happen in the early years of implementation.

With respect to the potential upsides of the BEPS project outcomes, five items can be singled out:

- the new obligations may provide more certainty and assist companies in complying with their domestic obligations;
- companies will benefit from the overall improved and more thorough treatment of group economic information;
- transfer pricing harmonization will help avoid double taxation;
- improvements are likely in dispute resolution;
- the damage caused to companies’ images by tax scandals may start to be overcome by the perception that gaps that allow aggressive tax planning are being closed.

The BEPS project work on transfer pricing is not a finishing line, but another step in the development of rules that are effective in the fair allocation of taxing rights among jurisdictions in cross-border transactions within MNE groups. Therefore, one of the major goals of this General Report was to invite IFA’s branch reporters to comment on what the future holds. A summary of comments from branch reporters is included in the list below:

- The arm’s length principle – even in a revised form – will remain the dominant criterion for allocating taxing rights in cross-border transactions within MNE groups.
- One future trend will be alignment with the transfer pricing BEPS outcomes, indicating that the reshaped arm’s length principle will become the standard.
- The new approach to the arm’s length principle will tend to increase the number of cases of double taxation.
- The BEPS project has raised awareness of the problems existing in the allocation of taxing rights in cross-border transactions within MNE groups. In this context, some branch reporters foresee a future where audits will be increased as tax authorities try to collect more tax revenue, which may increase transfer pricing disputes. Therefore, the future of transfer pricing includes a focus on the avoidance of double taxation and dispute resolution.
- In the European context, some reports pointed out that the future of transfer pricing may hold some degree of harmonization, in the context of the debates revolving around the common consolidated corporate tax base (CCCTB).
- Some argued that the future of transfer pricing may bring about an increase in the use of profit split mechanisms, considering the shortcomings of the traditional arm’s length approach.
- There was also reference to the “popularization” of transfer pricing debates.
- A tendency to prefer economic substance over legal form was identified. Even reporters from jurisdictions where legal formalism still prevails as a rule noted that transfer pricing was an exception to this general rule.
- Along these lines, there is a clear trend for the complete disregard of extreme business models and structures that rely only on a strict formalist transfer pricing approach.
Even though there is no indication that an extremely simplified approach, such as that found in Brazil, will become a global standard, there is some movement in the direction of simplification, as seen in the case of transactions with commodities and low value-adding services.

1. Introduction

The BEPS project has certainly been the most influential factor in international taxation in recent decades. Some of the circumstances that made BEPS possible – such as globalization and harmful tax competition – are not new. However, the development of the digital economy has created problems that did not exist in an industrial-based economy. The rise of services and intangibles has changed the face of cross-border transactions, putting in jeopardy states’ capacity to collect their fair share of tax in such areas. Finally, the global financial crisis set the stage and forced jurisdictions to act. The decline in tax collection harmed jurisdictions’ capacity to maintain levels of welfare – in the case of developed jurisdictions – and negatively affected flourishing developing nations.

At the heart of the BEPS project are discussions regarding the control of transfer pricing in transactions involving related entities. Not only is transfer pricing the direct object of no fewer than four BEPS actions – 8–10 and 13 – it is also indirectly linked to several others. One might agree with Yariv Brauner when he states that “[a]ggresive transfer pricing is the beating heart of BEPS planning – the sine qua non of the transactions that triggered the universal interest in BEPS and eventually the BEPS project”.

In another text, the same author has claimed that “[t]ransfer pricing is by far the single most important and impactful tool among the current international tax planner’s tools of trade”. That is why the European Union reporters have pointed out that “BEPS resulting from the misuse or manipulation of transfer prices has been identified as a priority in the EU Commission’s corporate tax agenda”.

For several decades, transfer pricing analysis has been equivalent to the application of the arm’s length principle, which is considered to be the cornerstone of the transfer pricing international tax regime. Again according to Yariv Brauner, “[t]he arm’s length standard is the heart, spirit and the foundation of the current

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4. See section 2.1 of the European Union report.

5. As pointed out by Raffaele Petruzzi, “Since that moment [1933], the arm’s length principle has been the preferred method for allocating business income between head offices and permanent establishments and also between related companies both in the OECD Model Tax Convention on Income and on Capital (OECD Model) and in the United Nations Model Double Taxation Convention Between Developed and Developing Countries (UN Model) as well as being the relevant principle embedded in most transfer pricing rules around the world”: Raffaele Petruzzi,
transfer pricing regime”. However, as changes in the economic environment came into play, it became clearer and clearer that the existing rules were no longer capable of correctly allocating income among jurisdictions in the global economy.

As noted by Sébastien Gonnet, “[a]lthough markets and business have globalized, taxation of business had not kept pace; global profits (per business unit or industry group) had to be converted and adapted exclusively for purposes of calculating national corporate income tax bills”.

The arm’s length principle was conceived as a criterion for allocating taxing rights among jurisdictions arising from international transactions. As Scott Wilkie correctly puts it, “[f]undamentally, transfer pricing attempts to illuminate the organizational and qualitative source of income”. Notwithstanding, as pointed out by the same author, “In the absence of significant international synchronicity – there is no world tax order, legislator, or administrator – the leaves may fall where they fall, too often it came to be thought in places where there are no trees” (emphasis added).

Originally, the arm’s length principle was based on three pillars, as highlighted by Raffaele Petruzzi: “the fiction of separate legal entities (the so-called separate entity approach), the relevance of the contractual arrangements, and the comparability of the transaction”.

However, the foundations of these pillars are not as strong as expected. The fiction of separate legal entities disregards the argument that “[t]he very existence of integrated multinationals is evidence that the ALS [arm’s length standard] does not reflect economic reality”. In other words, the arm’s length principle – at least in its pre-BEPS form – mainly viewed transactions within MNE groups as transactions between independent entities. However, transactions within MNEs are far from

8 This view is not uniform among international tax scholars. For instance, in Luís Eduardo Schoueri’s interpretation, “Although the ALS has been said to provide fairness in the distribution of tax revenues among states, its rationality should be considered based on its original intent, i.e. the need for equality between related and unrelated firms.” Luís Eduardo Schoueri, “Arm’s Length: Beyond the Guidelines of the OECD” (2015) 69 (12) Bulletin for International Taxation, p. 695.
10 Wilkie, op. cit., p. 68.
11 Petruzzi, op. cit., p. 11.
13 As Scott Wilkie points out, “The transfer pricing paradigm assumes that these ‘transactions’ should take place without distortions induced by common ownership of the parties so as to take advantage of the presumptive lack of genuine adversity of interest between them in striking their erstwhile
from equivalent to dealings between independent entities. As noted by Luís Eduardo Schoueri, “[i]nternationalization allows integrated enterprises to carry out transactions more efficiently than independent enterprises, which must follow market prices”.

On the other hand, the reliance on a formal analysis of the terms and conditions of intra-group transactions also distanced transfer pricing analysis from the actual economic substance of the transactions, leading to “leaves falling where there are no trees”, in Scott Wilkie’s words quoted above. According to Sébastien Gonnet, “[r]isk was captured in contractual stereotypes that perfectly matched the requirements of applying TNMM [transactional net margin method] but lost connection with realities inside MNE business”.

The formalistic analysis of international transactions has particularly distorting effects in operations involving intangibles. More often than would be expected, entities that did not contribute to the creation of an intangible – or that do not bear the risks associated with it – end up entitled to the income it generates. Moritz Hiemann and Stefan Reichelstein have analysed this aspect. According to them, “[i]n the current debate over formula apportionment versus traditional arm’s length transfer pricing, advocates of formula apportionment frequently point out that the ease of transferring intangible assets has effectively rendered the arm’s length standard dysfunctional”.

In addition, the weight laid on the comparability of transactions, which is expected to serve as an instrument for the definition of the arm’s length price, has its shortcomings. As pointed out by Reuven Avi-Yonah:

“[p]roblems with the current system derive not from rules at its periphery, but instead from a fallacy that lies at the system’s core: namely, the belief that transactions among unrelated parties can be found that are sufficiently comparable to transactions among members of multinational groups that they can be used as meaningful benchmarks for tax compliance and enforcement…”

Even though nothing indicates that the arm’s length principle will be set aside as the primary criterion for allocating taxing rights in transactions between related parties, the fact of the matter is that the BEPS project outcomes are just one more step in the direction of a renewed version of the arm’s length principle. The report on Actions 8–10 advocates that “[t]he guidance on the arm’s length principle … be clarified and strengthened, and furthermore, if transfer pricing risks remain after

cont.


Schoueri, op. cit., p. 698.


Gonnet, op. cit., p. 35.


Petruzzi, op. cit., p. 28; Schoueri, op. cit., p. 716.
clarifying and strengthening the guidance, the BEPS Action Plan foresaw the possibility of introducing special measures either within or beyond the arm’s length principle” (emphasis added).

Indeed, the idea that related entities are operating independently is replaced by the view that “MNE groups and the associated enterprises that comprise such groups may benefit from interactions or synergies amongst the group members that would not be generally available to similarly situated independent enterprises”.

The approach based on the legal form is balanced by the consideration of the economic features of the transaction. According to the BEPS report on Actions 8–10, “[t]he transfer pricing analysis will have identified the substance of the commercial or financial relations between the parties, and will have accurately delineated the actual transaction by analysing the economically relevant characteristics”.

Finally, the usual comparability analysis may be replaced by simplified methodologies in some special situations, such as for low value-adding services, transactions with commodities, or the emphasis on profit splits as the “go to” method in some circumstances. According to Mirjam Koomen:

“A broadened interpretation of the arm’s length principle, including special measures beyond the arm’s length principle, are contemplated in this BEPS era in order to address the alignment of value creation with transactions with reported profits. Options such as profit split methods, formulary arrangements, recharacterization, reallocation of profits, commensurate-with-income standards and price adjustment clauses are considered and briefly mentioned here.”

The risk and functional analysis proposed by the OECD is far from being immune to criticism. Most will generally agree with Sébastien Gonnet’s commentary, when he states that “[t]he new OECD risk process may prove as advantageous for tax authorities when strongly criticizing extreme circumstances where risk follows neither the functions nor the financial capacity; cash boxes illustrate good examples of such a situation”. Notwithstanding, as he correctly puts it, “[w]hat about the rest, i.e. the non-extreme situations? In most situations, defining risk, identifying risk management and financial capacity are not as obvious and free from ambiguity.”

It is also fair to state that a model based on functions and risks may bring additional complexity for developing jurisdictions. Moreover, one of the most relevant aspects from a developing country’s perspective — the consumer market — has been entirely forgotten by the OECD. As noted by Marta Milewska:

21 Ibid., p. 47. As pointed out by Mirjam Koomen, “MNEs generate economic profits. The arm’s length principle, as originally developed, captured the economic profit by retaining the residual profit within the residence state of the MNE after remuneration of the outlying establishments for their services. Many MNEs are far more integrated than typically was true in the past, however, and the residual economic profit is no longer necessarily related to one separate central and vital entity.” Mirjam Koomen, “Transfer Pricing in a BEPS Era: Rethinking the Arm’s Length Principle – Part II” (2015) 22(4) International Transfer Pricing Journal, p. 240.
22 OECD, op. cit., p. 38.
24 Gonnet, op. cit., p. 40.
“In addition to resources and capabilities, which converge and transform into competitive advantages, market characteristics also may have an impact on profitability under industrial organization economics. Although academic studies show that an entity’s competitive advantages (rather than market characteristics) are the main source of long-term premium profitability, market characteristics may boost the entity effect on profitability. In that sense, it is noteworthy that the market power of entities has its basis in entity resources. For instance, the prerequisite for market power may be the presence of barriers to entry or vertical bargaining power, which have the effect of reducing or limiting competition by preventing potential competitors from entering a market.”25

The complexity of the current business environment has checked current transfer pricing control mechanisms. However, it is unclear whether the new model will resolve the problems or just increase complexity. This is the background against which the branch reports were prepared. Their focus was to adapt this international context to a domestic framework and attempt to ascertain the future of transfer pricing.

2. Transfer pricing and previous congresses

The Rio de Janeiro Congress is not the first to have transfer pricing as one of its main subjects.

Subject 1 of the Cancun, Mexico, Congress of 1992 was *Transfer pricing in the absence of comparable market prices*. Its General Reporter was Guglielmo Maisto, who, at that time, supported the need for closer attention to transfer pricing from IFA. In his words, the need for the analysis presented in subject 1 of the Cancun Congress was “also suggested by the limited attention given by IFA to the subject matter. In particular IFA has dealt, in the past, with transfer pricing only in a limited, peripheral or ancillary fashion.”26

Transfer pricing was again the focus of an IFA congress in 2007. Subject 1 of this congress, which was held in Kyoto, Japan, was *Transfer pricing and intangibles*. The General Reporter in this case was Toshio Miyatake. The issues that were analysed in this report are closer to the topics that are the focus of the BEPS project. In his conclusion, the General Reporter stated that “[c]oncrete measures are required to achieve better circumstances for the application of appropriate uniform transfer pricing rules to intangible transactions”.27

This General Report – as well as the debates that will take place during the Rio de Janeiro Congress, under the coordination of Professor Luís Eduardo Schoueri – renews IFA’s commitment to the study of transfer pricing. It is not the end of the road, but one more step along the way.

3. Outline and branch reports

The outline sent to branch reporters invited them to start their analysis with an overall assessment of their current domestic transfer pricing policy, regulations and practice. The core of the reports’ outline was the request to reporters to comment on how the BEPS project had affected their jurisdiction’s transfer pricing policies and practices. Reporters were also requested to comment on how the proposed changes in transfer pricing would potentially affect transfer pricing documentation and compliance costs and whether the BEPS project might work in favour of companies. Finally – and this part may be considered the end-goal of the reports – reporters were invited to present their views on the future of transfer pricing.

The General Reporter received 44 reports from the European Union and the following jurisdictions: Argentina, Australia, Austria, Belgium, Bolivia, Brazil, Bulgaria, Canada, Chile, Chinese Taipei, Colombia, the Czech Republic, Denmark, Finland, France, Germany, Hungary, India, Italy, Japan, Korea, Liechtenstein, Luxembourg, Malaysia, Mexico, the Netherlands, New Zealand, Norway, Peru, Poland, Portugal, Serbia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, Ukraine, the United Kingdom, the United States of America, Uruguay and Venezuela. The reports reflect the effort of all reporters to provide relevant information from their jurisdiction, which was helpful and essential for the preparation of this General Report. The General Reporter is grateful for all the branch reporters’ hard work.

In the observations in the sections below, the report has tried to use the branch reports as extensively as possible. However, the reader will notice that in those instances where this report makes references to certain branch reports, most of the time not all the branch reports are mentioned. This only happened in those cases where a particular report did not make explicit reference to the issue under analysis, considering the specific focus of the General Reporter.

4. The influence of the OECD

As pointed out by Yariv Brauner, “[t]he OECD was not only charged by the G20 to lead the BEPS project with no supervision beyond the highest political levels but also succeeded in positioning itself as an independent partner to the G20, taking ownership of the project rather than acting in a subordinate role”.28 The OECD’s leadership in international taxation goes beyond the BEPS project. It is well known that most of the double tax conventions currently in force are directly or indirectly based on the OECD model.29 The analysis of the branch reports reinforces the fact that the OECD is also a major influence when it comes to transfer pricing policy.

It was expected that reports from developed jurisdictions would refer to the influence of the OECD and, in fact, they did. Several reports from developed jurisdictions highlighted that the OECD transfer pricing guidelines are relevant when it comes to transfer pricing.\textsuperscript{30} In some cases, branch reporters even pointed out that the BEPS project’s outcomes included in the OECD transfer pricing guidelines would be immediately applicable in their jurisdiction without the enactment of any further domestic regulation.\textsuperscript{31}

In these cases – where changes in the OECD transfer pricing guidelines are applicable immediately – the question arises of whether such changes will apply retroactively or only to future transactions. This issue was highlighted by the Austrian reporters, according to whom:

“A relevant question would be whether the new guidance will apply only to transactions taking place after the implementation of the new OECD TPG [transfer pricing guidelines] (hence, by means of a ‘static approach’), or rather retrospectively, to transactions started before this point in time (hence, with a ‘dynamic approach’). The answer to this question will largely depend on whether the new OECD guidance is considered as including new concepts or as clarifying the concepts of the arm’s length principle as included in section 6 paragraph 6 ITA. When analysing the outcome of the BEPS project relating to transfer pricing topics and considering unofficial discussions with members of the tax administration as well as recent developments in tax audits, the answer to this question seems to be going in the direction of a dynamic use of the new OECD TPG. Moreover, according to the Austrian TPG, domestic law will – in case of doubt – be interpreted in line with the current version of the OECD TPG. However, this approach could be criticized from a constitutional perspective.”\textsuperscript{32}

The reporters’ position was that the Austrian authorities will most probably favour a “dynamic application” of the transfer pricing guidelines rather than a “static application”.\textsuperscript{33} The same position was supported in the Belgian,\textsuperscript{34} Canadian,\textsuperscript{35} Norwegian,\textsuperscript{36} Spanish\textsuperscript{37} and Swedish\textsuperscript{38} reports. This issue was also included in the Mexican report. However, the branch reporter was less assertive when analysing the topic. In his words:

“further analysis is required in order to determine whether the resulting guidelines from the BEPS project could be applied for interpreting the TP provisions

\textsuperscript{30} See reports from Australia, Denmark, France, Italy, Japan, Luxembourg, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, the United Kingdom and the United States.
\textsuperscript{31} See reports from Austria and Belgium.
\textsuperscript{32} See section 2.1 of the Austrian report (footnotes omitted in this and all subsequent citations from branch reports).
\textsuperscript{33} On the distinction between a “static” and “dynamic” interpretation, see Sergio André Rocha, \textit{Interpretation of Double Taxation Conventions: General Theory and Brazilian Perspective} (The Netherlands: Kluwer, 2009), pp. 123–126.
\textsuperscript{34} See section 3 of the Belgian report.
\textsuperscript{35} See section 2.1 of the Canadian report.
\textsuperscript{36} See section 2.1 of the Norwegian report.
\textsuperscript{37} See section 2.1 of the Spanish report.
\textsuperscript{38} See section 2.2.3 of the Swedish report.
in previous years or could only be applied as of the date of approval by the OECD of such guidelines and beyond. Issues related with static and dynamic interpretation of the MITL [Mexican Income Tax Law] and the OECD TP guidelines should be analysed.”

These issues appeared in passing in other reports. It seems that there is a trend for changes in the OECD transfer pricing guidelines to be applied retroactively, as interpretative provisions.

However, this position must be taken with caution. As noted by the General Reporter in a previous work, “[i]n order that a treaty (as well as any other legal rule) may be classified as interpretative, it must remain entirely in the field of the framework of the rule interpreted, having as its purpose only the selection of one of the rules that may be created from the normative text”. Therefore, if the new transfer pricing guidelines significantly change transfer pricing standards, establishing obligations that could not be inferred from previous provisions, they should only be applied for the future.

It is interesting to note that the analysis of reports from developing countries points in the same direction as that from developed jurisdictions’ reports. In most cases, reference is made to the influence and relevance of the OECD transfer pricing guidelines. In the Argentinian report, for instance, the OECD’s influence is also a part of a larger government policy objective of joining the OECD. The intention of becoming an OECD member is also highlighted in Peru’s branch report.

4.1. Divergent practice

One of the aims of the outline sent to branch reporters was to identify jurisdictions whose practices depart from the OECD standards. A review of the reports received indicates that very few reporters mentioned the existence of relevant divergent practices. In general, the OECD transfer pricing guidelines are the most relevant global standard for transfer pricing. In the following paragraphs these divergent practices are highlighted.

To prevent tax planning involving transfer pricing in commodity transactions, Argentina was the first to introduce the so-called “sixth method”, which received this name “because it has been added to the existing five OECD-based TP methods provided for in Argentine domestic law. The sixth method aims to deter schemes in

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39 See section 1 of the Mexican report.
40 Rocha, op. cit., p. 88.
41 The term “developing country” has an open interpretation. It includes jurisdictions with different levels of development and infrastructure. It is worth pointing out that in this report the expression “developing countries” includes all such jurisdictions, even those that are G20 members. For further analysis on this topic, see Paulo Rosenblatt, General Anti-Avoidance Rules for Major Developing Countries (The Netherlands: Kluwer, 2015), pp. 9–13. In this General Report, “developing countries” are those so categorized by the IMF’s Economic Outlook Report of 2015. See IMF, World Economic Outlook (Washington: International Monetary Fund, 2015), p. 152.
42 See reports from Bolivia, Bulgaria, Chile, Colombia, Hungary, India, Korea, Malaysia, Mexico, Peru, Poland, Singapore, South Africa, Turkey, Ukraine, Uruguay and Venezuela. See sections 2.4 and 2.6 of the Argentinian report.
43 See section 2.1 of the Peruvian report.
the commodity industry similar to those implemented by La Anglo, a subsidiary of a British MNE, in the early 1930s.”45 Specific transfer pricing methods applicable to transactions with commodities have been included in the BEPS report on Actions 8–10 (see section 9 below).

The most blatant case of divergent practice is found in Brazil. According to the Brazilian reporters:

“Brazil does not follow the OECD’s transfer pricing (TP) guidelines for multinational enterprises and tax administrations. Brazil is not a member of the OECD and is not bound to the application of the guidelines, either by means of international conventions, or by virtue of its domestic legislation.”46

According to the Italian report, the jurisdiction’s legislation and court decisions provide for a few deviations from the OECD’s standards, regarding: (a) a safe harbour related to royalty transactions; (b) the application of a mark-up in cost-sharing related to intra-group services; and (c) the determination of costs in the field of online advertising and connected services.47

Per the Malaysian report, even though the jurisdiction’s transfer pricing regulations are largely based on the OECD’s standards, there are a few areas of difference, such as: (a) the definition of “control” is wider than the OECD meaning; (b) the Inland Revenue Board of Malaysia “has the tendency in most cases to apply the median without considering the use of other measures such as the mean, weighted averages, the interquartile range, etc.”; and (c) “[p]rofit split methodology is rarely applied and in most cases, the tax authority moves back to the comparable uncontrolled price method or the transactional net margin method”.48

The New Zealand report also includes a few distinctive features of this jurisdiction’s transfer pricing regulations, as follows: (a) regarding low-value and non-core services, “[t]he Income Tax Act provides for the transfer of the burden of proof from the taxpayer to Inland Revenue to prove a ‘more reliable measure of the arm’s length amount’”; and (b) simplified methodologies exist for low-value and non-core services, as well as for low-value loans.49

According to the Peruvian report, there are also some “peculiarities” in this jurisdiction’s transfer pricing regulations, such as: (a) “TP rules are applicable not only to international controlled transactions, but also to controlled domestic transactions and even to non-controlled tax haven transactions”; (b) “[i]t is mandatory to use interquartile ranges where there is more than one comparable observation”; (c) since 2013, Peru has introduced a version of the so-called “sixth method”; and (d) there are two versions of the profit split method.50

Poland’s branch report pointed out some deviations from OECD standards, as follows:

45 See section 4.1.1 of the Argentinian report.
46 For a detailed analysis of Brazil’s divergent practice, see section 1 of the Brazilian report.
47 See section 1 of the Italian report.
48 See section 1 of the Malaysian report.
49 See section 1 of the report from New Zealand.
50 See section 1 of the Peruvian report.
“Major deviations between the OECD TP guidelines and Polish rules include a 5 per cent independence threshold (subject to change to 25 per cent as of 2017), a fragmented transaction-by-transaction TP approach with low transaction value thresholds subject to documentation, and a lack of requirement for economic comparable analyses as part of TP documentation. The extremely low 5 per cent independence threshold results in the qualification of counterparties as related entities even in cases of transactions undertaken between commercially independent businesses and publicly owned companies with low interest stakeholders. The 5 per cent threshold also has an impact on the application of independence criteria in searches for comparable companies – in practice its literal application results in the rejection of otherwise comparable entities and degrades the search results.

A specific deviation from the OECD TP guidelines relates to the pricing of financial transactions – loans, guarantees and the like – which according to Polish TP regulations should be priced at the lowest interest/price applicable to comparable financial transactions. As a result, use of publicly available data and data requested from financial institutions both by taxpayers as well as by tax authorities during audits is still the predominant way for both the set up as well as the examination of such transactions.”

Portugal’s report also mentioned the existence of small divergences between the jurisdiction’s practices and the OECD standards. According to the report:

“Although the Portuguese TP rules are closely based on the OECD standards, the Portuguese TA [tax authorities] launched, in 2014, some new rules regarding the tax deductibility of some types of costs, namely financial ones, which define a threshold above which those costs will not be tax deductible, even when they comply with the TP rules. This turns out to be the first deviation from the strict application of the arm’s length principle in some specific situation where the TA has faced, through consistent litigation, difficulties in effectively applying the arm’s length based approach.”

As previously noted, even though there are some references to divergent practices, overall, they seemed to be minor. In fact, it is worth pointing out that most of the jurisdictions whose reporters mentioned divergent practices stated that, in general, their transfer pricing regulations were aligned with OECD standards. The only branch that reported a significant departure from OECD practices was the Brazilian branch.

4.2. Summary

Considering the comments above, it is possible to state the following:
• The OECD transfer pricing guidelines are the most influential transfer pricing standard in the participating IFA branches.

51 See section 1 of the Polish report.
52 See section 1 of the Portuguese report.
Even developing countries refer to the OECD standard as the basis for their transfer pricing, or as a secondary support document.

Although a few branch reports make reference to divergent practices the only example of significantly divergent practice is the case of Brazil.

5. Effects of the BEPS project

It was noted in the previous section that the OECD transfer pricing guidelines are generally considered to be the most influential source of reference for domestic transfer pricing regulations. Assuming this to be true, it is interesting to inquire how jurisdictions reacted to the BEPS project’s outcomes in this area. Accordingly, branch reporters were asked to comment on how such outcomes affected their jurisdiction’s domestic transfer pricing policies and practices.

The position taken by the BEPS report on Actions 8–10 is that:

“This Report contains revised guidance which responds to these issues and ensures that the transfer pricing rules secure outcomes that see operational profits allocated to the economic activities which generate them. It represents an agreement of the countries participating in the OECD/G20 BEPS Project. For countries that formally subscribe to the Transfer Pricing Guidelines, the guidance in this Report takes the form of amendments to the Transfer Pricing Guidelines. Therefore, this Report also reflects how the changes will be incorporated in those Guidelines” [emphasis added].

Some branch reporters from developed jurisdictions communicated that the outcomes of the BEPS project in Actions 8–10 will be generally accepted without the need for changes in domestic provisions – even if, in some cases, as an interpretative tool or soft law. However, that is not the case in many jurisdictions. For instance, in the case of Germany changes in domestic regulations will be required for the implementation of the BEPS outcomes related to transfer pricing. The report from New Zealand mentions the relevance of the transfer pricing guidelines. However, as noted by the branch reporters, “New Zealand’s TP provisions do not expressly incorporate the OECD TP guidelines ... in the event of any inconsistency between the legislative provisions and the guidelines, the legislative provisions (interpreted in the usual way) would prevail”.

It is worth noting the Australian branch position: “[t]he most significant moves by Australia in addressing BEPS are the unilateral adoption of the MAAL [Multinational Anti-Avoidance Law]”. Hence, for the Australian branch reporter, even though the “TP outcomes of the BEPS project have been generally accepted as positive and embraced by the Australian government and Australia’s tax authority”, the most relevant instrument enacted to combat BEPS is domestic. Australia was

53 OECD, op. cit., p. 10.
54 See reports from Austria, Belgium, Canada, Finland, Italy, Norway, Spain, Sweden and Switzerland.
55 See section 2.1 of the German report.
56 See section 2.1 of the Australian report.
the only jurisdiction that referred to a domestic initiative that was currently more relevant for transfer pricing purposes than the BEPS project itself.

Considering the scope of this section, it is interesting to analyse how reporters from developing jurisdictions commented on the effects of the BEPS project on their transfer pricing policies and practice. It is also pertinent to investigate whether these reporters indicated that their jurisdiction had had relevant participation in the discussions coordinated by the OECD.

Two developing countries’ reports did not make any explicit reference to a direct influence of the BEPS project on their transfer pricing policies and practice, or to their jurisdiction’s participation in the project. Others mentioned their participation in the project and/or their intention to adopt, to some extent, its transfer pricing outcomes. The Czech branch reporter commented that the modified transfer pricing guidelines should be applied directly.

Brazil’s position is singular, in line with the jurisdiction’s distinctive approach to transfer pricing. The Brazilian branch reporters highlighted note 1 at the end of the report on Actions 8–10, according to which:

“Brazil provides for an approach in its domestic legislation that makes use of fixed margins derived from industry practices and considers this in line with the arm’s length principle. Brazil will continue to apply this approach and will use the guidance in this report in this context. When Brazil’s Tax Treaties contain Article 9, paragraph 1 of the OECD and UN Model Tax Conventions and a case of double taxation arises that is captured by this Treaty provision, Brazil will provide access to an MAP [mutual agreement procedure] in line with the minimum standard of Action 14.”

Per the reporters’ view, this could be seen as a waiver from the OECD for the jurisdiction to continue adopting an independent approach to transfer pricing – as this note is linked to the paragraph transcribed above, according to which jurisdictions that adopt the transfer pricing guidelines should consider BEPS outcomes as changes to those guidelines – which could be read as “jurisdictions that do not adopt the transfer pricing guidelines should not consider the BEPS outcomes as changes to those guidelines”.

The Uruguayan reporters voiced a rather common criticism from developing jurisdictions: that the BEPS project was not conceived or developed taking into account the distinctions between developed and developing jurisdictions. According to them:

“some academic opinion has expressed a more critical view on the matter. Blanco, in a presentation at the University of the Republic of Uruguay, argued that the political structure of taxation pursued by this plan has ‘two significant
features: (a) the decrease of the autonomous decision making capacity of states in tax matters; and (b) the establishment of the OECD (and similar organizations) as the new centres of global fiscal power’. Mazz highlights that when the BEPS project proposes the unification of domestic rules and provisions stated in the conventions, it should consider the major economic and regulatory differences existing between members and non-members of the OECD.”

The reports from Finland, France, Korea and Norway referred to an aspect that was not mentioned in this section in most of the reports: the reaction from the business community to the transfer pricing BEPS project outcomes.

According to the Finnish reporters, the transfer pricing outcomes have:

“been widely criticized by some business stakeholders. There are two main arguments that have especially been mentioned. First, the status of a signed contract has met with strong criticism. Actions 8–10 state that factors other than a contract could also be determinative in pricing some transactions. This has been considered to open up too far-reaching opportunities for tax administrations to collect tax on the basis of almost anything that the tax administration claims to be at arm’s length. Secondly, CbCR [country-by-country reporting] has met a highly critical reception from business due to the heavy compliance burden, as well as the confidentiality issues, it is bound to create. Some stakeholders fear that confidential information will be leaked publicly.”

The French branch report pointed out that “[t]he private sector approach consisted, in a nutshell, in a fear of an unfair implementation of the BEPS recommendations by tax auditors, knowing that the changes brought about by the OECD reports were major and that groups would have to adapt in the context of limited guidance”. The French report also mentioned that “[r]epresentatives of the financial sector and insurance companies were worried about the fact that these recommendations did not provide guidance specifically applicable to these two particular sectors”.

After mentioning that the tax authorities, legislators and the academic community generally praised the BEPS outcomes, the Korean branch report stated that, “Korea’s business sectors, however, are concerned about the overall effect that the domestic implementation of the BEPS Action Plan will produce in the future”. This report raises an interesting fairness aspect related to the BEPS implementation: once you have changed the rules you have changed them for everybody. In the words of the Korean reporters:

“the position of Korean MNEs is that, although they have never been active, unlike their global counterparts, in taking advantage of the current international tax rules to gain leverage on tax avoidance strategies, they are unfairly obliged to sustain the hardships of compliance burdens and tax disputes, which will be likely to increase significantly as the implementation of the OECD’s BEPS

62 See section 3.1 of the Uruguayan report.
63 See section 2.1 of the Finnish report.
64 See section 3.1 of the French report.
project outcomes unfolds. Korean corporations are concerned that the rapidly expanding scope of information to be disclosed to tax authorities due to the BEPS project may infringe their rights to confidentiality. Further, they are afraid that BEPS-related measures, especially unilateral measures, which could be introduced by a number of countries, may give rise to double taxation and tax disputes, which would probably undermine their business competitiveness.”

Another report that mentioned the business community reaction was the Norwegian branch report. In its words:

“In general, the business community in Norway, including professional TP advisers, seems to understand and accept many of the changes suggested by the OECD in the BEPS project. In particular, the new documentation requirements following from BEPS Action 13 are not considered controversial. On the other hand, CbCR is seen by most companies as a burdensome obligation, where companies and advisers question the benefit of the report in its current form. Furthermore, there is a general perception that the emphasis on functional contribution and control over assets and risks may lead to subjective, incorrect and arbitrary allocations of profits that are not consistent with the arm’s length principle. Clearly, some of the new guidance on intangibles, cost contribution arrangements (CCAs), risk and capital is perceived as a significant change to the current practice, and should not be applied retroactively. There is also a general consensus that the OECD seems to underestimate the value and risk attributable to capital. Furthermore, there is a general perception that the new OECD guidelines open the door for too much subjective interpretation by the tax authorities of what is a significant contribution. Hence, taxpayers fear that this may in some cases lead to more arbitrary and unreasonable reallocation of profits or losses, which again will lead to double taxation for taxpayers. It is also believed that the new guidelines will require more work by the taxpayer in terms of how transactions are structured, implemented, executed and documented. Accordingly, the new OECD TP guidelines will be more burdensome to apply in practice for the taxpayer than the current situation.”

The Swedish branch report voiced a different concern: that “[t]he BEPS project is likely to result in complex disputes given the focus on substance and important functions performed, as tax administrations in different jurisdictions could interpret the commercial reality underpinning TP policies differently.” This could end up being a cause of double taxation.

This is an interesting point. As previously noted, the risk analysis proposed in the BEPS report on Actions 8–10 can be easily applied in extreme situations. However, there are a variety of cases where the allocation of functions and risks will prove to be troublesome, may trigger controversies and even result in double taxation. These two aspects, the potential to generate tax controversies and to bring about double taxation, will be addressed in another section of this General Report.

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65 See section 2.1 of the Korean report.
66 See section 2.1 of the Norwegian report.
5.1. Summary

In view of these comments, it is possible to summarize the findings of this section as follows:

• Most jurisdictions – developed and developing – are committed to the adoption of the BEPS project outcomes – at least to some extent.
• There was an isolated commentary from Uruguay that raises concern about a jurisdiction’s tax sovereignty and the role of the OECD as some sort of central tax power.
• Some branch reporters stated that the reaction to the BEPS project from the business community had not been as positive as the reactions from government, tax authorities and academia.

6. Challenges of transactions with intangibles

As previously mentioned, transactions with intangibles are at the core of many of the aggressive tax planning structures that triggered the BEPS project. It is therefore only natural that transactions with intangibles occupy a protagonist position in the OECD work on transfer pricing. Aspects related to the outcomes of Actions 8–10 on intangibles will be the focus of this section.

6.1. Definition of intangibles and transactions with intangibles

Many jurisdictions do not have a clear definition of intangibles. As noted by the OECD, definitions of intangibles that are either too broad or too narrow may generate transfer pricing problems.67 One of the BEPS project’s goals is to provide a clear and uniform definition.

It is one thing to define intangible assets, but it is another to identify transactions with intangibles. Reporters were invited to indicate whether there are any specific rules for the definition of transactions with intangibles in their jurisdiction – including identifying the legal owner of the assets and how they benefited each entity of the MNE group.

In general, it was apparent that, with very few exceptions,68 most jurisdictions do not have a definition of intangible assets specifically for transfer pricing purposes.69 In some cases, there were definitions that were established in regulations covering other areas – such as intellectual property or civil law – that might be used for transfer pricing. There are also jurisdictions that make reference to accounting principles as one of the elements that could be used to reach a definition of intangibles.70 Some reporters highlighted that their jurisdiction would probably

67 OECD, op. cit., p. 67.
68 See reports from Chinese Taipei, India, Malaysia, South Africa and the United States.
69 See reports from Argentina, Australia, Austria, Bolivia, Bulgaria, Canada, Chile, Colombia, Denmark, Finland, France, Germany, Hungary, Japan, Korea, Luxembourg, the Netherlands, New Zealand, Norway, Peru, Poland, Portugal, Serbia, Singapore, Spain, Sweden, Switzerland, Turkey, Ukraine, the United Kingdom, Uruguay and Venezuela.
70 See reports from Belgium, Brazil, Colombia, Italy and Portugal.
follow the amended OECD transfer pricing guidelines. This position is supported by the European Union reporters, according to whom “in practice, in the TP area, the definition used should correspond overall to that proposed in the OECD TP guidelines”.

Brazil’s branch reporters commented on the distinctive approach of this jurisdiction to transactions with intangibles. In their words:

“In practical terms, Brazilian legislation deals with the issue of transactions with intangibles by denying or significantly limiting the deduction of royalties and payments for technical, scientific, administrative or similar assistance. Even though this approach is a serious violation of taxpayers’ rights (indeed unconstitutional), it could be seen as an effective means to combat BEPS.”

Most reports did not refer to the existence of explicit rules regarding transactions with intangibles, with a few exceptions. Other reports pointed out that the amended transfer pricing guidelines will be used as reference.

It is worth highlighting the Belgian report, particularly the part that states:

“Belgian legislation is based on civil law principles. This means that, for legal purposes, only the legal owner can exercise all rights related to an asset, whether tangible or intangible, unless some of those rights are transferred contractually to another party. Legally speaking, economic ownership is not recognized under civil law. Some rights related to an asset such as ‘usufruct’ (a sort of ‘life interest’) do not correspond to economic ownership.”

This analysis between the prevalence of form over substance – or vice versa – will be the focus of the following section.

6.2. Substance-over-form approach towards intangibles

Over time, a shift has occurred from a formalistic approach to transfer pricing – which would analyse transactions based on the formal contracts signed by the parties – to a more substance-over-form oriented approach.

Transactions involving intangibles have been central to international tax planning. Many of the cases that have gained notoriety in recent years are related to the transfer of intangibles themselves or of the right to use them.

71 See reports from Argentina, Austria, Chile, Denmark, New Zealand, Norway and the United Kingdom.
72 See section 2.2.2 of the Brazilian report.
73 See reports from Argentina, Australia, Austria, Bolivia, Bulgaria, Canada, Chile, Colombia, Denmark, Finland, France, Germany, Hungary, India, Italy, Korea, Luxembourg, the Netherlands, New Zealand, Norway, Peru, Portugal, Singapore, Spain, Sweden, Switzerland, Turkey, Ukraine, the United Kingdom, Uruguay and Venezuela.
74 See reports from Bulgaria, Malaysia, South Africa and the United States.
75 See reports from Argentina, Austria, Belgium, France, Italy and the United Kingdom.
76 See section 2.2.2 of the report from Belgium.
77 On this topic, see Rosenblatt, op. cit., pp. 134–147.
This scenario has encouraged a “substance-over-form” approach towards transactions with intangibles, requiring an analysis beyond legal ownership. Therefore, entitlement to returns deriving from intangibles should also be based on a “substance-over-form” analysis. According to proposed changes to the OECD transfer pricing guidelines:

“Although the legal owner of an intangible may receive the proceeds from exploitation of the intangible, other members of the legal owner’s MNE group may have performed functions, used assets, or assumed risks that are expected to contribute to the value of the intangible. Members of the MNE group performing such functions, using such assets, and assuming such risks must be compensated for their contributions under the arm’s length principle.”

The debate regarding the preference for substance over the legal form raises the issue of what exactly substance is. This aspect was mentioned by the Australian reporter. In his words, the lack of guidance regarding the meanings of “form” and “substance” raises the following questions: does ‘form’ mean ‘legal form’ or something more akin to ‘legal substance’ or something else? Does ‘substance’ mean ‘legal substance’ or ‘economic substance’ or ‘economic equivalence’ or something else?”

The substance-over-form approach supported by the BEPS project outcomes makes the analysis of the risks taken and the functions performed by the entity even more relevant. As noted by the Austrian reporters, the new guidance from the OECD is specifically concerned with “the analysis of functions related to development, enhancement, maintenance, protection and exploitation (DEMPE functions)”. According to the BEPS report on Actions 8–10:

“In transfer pricing cases involving intangibles, the determination of the entity or entities within an MNE group which are ultimately entitled to share in the returns derived by the group from exploiting intangibles is crucial. A related issue is which entity or entities within the group should ultimately bear the costs, investments and other burdens associated with the development, enhancement, maintenance, protection and exploitation of intangibles. Although the legal owner of an intangible may receive the proceeds from exploitation of the intangible, other members of the legal owner’s MNE group may have performed functions, used assets, or assumed risks that are expected to contribute to the value of the intangible. Members of the MNE group performing such functions, using such assets, and assuming such risks must be compensated for their contributions under the arm’s length principle. This Section B confirms that the ultimate allocation of the returns derived by the MNE group from the exploitation of intangibles, and the ultimate allocation of costs and other burdens related to intangibles among members of the MNE group, is accomplished by compensating members of the MNE group for functions performed, assets

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78 OECD, *op. cit.*, p. 73.
79 See section 2.2.3.2 of the Australian report.
80 See section 2.2.3 of the Austrian report.
used, and risks assumed in the development, enhancement, maintenance, protection and exploitation of intangibles according to the principles described in Chapters I–III.”

In most cases, branch reporters observed that in their jurisdiction there were no specific substance-over-form provisions related to transfer pricing. However, many of them made reference to the application of domestic general substance-over-form provisions or practices in the field of transfer pricing. In the case of Bulgaria, reference was made to explicit transfer pricing substance-over-form rules. In Chile, the formalistic approach still prevails, with the application of transfer pricing rules having as reference the contracts actually signed by the parties and the legal ownership of intangibles. Argentina reported that even though the legal form prevailed, there were some cases where the tax authorities attempted to apply a substance-over-form approach. A few jurisdictions mentioned that, although the legal form generally prevailed in the tax field, transfer pricing was an exception, with the tax authorities applying a substance-over-form approach.

There are jurisdictions where the changes in the OECD transfer pricing guidelines in this area will probably become the standard.

The German report presented an interesting observation highlighting the need for a clearer and more explicit substance-over-form provision as follows:

“However, this general anti-abuse clause has not proved to be fully effective in the past, and from the perspective of the German tax authorities, implementation of the OECD/G20 recommendations requires an explicit ‘substance-over-form’ provision providing a clear statutory definition for a specific legal consequence. In the business community, however, there are serious reservations about introducing a provision of this kind since doubts exist about whether this is consistent with the arm’s length principle. Moreover, agreement between the Federal Ministry of Finance and the Länder (federal state governments) has yet to be completed. The former regards the introduction of a specific substance-over-form provision as being necessary, in order for it to enable Germany to withstand or enforce claims vis-à-vis treaty partners. No decision has been made as yet in this area.”

Not surprisingly, Brazil’s approach in this area is also distinct from that identified in all other jurisdictions. In the words of the branch reporters, “[t]he restrictive Brazilian legislation with respect to deductibility of expenses related to intangibles does not entail significant tax strategies that would demand a substance-over-form

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81 OECD, op. cit., pp. 73–74.
82 See reports from Austria, Bolivia, Chinese Taipei, Colombia, France, Hungary, Italy, Japan, Korea, the Netherlands, New Zealand, Norway, Peru, Poland, South Africa, Sweden, Turkey, Ukraine, the United Kingdom, the United States, Uruguay and Venezuela.
83 See section 2.2.3 of the Bulgarian report.
84 See section 2.1.3 of the Chilean report.
85 See section 2.3 of the Argentinian report.
86 See reports from Belgium, Canada and Malaysia.
87 See reports from Austria, Denmark, Norway, Portugal, Singapore and Spain.
88 See section 2.2.3 of the German report.
approach towards intangibles. Therefore, there is no example of such treatment in legislation or case law.”

6.3. Hard-to-value intangibles

The BEPS project has raised concerns regarding the valuation of hard-to-value intangibles. In fact, the valuation of intangibles per se poses several challenges due to problems in comparability.

According to the OECD:

“When valuation of an intangible or rights in an intangible at the time of the transaction is highly uncertain, the question arises as to how arm’s length pricing should be determined. The question should be resolved, both by taxpayers and tax administrations, by reference to what independent enterprises would have done in comparable circumstances to take account of the valuation uncertainty in the pricing of the transaction.”

Oleh Fedusiv has commented on the outcome of the OECD’s work in this area. In his words:

“Action 8 equips tax administrations with a special tool to examine transfer prices set in relation to the transfer or the use of HTVIs, namely ex post assessment. The rationale behind this approach is that tax authorities suffer from information asymmetry when assessing transfer prices in HTVI transactions. They may not have ‘specialized knowledge, expertise and insight into the business environment in which the intangible is developed or exploited’. The OECD argues that tax authorities are, as a rule, dependent on information provided by taxpayers – which makes it difficult for them to reliably examine relevant transfer prices.”

The analysis of the branch reports in this area showed that most jurisdictions do not have any specific provisions or established practices dealing with hard-to-value intangibles. Moreover, in most cases no reference has been made to changes as a result of the BEPS report on Actions 8–10. A few branch reporters commented specifically on their experience in this area.

6.4. Cost contribution agreements (CCAs)

CCAs are agreements “among business enterprises to share the contributions and risks involved in the joint development, production or the obtaining of intangibles, tangible assets or services with the understanding that such intangibles, tangible assets or services are expected to create direct benefits for the businesses of each of the participants.”

89 See section 2.2.3 of the Brazilian report.
90 OECD, op. cit., p. 107.
92 See reports from Belgium, Canada, India, the Netherlands, Portugal and the United States.
93 OECD, op. cit., p. 161.
CCAs can be a source of BEPS if contributions and benefits to the participant companies are not properly determined. According to the Finnish report:

“In some countries CCAs have created significant BEPS issues in cases where intangibles were contractually moved between group members without arm’s length compensation. CCAs have sometimes included elements where the compensation for contributing existing intangibles that were part of the arrangement has been more or less nominal compared to the pricing of the comparable intangible in a transaction between unrelated parties.”

The post-BEPS approach to CCAs – in line with other BEPS recommendations – puts risk at the heart of transfer pricing analysis. As noted by the Hungarian report:

“According to the BEPS approach, CCAs continue to be evaluated based on the substance of the arrangement rather than the contractual form. The requirement that all CCA participants must have a clearly defined interest in the CCA output remains unchanged as well; however, under the BEPS project all CCA parties must also have the ability to exercise control over the risks and must also have the financial capacity to assume those risks.”

From the analysis of the branch reports it is possible to single out the usual features of CCAs as follows:

- the existence of a written agreement;
- a mutual and common interest shared by the participating entities;
- the existence of mutual benefits to the participating companies;
- contributions being proportionate to the benefits;
- reasonable and determinate allocation keys; and
- core activities cannot be their object.

In general, jurisdictions did not report changes in connection with the BEPS-related CCA measures.

**6.5. Comparability and group synergies**

In the words of Marta Pankiv:

“For transfer pricing analysis, it is critical to understand the MNE’s global business by identifying all factors that contribute to value creation, including the risks assumed by each member, specific market characteristics, location, business strategies and MNE group synergies. The group synergies that can be attributed to ‘deliberate concerted group actions’ should generally be shared between the members of the group in proportion to their contribution to the creation of the synergy.”

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94 See section 2.2.6 of the Finnish report.
95 See section 2.2.6 of the Spanish report.
96 See section 2.2.6 of the Hungarian report.
According to the BEPS report on Actions 8–10, “in some circumstances, MNE groups and the associated enterprises that comprise such groups may benefit from interactions or synergies amongst group members that would not generally be available to similarly situated independent enterprises”.98 On the other hand, as pointed out in the Hungarian report, “Negative effects can also arise, such as increased bureaucracy or ineffective IT systems.”99

Belgium’s branch report mentions that this jurisdiction was performing group synergy analysis before the BEPS report on Actions 8–10. According to the branch reporter, “Synergies were explicitly recognized by the tax authorities before the BEPS report, particularly by the Ruling Commission. From a TP perspective, synergies mean advantages stemming from the fact that a company belongs to a group and can benefit from advantages that an independent company would not obtain.”100

The reporter further described how the Belgium analysis works, as follows:

“Synergies have also been recognized in Belgium through the so-called ‘excess profit rulings’. These rulings are delivered by virtue of article 185(2) of the ITC, which deals with cross-border transactions of companies or branches belonging to an MNE. This article provides a downward adjustment: when a company is taxable on profits on which another company could be taxed or has already been taxed, the taxable income of the first company is adjusted in an appropriate manner, as if the agreed conditions between the two companies were those which would have been agreed between two independent companies.

Because a Belgian company benefits from synergies and other intangibles (a client list, a distribution network, etc.) for which it does not pay any consideration, it will generate additional profits stemming from those ‘received’ intangibles. Because an independent company would not benefit from those intangibles and in order to respect the arm’s length principle, the Belgian entity requests, in an advance ruling, the tax exemption of the portion of the profit stemming from the exploitation of those ‘received’ intangibles.”

Canada also has experience with group synergy analysis. According to this branch report:

“One significant implication of this prevailing approach arises in the context of large group pricing. That is, on the approach taken by the courts in General Electric Capital Canada Inc. and GlaxoSmithKline Inc., that the ability of a group to obtain more favourable prices when acting in concert should arguably be taken into account when determining the arm’s length price of fees paid to a central procurement entity.”

98 OECD, op. cit., p. 47.
99 See section 2.2.4 of the Hungarian report. A similar position is found in the branch report from the United States. According to the branch reporters: “Group synergies refer to the favourable (or disadvantageous) influences that may arise from being part of the enterprise as a whole. For example, a larger company may benefit from bulk purchase discounts (as compared to a smaller sized company). In general, under US rules, group synergies are comparability factors.” See section 2.2.4.2 of the report from the United States.
100 See section 2.2.4 of the report from Belgium.
The French report also mentioned that:

“French tax auditors have been active in the analysis of the integration of entities within a group, and the benefit the whole group may be able to gain from such integration. Once again, there is no specific law or tax administration regulation connected to this approach. However, tax auditors have developed a common understanding and are able to apply consistent argumentation.” 101

It is interesting to highlight Japan’s position, which is in clear opposition to the use of group synergies in the context of transfer pricing. In the words of the branch reporter: “Japan still has a negative attitude to the introduction of the notion of ‘group synergies’ into the TP guidelines. The Japanese perspective is that the notion of ‘intangibles’ is restricted to only that which can be held or controlled. Thus, group synergies of MNEs do not fall within the scope of the TP rules.” 102

However, many jurisdictions mentioned that they do not have any rules or experience with considering group synergies in the context of applying transfer pricing rules. 103

6.6. Summary

Taking the previous comments into account, we can summarize as follows:

- Most branches reported that their jurisdiction did not have specific rules for defining intangibles or transactions with intangibles.
- Similarly, most branch reporters commented that their jurisdiction applied a substance-over-form approach to transfer pricing – even though very few have specific rules on the matter. Even jurisdictions that are generally formalistic make an exception for transfer pricing.
- Across the board, there have been no significant developments in the fields of hard-to-value intangibles and CCAs.
- Some jurisdictions mentioned their experience with group synergy analysis. However, there have been no significant advances in this area.

7. Low value-adding services

The provision of intra-group services is part of the operations of any MNE. As pointed out by the OECD, “Nearly every MNE group must arrange for a wide scope of services to be available to its members, in particular administrative, technical, financial and commercial services. Such services may include management, coordination and control functions for the whole group.” 104

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101 See section 3.2.4 of the French report.
102 See section 2.2.4 of the Japanese report.
103 See reports from Argentina, Bolivia, Brazil, Bulgaria, Chile, Colombia, Denmark, Germany, Korea, Luxembourg, Malaysia, Poland, Portugal, Singapore, Sweden, Ukraine, Uruguay and Venezuela.
104 OECD, op. cit., p. 143.
However, while quite common, the provision of intra-group services may open up BEPS opportunities for MNEs, which (to some extent) can be avoided through the application of transfer pricing rules.

According to the BEPS report on Actions 8–10, “there are two issues in the analysis of transfer pricing for intra-group services. One issue is whether intra-group services have in fact been provided. The other issue is what the intra-group charge for such services for tax purposes should be in accordance with the arm’s length principle.”105

This topic is interesting, since the OECD has proposed a simplified approach to deal with transfer pricing and low value-adding services. The proposed fixed margin – 5 per cent mark-up – deviates from the arm’s length principle as traditionally supported by the OECD. As noted by Guglielmo Maisto:

“Paragraph 7.61 provides for a profit markup equal to 5% to be applied to all pool costs. It is doubtful if one margin for all costs will properly reflect the arm’s length remuneration. Accounting services may carry profit margins which are different from markups on monitoring safety and environmental matters. Furthermore, the flat markup disregards the location of the cost centre and the different labour cost levels which may be found in different countries. Group synergies leading to cost efficiency are also not taken into account (knowledge of business models within the group may result in lower cost compared to an arm’s length situation).”106

For the purposes of the simplified approach, the BEPS report on Actions 8–10 provides the following definition:

“7.45 Low value-adding intra-group services for the purposes of the simplified approach are services performed by one member or more than one member of an MNE group on behalf of one or more other group members which
• are of a supportive nature;
• are not part of the core business of the MNE group (i.e. not creating the profit-earning activities or contributing to economically significant activities of the MNE group);
• do not require the use of unique and valuable intangibles and do not lead to the creation of unique and valuable intangibles; and
• do not involve the assumption or control of substantial or significant risk by the service provider and do not give rise to the creation of significant risk for the service provider.”107

Since this simplified, fixed rate approach deviates from the traditional arm’s length principle, it is interesting to analyse how jurisdictions are reacting to this alternative. The Australian report indicated that:

“The Australian Treasury is of the view that the adoption of the elective, simplified approach is ‘likely to free up resources for tax administrators in ident-
ifying and examining cross border dealings with significant TP and BEPS risks’. However, currently Australia’s legislative provisions do not contain an election option in either section 815-125 or section 815-130 ITAA 1997. As such, it is unclear how taxpayers could elect to adopt the simplified approach in the amended OECD TP guidelines without specific legislative provision to do so.”

Other branch reporters also mentioned that their jurisdiction might come to accept the simplified methodology. The report from Denmark commented that the jurisdiction had already included the simplified methodology in its guideline.

Jurisdictions such as Belgium, which already have as policy requiring a profit margin on intra-group services, are uncertain regarding whether the simplified approach will be adopted, even though the Belgian report highlights that, “[t]his new regime will be welcome by companies as it will simplify the TP policy and documentation requirements”. Norway’s branch report indicated that this jurisdiction would probably not follow the new OECD alternative approach. The South African report pointed out that the jurisdiction’s tax authorities had already indicated that they would not apply the new simplified approach.

The United States has traditionally applied a “no mark-up policy” to intra-group services. According to this jurisdiction’s branch report:

“The regulations make the SCM [services cost method] permanent. The SCM allows certain services to be priced at cost, that is, it permits the services to be reimbursed at cost, without a mark-up. To qualify for the SCM, the service must: (a) be a ‘covered service’; (b) not be an ‘excluded activity’; (c) satisfy the business judgment rule; and (d) maintain adequate books and records. To apply the SCM, under the business judgment rule, the taxpayer must reasonably conclude that, in its business judgment, the service ‘does not contribute significantly to key competitive advantages, core capabilities, or fundamental risks of success or failure in one or more trades or businesses of the controlled group’.”

The US report did not indicate any change in the direction of levying a mark-up on intra-group services.

7.1. Summary

Considering the comments above, a summary of this section is that jurisdictions may move in the direction of applying a simplified, fixed margin methodology in
this case. However, there is no indication that this fact could lead to the application of simplified methodologies in other areas.

8. Risk and capital

As previously mentioned, BEPS actions regarding transfer pricing are still based on the arm’s length principle. On the other hand, the allocation of the fair share of tax to each jurisdiction where an MNE operates is one of the major goals of the project.

Action 9 of the BEPS project aimed at “adopting transfer pricing rules or special measures to ensure that inappropriate returns will not accrue to an entity solely because it has contractually assumed risks or has provided capital”.116

In the 2013 OECD Secretary-General’s Report to the G20 finance ministers and central bank governors, it was stated that:

“In particular, the current interpretation of the arm’s length principle is challenged by the ability of MNEs to artificially shift profits by transferring easily movable assets (such as intangibles and capital). The action plan will fix these issues with measures, either within or beyond the arm’s length principle, to ensure that taxable profits can no longer be artificially shifted away from the countries where value is created.”

This goal reinforces the close connection between the application of the arm’s length principle and the analysis of the functions and risks undertaken by the entities. According to the BEPS report on Actions 8–10, “in transactions between two independent enterprises, compensation usually will reflect the functions that each enterprise performs (taking into account assets used and risks assumed)”.117 Furthermore, “a functional analysis is incomplete unless the material risks assumed by each party have been identified and considered since the actual assumption of risks would influence the prices and other conditions of transactions between the associated enterprises”.118

This means one more step towards putting the formal agreements signed by the parties in second place and determining the arm’s length price based on the business and economic factors of the transaction carried out by the parties. Belgium’s branch reporter supported the same view, as follows:

“Since the tax authorities apply the OECD TP guidelines as they are modified over time, it is to be expected that they will apply the new OECD approach, which aligns returns with value creation and which comprises measures to ensure that inappropriate returns will not accrue to an entity solely because it has contractually assumed risks or has provided capital. As requested by the OECD, it is to be expected that the authorities will put less emphasis on the con-
tractual arrangements where the actual behaviour of the related parties deviates from those contractual arrangements, and if the legal owner of the assets does not carry out the important functions, assume the most significant risks and enhance the value of its assets.”  

Some branch reporters mentioned that their jurisdiction had not implemented any sort of risk analysis or was not focused on determining the compatibility between benefits received and capital employed.  

On the other hand, there are jurisdictions like Australia where the tax authorities’ position is that:

“TP analysis should look at the substance of transactions which is achieved by delineating between the entity which bears the risk of the transaction and the entity which derives the actual economic value of the transaction. The Treasury suggests that amendments to the 2010 OECD TP guidelines provide an approach which is consistent with how the ATO currently applies the Australian TP rules. That is, any TP analysis is based on an accurate delineation of what the associated enterprises actually contribute rather than contractual arrangements which may not reflect economic reality.”

Functional and risk analysis are also a reality in other jurisdictions.  

New Zealand’s branch report singled out that this approach of functional and risk analysis would depend on the application of the jurisdiction’s general anti-abuse rule. In the words of the reporters:

“Under current New Zealand law it could only be through application of the GAAR, and the associated powers of reconstruction, that Inland Revenue could attempt to ensure that inappropriate returns do not accrue to entities solely because of contractually assumed risks or the provision of capital. Otherwise (and as described above) Inland Revenue must apply the TP provisions based on the legal arrangements actually entered into, even if those arrangements are motivated or structured to shift profits.”

Therefore legislative changes would be required in this jurisdiction for it to apply the suggested functional and risk analysis.

The Austrian branch report raised an interesting point, in that it refers to the fact that it is important to analyse the “role of capital in the future”, as it “now appears clear that taxpayers should consider not only issues related to thin capitalization, but also the question of whether a company is overcapitalized”.

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119 See section 2.3 of the Belgian report. Also see section 2.3 of the Finnish report.  
120 See reports from Argentina, Brazil, Canada, Colombia, Italy, Japan, Ukraine and Venezuela.  
121 See section 2.3 of the Australian report.  
122 See the reports from Bolivia, Bulgaria, Chile, France, Hungary, India, Luxembourg, Mexico, the Netherlands and the United States.  
123 See section 2.3 of the report from New Zealand. The same appears to be the case in Peru (see section 2.3 of the Peruvian report).  
124 See section 2.3 of the Austrian report.
Another relevant aspect was pointed out in the Norwegian report related to how functions and risks are determined in certain areas. In the opinion of the reporter:

“the ramifications of the new guidelines for the allocation of returns to risk and capital as described by the OECD in the BEPS Actions 8–10 report may have severe impacts on how returns are currently allocated within a group. In particular, groups where a significant part of the group’s returns are attributed to asset owning companies, such as IP, shipping and rig companies, will probably be scrutinized in the years to come. If such asset owning companies are not able to demonstrate sufficient functional and financial capacity to effectively manage those assets and associated risks, it can be assumed that the tax authorities will try to reallocate profits to other companies within the group where the assets and associated risks are actually managed according to the tax authorities. This will be very relevant in Norway, which has a large offshore and shipping industry, where typically the vessels are owned by asset owning companies in low-tax jurisdictions or the Norwegian tonnage tax regime, and where the management company is located in Norway and taxed under the normal tax regime. In the light of this, it may be expected that companies will have to look at how they are currently operating the business and managing the assets and associated risks. Accordingly, it is safe to assume that the new guidelines on attribution of profits to risk and capital will have a significant impact on tax practice in Norway.”

This point goes back to Sébastien Gonnet’s critique (see note 24). Indeed, the risk analysis is very appropriate – and provides clearer results – for extreme cases, where income is attributed to entities that bear no risk and earn a large portion of the MNE’s global income. However, in most cases the analysis will not be so simple. The outcome of this situation might be an increase in double taxation and transfer pricing litigation – which, by the way, seems to be a trend of post-BEPS transfer pricing. This same position was taken by the UK reporters, according to whom, “[t]he complexities around business risks and the link with the provision of capital mean that this is an area which is likely to be the subject of disputes between business and tax authorities – and between tax authorities – in the short term”.125

Another branch report that highlighted the difficulties in applying the new OECD approach was the Uruguayan report. However, these branch reporters also pointed out another aspect: the risk of tax revenues ending up being shifted from developing to developed jurisdictions. It is worth quoting their words:

“While the proposition put forward by these actions may be worthy of consideration in theory, in practice it will be an extremely complex and subjective task, not only because of the difficulty of identifying risks (non-tangibles) and measuring their level (full, medium or limited), but because for the arm’s length principle to be effective such risks must be identifiable and measured equally in potential comparables. It is extremely difficult to determine the level of risk assumed by independent parties in view of the scant information that can be accessed publicly.

125 See section 2.3 of the UK report.
The position taken by these actions – if not interpreted in the proper way – runs the risk of strengthening the old claim of the developed jurisdictions of allocating income to the headquarters company, which – ultimately – will always end up making the decisions, to a greater or lesser extent. In the reporters’ view, the notion of risk should therefore be interpreted very carefully by developing jurisdictions, if they do not want the income genuinely generated in their territories to migrate to developed countries.”

8.1. Summary

To wrap up this section, this General Reporter considers that even though a substance-over-form approach is part of the future of transfer pricing, there has not been a massive turn in the direction of functional and risk analysis. This is the case even though it seems that the general acceptance of the OECD transfer pricing guidelines as the transfer pricing standard will probably lead to a shift in this direction.

9. CUP and quoted prices for commodity transactions

As previously mentioned, the so-called “sixth method” was created by Argentina in 2003. As discussed in the Argentinian branch report, “it was targeted at the commodity industry because of the government’s perception that this industry was involved in aggressive international transfer pricing manipulation based on a report by the tax authority”. The Argentinian branch reporter mentioned that in its first decade of implementation the “sixth method” led to significant transfer pricing litigation between taxpayers and tax authorities.127

This situation was described by the Brazilian branch reporters:

“Following the experience of Argentina, which created a specific method aiming at avoiding the use of traders in the export transactions of certain commodities, many countries, such as Uruguay, Ecuador, Mexico, Peru, Guatemala, Honduras, Dominican Republic, Ukraine and Brazil, also enacted variations of the sixth method. Although these methods are usually referred to under the same denomination, each jurisdiction’s domestic legislation has its own peculiarities.

The sixth method in those jurisdictions has a common aspect its applicability to export or import transactions of commodities between controlled parties in which there is a trader involved or for which there is a comparable price internationally quoted by a transparent market. The sixth method can be described as a variation of the CUP method, through which the transaction price is determined taking into account not the circumstances of the operation, but quotations from stock exchanges.”

126 See section 3.3 of the Uruguayan report.
127 See section 4.1.2 of the Argentinian report.
128 See section 2.4.1 of the Brazilian report.
According to its branch report, Bolivia implemented a “sixth method”, called “Argentino” in its regulations, in reference to its creation by Argentina. However, the Bolivian branch reporter pointed out that there are still many blank spots regarding its application.\textsuperscript{129} Brazil also created a “sixth method”, which was explained at length by the branch reporters.\textsuperscript{130} India also has rules specific for transfer pricing and commodities, as does Peru. According to the Peruvian branch reporters, cross-border transactions with commodities between related parties became a focus of the Peruvian tax authorities, which led to the introduction, in 2012, of the new rules. In their words, the “new piece of legislation became informally known as the ‘sixth method’, since it was inspired by a trend which started in Argentina, where the rules were in the sixth paragraph of the relevant law, and then spread all over Latin America”.\textsuperscript{131} Uruguay also has a specific methodology for commodities, which is viewed as the adoption of the “comparable uncontrolled price method together with a special anti-evasion measure”.\textsuperscript{132}

Some commodity-exporting jurisdictions did not implement any specific transfer pricing method for commodities. This is the case of Australia. Per the Australian report:

“The new OECD guidance relating to deeming the pricing date for commodity transactions when the taxpayer does not provide reliable evidence of the agreed pricing date may not be consistent with Australia’s domestic TP rules. If the pricing date for commodity transactions is unknown, it seems likely that the reconstruction provision in subsection 815-130(3) would need to be applied to establish the date that independent enterprises might reasonably have agreed to.”\textsuperscript{133}

Many jurisdictions do not have any specific provisions relating to transfer pricing in transactions with commodities similar to the “sixth method” – generally applying the CUP method. And their branch reporters did not make reference to any intention to adopt regulations to this end.\textsuperscript{134} The Italian report also pointed out that the CUP will continue to be the “go to” method for commodities. However, the branch reporter highlighted that changes in the OECD transfer pricing guidelines will be applicable in Italy.\textsuperscript{135} Norway does not have specific transfer pricing rules for commodity transactions – even though this jurisdiction has some specific regulations regarding the determination of the price of oil.\textsuperscript{136} The report from the European Union highlighted that “although several EU Member States apply specific transfer pricing legislation to commodity transactions, the most recent being Romania (2016), the topic has so far not been considered as part of coordinated works at EU level”.\textsuperscript{137}

\textsuperscript{129} See section 2.4.1 of the Bolivian report.
\textsuperscript{130} See section 2.4.1 of the Brazilian report.
\textsuperscript{131} See section 2.4.1 of the Peruvian report.
\textsuperscript{132} See section 3.4.1 of the Uruguayan report.
\textsuperscript{133} See section 2.4.1 of the Australian report.
\textsuperscript{134} See reports from Bulgaria, Canada, Chile, Chinese Taipei, Denmark, Finland, Hungary, Japan, Luxembourg, Malaysia, Mexico, the Netherlands, New Zealand, Portugal, Serbia, Sweden, Switzerland and Ukraine.
\textsuperscript{135} See section 2.4.1 of the Italian report.
\textsuperscript{136} See section 2.4.1 of the Norwegian report.
\textsuperscript{137} See section 2.3.1 of the report from the EU.
9.1. Summary

Only a few commodity-exporting jurisdictions have enacted the “sixth method” – mostly Latin American jurisdictions. Most jurisdictions use the CUP as the applicable transfer pricing methodology for transactions with commodities.

10. Profit split in the context of value chains

Vikram Chand and Sagar Wagh analysed the general concept of the profit split method and how it differs from the formulary apportionment methodology as follows:

“The profit split method is one of the transactional profit methods and the only two-sided method provided by the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines). This method aims at splitting the combined profits (or losses) arising from controlled transactions between associated enterprises on an economically valid basis, that approximates the division of profits that would have been anticipated and reflected in an agreement made at arm’s length. It is important that the profit split method not be confused with the non-arm’s length approach of profit allocation, namely the global formulary apportionment method. This is because, when applying the profit split method, the division of profits arising from the controlled transactions between associated enterprises is based on a scientific analysis, while in case of the non-arm’s length approaches, the division of profits arising from a controlled transaction is based on a pre-determined formula.”

In a recent article, Raffaele Petruzzi and Claire (Xue) Peng mentioned that:

“Despite being one of the five OECD authorized transfer pricing methods, the profit split method is slightly different from the other methods. First, the profit split method is a two-sided method: it requires a consideration of both sides (goods seller and goods purchaser, or service provider and service recipient) of the controlled transaction to assess the relative contributions of each party. … Second, the profit split method is a profit-based method. It begins with calculating the combined profits of a transaction which are subsequently subject to a division through the arm’s length principle.”

Several jurisdictions that use the OECD transfer pricing guidelines as a basis for domestic transfer pricing rules have the profit split method as one of their viable

methods for transfer pricing control. Therefore, as pointed out by the Portuguese branch report, “[i]f it is demonstrated that it constitutes the best method based on the facts and circumstances, then the profit split method is allowed to be considered under the Portuguese TP rules”.140

However, the analysis of the branch reports showed that there was a great deal of mistrust in relation to profit split.

According to the French report, “experience shows that tax auditors may not always be keen to use the profit split method, as the way some groups implement that method may be complicated, with no detailed information about the keys they use and no clear explanation of the link between these keys and the activities performed or the profit to share”.141

In Germany, the profit split method can be used only if other methods cannot reasonably be applied. As stated in the branch report:

“Use of the transaction profit split method has the explicit acceptance of the tax authorities, but due to a statutorily determined order of application, it can only be employed where the standard methods cannot or cannot reliably be used in the absence of unequivocally comparable arm’s length prices (section 1(3) FTC).”142

Australia143 and Spain144 take the same position.

The risk of poor harmonization among jurisdictions in the application of profit split methodologies is highlighted in the UK report.145 According to the branch reporters:

“While profit split may be the most appropriate method depending on the facts and circumstances of the case (and particularly in cases involving the development of valuable intangibles) the practical difficulties of implementing and managing a profit split should not be underestimated. This is particularly the case when multiple countries are involved, due to the timing of local country audits and the potential consequential adjustments required in other participating countries.”

In line with the UK position, the Swedish report also observed that the application of the profit split method requires a great deal of harmonization and that in the absence of such a harmonized approach the outcome could be double taxation. According to this jurisdiction’s report, “[b]oth the Swedish TP network and the STA see a challenge in the practical and uniform implementation and interpretation at a worldwide level of profit (or loss) splits by tax administrations and companies, where different approaches would lead to an increased risk of disputes and double taxation”.146

140 See section 2.4.3 of the Portuguese report.
141 See section 3.4.3 of the French report.
142 See section 2.4.3 of the German report.
143 See section 2.4.3 of the Australian report.
144 See section 2.4.3 of the Spanish report.
145 See section 2.4.3 of the UK report.
146 See section 2.4.3 of the Swedish report.
South Africa’s report suggested that subjectivity is a downside of profit split. Per this report:

“With reference to the profit split method, the SARS [South African Revenue Service] highlights the subjectivity surrounding the allocation of profits as a key weakness of the method and goes further to state that it could result in a less reliable measure of the arm’s length price than an analysis under one of the other methods. Although the exact facts and circumstances surrounding each case would determine which method was most suited to arriving at the arm’s length result, this implied hierarchy would indicate that the SARS would not advocate the use of the profit split method as the default mechanism of first resort.”

Some branches reported that their jurisdiction had no position in relation to the profit split method. Austria and Hungary stated that they have no profit split provisions but tend to follow the OECD.

The reports from Chile, India and Peru mentioned that the profit split method is possible in these jurisdictions but has never been used. The Colombian report also referred to the rare use of the method. The Finnish report went in the same direction, mentioning that there is very little case law about the issue.

Few jurisdictions reported a more consistent use of the profit split method. Canada and Japan are waiting for the OECD to finish its work on this topic.

10.1. Summary

In reviewing the branch reports, it is possible to state that, even though the use of the profit split method is possible in several jurisdictions, there are actually only a few that use the method customarily. On the other hand, there is a perception that the increase in the use of the profit split will also increase litigation and potentially the incidence of double taxation.

11. Transfer pricing documentation

The great majority of the jurisdictions surveyed indicated that they have either implemented or will implement country-by-country reporting requirements. On the other hand, only a few branch reporters stated that their jurisdiction might not implement it at all.

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147 See section 2.4.3 of the South African report.
148 See reports from Argentina, Bolivia, Brazil, Korea, New Zealand and Turkey.
149 See reports from Belgium, Bulgaria, Denmark, Poland and Singapore.
150 See reports from Argentina, Australia, Austria, Belgium, Brazil, Canada, Chile, Chinese Taipei, Colombia, Denmark, Finland, Germany, Hungary, India, Italy, Japan, Korea, Luxembourg, Malaysia, Mexico, the Netherlands, New Zealand, Norway, Peru, Poland, Portugal, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, Ukraine, the United Kingdom, the United States and Uruguay.
151 See reports from Bolivia, Bulgaria, Hungary and Venezuela.
Regarding the master and local files, the majority of the jurisdictions have also already implemented them, will implement them or have domestic rules that are equivalent to them, rendering new rules unnecessary.\textsuperscript{152} A few branch reports mentioned that there was no indication that these transfer pricing documentation obligations would be created.\textsuperscript{153}

The Brazilian branch reporters questioned the compatibility of country-by-country reporting with Brazil’s National Tax Code provisions. In their words:

“It is doubtful whether the ancillary obligations under CbCR are compatible with the Brazilian National Tax Code. According to the Code, ancillary obligations should be within the scope of tax collection or tax auditing (article 113, paragraph 2). The obligations pursuant to CbCR are not aimed at tax collection or tax auditing, but at collecting data for the purposes of economic and statistical analysis.

The National Tax Code sets forth limits for the enactment of tax legislation. Article 113 allows the tax administration to create additional obligations for taxpayers, provided that they are relevant to the auditing and collection of taxes. The power to institute fines and penalties can only be exercised within this scope.

However, CbCR demands a power which is not immediately within the scope of the provision, as traditionally conceived. The proposal does not aim at creating obligations in the interest of tax auditing and tax collection, but transfers part of the burden of gathering information relevant for the purposes of tax policy from the tax authorities to the taxpayers.

It is not immediately obvious whether such a measure could be enforced by means of fines and penalties under the Brazilian National Tax Code – and, as a consequence, whether this measure could be, in fact, enforced under that Code. However, a broadened interpretation of the term ‘in the interest of tax auditing and tax collection’ could be sufficient to comprise measures similar to those set forth by CbCR, provided that the tax administration does not have access to the relevant information by other means. It is relevant to note that article 113 also limits the ability of tax authorities to redundantly require information to which they already have access by other means.”\textsuperscript{154}

The report from Denmark made an interesting point correlating country-by-country reporting with formulary apportionment. According to the Danish report:

“Moreover, the Danish tax authorities have explicitly stated that the country-by-country report should not be applied as a substitute for core TP analyses, including whether a Danish entity has applied the arm’s length principle on its intercompany transactions.

\textsuperscript{152} See reports from Argentina, Australia, Austria, Belgium, Bolivia, Chile, Chinese Taipei, Colombia, Denmark, Finland, Germany, India, Italy, Japan, Korea, Luxembourg, Malaysia, Mexico, the Netherlands, New Zealand, Norway, Peru, Poland, Portugal, Singapore, South Africa, Spain, Sweden, Turkey, Ukraine, the United Kingdom and Uruguay.

\textsuperscript{153} See reports from Brazil, Bulgaria, Canada, France, Switzerland, the United States and Venezuela.

\textsuperscript{154} See section 2.5.1 of the Brazilian report.
Hence, the Danish tax authorities are expected to follow the OECD’s recommendation to use the country-by-country report solely as a risk assessment tool, not in a formula apportionment type approach. Further, on 27 January 2016 Denmark signed the Multilateral Competent Authority Agreement on the exchange of country-by-country reports.”\textsuperscript{155}

The new transfer pricing documentation standard is related to the topic of automatic exchange of tax-related information. This is another area where the optimization of tax authorities’ collection instruments is ahead of concerns for the protection of taxpayers’ rights. Regarding the topic, this General Reporter has stated the following in a previous work:

“One clear aspect of the way in which the exchange of information for tax purposes is being treated is the fact that the protagonists in the discussions on the matter are the states, themselves. The taxpayers only have, at best, a supporting role to play, although it is constantly stated that the preservation of their rights is fundamental. After all, it would be impossible to imagine a perspective that advocated disregard for the rights of taxpayers, although, in most cases, practice appears to be somewhat distant from theory.”\textsuperscript{156}

One of the most relevant aspects related to the protection of taxpayers’ rights in the context of the exchange of tax-related information is the confidentiality of the information actually transferred from one jurisdiction to another. Therefore, it is no surprise that the issue was raised in some reports. According to the Austrian branch report, “the confidentiality of the data provided to other tax authorities must be ensured at the level of all the tax authorities involved. Also, the use of such information needs to be discussed.”\textsuperscript{157} Belgium’s report raised the same issue, stating that, “[c]oncerning the exchange of CbCR between tax authorities, the law of 2016 does not provide any specific obligations for the tax authorities in order to guarantee the strict confidentiality of the information included in the CbCR. This creates a major concern for MNEs.”\textsuperscript{158} According to the branch report from Singapore, the country-by-country reporting information exchange will only take place “after establishing that the jurisdictions have a strong rule of law and are able to ensure confidentiality”.\textsuperscript{159}

One aspect related to the new model for transfer pricing documentation that generates a lot of concern across the board is the increase in compliance costs – even though some reporters mentioned that such costs will tend to decrease in the future as MNEs become used to the new requirements.

\begin{flushright}
\textsuperscript{155} See section 2.5.1 of the Danish report.
\textsuperscript{157} See section 2.5.1 of the Austrian report.
\textsuperscript{158} See section 2.5.1 of the report from Belgium.
\textsuperscript{159} See section 2.5.1 of the report from Singapore.
\end{flushright}
11.1. Compliance costs

One of the concerns of MNEs with the BEPS work on transfer pricing documentation is the increase in compliance costs, especially during a period of financial crisis and limited resources. As mentioned by the Turkish branch reporter, “[c]ompliance costs cover documentation, employing personnel, fees paid to consulting firms assigned to a joint study, and the fines incurred if compliance falls short”.160

The Australian report raised two important concerns related to compliance costs connected with the BEPS project outcomes: (a) the potential duplication of ancillary obligations; and (b) the risk of high fines that companies will be exposed to. In the words of the reporters:

“The further requirement of the three reports packaged as country-by-country reporting is a significant shift in the obligations on taxpayers. In addition to the extra compliance costs, penalties for non-compliance will also be significant. Entities which fail to comply with country-by-country reporting obligations will face administrative penalties, which are currently A$4,500 but proposed to increase to A$450,000 for significant global entities. Failure to comply is also likely to lead to future increased scrutiny by the ATO with indications that non-compliant taxpayers will be viewed adversely in risk assessment and audit scenarios. At the time of introduction, concern was raised by tax practitioners about the reporting requirements being potentially cost intensive for taxpayers. This concern centred around whether other jurisdictions would move towards a similar system to reduce global compliance costs. To date, there is a global move towards country-by-country reporting thereby reducing the need for more than one set of reports.”161

A similar concern was raised in the branch report from Belgium:

“The additional administrative costs relating to the gathering of the requested information could divert MNEs from their core business while they will not gain any benefit from it. The OECD has not recommended replacing current domestic requirements for TP documentation by the three-tier approach so that each country is free to add the OECD filing to its existing documentation requirements. Moreover, MNEs had expected that, as a compensation for all the additional constraints contained in the BEPS report, a mandatory and binding arbitration provision would be added to the multilateral instrument foreseen in Action 15 of the BEPS report, allowing the removal of double taxation within a fixed timeframe.”162

Another concern, highlighted in the Hungarian report, is the potential impact of compliance costs on small MNEs. According to the branch reporter:

160 See section 6.3 of the Turkish report.
161 See section 2.5.3 of the Australian report.
162 See section 2.5 of the report from Belgium.
“In Hungary there are numerous MNE entities which are considered as small in terms of revenue, headcount and balance sheet total; however, they are still expected to participate in CbCR if the MNE group becomes obliged to do so. From a Hungarian perspective CbCR would create a disproportionately high compliance burden for the smallest entities. Therefore, it would be beneficial to seek for a solution that would still exempt such entities from reporting; however, the probability of this change is rather low, as BEPS Action 13 provides sufficient argumentation that once an MNE group becomes obliged to perform CbCR, in no event can any of its constituent entities become exempted from the reporting obligation.”

The Indian branch reporters voiced concern about the potential costs related to audits that might be triggered by country-by-country reporting:

“in view of the risk-based audit process introduced recently, it is expected that smaller groups of companies will be taken up for audit, but these are likely to be the outcome of CbCR review, for which the department is expected to deploy analytical tools. More detailed scrutiny will, therefore, be adopted for such companies. The Indian experience has been that several cases are normally taken up for audit and even then, the intensity of audit is considerable. This is expected to be increased due to the smaller number of cases and the focus on BEPS-related issues. Therefore, it is presumed that in addition to compliance costs, there will be more spending to defend the audit and possible litigation for AEs [associated enterprises] whose parent companies meet the CbCR threshold.”

The concern with defence costs was also raised in the Swedish report.

Reports from other jurisdictions also pointed out that the post-BEPS transfer pricing standards might increase costs for MNEs. Few reports supported the view that no additional compliance costs should be expected. The branch report from Singapore supported the view that, even though compliance costs tend to increase, “looking at it from the group’s perspective, efforts aimed at achieving the international harmonization of TP documentation could help MNEs avoid costly duplicative work derived from the multiplicity of documentation regulations in different countries”.

The South African reporters pointed out that there is another side to the story. They highlighted that the tax authorities’ administrative burden would also be increased. In their words, “[a]lthough the influx of detailed TP information will add to the SARS arsenal in its fight against ‘transfer mispricing’ (as it has come to

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163 See section 2.5.3 of the Hungarian report.
164 See section 2.5.3 of the Indian report.
165 See section 2.5.4 of the Swedish report.
166 See reports from Austria, Brazil, Chinese Taipei, Colombia, Denmark, Finland, France, Germany, Japan, Korea, Malaysia, the Netherlands, Peru, Poland, Portugal, Ukraine and the United Kingdom.
167 See reports from Canada, New Zealand and Switzerland.
168 See section 2.5.3 of the report from Singapore.
be known), the increased disclosures and filings, along with the duty to exchange the information with other competent authorities, will also add significantly to the SARS’ administrative burden”.

11.2. Can BEPS work in favour of MNEs?

To some extent, the search for transparency in the context of the BEPS project has been one sided, primarily focusing on generating information for tax administrations. However, automatic exchange of information could also work in favour of taxpayers, with tax authorities automatically exchanging information necessary for the application of domestic transfer pricing regulations.

In general, branch reporters did not mention any specific initiative to use tax transparency in favour of MNEs. Moreover, some reports made explicit reference to the one-sided focus of the BEPS project. However, some reports indicated potential benefits that international tax transparency could bring to MNEs.

According to the Australian report, there are two ways in which “the information gathering initiatives of the BEPS project may arguably benefit MNEs operating in Australia”: (a) “information provided in the country-by-country report and master file may assist the local entity to comply with its domestic TP documentation requirements”; and (b) despite the overall confidentiality of the information provided, “there are new transparency initiatives which may assist MNEs to obtain limited information about their competitors”.

The Canadian report pointed out that “[t]he creation of a largely uniform cross-border system of reporting and taxation may, ultimately, increase certainty and reduce compliance costs for MNEs. Increased transparency may also improve public perception of MNEs’ compliance with tax laws.”

The European Union reporters mentioned that:

“Measures such as the TP documentation, when they are coordinated in the EU, have proved that they ensure uniformity in the implementation at EU level, more consistency and economies of scale for companies. A similar approach has been taken as regards the amendments to the EU directive on exchange of information which was adopted on 25 May 2016, which complements the EU TPD.”

France’s branch report focused on the potential for information gathering in the new transfer pricing documentation rules, indicating that:

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169 See section 2.5.3 of the South African report.

170 As pointed out by the General Reporter, “In choosing between the effectiveness of the exchange of information and protection of the rights of the taxpayers, greater importance has been attached to the former, thereby leaving the rules governing the rights of taxpayers to the domestic legislation of the states involved. Even then, these are always subject to the principle that rights guaranteed by domestic law cannot jeopardize the exchange of information.” Sergio André Rocha, “Exchange of Tax-Related Information and the Protection of Taxpayer Rights: General Comments and the Brazilian Perspective” (2016) 70(9) Bulletin for International Taxation, p. 503.

171 See reports from Mexico, Poland and Singapore.

172 See section 2.7 of the Australian report.

173 See section 2.7 of the Canadian report.

174 See section 2.6 of the report from the European Union.
"This move towards transparency and exchange of information would lead groups to collect, more systematically and on a larger scale, information that may have been somewhere in the accounts or in a specific subsidiary but has not been used to date. It may also lead to the setting in place of specific procedures or methodologies to find and keep information which was not collected before, or to collect much more detailed figures and indicators."\(^{175}\)

The Polish report highlighted that the potential increase in transfer pricing audits could lead to an increase in double economic taxation. Therefore, one potential advantage of the BEPS project would be the enhancement of dispute resolution mechanisms.\(^{176}\)

The report from the Portuguese branch also referred to the prevention of double taxation situations as one of the upsides of BEPS, adding that "[a]nother potential benefit for MNEs could be a greater consistency of application of TP rules within the OECD that could derive from the CbCR requirements and the new BEPS guidance".\(^{177}\)

According to the Spanish report, "the tax authorities could obtain from foreign tax authorities information on intercompany transactions that simplify taxpayers’ obligations, during the course of an audit of TP documentation".\(^{178}\)

Like the Canadian report, the UK report also referred to the BEPS project’s potential to "restore public trust in the system and framework for the taxation of international business". As pointed out in other reports, the UK report also mentioned that the improvement of dispute resolution would also be an upside to taxpayers.\(^{179}\)

In the view of the Uruguayan reporters:

"If countries converge towards a common interpretation of the arm’s length principle and the proposed measures are adopted in a global, coherent and coordinated manner, there would be a legal framework that would provide security and avoid double taxation internationally. In this sense, the BEPS project would favour MNEs. Otherwise, dispute resolution mechanisms will operate as a safeguard."\(^{180}\)

It is not unusual for MNEs to have compliance issues in their own jurisdiction because of problems in providing proof of information from other jurisdictions. This is true with respect to transfer pricing, but also in relation to other areas such as the use of foreign tax credits and application of controlled foreign company (CFC) regulations, where local compliance could be made easier – or even replaced – by information directly exchanged between tax authorities.

\(^{175}\) See section 3.7 of the French report.
\(^{176}\) See section 2.7 of the Polish report. Also see the report from Singapore.
\(^{177}\) See section 2.7 of the Portuguese report.
\(^{178}\) See section 2.7 of the Spanish report.
\(^{179}\) See section 2.7 of the UK report.
\(^{180}\) See section 3.7 of the Uruguayan report.
11.3. Summary

The summary of this section is as follows:

- Country-by-country reporting will become a reality. In most cases jurisdictions will also implement – or will already have in place – the master and local file requirements.
- In general, there is a concern that the new transfer pricing documentation package will increase MNE compliance costs – even though a few branch reporters mentioned that this cost increase would only take place in the early years of implementation.
- With respect to the potential upsides of the BEPS project Actions 8–10 outcomes, five items can be singled out:
  - the new obligations can provide more certainty and assist companies in complying with their domestic obligations;
  - companies would benefit from the overall improved and more thorough treatment of the group economic information;
  - transfer pricing harmonization will help avoid double taxation;
  - improvements are likely in dispute resolution;
  - damage to companies’ image caused by tax scandals might start to be overcome by the perception that gaps that allow aggressive tax planning are being closed.

12. Transfer pricing-related measures in other BEPS actions and other measures against BEPS

It is a fact that transfer pricing is at the core of the BEPS project. Therefore, it comes as no surprise that other BEPS actions rely on changes in transfer pricing rules to achieve their goals. For instance, Action 1 and the work to address BEPS challenges in the context of the digital economy has a close interaction with transfer pricing, notably the control of transactions involving intangibles. In this section, reporters analysed whether there have been any transfer pricing developments in their jurisdiction that were driven by any BEPS actions not directly related to transfer pricing.

In jurisdictions that are members of the European Union, the implementation of transfer pricing measures that are related to non-transfer pricing actions is very much related to the European Union’s anti-tax avoidance package. This aspect was highlighted in the Bulgarian report, as follows:

“Bulgaria has not yet implemented any specific TP-related measures in other BEPS actions and other measures against BEPS. This is due largely to the fact that Bulgaria, as an EU Member State, has to implement the BEPS measures in an EU law compliant manner and it is expected that new EU law ensuring a common approach by all Member States in respect of BEPS-related measures will be enacted soon.

In particular, in January 2016 the EU Commission introduced its anti-tax avoidance package, which contains, among other things, a draft anti-tax avoid-
ance directive proposing common minimum solutions for the implementation of the BEPS measures and a proposal for a directive implementing the country-by-country reporting envisaged by the BEPS project. In its communication of 28 January 2016 for the introduction of the anti-tax avoidance package, the EU Commission has expressed its position that the Member States should develop a common approach to BEPS-related measures, which should include, *inter alia*, minimum standard measures to be implemented in every Member State. In the view of the EU Commission this should be done through the legal instruments of EU law which would ensure that BEPS-related measures were implemented in a coordinated manner in all Member States.

Against this background, it is clear that Bulgaria will not undertake unilateral measures to implement BEPS solutions, but would rather wait for the development of a coordinated approach across the EU.”\(^{181}\)

Some branch reporters stated that nothing significant in relation to transfer pricing issues in other BEPS actions had happened in their jurisdiction.\(^{182}\)

The Australian report pointed out that its most important transfer pricing development, which was domestic, would have impacts on other BEPS actions.

Many reporters mentioned that there had been movements from a domestic perspective in relation to other BEPS actions. However, such movements had no relation to transfer pricing.\(^{183}\)

### 12.1. Summary

At this point, there is very little progress in this area, and few reporters commented on relevant developments in this area.

### 13. What is the future of transfer pricing?

The BEPS project work on transfer pricing is not a finishing line, but another step in the development of rules that are effective in the fair allocation of taxing rights among jurisdictions in cross-border transactions within MNE groups. Therefore, one of the major goals of this General Report was to invite IFA branch reporters to comment on what the future holds. Such comments from branch reporters are included in the list below:

- Some reports reinforced the notion that the arm’s length principle – even in a revised form – will remain the dominant criterion for allocating taxing rights in cross-border transactions within MNE groups.\(^{184}\)

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\(^{181}\) See section 2.6 of the Bulgarian report. See also section 2.6 of the Finnish report, section 3.6 of the French report, section 2.6 of the Luxembourg report and section 2.6 of the Swedish report.

\(^{182}\) See reports from Argentina, Chinese Taipei, Korea, Liechtenstein, Malaysia, Portugal, Uruguay and Venezuela.

\(^{183}\) See reports from Austria, Italy, India, New Zealand, Norway, Singapore, South Africa, Sweden, Switzerland, Ukraine and the United States.

\(^{184}\) See reports from Australia, Finland, Italy and the United States.
Many branch reports made explicit reference to the fact that one future trend will be the alignment with the transfer pricing BEPS outcomes, indicating that the reshaped arm’s length principle will become the global standard.\textsuperscript{185}

The branch reporters from France, Liechtenstein and Korea pointed out that the new approach of the arm’s length principle tends to increase the number of cases of double taxation.

In line with this position, some reports suggested that the BEPS project raised awareness about the problems existing in the allocation of taxing rights in cross-border transactions within MNE groups. In this context, they foresee a future where audits will be increased as tax authorities try to collect more tax revenues.\textsuperscript{186} The Bulgarian report highlighted that the focus on transfer pricing and the current scenario tend to increase international disputes about tax revenues.

Reporters also mentioned that the future of transfer pricing includes a focus on the avoidance of double taxation and dispute resolution.\textsuperscript{187}

In the European context, reports from France and Portugal pointed out that the future of transfer pricing might be connected with some degree of harmonization, in the context of the debates revolving around the CCCTB. This aspect was also included in the report from the European Union. In the words of the reporters:

“a key initiative resulting in a broader approach is the relaunch of the CCTB/CCCTB in a two-staged approach. Indeed, on different aspects, including fighting against transfer pricing as a profit shifting route and removing the need for complex and costly TP rules, the EU Commission concluded that the CCCTB would be the more appropriate solution for the EU and therefore re-launched the directive proposal.”\textsuperscript{188}

France and Liechtenstein noticed that the future of transfer pricing might bring about an increase in the use of profit split mechanisms, in the light of the shortcomings of the traditional arm’s length approach. The reporter from Liechtenstein stated that “various forms of formulary apportionment and profit splits are on the rise”. However, as highlighted in the same report, “formulary apportionment in the international context would only work if all jurisdictions worldwide agreed on the same tax base calculation and the same formula to apportion the MNE’s global profits”.\textsuperscript{189}

The French report identified an interesting aspect, which is related to the “popularization” of transfer pricing debates. In the words of the branch reporter:

“TP aspects may become a matter of concern for people outside the traditional tax area. If more information is made public, this will become of specific interest for non-tax partners of MNEs, whether employees, NGOs, customers, share-

\textsuperscript{185} See reports from Australia, Austria, Belgium, Bolivia, the Czech Republic, Germany, Japan, Korea, Mexico, Peru, Singapore, South Africa, Spain, Sweden and the United Kingdom.
\textsuperscript{186} See reports from Finland, France, Hungary, New Zealand and Sweden.
\textsuperscript{187} See reports from Austria, Italy, Korea and South Africa.
\textsuperscript{188} See section 3 of the EU report.
\textsuperscript{189} See section 3 of the report from Liechtenstein.
holders or managers of the group. This has already started, in France as in other European countries, due to recent leaks and following the recent public actions of Mrs Vestager, the European Commissioner for Competition. Specific technical attention may then be needed to design a TP policy, which would have to be simple enough to be explained to the public and to carefully ensure the full implementation of that policy, to avoid an adverse impact on the group brand and image.”

In addition to these topics, and considering comments presented in previous sections, it is possible to state that the future of transfer pricing also entails the following:

- A tendency to prefer economic substance over legal form. Even reporters from jurisdictions where legal formalism still prevails as a general rule – see the cases of Belgium and Canada – noted that transfer pricing was an exception to this general rule.
- Along these lines, there is a clear trend for the complete disregard of extreme business models and structures that rely only on a strict formalist transfer pricing approach.
- Even though there is no indication that an extremely simplified approach, such as the Brazilian approach, will become a global standard, there is some movement in the direction of simplification, as seen in the case of transactions with commodities and low value-adding services.

One relevant aspect that will be present in discussions about the future of transfer pricing is whether the OECD is moving in the direction of some form of formulary apportionment and whether country-by-country reporting would be a first stage of implementation. The only report to mention this aspect was the Danish report, which expressly rejected the use of country-by-country reporting as a first step in the direction of formulary apportionment. According to this jurisdiction’s report, “the Danish tax authorities are expected to follow the OECD’s recommendation to use the country-by-country report solely as a risk assessment tool, not in a formula apportionment type approach”.

Another topic that must be debated is whether the new approach to transfer pricing might be used to shift tax revenues to developed jurisdictions in the context of global MNEs, under the argument that entities located there undertake more functions and risks. This concern is particularly relevant in a world of intangibles and a system that pays little attention to the consumer market as a driver for value creation. As pointed out by the Brazilian branch reporters, “[t]he main impact of this concept is the transfer of taxing rights to states where highly skilled personnel and valuable technologies are located. The concept ignores the importance of the market for the creation of value, being a biased interpretation of the ALP, which cannot be inferred from its wording.”

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190 See section 4 of the French report.
191 See section 2.5.1 of the Danish report.
192 See section 3 of the Brazilian report.
Furthermore, there is also a concern – which permeates the entire BEPS project – that the tax sovereignty of jurisdictions could be affected. This topic was mentioned in the Liechtenstein report:

“another major concern is that certain individual countries or supranational institutions are now taking advantage of the changing environment to implement unilateral measures which go far beyond the consensus reached under the BEPS project and which will lead to even higher compliance costs and, at least to some extent, also prohibit the implementation and/or maintenance of consistent and coherent tax and TP policies. This will, in turn, again affect the ability to defend the appropriateness of a given transaction as there may no longer be an agreed fundamental principle which can be used on all sides of the transaction.”

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193 This General Reporter, together with one of the General Reporters of subject 1, Professor Allison Christians, edited a book on the topic of sovereignty in post-BEPS times that will be released later this year. Sergio André Rocha and Allison Christians (eds.), Tax Sovereignty in the BEPS Era (The Netherlands: Kluwer, 2017).

194 See section 2.5 of the report from Liechtenstein.
Summary and conclusions

In the European Union (EU), the current situation as regards application of the transfer pricing (TP) rules is that all the EU Member States have adopted or are following the OECD TP standard, i.e. the arm’s length principle (ALP) or equivalent. Since 2002, a series of initiatives have been launched at EU level to create a common TP framework for coordinating and making these domestic rules work effectively and efficiently together. An EU intervention is indeed justified as regards the taxation of intra-group transactions (TP) insofar as the internal market can be affected by diverging approaches, resulting in too many, complex or sophisticated rules at all EU Member State levels, which then create significant costs and administration burdens for both tax administrations and taxpayers or are a source of profit shifting as taxpayers can exploit loopholes when rules diverge. Consequently, the EU Commission has initiated a set of coordinated measures, either guidance or recommendations, all subsequently endorsed by the EU Council. They now constitute a recognized, congruent and efficient enabling TP framework in the EU. They cover all steps of the TP process, from the determination and documentation stage (including the EU Transfer Pricing Documentation Code of Conduct (2006/C 176/01) (EU TPD); DAC4¹ (Directive on Administrative Cooperation, 2011/16/EU revised)); the TP audit phase (including the reports and guidance on TP risk management, small and medium-sized companies (SMEs); secondary and compensating TP adjustments; exchange of information on TP advance pricing agreements (APAs) under the DAC); and finally, the dispute resolution phase on the application of the multilateral EU Arbitration Convention on TP.

In the base erosion and profit shifting (BEPS) context, TP is part of a broader approach of the EU Commission to introduce hard law aimed not only at fighting tax evasion but also at significantly strengthening the TP framework as the existing TP rules no longer fit with the realities of multinational companies’ (MNEs’) business models and can be a source of major profit shifting. The objective is to

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1 The views expressed in the present report are solely those of the reporters and do not necessarily reflect the views of the European Commission.

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achieve a fair and efficient corporate taxation system in the EU, as announced by
the June 2015 EU Action Plan. Reforming TP rules in this context is a priority to
ensure that profits are taxed where value is created.

The BEPS project has affected the EU TP policy approach: the EU is working
on further guidelines to increase the clarity of the rules and reduce the risk of TP
misuse. This has justified launching a study on the use of comparables in the EU
(2016). A draft report has been initiated on the same subject with concluding rec-
ommendations on how to perform consistent and transparent comparable searches,
the availability, quality and use of internal and external comparables in the context
of properly delineated transactions, comparability adjustments and the proper use
of EU comparable databases.

The situation as regards TP documentation is quite advanced: the EU TPD has
already defined requirements for a master file and local file aligned with the con-
cclusions of BEPS Action 13. This has been a reference for all EU Member States’
legislation now enacted in this area. Regarding non-public CbCR, the DAC di-
rective 2011/16/EU was revised in June 2016, effective 1 January 2017 in the EU,
so as to fully implement BEPS Action 13 in a coordinated and efficient manner in
the EU. Further monitoring and risk management work should be performed in
this area.

Regarding cost contribution agreements (CCAs), the EU approach has been
limited to services not creating intangibles with a focus on documentation and
simplification. Conclusions are consistent with the BEPS Action 8 final report as
regards valuing participants’ contribution at cost for services CCAs and the
determination of the participants’ contribution to the CCA (i.e. the “benefit test”
principle).

Guidance on low value-adding intra-group services had been developed in the
EU prior to BEPS Action 10 (2011): it contains further elaboration on implementa-
tion and practical aspects, and some small differences (e.g. a 3–10 per cent mark-
up whereas in 2016 the OECD agreed on a 5 per cent mark-up).

The focus is also placed on transactions with intangibles: in this area, a study
has been commissioned by the EU Commission and a report is currently being pre-
pared by the Joint Transfer Pricing Forum (JTPF), an expert group advising the EU
Commission in the TP area. The objective is to make progress on the definition of
intangibles, particularly in relation to the accounting and valuation rules applied in
the EU and also to develop guidance or possibly conclude on legislation initiatives,
either limited (e.g. focused on statute of limitation rules so as to consider ex post
evidence) or possibly more substantial as regards the details of the valuation meth-
ods to be used and possibly also covering hard-to-value intangibles (HTVI). No
specific “substance-over-form” approach has been developed in the EU so far
regarding intangibles, but the recent directive of 12 July 2016 laying down rules
against tax avoidance practices that directly affect the functioning of the internal
market (ATAD) generally clarifies in its recital 14 that general anti-abuse rules
(GAAR) aimed at questioning tax-driven non-genuine arrangements should not
affect taxpayers’ compliance obligations with TP rules.

Noticeably, anti-avoidance targeted initiatives have been taken in this ATAD to
tackle and prevent BEPS situations using the TP approach. For example, the exit
taxation rule (article 5) states that the taxable gain upon exit should be computed
with reference to the ALP and the controlled foreign company rules (CFC, article
8) provide that when a jurisdiction taxes CFC income the taxable income is adjusted (when necessary) on an arm’s length basis.

Future initiatives should finally and importantly address the profit split in the context of MNEs’ value chains, focused on practical and cost-efficient implementation aspects. Generally, the future of TP in the EU should now lead to creating more tax certainty and transparency for both tax administrations and taxpayers. This requires integrating innovative approaches in the TP framework, promoting the further use of information technology and intelligence gathering, as well as risk analysis and management tools, particularly to link value creation analysis and the determination of transfer prices.

1. Current TP regulation and practice in the EU

The EU has had a significant influence on direct taxes and, more particularly, on TP, although the Treaty on the Functioning of the European Union (TFEU) does not provide for the harmonization of direct taxes and direct taxation remains primarily within Member States’ jurisdiction. Since the creation of the European Communities, company taxation has indeed received particular attention as an important element for the establishment and the completion of the internal market. The subject of TP has also been considered from this perspective: an intervention is justified and measures can be taken at EU level when the existing rules need improvement to avoid an adverse impact on the internal market, leading to economic distortions and obstacles to trade or investment.

The founding text in this area, which is the 2001 Communication Towards an Internal Market without tax obstacles,² originally stated that:

“The obstacles and problems identified concerning the taxation of intragroup transactions (transfer pricing) are varied in nature but all are increasingly important and call for urgent action. The Commission considers it important to take into account the legitimate concerns of tax administrations and businesses and to develop commonly accepted practices in this field. This can be achieved through a dialogue at EU level.”

All the EU Member States have implemented the ALP or equivalent in their domestic law or regulations³ and follow the OECD standard. On this basis, unlike in other areas of direct taxation,⁴ EU intervention in the TP area has been coordinated

² See Communication 2001/582, Towards an Internal Market without tax obstacles – a strategy for providing companies with a consolidated corporate tax base for their EU-wide activities and staff working paper SEC(2001)1681 on company taxation in the internal market.
³ The EU Member States all apply the ALP, or equivalent, in accordance with the OECD model and generally refer either in law or in practice to the OECD TP guidelines. For an overview see section “Member States’ Transfer Pricing Profiles” on the EU Commission JTPF website.
using a soft-law approach,\(^5\) rather than harmonized by way of legislative acts in the form of directives.

Consequently, an EU TP framework has been set up over the years since 2002, encompassing all recommendations and guidelines which were initiated by the EU Commission\(^6\) and subsequently endorsed by the EU Council,\(^7\) thus being politically binding.\(^8\)

The key guidance and recommendations constituting this TP framework can be grouped under three different sets of rules, reflecting the three stages of a typical TP risk management process as follows.

The initial stage, which relates to the determination and documentation of TP, includes:
(a) the EU TPD (2006);\(^9\)
(b) non-public CbCR in the field of taxation under the DAC (2016);\(^10\)
(c) the Communication from the Commission on guidelines on low value-adding intra-group services (2011);\(^11\)
(d) the report on CCAs on services not creating intangibles which covers some simplification and documentation aspects (2012);\(^12\)

payments made between associated companies of different Member States, Official Journal of the European Union L 157/49; and most recently Council Directive 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market; Official Journal L 193/1, 19 July 2016.

5 See the above-mentioned Communication 2001/582, p. 13: “There are effective means for avoiding or removing double taxation resulting from transfer pricing. Advance Pricing Agreements and co-ordination among Member States and between Member States and businesses should be encouraged.” See also Communication coordinating Member States’ direct tax systems in the internal market (COM(2006) 823 final) of 19 December 2006, ss. 2.4 and 3 respectively.

6 The European Commission is assisted and advised in this respect by the EU JTPF, an expert group comprising representatives of Member States and non-governmental members (see EU Commission DG TAXUD website, JTPF section).

7 The guidance and recommendations are issued as follows: the Commission is assisted and advised by an expert group, the EU JTPF, which is made up of appointed Member States and non-governmental experts and was created in 2001, subsequent to the above-mentioned Communication 2001/582. This expert group provides experts’ reports, guidance and recommendations. The Commission recommends Member States to endorse these. They are then finally endorsed by the EU Council and Member States implement them if they see fit. Examples of endorsed reports, guidance or recommendations are the EU TPD, the Code of Conduct on the functioning of the EU Arbitration Convention or the report on low value-adding services (see below).

8 See section on achievements on the EU Commission JTPF website.

9 Resolution of the Council and of the representatives of the governments of the Member States, meeting within the Council, of 27 June 2006 on a code of conduct on transfer pricing documentation for associated enterprises in the European Union (EU TPD) (2006/C 176/01).


11 Communication from the Commission to the European Parliament, the Council and the European Economic and Social Committee on the work of the EU JTPF in the period April 2009 to June 2010 and related proposals: (1) guidelines on low value adding intra-group services and (2) potential approaches to non-EU triangular cases COM(2011) 16 final.

12 Communication from the Commission to the European Parliament, the Council and the European Economic and Social Committee on the work of the EU JTPF in the period July 2010 to June 2012 and related proposals: (1) Report on small and medium enterprises and transfer pricing; and (2) Report on cost contribution arrangements on services not creating intangible property (IP) (COM(2012) 516 final).

68
The audit phase (preparation and conduct of a TP audit) includes:

(a) a report on TP risk management (2014); 14
(b) a report on SMEs and TP (2012); 15
(c) a report on secondary adjustments (2014); 16
(d) possibilities for cooperation between Member States in the field of audits under the DAC (multilateral controls – simultaneous or joint audits); 17
(e) exchange of information and exchange of APAs under the DAC (2016); 18
(f) the guidelines on APAs 19 and statistics on APAs in the EU showing that 23 of the 28 EU Member States offer APAs and that an increasing number of bi- and multilateral APAs are now concluded within the EU, and between EU Member States and third jurisdictions. 20

The dispute resolution phase includes the EU Arbitration Convention (EU AC) 21 with its code of conduct 22 and the most recent Commission proposal for double taxation dispute resolution in the EU. 23

In the BEPS context, the EU Commission work on TP now goes further: hard-law measures have been introduced under the recent corporate tax reform strategy to address specific TP challenges from an anti-avoidance perspective and therefore target aggressive tax planning (see below sections 2.2.3 and 2.4.1 in particular). A similar approach has been taken by the EU Commission both when it initially proposed a common consolidated corporate tax base (CCCTB) in 2011 and when it relaunched it in 2016: indeed, establishing a multi-jurisdictional enterprise’s tax base on a “unitary” basis which would be consolidated across the entire MNE group and allocated across jurisdictions by using a specific formulation-apportionment key would eliminate direct opportunities to shift profits through TP. 24

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14 Ibid.
15 See note 12 above.
16 See note 13 above.
17 See note 10 above and Report on transfer pricing risk management (under note 13) recommendations 4, 8, 9a and 9b.
18 See note 10 above.
19 Communication from the Commission to the European Parliament, the Council and the European Economic and Social Committee on the work of the EU JTPF in the field of dispute avoidance and resolution procedures and on guidelines for advance pricing agreements within the EU (COM(2007)71 final).
21 Convention on the elimination of double taxation in connection with the adjustment of profits of associated enterprises (90/436/EEC).
22 Final report on improving the functioning of the Arbitration Convention (doc. JTPF/002/2015/EN), not yet adopted by the Council.
24 COM(2016)685 final. NB: the removal of this TP profit shifting implication will occur only at the consolidation stage (i.e. second stage “CCCTB” in the current directive proposal) and concern only transactions construed as controlled transactions under the CCCTB which take place within the EU.
It should also be noted that the European Court of Justice (CJEU) has taken several decisions regarding the compatibility of some TP domestic rules and the fundamental freedoms provided for by the TFEU.25 Last, another area in which TP has received attention at EU level is the state aid area within the meaning of article 107(1) of the TFEU, i.e. when the application of TP rules in a given case can create distortions of competition through the granting of special tax advantages that are not available to all similarly situated taxpayers in a given Member State.26 Several state aid decisions, some involving TP, have recently been published by the Commission. However, due to the special nature of EU provisions on state aid, this report does not address these specific aspects further.27

2. The impact of the BEPS project on TP

2.1. Introduction

BEPS resulting from the misuse or manipulation of transfer prices has been identified as a priority in the EU Commission’s corporate tax agenda. While building on the BEPS reforms, it is important to consider how to best integrate them in the broader EU context and ensure that the EU Member States all implement the corresponding international initiatives at the same pace and to the same extent as their global partners in order to ensure a level playing field.28 Additionally, certain factors which are unique to the EU were taken into account in developing effective solutions. These relate to unique elements of the single market and the single currency area. The EU treaties require that the above-mentioned fundamental freedoms29 – including the freedom of establishment – are respected.

The EU’s policy in the area of corporate taxation is governed by the EU Commission’s action plan for fair and efficient corporate taxation in the EU as adopted on 17 June 2015.30 This sets out various initiatives to reform the corporate tax

25 Domestic tax rules of the Member States may indeed unduly hinder free movement of mainly establishment (art. 49 TFEU), services (art. 56 TFEU), or capital (art. 63 TFEU). In preliminary reference or infringement cases, the CJEU can rule that such domestic tax rules disallowing non-residents tax advantages granted to residents of a Member State infringe one of the free movement provisions of the TFEU without justification. This leads to so-called negative harmonization. For illustration in the TP area, see SGI v. The Belgian State (SGI) (C-311/08 of 21 January 2010) in which the Court upheld Belgian TP rules that treat cross-border situations less favourably than similar domestic situations, due to the justified need to safeguard a balance in the allocation of taxing rights, the need to prevent tax avoidance, and the need to combat abusive practices. See also the Lankhorst (C-324/00) and Thin Cap GLO cases (C-523/00).

26 See DG Competition, working paper on state aid and tax rulings of 3 June 2016 for an overview.


28 For an illustration see the initiative on corporate tax transparency.

29 See note 26.

framework in the EU, in order to tackle tax abuse, ensure sustainable revenues and support a better business environment in the single market.

In the TP area, the action plan aims at improving the TP framework in the EU. The Commission works with Member States and businesses in the EU to build on these rules and develop a coordinated and more concrete implementation within the EU so as to reflect the economic reality of the single market.

In this context, the European Parliament concluded that the current framework on rules for TP is too vague and gives too much flexibility to companies in shifting profits between different entities within the same group: the European Parliament has stated that the EU could go further in specifying particular guidelines to be used for the assessment of TP, in order to increase the clarity of the rules and to reduce the risk of their misuse for profit shifting purposes. The European Parliament also called on the European Commission to bring forward a legislative proposal to develop, based on its experience and on analysis of the new OECD principles on TP, specific EU guidelines setting out how the OECD principles should be applied and how they should be interpreted within the EU context.

The work programme of the EU JTPF for 2015–2019 reflects the priority initiatives envisaged by the European Commission in this area. It is not limited to working on BEPS measures but also aims at ensuring effective and efficient tax collection and increasing compliance without imposing an excessive administrative burden. Two key aspects have been specifically considered as part of recent evolutions in the TP area and global tax environment:

The increased importance of economic analysis in TP means that techniques such as bargaining power analysis, advanced valuation techniques, real options or scenario analysis rooted in the value chain of the group should be used in the TP area to provide a more accurate view of the value creation process, as well as the interaction between TP and companies’ internal information systems and tools (e.g. management reporting and IT systems).

As regards the actual application of TP rules in general, especially when considering the BEPS conclusions, a key aspect is the question of whether there are sufficient comparable data about transactions between third parties available in the EU to reliably price intercompany transactions which have been accurately delineated as provided for by the OECD TP guidelines (chapter I). For this purpose, a comprehensive study was commissioned by the European Commission to assess the availability and use of comparable data within the EU. The focus of the study is the assessment of the availability and quality of comparables used under the comparable uncontrolled price (CUP) method and under the transactional net margin method (TNMM) in the 28 Member States of the EU. Inter alia, different databases and other sources were examined and discussed and the data available have been assessed from both a qualitative and quantitative perspective.

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31 Recommendation C5 of the Report with recommendations to the Commission on Bringing transparency, coordination and convergence to corporate tax policies in the Union (2015/2010(INL)) Improving the transfer pricing framework in the EU.

32 Ibid.

33 JTPF Programme of Work 2015–2019, doc. JTPF/005/FINAL/2015/EN.

34 S. II 1.1 EU JTPF Programme of Work (JTPF/005/FINAL/2015/EN).

35 S. III 1.2 EU JTPF Programme of Work (JTPF/005/FINAL/2015/EN).

36 See study on comparable data used for TP in the EU, Deloitte Belgium (2016).
A draft JTPF report based on contributions from JTPF non-governmental members and Member States’ representatives was issued in February 2017 and includes practical recommendations for issues identified: this may lead to the issuing of complementary guidance on TP documentation.37

2.2. Challenges of transactions with intangibles

2.2.1. Definition of intangibles

There is broadly speaking no clear definition of an “intangible” in the EU.38

In practice, in the TP area, the definition used should correspond overall to the one proposed in the OECD TP guidelines. Under the Actions 8–10 final deliverable of the BEPS project, the OECD has identified the word “intangible” as:

“intended to address:
• something which is not a physical asset or a financial asset,
• which is capable of being owned or controlled for use in commercial activities, and
• whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances.”39

A recent study commissioned by the Commission40 has attempted to define the notion more precisely in the context of TP rules post-BEPS and to draw similarities and differences between the notions used respectively for TP and for financial reporting purposes.

The study concluded that, for both cases, there was:
• a requirement for ownership or control;
• a clarification that intangible assets are non-physical and non-monetary/financial; and
• a reference to economic benefits/compensation.

The study underlined that these definitions were “in fact much closer together than some broad definitions of intangible sources of value used elsewhere”.

One main identical characteristic required for intangibles is that the OECD broadens the definition of intangible property by not explicitly requiring an item to (a) enjoy legal protection or (b) be separately transferable in order to be considered intangible property.41

Two differences remain and relate to the definition of goodwill42 and the necessary distinction between intangibles and market conditions or local market circumstances.

37 Draft report on the use of comparables in the EU (doc. JTPF/007/2016/EN).
38 See in this respect, conclusions of a European Commission’s expert group on the valuation of intangibles: final report from the expert group on intellectual property valuation, 29 November (RTD, DG Research and Innovation), 2013, p. 11.
40 Study on the application of economic valuation techniques for determining transfer prices of cross-border transactions between members of multinational enterprise groups in the EU – final report, Deloitte Belgium, 2016, p. 34.
41 OECD, op. cit., p. 67, para. 6.8.
42 According to the OECD BEPS Actions 8–10 report, depending on facts and circumstances, goodwill may or may not be an intangible, taxpayers being advised to consider whether independent
Table 1 summarizes the current state of play in the EU as surveyed in the study.\textsuperscript{43} It shows how the various types of intangibles are perceived and sorted per category by practitioners of the single market, whether referring to financial reporting valuations or for TP purposes. It is based on a survey of practitioners in all EU Member States after the BEPS conclusions were issued.\textsuperscript{44}

### 2.2.2. Transactions with intangibles

One important source of profit shifting identified in the EU by its action plan relates to transactions with intangibles.\textsuperscript{45} Improving the TP framework in the EU enterprises would provide compensation for such intangibles in comparable circumstances. See OECD, \textit{op. cit.}, p. 72, para. 6.29.

<table>
<thead>
<tr>
<th>No.</th>
<th>Various types of intangibles in valuation studies</th>
<th>Categories for financial reporting valuations</th>
<th>Categories/grouping for the purposes of TP approach</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Patented technology</td>
<td>Technology-based intangible assets</td>
<td>Patents</td>
</tr>
<tr>
<td>2</td>
<td>Trade secrets</td>
<td></td>
<td>Non-patented technology</td>
</tr>
<tr>
<td>3</td>
<td>In-process research and development</td>
<td></td>
<td>L</td>
</tr>
<tr>
<td>4</td>
<td>Computer software</td>
<td>Marketing-related intangible assets</td>
<td>Trademarks, tradenames, brands</td>
</tr>
<tr>
<td>5</td>
<td>Unpatented technology</td>
<td></td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>Trade marks</td>
<td></td>
<td></td>
</tr>
<tr>
<td>7</td>
<td>Trade names</td>
<td></td>
<td></td>
</tr>
<tr>
<td>8</td>
<td>Service marks</td>
<td></td>
<td></td>
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<tr>
<td>9</td>
<td>Collective marks</td>
<td></td>
<td></td>
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<tr>
<td>10</td>
<td>Certification marks</td>
<td></td>
<td></td>
</tr>
<tr>
<td>11</td>
<td>Trade dress</td>
<td></td>
<td></td>
</tr>
<tr>
<td>12</td>
<td>Newspaper mastheads</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

\textit{cont.}

\textsuperscript{43} Study on the application of economic valuation techniques for determining transfer prices of cross-border transactions between members of multinational enterprise groups in the EU – final report, 2016, p. 41.

\textsuperscript{44} \textit{Ibid.}: desk research and interviews with TP and corporate finance valuation specialists from all EU Member States as well as Australia, Canada, China, India, Japan, Norway, South Korea, Switzerland and the United States.

\textsuperscript{45} See e.g. s. 3.2.3(b) of Commission staff working document: Corporate income taxation in the European Union accompanying the document Communication from the Commission to the European Parliament and the Council on a fair and efficient corporate tax system in the European Union: 5 key areas for action (COM(2015) 302 final).
as mentioned under point 3.2 of the June 2015 action plan will therefore require addressing the challenges of transactions with intangibles.

Table 1. Types of intangible (cont.)

<table>
<thead>
<tr>
<th>No.</th>
<th>Various types of intangibles in valuation studies</th>
<th>Categories for financial reporting valuations</th>
<th>Categories/grouping for the purposes of TP approach</th>
</tr>
</thead>
<tbody>
<tr>
<td>13</td>
<td>Copyrights (especially for media companies)</td>
<td>Artistic-related intangible assets</td>
<td></td>
</tr>
<tr>
<td>14</td>
<td>Non-competition agreements</td>
<td></td>
<td></td>
</tr>
<tr>
<td>15</td>
<td>Customer contracts</td>
<td></td>
<td>Rights under contracts/ (government) licences</td>
</tr>
<tr>
<td>16</td>
<td>Concessions, permits</td>
<td>Contract-based intangible assets</td>
<td></td>
</tr>
<tr>
<td>17</td>
<td>Order or production backlog</td>
<td></td>
<td></td>
</tr>
<tr>
<td>18</td>
<td>Other contract-based intangible assets (e.g. lease agreements, advertising contracts)</td>
<td>Customer-related intangible assets</td>
<td>Customer-related intangibles such as customer-related goodwill</td>
</tr>
<tr>
<td>19</td>
<td>Customer lists</td>
<td></td>
<td></td>
</tr>
<tr>
<td>20</td>
<td>Related customer relationships (customer contracts and related customer relationships)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>21</td>
<td>Internet domain names</td>
<td></td>
<td></td>
</tr>
<tr>
<td>22</td>
<td>Customer base</td>
<td>Not an identifiable intangible asset if not linked to a customer contract</td>
<td></td>
</tr>
<tr>
<td>23</td>
<td>Workforce</td>
<td>Not an identifiable intangible (no control)</td>
<td></td>
</tr>
<tr>
<td>24</td>
<td>Location savings</td>
<td>Not an identifiable intangible (not separable from the business, not arising from a contract/ legal right)</td>
<td>Specifically excluded by the OECD from the definition of intangibles (suggested to consider as comparability factors)</td>
</tr>
<tr>
<td>25</td>
<td>Goodwill/ongoing concern (may or may not be intangible depending on the context)</td>
<td>Not an identifiable intangible BUT a significant intangible asset (difference between business value and value of all intangible assets)</td>
<td></td>
</tr>
</tbody>
</table>
The context is currently the following in the EU. As a result of BEPS Actions 8–10, tax administrations are now provided with new tools to tackle the challenges of transactions with intangibles. Guidance is indeed provided on two key aspects:

(a) identifying intangibles and delineating the actual transactions related to intangibles, this including the analysis of the intangible related risks and their allocation;\textsuperscript{46}

(b) determining the appropriate pricing of intangible-related transactions, including by using valuation techniques when pricing transactions involving intangibles and especially when it relates to so-called HTVI.\textsuperscript{47}

The first aspect mentioned above is comprehensively elaborated in the new OECD TP guidelines and further refines the existing TP rules.

The second aspect, especially the application of economic valuation techniques in the context of transfer pricing is rather a new field which was first recognized in chapter XI (business restructuring) of the 2010 update to the TP guidelines.\textsuperscript{48} This recent introduction, the lack of practice when applying the methods in the TP context, as well as the expected challenges as regards complexity and the amounts involved when applying these methods, led the EU Commission services to explore at an early stage the practical application of these methods in the EU. The aim of the work in progress is to give an overview on the state of play in the EU, to evaluate the strengths and weaknesses of the various valuation methods when used for transfer pricing purposes and to identify pitfalls in their practical application.\textsuperscript{49}

The key issues currently identified and to be covered are the following:

(a) What should be priced (e.g. should the price be established at the level of a given transaction, an asset and/or aggregated transactions)?

(b) How should the methods chosen be used and what are the key aspects to define (e.g. lifetime of the intangibles, risk and interest factor, treatment of tax)?

(c) What should be the key underlying relevant information to consider when applying such methods?

On the basis of contributions received from governmental and non-governmental members of the JTPF and the findings of the study a draft discussion paper was prepared which will lead to the issuance of a final report and possible guidance\textsuperscript{50} in 2017. The objective is to build a bridge between the general practice of economic valuation and TP.

\textbf{2.2.3. “Substance-over-form” approach towards intangibles}

There is currently no coordinated approach in the EU as regards how to consider the “substance-over-form” principle, particularly regarding transactions with intangibles. The profiles of the Member States, as disclosed on the EU Commission JTPF website, show a variety of situations in this respect, particularly, on how

\textsuperscript{46} Chapter I, TP guidelines.
\textsuperscript{47} Chapter VI, TP guidelines.
\textsuperscript{48} Para. 9.94 TP guidelines.
\textsuperscript{49} Para. 2.4 JTPF Program of Work 2015–2019 (doc. JTPF/005/FINAL/2015/EN).
\textsuperscript{50} Discussion paper on the use of economic valuation techniques in TP (doc. JTPF/012/2016/EN).
the GAARs can be applied in combination with TP rules (specific anti-abuse rules (SAARs)) to look through artificial arrangements and apply tax rules based on the factual economically intended fact pattern rather than the legal characterization chosen by the parties.\textsuperscript{51}

However, some references can be found in the recent ATAD\textsuperscript{52} of 12 July 2016. This includes a GAAR (article 6 of the directive), which should serve as a minimum standard in the EU.

According to these GAAR provisions of the directive, non-genuine arrangements or series thereof that are put in place for the essential purpose of obtaining a tax advantage that defeats the object or purpose of the applicable law should be ignored for the purposes of determining the corporate tax liability. Terms and conditions under which such a GAAR should coexist with SAARs and TP rules are considered in recital 14 of the directive: “It is necessary to clarify that the implementation of the rules against tax avoidance provided in this Directive should not affect the taxpayer’s obligation to comply with the arm’s length principle or the Member State’s right to adjust a tax liability upwards in accordance with the arm’s length principle, where applicable.”

The above-mentioned GAAR provision therefore has a function intended to fill in gaps, which should not affect the applicability of SAARs, such as TP. In practice, it may be now possible in the EU to apply “substance-over-form” approaches using these two categories of rules.

2.2.4. Comparability and group synergies

A fairly coordinated approach has been recently followed in the EU to develop specific guidance on comparability issues\textsuperscript{53} but it did not address group synergies in particular.

2.2.5. HTVI

The recent work initiated as part of the implementation of the June 2015 action plan on improving the TP framework in the EU confirmed the many challenges raised by comparables and comparable searches, including within the EU internal market.\textsuperscript{54} These conclusions are particularly relevant as regards intangibles.

As mentioned above, the EU JTPF, i.e. the expert group advising the Commission in the TP area, is currently working on the subject of the economic valuation of intangibles. The relevant provisions of the OECD TP guidelines on which such works are based include, for example, section D.4 of chapter VI on HTVI (paragraph 6.186–6.195).

Conclusions on possible changes in legislation could arise from this work which could vary from a limited change focused on statute of limitation rules, so

\textsuperscript{51} DG TAXUD website, JTPF section under Member States’ TP profiles, for illustration, Austria which refers to such a “substance-over-form” approach under its TP rules.

\textsuperscript{52} Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market.

\textsuperscript{53} Draft report on the use of comparables in the EU (doc. JTPF/007/REV/2016/EN).

\textsuperscript{54} Draft report on the use of comparables in the EU (doc. JTPF/007/2016/EN).
as to enable tax authorities to take into consideration ex post evidence, to a more substantial revision of the TP rules, e.g. addressing economic valuation-related aspects.

2.2.6. CCAs

The topic of CCAs has long been a part of the EU TP framework. A broad approach has been developed in this respect, including the issue of documenting CCAs and the possibilities of simplification. As work was ongoing at the OECD level at the same time, focused on the TP aspects of intangibles including CCAs, the scope was limited at the EU level to CCAs on services not creating intangibles, in order to avoid duplication of work.

The report on CCAs clarifies the difference between various concepts of CCAs and provides guidance on the so-called benefit test in the context of services provided within an MNE group. For CCAs addressed by the guidance, i.e. those not creating intangibles, it is assumed that there is often a small difference between pricing at cost and at market value. As regards the above-mentioned focus on simplification and administrative aspects, the guidelines recommend for practical reasons to generally value the contributions at cost for services CCAs. This conclusion of the JTPF is consistent with the new guidance in chapter VIII of the OECD TP guidelines.

Based on this general conclusion and the general practical advantages of using costs rather than third-party value, the report provides also that the following simplification measures can apply in appropriate circumstances:

(a) using the accounting system of the MNE for determining the costs; and

(b) adjusting budgeted costs by actual costs prospectively, i.e. taking the eventual adjustment of budgeted costs to actual costs into account in the subsequent year.

Furthermore, recommendations on how to specifically document such a CCA for TP purposes were developed.

2.3. High-risk transactions

2.3.1. CUP and quoted prices for cross-border commodity transactions

Although several EU Member States apply specific TP legislation to commodity transactions, the most recent being Romania (2016), the topic has so far not been considered as part of coordinated works at EU level yet.

55 See Communication from the Commission to the European Parliament, the Council and the European Economic and Social Committee on the work of the EU JTPF in the period July 2010 to June 2012 and related proposals: (1) Report on small and medium enterprises and transfer pricing; and (2) Report on cost contribution arrangements on services not creating intangible property (IP) (COM(2012) 516 final).

56 (COM(2012) 516 final), ss. 4 and 6.1.

57 Para. 8.28 chapter VIII.
2.3.2. **Intra-group services**

The revision of chapter VII of the OECD TP guidelines includes changes to the general guidance on intra-group services and introduces an elective, simplified approach for low value-adding services. The simplified approach suggested is largely based on the above-mentioned EU Communication on low value-adding intra-group services endorsed by the Council of the European Union on 17 May 2011.\(^{58}\) It provides some further elaboration but contains also some differences. For example, while the OECD guidance provides for a fixed 5 per cent mark-up on costs the EU guidelines state that the mark-up observed is between 3 per cent and 10 per cent, often around 5 per cent. Furthermore, in order to give comfort that the elective simplified approach will not lead to base-eroding payments, the simplified approach under chapter VII of the OECD TP guidelines may be combined with the introduction of a threshold above which a full TP analysis has to be performed. The above-mentioned EU guidance does not contain such a threshold.

As regards the implementation and practical aspects, the EU guidelines develop a twin-track approach: first, by setting in context the breadth and depth of any evaluation that might be needed for a certain category of intra-group services; secondly, by giving more specific guidance on how an evaluation may be conducted. Given the wide range of intra-group services, the guidelines give some parameters for the type of services that would benefit from the approach suggested. The guidance outlines certain underpinning principles. For example: all relevant costs are deductible subject to domestic law provisions, good quality and relevant information should be made available and a flexible approach should be taken in the review of low value-adding intra-group services. The guidelines then explore in more detail how these principles should be applied and provide guidance on matters that commonly cause difficulties. Examples of the latter are analysing a cost pool, defining shareholder costs and evaluating an arm’s length charge and documentation. The evaluation carried out in accordance with the guidelines is also considered to be useful in other related areas, for example, the resolution of double tax disputes or consideration of the penalties related to TP documentation. It was noted that some of the elements proposed may equally be applied to the evaluation of other categories of services as well.

2.3.3. **Profit splits in the context of value chains**

As regards profit splits in the context of value chains, the work to be carried out at EU level should build on the OECD conclusions and has therefore been postponed until now.

The comments the OECD received on the public discussion draft on the use of profit splits in the context of global value chains highlight the problems that the profit split method (PSM) raises in its practical application for taxpayers and tax

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\(^{58}\) Communication from the Commission to the European Parliament, the Council and the European Economic and Social Committee on the work of the EU Joint Transfer Pricing Forum in the period April 2009 to June 2010 and related proposals: (1) Guidelines on low value adding intra-group services; and (2) Potential approaches to non-EU triangular cases, 25 January 2011, COM(2011) 16 final.
administrations, especially when the method is applied ex ante. Another consideration raised was the high degree of subjectivity encountered when stakeholders determine how to share the profit.

On this basis, it is envisaged to work at the EU level on the practical application of the PSM, e.g. on determining the profit to be split, on the need for a high degree of cooperation between tax administrations or the need and potential measures to defend the profit to be split against arrangements with entities not participating in the profit split. Another angle for further work should be an evaluation of models available to split the profits, their pros and cons in substance and as regards their practical application as well as the compliance burden they may create. The potential outcome may be an assessment of the various aspects and obstacles to recommendations and guidance for specific situations in the EU.

2.4. TP documentation

2.4.1. CbCR

The EU Commission regards transparency as a crucial element to identify aggressive tax planning practices by large companies and to ensure fair tax competition. On 28 January 2016 the Commission proposed extending further the exchange of information to include the CbCR of the BEPS project through a revision to the DAC. This revised directive was adopted on 25 May 2016 and applies for financial years commencing on or after 1 January 2016.

The directive was preceded by several discussions initiated by the Commission services at the level of the JTPF, aiming to ensure a consistent approach to CbCR in the EU.

Under the proposed rules, domestic authorities will exchange tax-related information on MNEs’ activities, on a CbC basis along the lines of the proposal developed by the OECD under BEPS Action 13. Differences compared to OECD BEPS Action 13 reflect the different context of the EU as opposed to individual tax jurisdictions: they relate mainly to the reporting entities’ characterizations and are summarized in Table 2.

Another aspect, to be explored at EU level further to this revision of Directive 2011/16, is how tax administrations could actually make best use of the information for the purpose of risk management, considering the particular information provided in the CbCR and the constraints CbCR data may involve. Rather than evaluating the CbCR information in isolation when assessing TP risk, the EU Member States and business may benefit from combining it with other data, e.g. from the master file or a value chain analysis. Furthermore the interaction of TP with internal management information and IT systems may be explored.

It should be noted in this respect that CbCR in general is not new in the EU. In the context of the 2008 financial crisis, the EU had already introduced binding rules on corporate governance and remuneration for credit institutions and investment firms (CRD IV package). The Directive 2013/36/EU (Capital Requirements Directive) and Regulation (EU) No. 575/2013 (Capital Requirements Regulation)
lay down rules for banks and investment firms to publish for each jurisdiction on a yearly and consolidated basis, name the nature of their activities and location, turnover, number of employees, profit and loss before tax, tax on profit or loss and public subsidies received.

In the light of this precedence, the Commission adopted on 12 April 2016 a directive proposal which imposes on EU and non-EU MNE groups the publication of a yearly report on profit and tax paid and other information. With such public reporting, citizens should be in a better position to assess the tax strategies and the contribution to welfare by multinationals. The proposal for a directive is now submitted to the European Parliament and the Council of the EU. Once adopted, the new directive would have to be transposed into domestic legislation by all EU Member States, within one year after its entry in force.

### 2.4.2. Master and local files

The other two pillars of the OECD TP documentation framework under BEPS Action 13, master file and local files, find their origin in the 2006 EU TPD. Its main features can be summarized as follows:

- standardization of the documentation requirements necessary for a tax administration as a risk assessment tool and to obtain sufficient information for the assessment of the group’s transfer prices;

<table>
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<td>Limited secondary reporting</td>
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<td>Surrogate parent reporting</td>
<td>One entity can file instead of secondary reporting, provided effective exchange with group tax jurisdictions</td>
<td>One EU or non-EU entity can file instead of secondary reporting, provided (if non-EU entity) effective exchange with group EU Member States</td>
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64 See press release (IP/02/1105).
the possibility for centralization of the core part of the documentation (the “master file” at group level) and the availability to all EU Member States concerned of common standardized TP;

- a set of standardized documentation ("country-specific documentation or local file") for each of the specific Member States concerned with the intra-group transactions. This documentation should include information such as amounts of transaction flows within that jurisdiction; contractual terms and the particular TP methods used and would only be available to the relevant Member State.

The functioning of the EU TPD was extensively monitored at EU level in 2013. Member States and non-government stakeholders of the JTPF completed questionnaires on the impact of the EU TPD. Using such a master file and local file approach has been recognized as a suitable concept in the EU, both in terms of structuring the TP documentation and defining its contents. The EU TPD created a reference point for structuring TP documentation requirements in the domestic laws of the EU Member States. All Member States now consider their domestic documentation requirements as being in line with the EU TPD. Additionally, the same concept has been adopted by the OECD as part of BEPS Action 13.

Although the structure and content of the OECD master file/local file concept reflect to a large degree the EU TPD, it has still been envisaged to monitor the EU TPD to take into account the conclusions of the BEPS project and the relevant conclusions of the JTPF, which has advised the EU Commission in this respect since 2006. The assessment should focus on how to best put tax administrations in a position to effectively assess the facts and circumstances of cases and transactions so that they can determine which of them are worth reviewing and draw well-founded conclusions. An important aspect will also be the possible development of new IT-based tools intended to minimize the compliance burden for taxpayers and increase the efficient use of TP documentation by tax administrations.

### 2.4.3. Compliance costs

Identifying and easing the compliance cost burden which may result from the implementation of TP rules by taxpayers in several Member States has been considered as a central issue at EU level. In a 2006 Communication, on coordinating Member States’ direct tax systems in the internal market for instance, it was considered how to reduce and simplify such cross-border compliance burdens, particularly for SMEs, by improving administrative cooperation between Member States. Consequently, improving and coordinating TP rules has been systematically envisaged from the perspective of compliance costs to ensure “economic efficiency” within the internal market and the “international competitiveness of
European companies”. The dialogue taking place between non-governmental members and tax administrations within the JTPF has led to recognized progress in this respect, e.g. on TP documentation (EU TPD), low value-adding services or TP risk management (TP audit plan).

This can be positioned also in a broader context, referring to researches and methodologies developed by the European Commission in order to promote overall measures which are compliance cost efficient.69

The post-BEPS context should lead to revisiting this issue, particularly regarding:

- the implications for SMEs. In this respect, the 2012 JTPF report on SMEs and TP70 appears to be still applicable based on the recent discussions having taken place at the JTPF level;
- otherwise, the BEPS Actions 8–10 report has substantially increased the TP compliance and defence requirements for companies, at the level of all EU Member States.

The coordination and dialogue between tax administrations and non-governmental members continues to be crucial in this respect. Several illustrations can be found in the recent report on the use of comparables in the EU:71 as regards the use of foreign and non-domestic data for comparable searches, it is specified that CbC researches may not be always performed “in cases where there are insufficient data available at the domestic level and/or in order to reduce compliance costs”.72 Similarly, the necessity of comparability adjustments should be assessed “in the light of costs and the compliance burden”. Finally, and more generally, the “general principles of quality, transparency, consistency and proportionality” will apply according to the report, this being a guarantee of more cost-efficient approaches.

2.5. TP-related measures in other BEPS actions and other measures against BEPS

Several BEPS-related measures have been taken in the EU as part of the above-mentioned ATAD.73

The directive provides for an exit tax (article 5) ensuring that where a taxpayer moves assets or its tax residence out of the tax jurisdiction of a state, that state is able to tax the economic value of any capital gain created in its territory even if this gain has not yet been realized at the time of the exit. The exit tax is computed by reference to “an amount equal to the market value of the transferred assets”. As mentioned in the directive’s recital (point 7), “it is critical to fix a market value for the transferred assets based on the arm’s length principle”.

Similarly, the directive also provides in its CFC rules (article 8) that the amounts of income attributed to the parent company further to the application of the CFC rule (i.e. in the case of tax-driven non-genuine arrangements) “should be adjusted by reference to the arm’s length principle, so that the state of the parent

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69 See Review and evaluation of methodologies to calculate tax compliance costs, European Commission, Taxation Papers, working paper no. 40, 2013.
70 COM/2012/5161.
71 Draft report on the use of comparables in the EU (doc. JTPF/007/2016/EN).
72 See also para. 3.35 of the OECD TP guidelines.
company only taxes amounts of CFC income to the extent that they do not comply with this principle”.

2.6. Can BEPS work in favour of MNEs?

Several elements appear to be favourable to MNEs in the context of BEPS at EU level.

Measures such as the TP documentation, when they are coordinated in the EU, have proved that they ensure uniformity in the implementation at EU level, more consistency and economies of scale for companies. A similar approach has been taken as regards the amendments to the EU directive on exchange of information which was adopted on 25 May 2016, which complements the EU TPD.

Otherwise, in its Communication COM(2015) 302 final of 17 June 2015 to the European Parliament and the Council for a fair and efficient corporate tax system in the EU, the European Commission underlined that cooperation between Member States is an essential element in tackling tax avoidance and aggressive tax planning also in the direct tax area. In this respect, “a better exploitation of the existing instruments should be achieved, particularly by promoting a greater cooperation between Member States and a more strategic approach to controlling and auditing cross-border companies”. This should benefit companies, notably through the development of so-termed “joint audits”, particularly in the area of TP.

3. What is the future of TP?

The future of TP is in the EU at the crossroad of challenges faced by taxpayers and tax administrations in a radically changed global tax environment.

TP rules and practices have already been significantly reshaped in the EU in relation to the BEPS project.

The EU has achieved setting up a robust enabling framework to fight tax fraud and evasion and developed specific instruments to address BEPS. This has led to strengthening the existing TP framework and making it more transparent. Some specific policy measures, such as the ATAD adopted in July 2016 as well as automatic exchange of tax rulings (DAC3) and CbCR (DAC4) have also been taken. All of these measures are closely related to or interact with TP rules.

As regards strengthening the TP framework, the European Commission focused on building on the existing rules and developing coordinated and practical solutions within the EU to cope with the reality of the single market: in this respect, the ongoing work at the JTPF on the use of comparables and economic valuation will contribute to new guidance and development of specific approaches. Similarly, the work conducted on CbCR and joint audit practices in the EU was aimed at con-

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75 See note 10 above.
76 See Towards a more certain tax environment: fighting BEPS, improving certainty and fighting tax crime and terrorism, Supplementary note prepared by the OECD and the Slovak Presidency, informal ECOFIN, 10 September 2016.
tributing to the development of new tools and good practices to investigate potentially high-risk transactions for TP purposes. All this will contribute to improving practices as regards TP documentation and risk assessment in TP. Together with improved dispute resolution mechanisms, these areas are viewed by practitioners and business in the EU as the main areas of concern in the BEPS context.

The general objective is, however, broader and aims at improving “the corporate tax environment in the EU, making it fairer, more efficient and more growth-friendly”\textsuperscript{77}

As mentioned above, a key initiative resulting in a broader approach is the relaunch of the CCTB/CCCTB in a two-staged approach. Indeed, on different aspects, including the fight against TP as a profit shifting route and removing the need for complex and costly TP rules, the EU Commission concluded that the CCCTB would be the more appropriate solution for the EU and therefore relaunched the directive proposal.\textsuperscript{78}

However, TP challenges remain under a CCTB (without consolidation, the first stage of the relaunch) and also under a CCCTB as regards relations with third countries and related entities not being part of a CCCTB group. SMEs or companies under the €750 million threshold of the CCCTB\textsuperscript{79} will also remain subject to TP rules. Therefore, further work on the TP framework will be required in a challenging and unstable tax environment (e.g. adoption of unilateral measures by Member States, unprecedented numbers of tax audits, heightened reporting and transparency requirements, the aggressive and diverging positions of tax administrations, political and governmental pressures and expansive assertion of permanent establishment (PE) status).

In the future, it has been announced that the focus should be on developing “a balanced approach favouring both tax certainty and tax transparency” in the EU so that tax policies contribute to “domestic revenue raising, increased fairness and enhanced growth”.\textsuperscript{80}

TP should be addressed as a priority when creating such a more stable and sustainable tax environment in the EU: for example, both tax administrations and taxpayers should be in a position to manage the increased risks of prolonged and multilateral TP procedures, the expected trend for more litigation, with a sufficient degree of predictability. Otherwise, both tax administration and taxpayers’ costs could be negatively affected and it could harm the tax revenue consolidation in the long term, due to adverse consequences on trade and investment decisions on the single market.

At the level of tax administrations: recent works of the JTPF have shown the importance of focusing on high-risk taxpayers and transactions, as well as of the need for a streamlined use of scarce resources at all stages of the TP procedure. The issues are more and more fact-intensive and technically sophisticated. This encompasses the tax audit stage but also dispute prevention and dispute resolution

\textsuperscript{77} See the above-mentioned action plan.
\textsuperscript{78} European Commission – DG Taxation and customs union website CCCTB page.
\textsuperscript{80} See above-mentioned note: Towards a more certain tax environment: fighting BEPS, improving certainty and fighting tax crime and terrorism, Supplementary note prepared by the OECD and the Slovak Presidency, informal ECOFIN, 10 September 2016.
stages. Overall, a process should be developed on an end-to-end basis (i.e. from the stage of the selection to the stage of effective tax collection and tax collection, together with ensuring an optimal voluntary compliance in the TP area) to produce the expected results (effectiveness) and make the best use of the available resources (efficiency).

This requires more coordination and sharing of best practices between tax administrations in the EU on these areas to achieve common recognized TP governance standards. Some identified areas are the following:

(a) Developing common standards and approaches for TP documentation and audits, fitting in particular with companies’ business model evolutions and promoting increased transparency and reliability in companies’ processes. For example, as regards conducting comparable searches, concepts such as the quality and consistency of the analysis and the overall process have been developed and illustrated in the recent report of the JTPF. Improving and developing at a broader scale coordinated audit processes and tools among different EU jurisdictions could also contribute to cost efficiency, better audit results and return on resources, dispute prevention or improved dispute resolution, as well as closer cooperation and improved compliance from taxpayers.

(b) Developing information technology, intelligence gathering and risk analysis and management tools in order to face the challenges of an exponential increase in tax audit numbers and magnitude, mass-data sharing, great expectations in terms of results to be achieved and the timeliness of procedures, but also the need for more audit enforcement activities. Such technologies and tools are particularly key for an effective implementation of theCbCR legislation.

(c) Integrating the TP strategy into the broader risk management systems of tax administrations in the EU, and in a structured approach to identifying, assessing, prioritizing and mitigating the corresponding risks. This requires in particular identifying how the strategy affects the analysis and monitoring of the tax compliance gap; developing a better understanding of TP issues, in terms of risks and nature of the threats they pose for the tax system. It also involves determining and anticipating how TP can affect tax revenues, government policy goals, confidence in the system and the reputation of tax administration. This could lead to developing both qualitative and quantitative tools (indicators of performance, monitoring tools, components of compliance risk registers).

At the level of the taxpayers, adjusting to the post-BEPS changes should be conducted so as to fit with MNEs’ business models and realities, working further on
the bridge between MNEs’ highly integrated business models and the need to allocate MNE groups’ profits where value is created.

Nowadays MNEs often work in a highly integrated manner. The kinds of transaction observed between entities participating in highly integrated value chains often do not have that close a resemblance to the kinds of transaction observed on the open market. The fact that the business reality of MNE groups seems in many cases to have diverged from what is actually observed on the open market between independent enterprises requires the unbundling of these highly integrated value chains into transactions between legal entities that are part of the MNE group and pricing them accordingly. This provides two kind of challenges: first as regards a certain degree of judgement required when translating these economic relationships into transactions (now called “delineation of transactions”) and second, judgement as regards the pricing of such delineated transactions and their individual nature in an environment with limitations on data availability in kind and granularity.

The future of TP will depend on whether it will be possible to bridge this gap between the economic reality of MNE groups and the requirement to price these economic relations with reference to situations on the open market.

Given the variety of economic activities of MNE groups, it will be difficult to bridge this gap by prescriptive and general guidance on what value creation means. However, it will be essential to agree on general principles. The conclusion of the OECD that risk and assets cannot be allocated to entities which do not control the respective assets and risk is a first step. The biggest challenge as regards general principles to be determined will, however, be whether it will be possible to reach consensus on the arm’s length treatment of two crucial aspects in the economic reality of MNE groups, i.e.

(a) how financial relations within an MNE group should be addressed; and
(b) which principles can be developed to address the challenges of the so-called digital economy.

Beyond such an agreement on principles, the approach to be taken will rather be to understand and take into account the MNE’s view and actual behaviour in creating value. The tool for establishing this is a value chain analysis. Such a value chain analysis will have to be evidenced by the way business decisions are actually taken and by the economic analysis underlying these decisions to be convincing. Access to and – even more important – understanding of company data, e.g. management accounts, will be necessary.

On this basis the value creation within the individual MNE group will have to be demonstrated and converted into transactions which are then priced.

It will also be necessary to develop the capabilities of information technology (IT) systems to make the process of collecting, calculating, analysing, and reporting TP data more efficient and productive. Companies should indeed use their information systems and make them compliant, consistent and reliable so as to meet additional data and transparency challenges under the TP documentation rule. They should ensure in this respect that tax regimes are more aligned with economic reality and that profits are generated and tax paid where value is generated. A broad range of sources of information will have to be exploited by companies, made transparent and used in the most streamlined manner, “including external
data bases, companies’ statutory books or internal management and information systems”. 84

These compliance requirements should be satisfied together with maintaining business and investment agility. Companies may adjust their strategy and management tools to ensure consistency of the TP reporting with their economic realities but also to avoid a negative impact on their investment decisions. Post-BEPS compliance requirements require the intensive use of tools which allow companies to map and anticipate changes for all group entities involved in the joint-value creation process and in the intangible creation within an MNE. As an example, many MNEs may employ and enhance organizational planning tools such as EPM to conduct profitability modelling and optimization across their value chains for TP purposes and to face these challenges.

Last, in terms of regulations and practices, TP can add value to the development of stronger and more robust substance-based anti-abuse rules and should focus on risky transactions (intangibles, PEs), in order to further protect Member States from profit shifting situations not in accordance with economic activities. The provisions of article 8 of the ATAD regarding CFC rules using TP approaches and methodologies to characterize the non-genuine character of an arrangement are good examples. Similar approaches could be envisaged for specific transactions involving intangibles or in order to ensure that tax authorities have access to a 360-degree view of transactions (global value chain, two-sided approaches, PSM, PEs’ profit attribution). A close monitoring of coordinated approaches regarding intangibles, particularly as regards valuation, and specific rules applicable to PEs may lead to legislation initiatives if some risks of diverging interpretations are confirmed.

Figure 1 gives an overview of the solutions which can be envisaged in view of these challenges faced by both tax administrations and taxpayers.

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84 See JTPF/007/2016/FINAL/EN – Report on the use of comparables in the EU – Recommendation 2 for illustration as regards comparable searches but the same approach can be used for the processing of CbCR.
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<th>Challenges</th>
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<td>Substance and transaction flow-based approaches — economic analysis (value creation analysis — risk analytical framework — significant IP and risk control)</td>
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<tr>
<td>Intangible property and PEs</td>
<td>Effective application of SAAR/GAAR — special guidance on economic valuation and risk analysis — profit split method — specific legislation if needed</td>
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<tr>
<td>Tax transparency</td>
<td>TP documentation (master file, local file, CbCR) — exchange of information (tax rulings, CbCR) — TP risk management (intelligence gathering, risk and value chain analysis) — use of technology and tools</td>
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<tr>
<td>Tax certainty</td>
<td>Effective dispute resolution and dispute prevention (joint audits) — monitoring TP in tax compliance gap and developing indicators (tax administrations) — use of IT and organizational tools (e.g. EPM) for strengthening TP compliance — compliance cost efficiency (taxpayers)</td>
</tr>
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**Figure 1. What is the future of TP in the EU?**
II IFA Branch Reports
Summary and conclusions

The evolution of the Argentine international tax system illustrates the impact of globalization on tax convergence in the first nearly hundred years of corporate income taxation in this G20 country. A representative example is the gradual convergence with international standards in the area of transfer pricing (TP). Indeed, the Argentine domestic legal framework has evolved to achieve greater consistency, first with the League of Nations 1933 Carroll Report and then with the 1995 version of the OECD guidelines. This convergence was reinforced by the implementation of the arm’s length standard (ALP) in the Argentine tax treaty network in 1966. The ALP later permeated Argentine domestic law as of 1998, when the foreign direct investment (FDI) flow, as a percentage of GDP, was at its highest since the 1911–1915 period. In this convergence, the OECD guidelines are increasingly playing a crucial role, as Congress and the courts have gradually been transplanting them into domestic law since 1998. The main role of the ALP, as applied by the Argentine tax authorities, is to protect the corporate income tax base. This deeply rooted convergence path with the global standard is expected to be in place in relation to the 2015 version of the OECD guidelines crystallized in the base erosion and income shifting (BEPS) reports. The policy objective of the Argentine government of joining the OECD within the next few years should further reinforce this convergence path.

1. Present and future of the ALP

The Argentine government has been concerned about international tax avoidance techniques based on TP almost since the inception of the UK-based income tax system in 1932.¹ A central reason for this concern has been to protect the corporate income tax base in the context of the globalization of the food industry, in which

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Argentina has been a key player since the beginning of the 20th century. The two core areas on which most TP disputes have been focused in Argentina over the last 80 years are conduit schemes and the strategic use of intangibles.

In consistency with G20 standards, taxpayers have prevailed in over 60 per cent of all TP litigation emerging in Argentina in the pre-BEPS reports era (1923–2015). This pattern in Argentina is grounded in a number of reasons.

The first point argued in this report is that the evolution of the Argentine TP regulatory framework can be divided into six periods since the inception of the income tax system. Each regulatory period is normally associated with a major domestic fiscal debacle. One dominant feature here is the convergence of TP law with international standards. Indeed, the Argentine legal framework has been gradually evolving to achieve consistency, first with the League of Nations 1933 Carroll Report and then with the 1995 OECD guidelines on TP. The OECD guidelines have played a crucial role in this convergence as Congress and the courts have been increasingly transplanting the OECD guidelines into Argentine domestic law since 1998, when FDI flow as a percentage of GDP was at its highest since the 1911–1915 period.

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3 A representative conduit scheme dispute in the TP arena is Nobleza Piccardo, decided by the Tax Court (Chamber B) on 15 July 2010. It dealt with a toll manufacturer and stripped distributor arrangement as defined by the OECD TP guidelines for multinational enterprises and tax administrations (Paris: OECD, 2010), para. 9.77. The entities involved were based in Argentina, Chile and Switzerland. The Tax Court decided in favour of the taxpayer. See section 4.2.1 below. See also Baistrocchi, op. cit.

4 A representative dispute in the intangibles area (e.g. payment of royalties for the use of trademarks) is Refinerías de Maíz, which involved entities based in Argentina and the United States. It was decided in favour of the government by the Supreme Court on 10 July 1964. See section 2.3.1 below. See also Baistrocchi, op. cit.


9 For example, the Congressional Committee Reports underpinning the 1998 and 1999 reforms explicitly refer to the 1995 OECD guidelines as their main source. See Baistrocchi, “Transfer Pricing Disputes”, op. cit.

10 For example, the TP dispute in Ericsson, decided by the Tax Court (Chamber C) on 15 August 2007, was resolved in the light of para. 1.52 of the OECD guidelines. This paragraph deals with the interpretation of contractual relationships where no written terms exist. The Tax Court said that the role of the OECD guidelines was to fill in the gaps of Argentine law to make TP regulations as clear as possible. See Baistrocchi, “Transfer Pricing Disputes”, op. cit.
The second point argued in this report is the following. TP dispute resolution in Argentina as of 1932 suggests that Argentina has been increasingly enforcing TP provisions strategically as a countercyclical measure to address its fiscal deficit problems on tax bases that find it relatively difficult to move rapidly to competing jurisdictions, such as Brazil and Uruguay. Multinational enterprises (MNEs) from the agribusiness and automobile industries are good examples of this.

Litigation is by far the most common method employed for resolving TP disputes in Argentina. Other dispute resolution methods, such as mutual agreement procedures (MAPs), advance pricing agreements (APAs) and tax arbitration, have never been implemented in the country. One important explanation for this is the structure of incentives that tax officials have in Argentina.\(^\text{11}\) There have been over 26 major TP litigation cases since 1998 when Argentina began implementing the OECD guidelines into domestic law. In most disputes, the taxpayer won on procedural grounds or on comparability issues based (either explicitly or implicitly) on the 1995 OECD guidelines.\(^\text{12}\) The OECD guidelines have been applied expansively; this includes TP disputes involving tax treaties not based on the OECD model.\(^\text{13}\)

Statutory changes are expected as a consequence of the 2015 BEPS reports and the multilateral approach to international tax matters they entail. These changes include the introduction of APAs.\(^\text{14}\)

1.1. TP disputes in Argentina

Argentina has experienced two major waves of TP litigation since 1932. The first wave, which ran from 1961–76, coincides with three relatively deep fiscal debacles: in 1958, 1962 and 1975. In the first wave, most TP disputes were resolved with the aid of the domestic general anti-avoidance provision (GAAR); this encapsulates the substance-over-form approach. The second wave was triggered in the context of the 2001 financial debacle; most cases were resolved in the light of a specific anti-avoidance provision, the ALP, as encapsulated in the 1995 OECD guidelines.\(^\text{15}\)

2. Challenges of transactions with intangibles

2.1. Definition of intangibles

Neither domestic nor tax treaty law provides a definition of intangibles for TP purposes. However, it is likely that both the tax administration and the courts will

\(^{11}\) See Baistrocchi, “Tax Disputes under Institutional Instability”, op. cit.

\(^{12}\) See Baistrocchi, “Transfer Pricing Disputes”, op. cit.

\(^{13}\) See, for example, the Nobleza Piccardo case analysed in section 4.2.1 below.

\(^{14}\) The TP rules and regulations currently in effect in Argentina are the following: (a) the Income Tax Law as amended by Laws Nos. 25,063, 25,239 and 25,784; (b) the Administrative Order as amended by Presidential Decrees Nos. 485/99, 290/00, 1,037/00, 115/03, 916/04 and 589/13; (c) AFIP General Resolutions Nos. 1,122/01, 1,227/02, 1,296/02, 1,339/02, 1,590/03, 1,633/04, 1,670/04, 1,918/05, 1,958/05, 1,987/05, 3,132/11, 3,149/11, 3,476/13, 3,572/13 and 3,576/13.

\(^{15}\) See also Baistrocchi, “Transfer Pricing Disputes”, op. cit.
deem the definitions of intangibles, as encapsulated in the 2015 BEPS reports, Action 8, as customary international law in Argentina in order to fill in these gaps in the law. The leading case on this point is Ericsson.\textsuperscript{16} Indeed, Ericsson is the first case to state that the role of the OECD guidelines is to fill in gaps in Argentine law to make TP regulations as clear as possible.

There have been no reported disputes so far in Argentina on the application of TP rules to transactions with intangibles that have resulted from the BEPS project. Future changes are expected as a direct result of Action 8.

2.2. Transactions with intangibles

There are no specific rules for recognizing transactions with intangibles in Argentina for TP purposes. For example, there are no TP rules on the legal owner of the assets and how assets benefit each entity of the MNE group. To date, there have been no developments in this area as a result of Action 8 of the BEPS project. As stated in section 2.1 above, it is likely that the domestic courts will eventually consider Action 8 as customary international law to fill in gaps in Argentine law.

2.3. Substance-over-form approach towards intangibles

There have been no changes in the analysis of transactions with intangibles from a TP perspective because of the BEPS project. TP analysis of a transaction involving intangibles is normally based on a formal legal approach, as suggested by the OECD in the pre-BEPS reports era (1995–2015). However, there are early disputes in which the substance-over-form approach was applied in TP cases involving intangibles; these disputes emerged during the first wave of TP disputes in Argentina (1961–1976) when the ALP had not been properly introduced into domestic law.\textsuperscript{17} This early case law offered a response as to how functions related to the development, enhancement, maintenance, protection and exploitation of intangibles were assigned within the MNE group in the light of the substance-over-form approach encapsulated in the local GAAR.


The leading case Refinerías de Maíz, decided on 6 December 1961, is the first TP case decided by an Argentine court. Corn Products Refining Co. was a US corporation that held 96.6 per cent of the shares of its Argentine subsidiary, Refinerías de Maíz, which was in charge of selling commodities to independent parties. They entered into a licence contract under which the subsidiary would pay royalties to


\textsuperscript{17} See section 1.2. above.
the head office to be entitled to use certain trademarks within Argentine territory. The royalties were fixed and had to be paid by the subsidiary even when it was unable to make a profit. This case arose because the Argentine tax authority (AFIP) had adjusted the subsidiary’s tax accounts on the basis that the royalties could not be deducted because they were the subsidiary’s hidden profits. The tax authority argued that under domestic GAAR, such royalties had to be deemed profits because the concept “contract” presupposes, at least, two different parties with opposing interests – a requirement not met in this case given that the American corporation was the controlling shareholder of the Argentine subsidiary.

The taxpayer’s main argument was that the subsidiary was a legal entity independent of its head office, and that the amount of the royalty was reasonable and normal. Thus, it concluded, the royalties had to be considered as an allowable expense.

The Tax Court accepted the tax authority’s view. It held that since Corn Products Refining Co. held over 90 per cent of the shares of the subsidiary, they could not be deemed independent entities. Therefore, “the royalties paid [to the US head office] were, due to its economic effects, a way for [the head office] to obtain additional profits from its Argentine subsidiary”.

The taxpayer had implicitly referred to the ALP when it argued that a “reasonable and normal” test should be applied to this case. However, the Tax Court, without giving any justification, considered this irrelevant to resolving the case.

The Tax Court did not explicitly refer to the legal basis of its decision to disregard the legal personality of the subsidiary and to recharacterize payments made to the head office. However, it can be inferred that the GAAR was the clear legal basis for its reasoning. This must be so given that, in subsequent cases, the Tax Court explicitly cited the GAAR as its deciding rationale.18

To conclude, in *Refinerías de Maíz*, the Tax Court made use of the domestic GAAR to establish a presumption, which was not rebuttable, according to which royalties remitted by subsidiaries to their head offices under licence contracts could not be deducted from the subsidiaries’ tax accounts. Moreover, the Tax Court did not explain why the GAAR took precedence over article 14 and its regulations, which encapsulated an obscure version of the ALP.19

*Parke Davis* was an extension of the *Refinerías de Maíz* rationale to the pharmaceutical industry.20 Parke Davis Co. was a US corporation that held 99.95 per cent of the shares of Parke Davis y Cía, its Argentine subsidiary.

It had entered into a licensing contract that allowed its subsidiary to use, *inter alia*, certain chemical formulae in exchange for the payment of royalties to its American head office. The contract was not a sham and the amount of the royalties was considered normal by the tax authorities.

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18 The proposition that the Tax Court grounded its reasoning on the GAAR, although it made no reference to it, is also backed by the fact that the Federal Court of Appeals, when it affirmed the Tax Court’s decision, explicitly employed the GAAR as its main legal basis.

19 The Tax Court’s decision in *Refinerías de Maíz* was upheld by the Federal Court of Appeals on 14 October 1963 (*Derecho Fiscal* XIV-332). It was also upheld by the Argentine Supreme Court on 10 July 1964 on procedural grounds (CSJN 259 Fallos 141, 1964).

20 The *Parke Davis* case was decided by the Tax Court on 24 March 1970.
The Tax Court, in a 2-to-1 decision, held that since the US corporation held virtually the entire capital of the Argentine subsidiary, they could not be considered separate legal entities. Hence, under the GAAR, the parent–subsidiary relationship had to be deemed a parent–branch relationship.

Thus, Parke Davis & Cía was not allowed to deduct from its tax accounts the payments made to its US head office. Unlike the Refinerías de Maíz case, the GAAR was explicitly applied in Parke Davis in order to disregard the legal personality of the subsidiary and recharacterize payments, despite the fact that the transaction was not a sham and the amount of the royalties was considered normal.

The Tax Court’s majority vote made no explicit reference to the ALP. However, it implicitly took it into account when it accepted that the amount of the royalties had been normal under arm’s length conditions. In other words, this implicit reference shows that the Tax Court was aware of the tension that had existed between the GAAR and the ALP.

Nevertheless, the Tax Court decided to give precedence to the GAAR over the ALP without offering any justification. This decision shows the impact that hostility towards MNEs had on legal reasoning in the early 1970s.

The dissenting opinion in the Parke Davis decision is noteworthy, because it was the first opportunity in which the ALP was used to resolve a TP case in Argentine history. It was argued that the GAAR did not allow the legal personality of the subsidiary to be disregarded when dealing with its foreign parent corporation. This proposition was based on the fact that the GAAR had to be construed narrowly because of the economic circumstances prevailing when it was passed in 1946, which were quite different from those that existed when this case was decided. No reference was made to the economic unit principle embodied in article 14(2) of the Income Tax Act (ITA), despite its close relationship with the GAAR.

The dissenting judge maintained that this case had to be resolved under the normal transaction test according to which a subsidiary may deduct any royalties paid to its foreign parent company if two requirements are met: first, if the licence contract is not a sham; and, second, if the amount of the royalties is normal. He said in an obiter dictum that only any excess amount of the royalties that did not meet the normal transaction test could be recharacterized as, for instance, profits remitted to the parent corporation. He concluded that in the present case, the royalties were allowable because the tax authority had failed to show that either the first or the second requirement had not been satisfied.

The dissenting opinion did not base its decision on article 14 of the ITA or its regulations. In fact, these provisions were not even referred to in the decision. This test was extrapolated from the regulations of the Capital Tax Act (CTA) that had been passed in 1965. This extrapolation was probably made to avoid the problems of the ALP as implemented by article 14 of the ITA. The National Court of Appeals upheld the Parke Davis decision on the grounds of the GAAR, similar to those developed by the Tax Court’s majority vote.

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21 This Capital Tax Act was titled Impuesto sustitutivo a la transmisión gratuita de bienes. The regulation on which the dissenting opinion grounded the ALP was art. 12 of Decree no. 3745/65.
22 Some of the problems emerging from art. 14 have been analysed elsewhere. See Baistrocchi, “Transfer pricing disputes”, op. cit., s. 17.3.
23 The Federal Court of Appeals decided the Parke Davis case on 31 August 1971.
The Productos Químicos CIBA case was also related to the pharmaceutical industry with one distinguishing feature: it was the only unanimous Tax Court case resolved during the 1961–1976 period on the grounds of the ALP.\textsuperscript{24} It was decided by a Tax Court chamber that was aware of the actual source of article 14, the 1933 Carroll Report.\textsuperscript{25}

Ciba Société Anonyme was a Swiss corporation that held over 99 per cent of the shares of its Argentine subsidiary, Productos Químicos CIBA Sociedad Anónima. They entered into both licence and loan contracts, and the issue was whether the subsidiary could deduct from its tax accounts the royalties and interest paid to the foreign head office.

The Tax Court held that the issue had to be decided on the grounds of the normal transaction test implicitly established in article 14(1) of the ITA. Such a test empowered the tax authority to adjust the taxpayer’s accounts if they did not reflect the transaction that would have been “entered into between separate or independent enterprises” in similar circumstances.

The Tax Court then said that this case was governed by the ALP, not the GAAR, as encapsulated by article 14(1). This was the case given that article 14(1) envisaged a scheme specially tailored for checking intra-group transactions on the basis of the ALP, without disregarding the legal personality of subsidiaries. This point was supported by the regulations under article 14.\textsuperscript{26} In the light of the normal transaction test, it was decided that any royalties paid by the Argentine subsidiary to its Swiss head office could be deducted based on the following two reasons: that the transfer of technology contract was not a sham transaction, and that the amount of the royalties was normal. By contrast, the interest paid to the head office was disallowed because it did not satisfy the normal transaction test (as the agreed interest was not deemed normal).

In early 1973, the Parke Davis case reached the Argentine Supreme Court in the context of the largest fiscal debacle since the 1940s.\textsuperscript{27} This was the first opportunity for the Supreme Court Justices to decide in a TP litigation.

They had to choose between two competing approaches: (a) the GAAR as developed by the Tax Court’s (Chamber B) majority vote in Parke Davis; or (b) the ALP as used by the Tax Court (Chamber A) in the CIBA case. The Supreme Court decided to follow the former approach.

The reasoning of the Court was fundamentally doctrinal. The starting point was that, under the French-based Argentine Civil Code, the concept of a “contract” assumes the existence of at least two parties with non-aligned interests. Thus, the transaction entered into between the foreign head office and its local subsidiary could not be deemed a valid contract since the former wholly owned the latter. This conclusion made the regulations under article 14 invalid as regards the paragraph referring to the ALP because, in the Supreme Court’s view, the parties had wrongly assumed the existence of a contract.

\textsuperscript{24} The Tax Court (Chamber A) decided the CIBA case on 9 February 1972.
\textsuperscript{25} This awareness is suggested by the fact that the only academic article that referred to this issue (i.e. Jarach, “Las empresas con intereses”) was quoted in the CIBA case.
\textsuperscript{26} The text of this regulation is quoted in Baistrocchi, “Transfer Pricing Disputes”, op. cit., s. 17.3.
\textsuperscript{27} \textit{Ibid.}, Table 17.1.
Under the GAAR approach, the Supreme Court held that both parties should be deemed members of one economic unit. Therefore, in the *Parke Davis* case, the intellectual rights assigned by the head office to its wholly owned subsidiary had to be considered an equity contribution to the latter. In addition, the royalties paid to the head office had to be deemed the subsidiary’s profits. Consequently, the so-called royalties could not be deducted from the subsidiary’s tax accounts.

The Supreme Court reinforced its holding as follows. The foreign head office received in the relevant fiscal years: (a) the royalties stemming from the assignment to its subsidiary of the right to exploit the marks and patents in Argentina; and (b) the profits derived by its subsidiary from the exploitation of such marks and patents. The justices pointed out that: “Therefore, if the royalties could be deducted from the subsidiary, it would be equivalent to a tax exemption, which was not established by the Income Tax Act.”

The decision of the Supreme Court in *Parke Davis* amounted to an irrebuttable presumption according to which transactions entered into by the foreign head office with its subsidiary resident in Argentina had to be recharacterized as either equity contributions or dividends. This presumption, based upon the substance-over-form doctrine, repealed the arm’s length approach as embodied in the regulations under article 14.

The *Parke Davis* holding implied an absolute denial of any deductions based on charges for intra-group transactions between the foreign head office and its local subsidiary, a policy that was common in Latin America during the 1970s. A major consequence of this case was discrimination against enterprises on the grounds of nationality. In effect, Argentine companies were put at a comparative advantage as opposed to foreign MNEs, because only the former were allowed to deduct from their tax accounts royalties paid to non-resident enterprises.

The application of the GAAR in TP cases opened three crucial questions. It is time to explore the courts’ responses during the 1961–76 period.

The first question focuses on how the GAAR interacted with the specific anti-avoidance rule for transfer pricing, i.e. the ALP. The majority of the chambers of the Tax Court and a unanimous Supreme Court ruled to repeal (albeit implicitly) the ALP and employ the GAAR in all types of TP cases, as developed in the *Parke Davis* case.

This repeal was facilitated by a number of factors. For instance, the ALP was so poorly drafted that even its legal basis was considered unclear. In this respect, it is pertinent to recall the different views that were developed in the *CIBA* case and the dissenting opinion presented in the *Parke Davis* case. In addition, Argentine judges at the time were probably more familiar with the GAAR than the cryptic

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28 J.M. Martín, “El principio de la realidad económica y los abusos de las estructuras societarias” (1973), *Jurisprudencia Argentina*, 1039. Martín argued that the Argentine Constitution does not empower the Supreme Court to issue such a presumption.

29 None of the courts that applied the GAAR to TP cases attempted to explain what scope was left to the ALP.

30 In the *CIBA* case, it was argued that the legal basis for the ALP were the regulations under art. 14 of the ITA.

31 It was maintained that the ALP was embodied in art. 12 of the regulations under the Capital Tax Act referred to previously. See Baistrocchi, “Transfer Pricing Disputes”, op. cit., s. 17.3.3.
ALP, whose rationale was not explained by its drafters. Moreover, the only scholar who wrote briefly about its sources, Professor Dino Jarach, referred to a bibliography written in foreign languages (French, English and German), rather than in Spanish. This language barrier surely made it difficult for both taxpayers and judges to improve their understanding of the ALP.

Finally, the information costs of applying the ALP were much higher than those of the GAAR. In effect, the former had to be applied on a case-by-case basis, evaluating complex facts and making difficult decisions, e.g. whether a given transaction was comparable to the one at issue. In contrast, the GAAR, as construed by the Supreme Court in *Parke Davis*, could be applied on a mechanical basis. The sole fact that a given transaction was entered into between a foreign head office and its local subsidiary was enough to refuse the deduction of payments in the subsidiary’s tax account.

The second question focuses on the circumstances under which the GAAR may be applied to TP cases. Case law ruled that under the GAAR, the fact that a foreign head office held at least 80 per cent of the equity of its local subsidiary caused an irrebuttable presumption that such enterprises were members of one economic unit. Hence, the subsidiary was unable to deduct payments made to its head office from its tax accounts. The Supreme Court thus created a specific anti-avoidance rule to deal with the problem of TP in the area of intangibles. This rule was assumed to be a derivation of the domestic GAAR.

The third question focuses on how cross-border, intra-firm transactions had to be recharacterized under the GAAR. As was maintained by the Supreme Court in *Parke Davis*, they were to be considered as either equity contributions or profit remittances.

In conclusion, this early case law brought about the demise of the ALP for transactions other than the import and export of goods. This demise was the direct result of extending the GAAR to TP. Indeed, the Supreme Court created a specific anti-avoidance rule to deal with the problem of TP in the area of intangibles: the prohibition of deducting any payments made by wholly owned local subsidiaries to their foreign holding companies. This rule was based on the domestic general anti-avoidance norm. This approach was later supported by a unanimous vote of the Congress and extended to any type of intra-firm payments in the context of foreign MNEs. This was probably an attempt to protect the corporate tax base in the context of the worst fiscal debacle since the Great Depression.

The TP normative system applied in the 1961–1976 era was substantially amended in 1998 when the ALP, within the wording of the 1995 guidelines, was

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33 An 80 per cent equity requirement was established by the Tax Court in *Le Carbone Lorraine SC*, decided on 17 November 1969. A.R. López, “Criteria for the Allocation of Items of Income and Expense between Related Corporations in Different States, Whether or Not Parties to Tax Conventions” (1971), vol. 56b, Cahiers de droit fiscal international II/51, II-77.
34 G.J. Glogauer argued that, “The arm’s length criteria cannot be applied since the reasoning of the Court [that was followed in the 1973 reform] does not take into consideration economic reality, even though it intends to, but prefers the organic theory [based on the domestic GAAR]”. G.J. Glogauer, “Tax Treatment of the Importation and Exportation of Technology, Know-how, Patents, Other Intangibles and Technical Assistance” (1975), 2 Cahiers de droit fiscal international 27.
introduced into Argentine domestic law. The domestic GAAR applied in the Parke Davis case and its progeny is still in force in Argentina.

2.4. Comparability and group synergies

Comparability issues normally arise when applying TP rules to transactions with intangibles. BEPS Action 8 suggests that group synergies also play an important role in this area. According to the OECD, in some circumstances, MNE groups and the associated enterprises that comprise such groups may benefit from interactions or synergies among group members that would not generally be available to similarly situated independent enterprises.

The rules in Argentina do not yet provide for mechanisms to identify group synergies in the application of TP rules. Moreover, there are no changes in domestic regulations – or practices – in the group synergies arena as a consequence of the BEPS project. The desire of the Argentine government to join the OECD within the next few years should induce the Argentine Congress and the tax authority to introduce regulations in the area of group synergies compatible with the BEPS project.

2.5. Hard-to-value intangibles

The BEPS project has raised concern with the valuation of hard-to-value intangibles. In fact, the valuation of intangibles per se poses several challenges due to problems in comparability. According to the OECD:

“when valuation of an intangible or rights in an intangible at the time of the transaction is highly uncertain, the question arises as to how arm’s length pricing should be determined. The question should be resolved, both by taxpayers and tax administrations, by reference to what independent enterprises would have done in comparable circumstances to take account of the valuation uncertainty in the pricing of the transaction.”

Argentina has not yet adopted any measures to improve valuation of hard-to-value assets following BEPS Action 8. The policy objective of the Argentine government of joining the OECD within the next few years should induce Congress and the tax authority to introduce regulations in the hard-to-value area of intangibles compatible with the BEPS project.

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35 The core TP regulations currently in force in Argentina are listed in note 14 above.
2.6. Cost contribution agreements (CCAs)

CCAs are agreements:

“among business enterprises to share the contributions and risks involved in
the joint development, production or the obtaining of intangibles, tangible
assets or services with the understanding that such intangibles, tangible assets
or services are expected to create direct benefits for the businesses of each of the
participants.”\textsuperscript{40}

CCAs can be a source of BEPS if the contributions and benefits to the participant
companies are not properly determined. As part of Action 8 of the BEPS project,
changes to the CCA chapter in the OECD TP guidelines have been proposed.

Argentine law does not yet regulate CCAs. Hence, there is no experience on
how this country applies TP rules to CCAs in the BEPS project era. The policy
objective of the Argentine government of joining the OECD within the next few
years should induce the Argentine Congress and the tax authority to introduce reg-
ulations in the CCA area compatible with the BEPS project.\textsuperscript{41}

3. Risk and capital

BEPS actions regarding TP are still based on the ALP. On the other hand, the allo-
cation of a fair share of taxes to each country where an MNE operates is one of the
major goals of the project. Action 9 of the BEPS project aims at “adopting transfer
pricing rules or special measures to ensure that inappropriate returns will not
accrue to an entity solely because it has contractually assumed risks or has provid-
ed capital”.\textsuperscript{42}

In the 2013 OECD Secretary-General’s report to the G20 finance ministers and
central bank governors, it was stated that:

“in particular, the current interpretation of the arm’s length principle is chal-
lenged by the ability of MNEs to artificially shift profits by transferring easily
movable assets (such as intangibles and capital). The action plan will fix these
issues with measures, either within or beyond the arm’s length principle, to
ensure that taxable profits can no longer be artificially shifted away from the
countries where value is created.”\textsuperscript{43}

Argentina has not yet adopted TP measures aligned with Action 9 to control
returns on capital or compensation for the assumption of risk. The policy objective
of the Argentine government of joining the OECD within the next few years should

\textsuperscript{40} OECD (2015), \textit{op. cit.}
\textsuperscript{41} See Baistrocchi, “Resolving Transfer Pricing Disputes”, \textit{op. cit.}
\textsuperscript{42} OECD (2015), \textit{op. cit.}
\textsuperscript{43} OECD Secretary-General’s Report to the G20 Finance Ministers and Central Bank Governors,
Moscow, Russia, 19–20 July 2013. Available at http://www.oecd.org/tax/exchange-of-tax-informa-
induce the Argentine Congress and the tax authority to introduce regulations in the areas of risk and capital compatible with the BEPS project.44

4. High-risk transactions

4.1. Commodity transactions

As noted by the OECD:

“the commodity sector provides the major source of economic activity for many countries, especially developing countries, in which the commodity sector contributes significantly to employment, government revenues, income growth and foreign exchange earnings. Accordingly, for many of these countries, dependence on commodities has defined their economic policy (making commodity exports the primary driver of growth and investment) and development trajectory.”45

Given the importance of the commodity sector, there is great concern with the artificial control of transactions involving commodities by MNEs. This is dealt with under BEPS Action 10.

4.1.1. Commodity transactions and the sixth method

The Argentine Congress introduced a specific anti-abuse provision in the TP arena in 2003; it was targeted at the commodity industry because of the government’s perception that this industry was involved in aggressive international TP manipulation based on a report by the tax authority.46 The anti-abuse provision states as follows:

“In the case of commodity exports to associated offshore traders who are not the effective recipients of the commodities, it will be deemed that the best method to determine income sourced in the Argentine Republic is the market price when goods are shipped regardless of the price agreed on with the offshore trader.

However, if the price agreed on with the offshore trader is higher than the market price at the aforementioned time [of shipping], the first price [agreed on] will be the relevant one to ascertain the transfer pricing of the transaction. This method will not be applied if the taxpayer demonstrates beyond a doubt that the offshore trader concurrently meets the following [three] requisites:

44 See Baistrocchi, “Resolving Transfer Pricing Disputes”, op. cit.
45 OECD (2015), op. cit.
46 The Argentine Federal Tax Authority’s Report on Transfer Pricing Abuses (2003) stated that, “As a result of an investigation on the seven largest Argentine traders controlling 60% of total agricultural exports, we have reached the conclusion that the income tax they have paid over the 1997–2001 period has been too low. These traders have paid ARS 19 million in income taxes on sales valued at ARS 20,000 million, actually accounting for 0.08% of the total sales.” In Libro de Sesiones de la Cámara de Diputados (13 August 2003). The report was included in the speech that congressman Giubergia delivered in the House of Representatives on that date.
(a) to have an effective presence in the [offshore] resident territory, a commercial establishment through which its businesses are administered and meet the [local] legal requirements of incorporation, registration and submission of accounting books. The assets, risks, and functions should be consistent with the volumes of the transactions;
(b) its core business should not consist in either obtaining passive income or the commercial intermediation of goods from or to the Argentine Republic with other members of the group;
(c) its international trade with other associated enterprises of the same group may not exceed 30 per cent of the annual total transactions concluded by the offshore trader.

The tax administration may limit the scope of this method when it considers that the causes that motivated its introduction have ceased.\textsuperscript{47}

This domestic targeted anti-avoidance rule is normally referred to as the “sixth method”,\textsuperscript{48} because it has been added to the existing five OECD-based TP methods\textsuperscript{49} provided for in Argentine domestic law.\textsuperscript{50} The sixth method aims to deter schemes in the commodity industry similar to those implemented by La Anglo, a subsidiary of a British MNE, in the early 1930s.\textsuperscript{51} It is on this area of law that the Argentine government is most likely to focus its TP enforcement efforts in the foreseeable future.\textsuperscript{52}

4.1.2. The sixth method, commodity transactions and TP litigation

The first decade of experience in Argentina with the enforcement of the sixth method has led to significant TP litigation. In most cases, taxpayers have prevailed. Representative disputes in the commodity transactions arena include the \textit{Toepfer} case.\textsuperscript{53}

The \textit{Toepfer} case\textsuperscript{53} focused on the temporal scope of the sixth method applied to the Argentine agribusiness industry. This anti-avoidance rule provided that, under certain conditions, the best method for determining the TP of commodity exports between a resident exporter and a non-resident associated trader was the higher of two alternative prices: (a) the market price in force when the relevant contract was entered into, or (b) the market price when the commodities were shipped overseas. As mentioned above, this anti-avoidance rule is normally called the sixth method.\textsuperscript{54}

\textsuperscript{47} Act No. 25,784.
\textsuperscript{48} The sixth method was introduced into Argentine federal law by Act No. 25,784 as of 22 October 2003.
\textsuperscript{49} OECD TP guidelines, \textit{op. cit.}, ch. II.
\textsuperscript{50} Art. 15 of the ITA (as amended by Act No. 25,063).
\textsuperscript{51} See Baistrocchi, “Transfer Pricing Disputes”, \textit{op. cit.}
\textsuperscript{53} \textit{Administración Federal de Ingresos Públicos} v.\textit{Alfred C. Toepfer Internacional SA}, decided by the Tax Court (Chamber D) on 5 July 2010.
\textsuperscript{54} See note 50 above.
The facts of the Toepfer case were the following. Alfred C. Toepfer Internacional, a subsidiary of a German MNE, was a major Argentine exporter of agricultural commodities. Its business model worked as follows during the relevant period. Toepfer had been selling commodities to two alternative non-resident associated traders: one based in Liechtenstein and the other in Brazil. On the one hand, the Liechtenstein trader was in charge of reselling the commodities to independent clients based in Europe, Africa and Asia. The Brazilian trader, on the other hand, was focused on reselling the commodities in the South American market.

Toepfer and its two offshore traders had set the relevant transfer prices in line with the market price in force when the relevant contracts were entered into, rather than the market price existing when the commodities were shipped overseas. The market price in force when the commodities were shipped overseas, i.e. the shipping market price, was consistently higher than the price at the time the contracts were entered into between Toepfer and its traders, known as the contract market price.

Consequently, the Argentine tax authority argued that the sixth method was applicable, i.e. the (higher) shipping market price was to prevail over the (lower) contract market price. The main issue emerging from the Toepfer case dealt with the retroactive application of the sixth method. Indeed, the question was whether it was valid to apply this domestic anti-avoidance rule, which had become effective in 2003, to the Toepfer case, which actually pertained to the fiscal year of 1999.

The Tax Court decided this case in favour of the taxpayer, based on two central propositions. First, transactions beyond the scope of the sixth method were to be governed by the market price in force at the time the relevant contracts were entered into. Second, the sixth method’s specific domestic anti-avoidance rule could only be applied prospectively (rather than retroactively) as of the date on which the law introducing this rule had become effective, i.e. 22 October 2003. Consequently, the sixth method did not apply to any of Toepfer’s transactions entered into before that date, in other words, the 1999 fiscal year. In sum, the Toepfer case was to be governed by the market price in force at the time the relevant contracts were entered into.

The Toepfer case was important for four reasons. First, it was the first TP litigation concerning the agribusiness industry since the 1970s. Second, the Tax Court began its analysis by quoting the OECD guidelines to determine the role and the international meaning of the ALP. Third, the Tax Court applied the ALP to identify the Argentine-sourced corporate tax base. Fourth, the decision limited the temporal scope of a domestic, specific anti-avoidance rule, without exploring the relevance, if any, of the domestic GAAR. This is noteworthy because the domestic GAAR had been predominantly applied by the Argentine courts during the 1960s to resolve most TP disputes.

However, the Toepfer decision failed to address a number of important issues and some of its propositions lacked sufficient reasoning. For example, the court did not decide on whether the sixth method was consistent with article 9 of the Argentina–Brazil double tax treaty, as it decided that this was irrelevant in this
case for unclear reasons. The *Toepfer* decision has since been appealed by the government.\(^{59}\)

The commodity pricing method has not yet evolved into a form of safe harbour method. Before this happens, it is likely that a body of domestic case law on this issue will be available in Argentina. In any case, the experience gained from the past decade in Argentina is likely to be informative to both taxpayers and tax authorities in all countries dealing with this type of dispute.\(^{60}\)

### 4.1.3. The sixth method and BEPS reports

The 2015 OECD report, Action 10, on commodity transactions, has implicitly given support to the Argentine sixth method if certain conditions are met. The BEPS report states the following:

> “If the pricing date specified in any written agreement between the associated enterprises is inconsistent with the actual conduct of the parties or with other facts of the case, tax administrations may determine a different pricing date consistent with those other facts of the case and what independent enterprises would have agreed in comparable circumstances (taking into consideration industry practices). When the taxpayer does not provide reliable evidence of the pricing date agreed by the associated enterprises in the controlled transaction and the tax administration cannot otherwise determine a different pricing date under the guidance in Section D of Chapter I, tax administrations may deem the pricing date for the commodity transaction on the basis of the evidence available to the tax administration; this may be the date of shipment as evidenced by the bill of lading or equivalent document depending on the means of transport. This would mean that the price for the commodities being transacted would be determined by reference to the average quoted price on the shipment date, subject to any appropriate comparability adjustments based on the information available to the tax administration. It would be important to permit resolution of cases of double taxation arising from application of the deemed pricing date through access to the mutual agreement procedure under the applicable Treaty.”\(^{61}\)

This proposition on commodity transactions in the BEPS report will be added to the 2016 version of the OECD guidelines.\(^{62}\) Action 10 implicitly supports the consistency of the Argentine sixth method with the ALP.

### 4.2. Intra-group services

The provision of intra-group services is part of the operations of any MNE. As pointed out by the OECD in its discussion draft regarding intra-group services, “nearly every MNE group must arrange for a wide scope of services to be available...

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\(^{59}\) The *Toepfer* decision for the taxpayer has been upheld by the Supreme Court. See 339/2013, *Alfred C. Toepfer Internacional SA* (TF 27014-I) *v.* *DGI*, 25 March 2015.

\(^{60}\) González Malla and Carrera, op. cit.

\(^{61}\) See the 2015 OECD reports, Action 10, Commodity transactions.

\(^{62}\) González Malla and Carrera, op. cit.
to its members, in particular administrative, technical, financial and commercial services. Such services may include management, coordination and control functions for the whole group.”\(^{63}\) However, as common as it is, the provision of intra-group services may open BEPS opportunities to MNEs, which (to some extent) can be avoided through the application of TP rules. The discussion draft identifies that, “there are two issues in the analysis of transfer pricing for intra-group services. One issue is whether intra-group services have in fact been provided. The other issue is what the intra-group charge for such services for tax purposes should be in accordance with the ALP.” Identifying that a service has actually been provided is the starting point for TP analysis of charges for the service.

Argentine law largely follows the OECD guidelines, version 1995, in the intra-group services arena.\(^{64}\) The outcomes of BEPS Action 10 have not yet had an impact on such treatment. Representative Argentine TP case law in the intra-group services follows.

### 4.2.1. Intra-group services: litigation

The *Nobleza Piccardo* case\(^{65}\) dealt with a toll manufacturer and stripped distributor arrangement.\(^{66}\) It was implemented by a triangular scheme between associated legal entities based in Argentina, Chile and Switzerland. This decision was a progeny of the *Bago*, *Aventis Pharma* and *Volkswagen I* cases on the issue of the tax administration’s burden of proof in TP cases.\(^{67}\)

The facts of the case were as follows.\(^{68}\) British American Tobacco Ltd (BAT Switzerland), a Swiss holding company, entered into a contract manufacturing agreement with Nobleza Piccardo SACI (NP Argentina), its Argentine subsidiary. According to this agreement, NP Argentina would produce cigarettes in Argentina, and all the relevant risks would be borne by BAT Switzerland.\(^{69}\) BAT Switzerland would then sell and invoice the cigarettes to Extralan, a Chilean tobacco trader based in a free zone in Chile (Extralan Chile), for US$
12,564,590.09. NP Argentina, in turn, would export the cigarettes to Extralan Chile for US$ 7,440,144.

The Tax Court’s decision suggested that Extralan Chile was an independent agent representing BAT Switzerland in Chile. The Argentine tax authority considered that NP Argentina had a TP problem during the 1999 and 2000 fiscal years in its exports to Extralan Chile. Indeed, the Argentine tax authority argued that NP Argentina had actually under-invoiced US$ 5,124,445.99 to Extralan Chile, i.e. US$ 12,564,590 (the sales price of cigarettes from BAT Switzerland to Extralan Chile) minus US$ 7,440,144 (the export price of cigarettes from NP Argentina to Extralan Chile). NP Argentina argued that this price gap was the result of the contract manufacturing agreement that NP Argentina had concluded with BAT Switzerland during the relevant period.

The Tax Court decided the case in favour of the taxpayer on procedural grounds. It argued that the tax authority’s letter of deficiency in TP cases should be based on compelling reasons to justify a deviation from contractual prices (the compelling reason test). This compelling reason test was not met in this case on the following three grounds:

(a) the tax authority had based its decision on the wrong TP method;
(b) the tax authority had used wrong comparables that attributed to NP Argentina a profit level of 116.12 per cent, which was inconsistent with the 45.2 per cent maximum profit level of comparable entities; and
(c) the NP Argentina profit level over the relevant period was comparable to that of similar Argentine-based contract manufacturers.

In its obiter dictum, the court maintained that the OECD guidelines may be relevant even in respect of those tax treaties that are not based on the OECD model, such as that concluded between Argentina and Chile, which is based on the Andean model.

### 4.3. Profit splits in the context of value chains

The analysis of the potential use of profit splits in the context of value chains considers that MNEs operate in an integrated manner. Therefore the application of traditional TP methods might prove ineffective. Argentina does not yet have any special rules concerning the application of TP rules to MNEs’ value chains.

### 5. TP documentation

Transparency is the motto of international taxation in the 21st century. If properly applied, tax transparency can be very useful in the allocation of the fair share of

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70 Ibid., s. 7.1, para. 2.
71 Ibid., s. 6, para. 4.
72 S. VII, para. 2 of Judge Porta’s judgment.
73 S. 8, paras. 1 and 2 of Torres’ and Castro’s judgment.
74 Ibid., s. 8, para. 4 in fine.
75 Ibid., s. 12.1, para. 2.
76 Ibid., ss. 10.1 and 12.1.
taxes to each jurisdiction where MNEs operate. In the field of TP, the search for transparency is based on a new set of support documentation, which will be the basis for disclosure of relevant information.

Action 13 of the BEPS project is based on a three-tier approach, which considers (a) the country-by-country report, (b) the master file, and (c) the local file. The search for transparency is an ambitious endeavour. In fact, the pursuit of transparency should be balanced with the efforts that will be required for such transparency to be achieved. Therefore, the most relevant concerns about compliance costs arise in the context of Action 13.77

5.1. Country-by-country reporting

Country-by-country reporting requires MNEs to annually report a variety of information relating to each jurisdiction where they do business. It relies heavily on the existence of mechanisms for the automatic exchange of information. According to the OECD:

“The country-by-country report requires multinational enterprises (MNEs) to report for each tax jurisdiction in which they do business the amount of revenue, profit before income tax and income tax paid and accrued. It also requires MNEs to report their total employment, capital, retained earnings and tangible assets in each tax jurisdiction. Finally, it requires MNEs to identify each entity within the group doing business in a particular tax jurisdiction and to provide an indication of the business activities each entity engages in.”78

In June 2015, the OECD issued the country-by-country reporting implementation package, including model legislation, which should be enacted (with necessary adaptations) by each country, as well as three model competent authority agreements that are required under article 6 of the Convention on Mutual Administrative Assistance in Tax Matters (MCAA).

Full implementation of country-by-country reporting is expected in Argentina within the next few years. However, no domestic legislation following the OECD’s template has yet been enacted.

Regarding the automatic exchange of information, the MCAA was already in force in Argentina as of 1 January 2013.79 The AFIP issued General Resolution No. 3826/2015;80 this establishes rules for the adoption of the OECD automatic exchange of financial information in tax matters. The general resolution states the rules to be followed by Argentine financial entities reporting to the AFIP financial information of non-residents for calendar year 2016 and onwards.

The general resolution follows the common reporting standard (CRS) guidelines for the information and accounts to be reported and the way that information should be reported to the AFIP. The new reporting regime applies to all financial institutions as they are defined in the CRS. Financial entities are required to report the information annually and file the information electronically before 31 May of the year following the year being reported. Financial entities should keep records of the information being reported for 10 years.

Under the general resolution, financial entities are required to report financial information for calendar year 2016 and onwards. Pre-existing accounts, created before 31 December 2015, with an account balance or value exceeding US$100,000 as of such date, must also be reported. According to the CRS and the general resolution, financial entities are to report the accounts held by non-residents in countries and jurisdictions with which Argentina exchanges information on tax matters in accordance with the MCAA.

Generally, financial entities are required to report the following information for each reportable account: (a) name, address, jurisdiction(s) of residence, taxpayer identification number, and date and place of birth of the account holder; (b) account number; (c) name and identifying number of the reporting financial institution; and (d) the account balance or value as of the end of the relevant calendar year. Other information may also be required. Financial entities that fail to comply with the due diligence and reporting obligations may be subject to penalties in accordance with Law No. 11,683 and other tax effects (such as inclusion or exclusion from certain tax registries).81

5.2. Master and local files

According to the OECD, the:

“master file should provide an overview of the MNE group business, including the nature of its global business operations, its overall transfer pricing policies, and its global allocation of income and economic activity in order to assist tax administrations in evaluating the presence of significant transfer pricing risk.”82

The “local file provides more detailed information relating to specific intercompany transactions. The information required in the local file supplements the master file and helps to meet the objective of assuring that the taxpayer has complied with the arm’s length principle in its material transfer pricing positions affecting a specific jurisdiction.”83

Argentina has not yet incorporated the master and local files in its TP documentation requirements. This incorporation is expected shortly.

83 Ibid., p. 19.
5.3. Compliance costs

One of the concerns of MNEs with the BEPS work on TP documentation is the increase in compliance costs, especially during a period of financial crisis and limited resources. There is no information on how BEPS Action 13 has affected compliance and its cost for MNEs operating in Argentina as Action 13 has yet to be introduced in the Argentine normative system.

6. TP-related measures in other BEPS actions

It is a fact that TP is at the core of the BEPS project. Therefore, it comes as no surprise that other BEPS actions rely on changes in TP rules to achieve their goals. For instance, Action 1 and the work to address BEPS challenges in the context of digital economy are closely tied to TP, notably the control of transactions involving intangibles. There have not yet been any significant TP developments in Argentina that were driven by any of the non-TP BEPS actions.

7. Other measures against BEPS

The BEPS project is perhaps the most extensive multilateral initiative in international taxation in history, and a great part of it is dedicated to TP issues. Notwithstanding this, it is possible that other measures adopted by countries to counter-attack BEPS may be included in the multilateral initiative. Argentina has not yet taken measures to prevent BEPS through TP that could be adopted multilaterally in the context of the BEPS project.

8. Can BEPS work in favour of MNEs?

To some extent, the search for transparency in the context of the BEPS project has been one-sided, primarily focusing on generating information for tax administrations. However, the automatic exchange of information could also work in favour of taxpayers, with tax authorities automatically exchanging the information necessary for the application of domestic TP regulations. So far, there has not been any initiative in Argentina to use the BEPS platform to benefit MNEs with information that is in the possession of other countries.

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84 The BEPS reports were only mentioned in passing in just two Argentine regulations issued by the tax authority: Circular 5/2014, on deductible expenses, and Resolución General 3577/2014, on the sixth method.
Summary and conclusions

Transfer pricing (TP) outcomes of the base erosion and profit shifting (BEPS) project have been generally accepted as positive and embraced by the Australian government and Australia’s tax authority, the Australian Taxation Office (ATO). Reporting in the form of country-by-country reporting, consistent with OECD recommendations in Action 13 of the October 2015 OECD final BEPS report was implemented in December 2015 and, on 3 May 2016, the government announced its intention to amend Australia’s new TP rules to give effect to the TP recommendations in Actions 8–10 of the October 2015 OECD final BEPS report. The amendments were announced to apply from 1 July 2016.

The domestic political environment is also having a significant impact on how BEPS is perceived in Australia, not least of all because of the Senate Economics References Committee inquiry into corporate tax avoidance. This inquiry was referred to the committee on 2 October 2014 and it was originally due to report in June 2015. Since then, the committee’s due date for reporting has been extended six times and it is now due to report by the end of September 2017. A number of multinational enterprises (MNEs) operating in Australia have appeared before the committee, particularly in the technology, energy and resources and pharmaceutical industries.

Notwithstanding the committee’s inquiry, MNEs operating in Australia, irrespective of whether they are headquartered in Australia or not, have generally been supportive of the TP outcomes of the BEPS project, including its underlying theme that tax should be paid where the value is created.

It also needs to be appreciated that the TP landscape in Australia had already changed before the BEPS project began. The catalyst for this change arose from the Commissioner’s loss in Commissioner of Taxation v. SNF (Australia) Pty Ltd [2011] FCAFC 74 (SNF). As a consequence of SNF, Australia introduced new

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1 Taxation Laws Amendment (Combating Multinational Tax Avoidance) Act 2015, Act No. 170 of 2015. Applies to years of income commencing on or after 1 January 2016.

2 At the time of writing, legislation to give effect to this announcement had not been introduced into Parliament.

3 The Committee issued interim reports in August 2015 (Part I: You cannot tax what you cannot see) and April 2016 (Part II: Gaming the system).
TP rules in subdivisions 815-B to 815-D of the Income Tax Assessment Act 1997 (ITAA1997) with effect for years of income commencing on or after 29 June 2013.\textsuperscript{4}

The underlying policy aims for introducing the new TP rules included:\textsuperscript{5}

- modernizing Australia’s domestic TP rules by better aligning them with the 2010 OECD TP guidelines;\textsuperscript{6}
- having the new rules apply to both tax treaty and non-tax treaty cases;\textsuperscript{7} and
- having the new rules operate on a self-assessment basis consistent with the design of Australia’s overall tax system.\textsuperscript{8}

Australia’s new TP rules are generic (as distinct from having specific rules for particular types of transaction) and pay close regard to the language used in article 9(1) of the OECD’s model double tax convention (DTC) and in the associated enterprises articles in Australia’s tax treaties. As such, they are based on comparing the conditions operating between an entity and another entity in connection with their commercial or financial relations (the actual conditions) with the arm’s length conditions. The arm’s length conditions are the conditions that might be expected to operate between independent entities dealing wholly independently with one another in comparable circumstances and are also required to be identified so as best to achieve consistency with \textit{inter alia} the 2010 OECD TP guidelines.

Notwithstanding the introduction of new TP rules in 2013, Australia’s ongoing support for the BEPS project and the announcement to give effect to the TP recommendations in Actions 8–10 of the October 2015 OECD final BEPS report, the government has nevertheless considered it necessary to go further. For example, parallel with changes to Australia’s TP rules has been the introduction of new disclosure rules requiring greater transparency with respect to taxes paid by MNEs in Australia. The ATO is now required to publish annually the Australian business number, total income, taxable income, tax payable, and amounts of petroleum resource rent tax and mineral resource rent tax payable by public and foreign owned entities reporting total income of A$100 million or more.

In addition, there has been a doubling of penalties associated with TP adjustments for significant global entities\textsuperscript{9} in the absence of having a position that is reasonably arguable.\textsuperscript{10} Furthermore, on 3 May 2016 the government announced a proposed one hundred fold increase in penalties for significant global entities which fail to comply with country-by-country reporting obligations.

However, the most significant move by Australia in addressing BEPS is the unilateral adoption of the Multinational Anti-Avoidance Law (MAAL) which is based

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\textsuperscript{4} Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Act 2013, Act No. 101 of 2013.

\textsuperscript{5} Explanatory Memorandum (EM) to Taxation Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013.

\textsuperscript{6} \textit{Ibid.} [2.1].

\textsuperscript{7} \textit{Ibid.} [2.2]. The previous TP rules in division 13 also applied to both tax treaty and non-tax treaty cases.

\textsuperscript{8} \textit{Ibid.} [2.17]. Neither division 13 nor subdivision 815-A applied on a self-assessment basis. Each required the Commissioner to make a determination that the relevant provision apply.

\textsuperscript{9} Members of an MNE that has annual global revenue of A$1 billion or more.

\textsuperscript{10} Taxation Administration Act 1953, Schedule 1, s. 284-155(3).
on the first limb of the United Kingdom’s diverted profits tax (DPT)). While not a specific TP measure, as it is targeted at arrangements to avoid the existence of a permanent establishment (PE) in Australia, the MAAL is clearly intertwined with ATO investigations into TP.

Further, the government, in the 2016–17 Budget, announced its intention to introduce a DPT based on the second limb of the UK’s DPT. A consultation process is currently being undertaken; however, at the date of writing, legislation has not been introduced into Parliament to implement a DPT.

1. Current TP regulation and practice in Australia

Australia introduced new TP rules in subdivisions 815-B to 815-D ITAA1997 with effect for years commencing on or after 29 June 2013. This followed the Commissioner’s loss in SNF. These new rules replaced the previous TP rules in division 13 of Part III of the Income Tax Assessment Act 1936 (ITAA1936) and the TP rules introduced in subdivision 815-A ITAA1997 in 2012 to clarify that the TP rules in Australia’s tax treaties (i.e. the associated enterprises article and the business profits article) operate as an alternative to division 13 ITAA1936. Subdivision 815-A had retrospective application to years of income commencing on or after 1 July 2004 but does not apply to a year of income to which subdivisions 815-B or 815-C apply.

Subdivision 815-B applies to cross-border dealings between separate legal entities that are not undertaken on an arm’s length basis while subdivision 815-C applies to cross-border dealings within a single legal entity (e.g. between an Australian PE of a non-resident entity and its overseas head office, between a foreign PE of an Australian resident entity and the Australian head office). Subdivision 815-D makes subdivisions 815-B and 815-C applicable to trusts and partnerships. This report focuses on subdivision 815-B.

Australia’s TP rules are generic (as distinct from having specific rules for particular types of transaction) and pay close regard to the language used in article 9(1) of the OECD’s model DTC and in the associated enterprises articles in Australia’s tax treaties.

Broadly, subdivision 815-B applies to cross-border dealings between separate legal entities and negates TP benefits where:

- the conditions operating between an entity and another entity in connection with their commercial or financial relations (the actual conditions) differ from the arm’s length conditions;
- the actual conditions satisfy the cross-border test for the entity; and

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**Notes:**

11 See note 4 above.
15 Ibid., s. 815-1(2).
16 It does not matter whether such dealings are between related parties or independent parties.
17 ITAA1997 s. 815-120(1).
had the arm’s length conditions operated instead of the actual conditions, the entity would have obtained a TP benefit (i.e. a tax advantage in Australia).18

Where the actual conditions differ from the arm’s length conditions and a taxpayer has obtained a TP benefit, the arm’s length conditions replace the actual conditions for the following purposes (as relevant): working out the amount of the entity’s taxable income, loss and tax offsets for an income year and the amount of withholding tax payable by the entity in respect of interest or royalties.19

In some situations, the actual conditions may differ from the arm’s length conditions; however, unless a TP benefit arises as a result of such a difference, there will be no tax impact for the taxpayer.

Both the meaning and the process of identification of arm’s length conditions underpin Australia’s TP rules and have been set out in some detail.

Arm’s length conditions are defined as the conditions that might be expected to operate between independent entities dealing wholly independently with one another in comparable circumstances.20 Identifying the arm’s length conditions entails:

- using the most appropriate and reliable method(s) having regard to all relevant factors;21
- identifying comparable circumstances having regard to all relevant factors (broadly, the five factors of comparability described in the 2010 OECD TP guidelines);22 and
- assessing whether the actual commercial or financial relations should be respected or disregarded for purposes of identifying the arm’s length conditions.23

Identification of the arm’s length conditions must also:24
- be based on the commercial or financial relations in connection with which the actual conditions operate; and
- have regard to both the form and substance of those relations.

This is known as the “basic rule” and constrains the way in which the arm’s length conditions are determined.

There are, however, three exceptions to the basic rule (colloquially and collectively referred to as the reconstruction provisions). Where an exception applies, specific rules provide the alternative basis upon which the arm’s length conditions are to be determined:

- the form of the actual commercial or financial relations is disregarded to the extent that it is inconsistent with the substance of those relations;25
- where independent entities would not have entered into the actual commercial or financial relations but would have entered into other commercial or

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18 Also applies to an amount of withholding tax payable in respect of interest or royalties.
19 ITAA1997, s. 815-115.
20 ITAA1997, s. 815-125(1).
21 ITAA1997, s. 815-125(2).
22 ITAA1997, s. 815-125(3) and (4).
23 ITAA1997, s. 815-130.
24 ITAA1997, s. 815-130(1)
25 ITAA1997, s. 815-130(2).
financial relations, the arm’s length conditions must be based on those other commercial or financial relations;\(^{26}\) and

- where independent entities would not have entered into any commercial or financial relations the arm’s length conditions are to be based on that absence of commercial or financial relations.\(^{27}\)

Significantly, arm’s length conditions under Australia’s TP rules are also required to be identified so as best to achieve consistency with \textit{inter alia} the 2010 OECD TP guidelines.\(^{28}\) That is, guidance in the 2010 OECD TP guidelines for identifying arm’s length conditions is to be followed unless its application leads to outcomes inconsistent with identification of the arm’s length conditions as required by subdivision 815-B (in particular, sections 815-125 and 815-130 ITAA1997).

While Australia’s TP rules are intended to align with the 2010 OECD TP guidelines, there are some deviations, the most significant of which is in relation to disregarding transactions. Paragraph 1(65) of the 2010 OECD TP guidelines sets out two circumstances in which it may, exceptionally, be appropriate and legitimate for a tax administration to consider disregarding the structure adopted by a taxpayer in entering into a controlled transaction. However, the reconstruction provisions in section 815-130 ITAA1997 are not limited to exceptional cases but must be considered in all cases to determine if they apply.\(^{29}\)

Other provisions set out how Australia’s TP rules interact with the thin capitalization rules in division 820 ITAA1997;\(^{30}\) how taxpayers might obtain consequential adjustments;\(^{31}\) and the length of time in which the Commissioner can amend an assessment to apply the TP rules (seven years from the date on which an assessment has been issued).\(^{32}\)

2. The impact of the BEPS project on TP

2.1. Introduction

TP outcomes of the BEPS project have been generally accepted as positive and embraced by the Australian government and Australia’s tax authority, the ATO. Reporting in the form of country-by-country reporting, consistent with OECD recommendations in Action 13 of the October 2015 OECD final BEPS report was implemented in December 2015 and, on 3 May 2016, the government announced its intention to amend Australia’s TP rules to give effect to the TP recommendations in Actions 8–10 of the October 2015 OECD final BEPS report.

\(^{26}\) ITAA1997, s. 815-130(3).
\(^{27}\) ITAA1997, s. 815-130(4).
\(^{28}\) ITAA1997, s. 815-135.
\(^{29}\) The ATO considers this view to be a correct interpretation (TR 2014/6 [30]).
\(^{30}\) ITAA1997, s. 815-140.
\(^{31}\) ITAA1997, s. 815-145.
\(^{32}\) ITAA1997, s. 815-150. This can be contrasted with the unlimited time period that existed under division 13 and subdivision 815-A.
The amendments were announced to apply from 1 July 2016. This followed the February 2016 release by the Australian Treasury of a consultation paper entitled Income Tax: Cross-border profit allocation – review of transfer pricing rules, specifically seeking feedback on the impact of incorporating the TP recommendations in Actions 8–10 of the October 2015 OECD final BEPS report into Australia’s TP rules.

Changes to Australia’s TP documentation requirements and the proposed changes to give effect to the TP recommendations in Actions 8–10 of the October 2015 OECD final BEPS report are part of a broader suite of international tax measures already introduced or announced by Australia. For example, in parallel with changes to Australia’s TP rules has come the introduction of new disclosure rules requiring greater transparency with respect to taxes paid by MNEs in Australia. The ATO is now required to publish annually the Australian business number, total income, taxable income, tax payable, and amounts of petroleum resource rent tax and mineral resource rent tax payable by public and foreign owned entities reporting total income of A$100 million or more. These changes are discussed in more detail in section 2.7.

In addition, there has been a doubling of penalties associated with TP adjustments for significant global entities in the absence of having a position that is reasonably arguable. Furthermore, on 3 May 2016 the government announced a proposed one hundred fold increase in penalties for significant global entities which fail to comply with country-by-country reporting obligations.

However, the most significant moves by Australia in addressing BEPS are the unilateral adoption of the MAAL with effect from 1 January 2016 and the government’s May 2016 announcement to introduce a DPT based on the second limb of the UK’s DPT. These moves are discussed in more detail in section 2.6.

2.2. Challenges of transactions with intangibles

2.2.1. Definition of intangibles

As previously mentioned, Australia’s TP rules have been drafted generically and like article 9(1) of the OECD model DTC are based on a comparison between the conditions operating between an entity and another entity in connection with their commercial or financial relations (the actual conditions) and the conditions that might be expected to operate in comparable dealings between independent parties (arm’s length conditions). Given such broad drafting, the perceived need to include a definition of intangibles in Australia’s TP rules was undoubtedly need not be necessary.

While arm’s length conditions for purposes of Australia’s TP rules are to be identified so as best to achieve consistency with inter alia the 2010 OECD TP guidelines, section 815-135, it would, in the reporters’ view, be outside the scope of the language of section 815-135 to suggest that the 2010 OECD TP guidelines determine – for the purposes of Australia’s TP rules – what is and what is not an intangible.

33 See note 2 above.
34 See note 9 above.
35 See note 10 above.
Nevertheless, the ATO has historically taken a broad view as to what is an intangible for the purposes of Australia’s TP rules, and in doing so has been guided by the OECD’s TP guidelines. For example, the ATO has adopted the broad categories of trade intangibles and marketing intangibles referred to in the 1995 and 2010 OECD TP guidelines but has also considered that human capital or competencies or human resources should be regarded as an intangible asset for the purposes of Australia’s previous TP rules in division 13.36 This has been noted in a previous Australian branch report.37

In this respect, the historical ATO position may go beyond the position reflected in chapter VI of the 2010 OECD TP guidelines. However, the ATO approach with respect to human capital or resources, notwithstanding the view that they represent an intangible asset, has also been to determine how such an asset should be taken into account in the TP analysis.38 That is, human capital or resources could be regarded as a comparability issue and not as something that requires separate compensation. As such, the historical ATO approach appears closer to the position reflected in the amended 2010 OECD TP guidelines.39

The addition of chapter IX (business restructurings) of the 2010 OECD TP guidelines has also led to an increased focus on contractual rights as intangibles on the part of the OECD and also by the ATO40 and therefore to an expanding range of things which fall to be considered as intangibles.

2.2.2. Transactions with intangibles

Given the broad drafting of Australia’s TP rules, the perceived need to include specific rules with respect to the recognition of transactions involving intangibles was undoubtedly considered unnecessary. Australia’s TP rules do not determine the income tax consequences of transactions involving intangibles. Rather, the income tax consequences that flow from transactions involving intangibles will ordinarily be determined by reference to general income tax law provisions, after the TP rules are applied.41 For example, Australia’s capital gains tax, capital allowance, R&D, and withholding tax rules, among others could apply to transactions involving intangibles. As such, while the application of the TP rules could change the price or the structure of arrangements involving intangibles where a TP benefit arises, the income tax consequences that follow will be determined by reference to general income tax law provisions. Additionally, there will often be overlap between Australia’s TP rules and general or specific income tax provisions.

The ATO has issued limited guidance in relation to how Australia’s TP rules apply to transactions involving intangibles. Despite this limited guidance, the ATO has, through tax rulings and other means of communication, suggested that taxpayers should have regard to the potential or actual existence of intangibles in their TP analyses.

36 TR 98/11, [5.39], [5.43].
37 Transfer pricing and intangibles, Lyndon James, Australian branch report, IFA, Cahiers de droit fiscal international, vol. 92a, 2007, section 2.
38 TR 98/11, [5.44].
39 Chapter I, s. D.7 (Assembled workforce).
40 TR 2011/1, [118(2)].
41 ITAA1997, s. 815-110.
The ATO did, however, issue a booklet in 2005 titled *Marketing Intangibles* which contains examples showing how the ATO will determine an appropriate reward for marketing activities performed by an enterprise using trademarks or trade names it does not own. The six examples in this booklet have now been substantially reproduced as examples 8 to 13 of the annex to chapter VI of the amended 2010 OECD TP guidelines.

The increased focus on contractual rights as intangibles resulting from the addition of chapter IX of the 2010 OECD TP guidelines has also resulted in an expanding range of transactions involving intangibles including transactions involving the termination of such rights.

2.2.3. “Substance-over-form” approach towards intangibles

2.2.3.1. Introduction

In the absence of a specific legislative direction, Australian courts have generally rejected a doctrine of economic equivalence. That is, they have not been willing to recharacterize the legal rights produced by a transaction as being in substance another set of legal rights with equivalent economic effects. Even in the context of Australia’s previous TP rules in division 13 (but not in relation to subdivision 815-A), the Federal Court recently rejected the Commissioner’s submission that sections 136AD and 136AA ITAA1936 ask what form an agreement might have taken if it had been negotiated by entities dealing with each other at arm’s length.

However, Australia’s new TP rules provide a statutory warrant for not only having regard to the form and substance of the commercial or financial arrangements but also requiring that the form of the actual commercial or financial relations be disregarded to the extent, if any, that it is inconsistent with the substance of those relations.

Three technical issues arise with respect to the use of the words “form” and “substance” in the context of the commercial or financial relations as they appear in paragraph 815-130(1)(b) and sections 815-130(2):

- What is the meaning of the words “form” and “substance”?
- What is an inconsistency between “form” and “substance”?
- What is the effect of disregarding some or all of the “form” of the commercial or financial relations?

42 TR 2011/1, [117–122].
43 Ibid. [134–136].
46 *Chevron Australia Holdings Pty Ltd v. Commissioner of Taxation (No. 4)* [2015] FCA 1092, at [499].
47 ITAA1997, s. 815-130(1)(b).
48 ITAA1997, s. 815-130(2).
2.2.3.2. The meaning of “form” and “substance” in section 815-130

There is no guidance provided in section 815-130 with respect to the meaning of the words “form” and “substance”. In particular, this raises the following questions: does “form” mean “legal form” or something more akin to “legal substance” or something else? Does “substance” mean “legal substance” or “economic substance” or “economic equivalence” or something else?50

Limited guidance is provided in the EM with respect to addressing the above questions. For example, the EM notes that:

“The ‘form’ of commercial or financial relations describes the prima facie features or legal characteristics of the dealings between entities. In contrast, the ‘substance’ of the commercial or financial relations describes the economic reality or essence of those dealings. The substance of commercial or financial relations is determined by examining all relevant facts and circumstances, including the economic and commercial context of any arrangements entered into, its object and effect from a practical and business point of view, the conduct of the entities and the functions performed, assets used and risks assumed by them.”51

In TR 2014/6, the ATO repeats the views expressed in the EM; however, it goes further and states that, in its view, “substance” means more than “legal substance”.52 However, some of the analysis of “substance” in TR 2014/6 seems to confuse “economic substance” with “legal substance”.53 TR 2014/6 also provides some practical guidance with respect to how the form of the commercial or financial relations should be determined where these relations have been documented and where they have not been documented (or not fully documented).54

The ATO also draws attention to a number of features or characteristics that, in its view, could be considered in determining the “substance” of the commercial or financial relations for the purposes of section 815-130. A number of the features or characteristics referred to, however, do not seem to relate so much to the question of the extent to which the “form” of the commercial or financial relations is consistent with the “substance” of those relations but rather seem more directed at what independent parties acting independently would do in comparable circumstances. In the reporters’ view, such matters fall within the domain of section 815-130(3) and (4) rather than subsection 815-130(2).55

While it is worth considering other provisions in the tax acts that use the words “form” and “substance”, in particular Part IVA ITAA1997, it is also necessary to bear in mind contextual differences as noted by Fullerton.56

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51 EM [3.84]. The reference in para. 3.84 of the EM to substance largely reproduces para. 143 of TR 2011/1 (which is in the context of the associated enterprises article of Australia’s tax treaties) which itself largely reproduces para. 9(170) of the 2010 OECD TP guidelines.
52 TR 2014/6, [45].
53 Ibid. [94–95].
54 Ibid. [37–38].
55 Ibid. [109].
56 See note 49 above, pp. 17–18.
2.2.3.3. What is an inconsistency between “form” and “substance” for the purposes of subsection 815-130(2)?

A question equally as significant as the meaning of “form” and “substance” in section 815-130 is what is an inconsistency between the “form” and “substance” for purposes of subsection 815-130(2)?

Where the arrangements between the parties have been reduced to a written agreement, the answer is likely to turn on how broadly or narrowly the words “form” and “substance” are delineated for the purposes of enabling the comparison to be made. By contrast, where the arrangements between the parties have not been reduced to a written agreement, determining the terms of the arrangement between the parties is reasonably likely to encompass both the “form” and the “substance” of the arrangement with the result that there may be little scope for inconsistency in such cases.

In the more usual situation where the arrangements between the parties have been reduced to a written agreement, the significance of how broadly or narrowly the words “form” and “substance” are interpreted is best illustrated by an example. Fullerton gives the example of a financial arrangement known as a sale and repurchase transaction (or repo) and posits the question in the following way: is the form of an arrangement (such as a sale and repurchase transaction or repo) inconsistent with the substance of the arrangement merely because it achieves the same economic effect as another form of arrangement (such as a loan) which is more commonly used to achieve the same economic effect?57

If a broad view is taken as to the substance of the arrangement (e.g. as a funding arrangement), then other arrangements which have a form consistent with that of a funding arrangement (e.g. a loan, redeemable preference shares, a repo,58 a sale and lease back arrangement)59 and which have the same economic effect should be considered consistent with the substance of the arrangement and subsection 815-130(2) would not apply. It should, however, be noted that while the form and substance of the commercial or financial relations may be consistent so that subsection 815-130(2) does not apply, it is still necessary for regard to be given to the potential application of subsections 815-130(3) and 815-130(4).

By contrast, if a narrow view is taken as to the substance of the arrangement (e.g. as a loan), then other arrangements which have a form consistent with that of a funding arrangement but which do not have the form of a loan are likely to be considered inconsistent with the substance of the arrangement and subsection 815-130(2) would apply notwithstanding that these other arrangements may have the same economic effect (i.e. as a funding arrangement).

As noted by Fullerton, it is not clear what the Commissioner’s position is in relation to this question.60 The absence of clarity in relation to how this question should be answered is likely to constitute a source of disputation between taxpayers and the Commissioner.

57 See note 49 above [16].
60 See note 49 above [16].
2.2.3.4. What is the effect of disregarding some or all of the “form” of the commercial or financial relations?

The third question raised is what is the effect of disregarding some or all of the “form” of the commercial or financial relations?

The role played by paragraph 815-130(1)(b) is a necessary step in the process of identifying the arm’s length conditions for purposes of paragraph 815-130(1)(a). That is, in identifying the arm’s length conditions regard must be given to the form and substance of the commercial or financial relations. As such, one of two situations will arise: either the form of the actual commercial or financial relations in connection with which the actual conditions operate is consistent with the substance of those relations or it is not.

Where form is consistent with substance, the arm’s length conditions are determined based on the commercial or financial relations in connection with which the actual conditions operate as required by paragraph 815-130(1)(a). Where form is not consistent with substance, subsection 815-130(2) applies so that for the purposes of paragraph 815-130(1)(a), the form of the actual commercial or financial relations is disregarded to the extent, if any, that it is inconsistent with the substance of those relations.

It is important to note that subsection 815-130(2) does nothing other than disregard the form of the actual commercial or financial relations to the extent, if any, that it is inconsistent with the substance of those relations. In this respect, it is akin to an annihilation provision (cf. the now repealed section 260 ITAA1936) but with a narrower focus. For example, subsection 815-130(2) does not recharacterize or impute terms and conditions into the dealings between the parties that did not exist,61 that role is played by subsection 815-130(3).62 This view is not, however, shared by the ATO.63

2.2.4. Comparability and group synergies

As mentioned in the introduction, under Australia’s TP rules, arm’s length conditions are required to be identified so as to achieve consistency with inter alia the 2010 OECD TP guidelines.64 As such, the guidance in the 2010 OECD TP guidelines relating to synergies is relevant for the purposes of identifying arm’s length conditions under Australia’s TP rules.65

The matter of group synergies recently arose for consideration under Australia’s previous TP rules in the case of Chevron Australia Holdings Pty Ltd v. Commissioner of Taxation (No.4) 2015 FCA 1092 (Chevron). The context in which the matter arose was in relation to the Commissioner’s submission that the Australian subsidiary borrower’s credit rating should be determined on the basis that it was a

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61 In this respect, subs. 815-130(2) is similar to s. 260 ITAA1936: see note 50 above [774].
62 Raised by one of the reporters with the ATO at the November 2014 meeting (item 5.2 of minutes of meeting) and subsequent meetings of the ATO’s division 815 Technical Working Group. See also note 49 above at pp. 17–18.
63 TR 2014/6, [46] and [135].
64 ITAA1997, s. 815-135.
member of the Chevron group (which had an AA credit rating at the time the loan was entered into) rather than have its credit rating determined as if it were a stand-alone company (which was claimed to be BB). This was notwithstanding the absence of any formal support being provided to the Australian subsidiary by other group members. The Federal Court held that implicit support was a relevant factor to have regard to, but nevertheless found on the evidence before it that the implicit support in the instant case had very little, if any, impact.\textsuperscript{66}

The ATO has not issued detailed guidance in relation to how it intends to administer group synergies under Australia’s TP rules. Nevertheless, as noted in section 2.4.1, the ATO released a discussion paper on 10 August 2016 on its compliance approach to TP issues related to centralized operating models, involving procurement, marketing, sales and distribution functions.\textsuperscript{67} The draft discussion paper notes that questions may arise as to how the synergistic benefits to the MNE group from the “group buying” activities of a procurement hub should be accounted for\textsuperscript{68} and foreshadows that the ATO intends to issue guidance on its compliance approach with respect to procurement hubs.\textsuperscript{69}

\textbf{2.2.5. Hard-to-value intangibles}

As previously mentioned, Australia’s TP rules have been drafted generically and do not distinguish between different types of transactions. Nor do they contain any additional measures to deal with complex dealings between related parties such as the global trading of financial instruments, insurance, or intangibles including hard-to-value intangibles.

While no particular methods are prescribed for purposes of identifying arm’s length conditions under Australia’s TP rules, and therefore valuation methods in addition to the five OECD recognized methods could be used, the method selected must still be the most appropriate and reliable\textsuperscript{70} have regard to all relevant factors for the purposes of identifying comparable circumstances,\textsuperscript{71} and be as consistent as possible with the 2010 OECD TP guidelines.\textsuperscript{72}

With respect to hard-to-value intangibles, when valuation at the time of the transaction is highly uncertain, arm’s length pricing should be determined consistently with the following:

“The question [of arm’s length pricing] should be resolved, both by taxpayers and tax administrations, by reference to what independent enterprises would have done in comparable circumstances to take account of the valuation uncertainty in the pricing of the transaction.”\textsuperscript{73}

\textsuperscript{66} Chevron [518], [601]–[607].
\textsuperscript{68} Ibid. note 2.
\textsuperscript{69} Ibid. [26].
\textsuperscript{70} ITAA1997, s. 815-125(2).
\textsuperscript{71} ITAA1997, s. 815-125(3).
\textsuperscript{72} ITAA1997, s. 815-135.
\textsuperscript{73} 2010 OECD TP guidelines [6.28]. Para. 6.181 of Actions 8–10 of the October 2015 OECD final BEPS report uses exactly the same words.
The ATO has not issued any guidance in relation to the valuation of intangibles for the purposes of either Australia’s new or previous TP rules. Instead, the ATO has tended to defer to the general guidance in paragraphs 6(13) to 6(35) of the 2010 OECD TP guidelines.74 It does, however, consider that the most appropriate methodology should be used and the comparable uncontrolled price (CUP) method is preferred where data are available. In the ATO’s view, where the CUP method cannot be reliably applied, other indirect methods may be used including the profit split method and traditional valuation approaches such as an income approach based on the earnings or cash flow generated by the intangible or a cost-based approach using the costs incurred in developing the intangible.75

The ATO has, however, issued guidance in relation to the valuation of intangibles in a 2008 publication titled Market valuation for tax purposes. While the ATO’s publication notes that market value is not always the same as the arm’s length price for purposes of Australia’s previous TP rules,76 it remains current in an updated form and provides useful insights into the ATO’s views for determining the market value of intangibles.77

At the time of writing, Australia has not adopted measures to improve the valuation of hard-to-value intangibles following the release of the Actions 8–10 of the October 2015 OECD final BEPS report. Nevertheless, as mentioned above, the government has announced its intention to amend Australia’s new TP rules to give effect to the TP recommendations in Actions 8–10 of the October 2015 OECD final BEPS report.

2.2.6. Cost contribution agreements (CCAs)

Given the broad drafting of Australia’s TP rules, the perceived need to include specific rules with respect to CCAs was undoubtedly considered unnecessary.

In 2004, the ATO issued taxation ruling TR 2004/1 addressing CCAs in the context of division 13 and the associated enterprises articles of Australia’s tax treaties.78 TR 2004/1 accepted and built upon the views in chapter VIII of the 1995 OECD TP guidelines in addressing how the ATO considered that guidance applied in the context of Australia’s TP rules.

Two matters stand out in relation to the ATO’s approach in TR 2004/1 and the guidance set out in the 2010 OECD TP guidelines: CCAs which are pure service arrangements; and the treatment of share-based remuneration (e.g. under employee share option plans).

In the ATO’s view, a pure service arrangement CCA is a CCA where any benefit to participants is immediate or short term, being ordinarily realized in the period in which the service activities are performed and that does not result in any property being produced or developed. The commercial rationale for the CCA is...
primarily to share, and thus save, costs.\textsuperscript{79} The example given is centralized management and administrative services undertaken by one group member for the benefit of it and others. In such cases, the ATO states that its ruling on intra-group services, TR 1999/1, would apply such that an arm’s length charge for the services provided to CCA participants will normally include a mark-up on the costs of performing the services.\textsuperscript{80}

In relation to the treatment of share-based remuneration in the context of CCAs, the ATO considers that the value of stock options forming part of the remuneration of employees involved in the performance of the CCA activity should be taken into account in determining the amount of a participant’s contribution.\textsuperscript{81} The ATO’s position is notwithstanding that this issue is not specifically addressed in chapter VIII of the 2010 OECD TP guidelines. Further analysis of this issue by the OECD did not result in a consensus position being reached.\textsuperscript{82}

It remains to be seen how these matters will be addressed by the ATO given that arm’s length conditions under Australia’s TP rules are required to be identified so as best to achieve consistency with \textit{inter alia} the 2010 OECD TP guidelines.

\section*{2.3. Risk and capital}

Section 1 explained that legislation is being developed in Australia to ensure that the revisions to the 2010 OECD TP guidelines are considered for purposes of determining arm’s length conditions under Australia’s domestic TP legislation. Consistent with the objectives of the OECD TP guidelines, the Australian Treasury is of the view that TP analysis should look at the substance of transactions which is achieved by delineating between the entity which bears the risk of the transaction and the entity which derives the actual economic value of the transaction.\textsuperscript{83} The Treasury suggests that amendments to the 2010 OECD TP guidelines provide an approach which is consistent with how the ATO currently applies the Australian TP rules. That is, any TP analysis is based on an accurate delineation of what the associated enterprises actually contribute rather than contractual arrangements which may not reflect economic reality.\textsuperscript{84} The Treasury lists three specific areas where it believes that the adoption of the amendments will further assist the ATO by providing additional guidance on how the approach should work in practice guidance:

\begin{itemize}
  \item situations where contractual allocations of risk will be respected: that is only when the party assuming the risk has the ability to control the risk and the financial capacity to assume it and the allocation of the risk between the parties makes commercial sense;
  \item where an entity with capital but without additional functionality is involved in the transfer: In this case, the entity will generate no more than a risk-free
\end{itemize}

\textsuperscript{79} Ibid. [14].
\textsuperscript{80} Ibid. [94].
\textsuperscript{81} Ibid. [85].
\textsuperscript{82} The Taxation of Employee Stock Options, OECD Tax Policy Studies No. 11, 2005.
\textsuperscript{84} Ibid., p. 6.
return, assuring that no premium returns will be allocated to cash boxes without relevant substance; and

- situations where exceptional circumstances of commercial irrationality applies. In this case, the revenue authority may disregard the transaction.\textsuperscript{85} While the Treasury makes specific reference to “cash boxes”\textsuperscript{86} to date, Australia has not gone further in suggesting specific rules will be introduced for “cash boxes”. Further, the adoption of the amended OECD TP guidelines may pose issues in relation to the interaction between the guidelines and subdivision 815-B. Section 815-135 ITAA1997 requires the arm’s length conditions to be identified so as best to achieve consistency with the 2010 OECD TP guidelines. However, the guidelines do not override the general consideration of the “the conditions that might be expected to operate between independent entities dealing wholly independently with one another in comparable circumstances”. Should a taxpayer be able to provide evidence that independent cash box entities are remunerated at something above a risk-free rate of return, this will satisfy the statutory test and therefore, the amended OECD TP guidelines will not be able to be applied consistently. While it might be anticipated the ATO would argue that the remuneration to a cash box company should be limited to a risk-free rate of return (assuming the amended OECD TP guidelines are adopted), a determination of the arm’s length price would still need to be evidenced based.

2.4. High-risk transactions

2.4.1. CUP and quoted prices for cross-border commodity transactions

Australia is rich in natural resources and a major exporter of commodities including iron ore, coal, natural gas and gold. Iron ores and concentrates rank as Australia’s number one export.\textsuperscript{87} Minerals and energy resources are significant contributors to the Australian economy with the mining sector accounting for as much as 8 per cent of gross domestic product in recent years.\textsuperscript{88} Australia has had a long history of dealing with commodity transactions in a TP context, particularly in relation to deficiencies exposed in earlier provisions.\textsuperscript{89}

To date, Australia has not provided any specific guidance on the application of its TP regime to commodity transactions, instead relying on the general TP legislation and guidance. Generally, in Australia, and marketing hub cases aside (discussed below), the CUP method is considered an appropriate method to determine the arm’s length price for cross-border commodity transactions. However, throughout various sources of guidance offered by the ATO, commodity transactions are

\textsuperscript{85} Ibid. p. 6.

\textsuperscript{86} Actions 8–10 of the October 2015 OECD final BEPS report [1.103].


\textsuperscript{89} For example, Case N69/Case 53 [1962] 13 TBRD (NS) 270, 11 CTBR (NS); FC of T v. Commonwealth Aluminium Corporation Ltd (1980) 143 CLR 646.
utilized as examples. Specifically, in relation to a discussion on arm’s length methodologies and in the context of the CUP method, the ATO, in Taxation Ruling TR 97/20 states:

“While all comparability factors need to be taken into consideration, the most important are similarity of product, contract terms and economic/market conditions. For example, the prices of internationally traded mineral commodities often differ because of geographic differences in the markets, the terms of the contractual arrangements (such as volumes, discounts, interest free periods, and exchange rate exposure), the particular time period of the contracts, or differences in the physical/chemical features of the commodity and the relative bargaining power and strategies of buyers and sellers.”

It should be noted that TR 97/20 relates to Australia’s previous TP regime under division 13; however, there is unlikely to be any practical difference under the new TP rules.

Recently, of greater concern to Australia is the use of marketing hubs, particularly by large resource companies operating in Australia which have these hubs in low- or no-tax jurisdictions which are set up to sell mining sector products to countries such as China and Japan. The ATO has indicated that it is concerned that the economic substance of the arrangements is materially different from the associated legal form and the pricing for functions performed, assets used and risks assumed in a marketing hub do not reflect an arm’s length price. The ATO has indicated that TP for commodity sales to marketing hubs is an ongoing issue of concern with numerous audits currently being conducted by the ATO. On 10 August 2016, the ATO released a draft discussion paper on its compliance approach to TP issues related to centralized operating models or “hubs” with a final report expected in the future.

Given arm’s length conditions under Australia’s domestic TP rules are determined by reference to the 2010 OECD TP guidelines insofar as the guidelines can be applied consistently, adoption of the revisions to Chapter II of the 2010 OECD TP guidelines will mean they are also used for this purpose. This will merely clarify Australia’s current position with the expectation that the CUP method is generally the appropriate TP method for commodity transactions between associated entities. The new OECD guidance relating to deeming the pricing date for commodity transactions when the taxpayer does not provide reliable evidence of the agreed pricing date may not be consistent with Australia’s domestic TP rules. If the pricing date for commodity transactions is unknown, it seems likely that the reconstruction provision in subsection 815-130(3) would need to be applied to establish the date that independent enterprises might reasonably have agreed to.

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90 For example, TR 98/11, [5.60], [10.7] and [10.8].
91 TR 97/20, [3.14].
92 See note 68 above.
93 Ibid.
94 Actions 8–10 of the October 2015 OECD final BEPS report [2.16E].
2.4.2. Intra-group services

The current TP legislation does not make specific reference to intra-group services as a type of transaction. Consequently, for services between entities, a consideration is undertaken of functions performed, assets used and risks assumed based on the conditions expected to operate between independent entities.

The ATO has also issued a practice statement providing simplified record keeping options for eligible entities with international related party intra-group services. The current ATO approach to simplifying TP record keeping is outlined in a practice statement with three separate service-related simplified measures highlighted: intra-group services; management and administration services; and technical services.95

Historically, the ATO has accepted the traditional transaction-based TP methods as generally being the most appropriate for determining the arm’s length price for services. It has also accepted that the profit-based methods such as the profit-split or transactional net margin method (TNMM) may be the most appropriate where it is either not practical or not possible to use one of the traditional methods. The broad drafting of the current TP provisions means that there is no longer a need for a phrase like “where it is not possible or practicable” to be included. However, from a practical perspective, little is likely to change in terms of the approach adopted.

Taxation Ruling TR 1999/1 specifically deals with international TP for intra-group transactions. However, an addendum to the ruling makes it clear that it only concerns the operation of division 13 which continues to apply to income years that commence before 29 June 2013.96 It is unlikely that an updated ruling will be issued given there is little need to do so with Australia’s approach to determining arm’s length conditions with respect to services being determined so as best to achieve consistency with the OECD TP guidelines.

Given Australia’s indication to adopt the amended 2010 TP guidelines, the revisions incorporated into chapter VII of the 2010 OECD TP guidelines are likely to be followed by Australia. This leads to a question of whether Australia will allow taxpayers to consider whether their services fall within the common intra-group low value-adding services, and, if so elect to adopt the simplified approach which applies a consistent allocation key for all recipients of those services and provides greater transparency through the specific reporting requirements. The Australian Treasury is of the view that the adoption of the elective, simplified approach is “likely to free up resources for tax administrators in identifying and examining cross border dealings with significant TP and BEPS risks”.97 However, currently Australia’s legislative provisions do not contain an election option in either section 815-125 or section 815-130 ITAA1997. As such, it is unclear how taxpayers could elect to adopt the simplified approach in the amended OECD TP guidelines without specific legislative provision to do so.

96 TR1999/1A1 (International transfer pricing for intra-group services), 19 August 2015.
97 See note 84 above, p. 8.
2.4.3. Profit splits in the context of value chains

As previously stated, Australia’s current TP rules do not prescribe specific TP methodologies. Instead, legislation provides that in identifying the arm’s length conditions, the method or the combination of methods to be used is the most appropriate and reliable, having regard to all relevant factors, including the respective strengths and weaknesses of the possible methods in their application, the circumstances including functions performed, assets used and risks borne, the availability of reliable information and the degree of comparability between the actual circumstances and the comparable circumstances.98

The transactional profit methods, including the profit split methods and TNMMs, have been recognized in Australia as being internationally accepted methodologies for many years.99 The ATO recognizes the need for profit methods on the basis that some global industries are based on highly sophisticated technology, involve valuable production, distribution or marketing intangibles and are generally vertically and horizontally integrated. The use of profit split methods is accepted in Australia where it is not possible or practicable to use the traditional methods, such as situations where there are insufficient reliable data to analyse comparability, the product or service in question is unique or contains out-of-the-ordinary intangibles, the complexity of the taxpayer’s business means the traditional methods are not practicable, a combination of the variety of the transactions means there are no comparables or the net margins are more tolerant to some functional differences between the controlled and uncontrolled transactions than gross profit margins.100

To date, the ATO in practice has tended to favour the use of the TNMM rather than the profit split method. This is evidenced by the methodology applied in SNF and Roche Products Pty Limited v. Commissioner of Taxation [2008] AATA 639. Given the announcement by the Australian government to adopt the 2015 OECD report in relation to Actions 8–10, it would be expected that Australia will also consider adopting any proposals which come out of the current work the OECD is undertaking on profit split methods in 2016 and 2017.

2.5. TP documentation

Concurrently with the introduction of the new TP rules, new TP record-keeping rules were introduced in subdivision 284-E of Schedule 1 to the Taxation Administration Act 1953 (TAA1953). Taxpayers are not required to keep documentation conforming with subdivision 284-E TAA1953 (subdivision 284-E); however, increased penalties can be imposed where such records are either not kept or the records kept do not satisfy the requirements of subdivision 284-E. Where taxpayers have not kept records that satisfy the requirements of subdivision 284-E, they are deemed not to have a reasonably arguable position for purposes of the penalty provisions in division 284 TAA1953.101 Subdivision 284-E aside, as

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98 ITAA1997, s. 815-125(2).
99 TR 94/14, [99] and [366].
100 TR 97/20, [3.52]. Note however that TR 97/20 specifically relates to division 13 which has now been repealed and to the associated enterprises article of Australia’s tax treaties [1].
101 TAA1953, s. 284-250.
Australia’s new TP rules apply on a self-assessment basis, taxpayers are nevertheless required to keep records that explain how they have self-assessed compliance with the TP rules in subdivisions 815-B and 815-C. Penalties can be imposed where such records have not been kept.

In addition, section 262A ITAA1936 provides the legally required general record-keeping requirements for taxpayers carrying on a business. Taxation Ruling TR 2014/8 sets out the Commissioner’s views on the TP documentation entities should prepare in order to comply with subdivision 284-E. In addition to these domestic requirements, country-by-country reporting has been implemented, which is discussed below.

### 2.5.1. Country-by-country reporting

On 16 September 2015, the Australian Federal Treasurer introduced a Bill into Parliament to implement the MAAL to apply to certain foreign MNEs (discussed further in section 2.6 below), country-by-country reporting to the ATO, and increased TP penalties for certain large companies. The Taxation Laws Amendment (Combating Multinational Tax Avoidance) Act 2015 was passed by both houses of Parliament on 3 December 2015 with country-by-country reporting applying to affected taxpayers for years of income commencing on or after 1 January 2016. As such, changes to Australia’s TP documentation requirements are part of a broader suite of international tax measures introduced by Australia.

The changes introduce a standardized concept of a “significant global entity”, which is used, among other provisions, for the purposes of country-by-country reporting. A significant global entity, as defined by section 960-555 ITAA1997, is one which has an annual global income of A$1 billion or more or is a member of a group of entities that are consolidated for accounting purposes as a single group and the global parent of that group has annual global income for the period of A$1 billion or more.

Australia’s country-by-country reporting requirements are essentially an adoption of Action 13 of the OECD BEPS plan and follow the OECD’s suggested three-tiered approach. That is, a “master-file”, a “local file”, and a “country-by-country report”. Significant global entities that are Australian residents or foreign residents with an Australian PE will be required to provide all three statements to the Commissioner of Taxation to enable the Commissioner to carry out a TP risk assessment. New provisions have been inserted into the ITAA1997 as subdivision 815-E to give effect to country-by-country reporting requirements. The country-by-country report will be required in the XML schema released by the OECD. Under section 815-365 ITAA1997, the Commissioner may provide an exemption to an entity from some or all of its country-by-country reporting requirements. The ATO has issued guidance on the process for applying for an exemption and the factors which will be taken into account in granting an exemption.

Australia signed the Convention on Mutual Administrative Assistance in Tax Matters on 3 November 2011, with entry into force occurring on 1 December 2012.

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102 ITAA1936, s. 262A.
103 TAA1953, s. 288-25.
Australia is also a signatory to the Multilateral Competent Authority Agreement on Automatic Exchange of Country-by-Country Reports, signing as part of the group of countries to do so on 27 January 2016.

2.5.2. Master and local files

Australia has adopted Annex I of the OECD guidance on Action 13 as the master file. However, the design of the local file requirements varies from the OECD guidelines. The rationale behind this variation is to minimize duplication. In particular, entities will still need to comply with existing documentation requirements which already contain information required under the OECD’s local file design. As such, the local file is not a traditional TP report. Rather, it will require certain specific TP and business information in a standardized format.

The local file reporting requirements have two tiers; a short form local file and a local file. Entities are only required to provide a short form local file if they meet one of three criteria: the aggregate value of their international related party dealings is less than A$2 million; they meet simplified TP record keeping criteria because their turnover is less than A$25 million or they meet simplified TP record keeping criteria because their total international related party dealings represent no more than 2.5 per cent of total turnover. In addition, the entity must not have any international related party dealings on the short form exceptions list. The short form exceptions list includes transactions which involve any derivative, any legal or equitable assignment of intellectual property, any licence or other grant of use or right to use intellectual property, or any international related party dealings of a capital nature.

A short form local file will require:

- a description and copy of the organizational structure of the reporting entity, including a description of the individuals to whom local management reports and the countries in which such individuals maintain their principal offices;
- a description of the reporting entity’s business and strategy;
- a description of any business restructures affecting the reporting entity in the current or previous income year, and an explanation of their significance;
- a description of any transfers of intangibles in the current or previous income year, and an explanation of their significance;
- a list of key competitors of the reporting entity.

A local file will require all of the information in the short form local file plus Part A and Part B.

Part A requires details of all controlled transactions for the income year, including the name of the counterparty and its country of tax residency, the category of the transaction, amounts of consideration or expenditure, and the TP methodology relied on.

Part B requires, for each transaction not covered in the exclusions list (material controlled transactions), the TP method relied on, an indication of whether there is a written agreement and, if so, whether it has previously been provided to the ATO, a copy of the agreement and any foreign APAs or rulings. Part B is not required for agreements covered by the simplified TP record-keeping option where those agreements deal with intra-group services, management and administrative
services, technical services and low-level loans (simplified TP record keeping for services is discussed in section 2.4.2).

2.5.3. Compliance costs

It is estimated that approximately 1,300–1,500 MNE groups operating in Australia will be affected by the new country-by-country reporting requirements. The thresholds for submitting a short form local file only are low. It is thus unlikely that, in practice, many entities will be able to take advantage of the short form. Further, there will be duplication between the information in the local file and the information in the international dealings schedule (IDS) which forms part of an entity’s annual tax return where the aggregate amount of international related party dealings is more than A$2 million. To avoid duplication, an entity may choose to lodge Part A of their local file at the same time as their income tax return. If an entity elects to do this, the details required in the IDS are reduced. Further, if an entity has already provided relevant agreements to the ATO, it will not need to do so again.

Country-by-country reporting does not replace the TP recordkeeping rules in subdivision 284-E or section 262A ITAA1936. As such, affected entities will need to complete a country-by-country report, a master file, a local file and a contemporaneous TP report for the purposes of compliance. Where the contemporaneous TP report is prepared for purposes of subdivision 284-E, it is required to be prepared prior to the filing of the annual tax return and, in the case of an audit and subsequent TP adjustment, it is necessary to ensure that a taxpayer can establish a reasonably arguable position and mitigate potential penalties. However, the contemporaneous TP report does not need to be filed with the ATO at the same time as lodgement of the income tax return. It is enough if the report is prepared and readily available.

The further requirement of the three reports packaged as country-by-country reporting is a significant shift in the obligations on taxpayers. In addition to the extra compliance costs, penalties for non-compliance will also be significant. Entities which fail to comply with country-by-country reporting obligations will face administrative penalties, which are currently A$4,500 but proposed to increase to A$450,000 for significant global entities. Failure to comply is also likely to lead to future increased scrutiny by the ATO with indications that non-compliant taxpayers will be viewed adversely in risk assessment and audit scenarios. At the time of introduction, concern was raised by tax practitioners about the reporting requirements being potentially cost intensive for taxpayers. This concern centred around whether other jurisdictions would move towards a similar system to reduce global compliance costs. To date, there is a global move towards country-by-country reporting thereby reducing the need for more than one set of reports.

2.6. TP-related measures in other BEPS actions and other measures against BEPS

The most significant move by Australia in addressing BEPS is the unilateral adoption of the MAAL. While not a specific TP measure, as it is targeted at arrangements to avoid the existence of a PE in Australia, the MAAL is clearly intertwined with the ATO investigations into TP. This is especially the case for taxpayers which fall within the scope of the MAAL and have a TP risk currently under review. The MAAL came into effect on 11 December 2015 and applies to certain schemes on or after 1 January 2016. Like Australia’s country-by-country reporting regime, the MAAL applies to significant global entities as defined. The MAAL is based on the first limb of the UK’s DPT.

The legislation amends Australia’s general anti-avoidance rules in Part IVA, ITAA1936. The purpose of the amendment is to counter the erosion of the Australian tax base by MNEs using artificial or contrived arrangements to avoid the attribution of profits to Australia through a taxable presence in Australia. The amendment addressed two perceived weaknesses in Australia’s general anti-avoidance regime: catching arrangements that are designed to obtain both Australian and foreign tax benefits; and, lowering the purpose test from “sole or dominant purpose” to “one of the principal purposes”, thereby making the provisions easier to apply.

The MAAL was originally targeted at 30 large MNEs but this number has increased and it is envisaged that up to 100 MNEs may need to review their arrangements to ensure compliance. Since the MAAL came into effect on 1 January 2016, however, the Commissioner has contacted 175 entities to assist with MAAL compliance and identify high-risk issues. The provisions target MNEs that avoid a taxable presence by undertaking significant work in Australia in direct connection with Australian sales but book their revenue offshore and have a principal purpose of avoiding tax in Australia or reducing their foreign tax liability. Where the provisions apply to the scheme in question, the Commissioner has the power to make a determination based on a reasonable alternative postulate, applying the tax rules as if the foreign entity had been making a supply through an Australian PE.

At the same time as the MAAL was introduced, amendments were made to the penalty regime in the TAA1953 to double the penalties imposed on significant global entities that enter into tax avoidance or profit shifting schemes. The federal government, in the 2016–17 Budget announced its intention to introduce a DPT based on the second limb of the UK’s DPT. A consultation

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108 Ibid.
109 Ibid.
110 Ibid.
111 ATO cautions on multinational profit shifting, ATO media release, 15 September 2016.
process is currently being undertaken; however, at the date of writing legislation has not been introduced into Parliament to implement a DPT.

2.7. Can BEPS work in favour of MNEs?

To date, there has been no specific initiative by Australia to use the BEPS platform to benefit MNEs. However, the information gathering initiatives of the BEPS project may arguably benefit MNEs operating in Australia in two ways. First, the obligations imposed on the entity to file the statements under section 815-355 ITAA1997 mean that information provided in the country-by-country report and master file may assist the local entity to comply with its domestic TP documentation requirements. Specifically, the move to mandatory reporting of the country-by-country report, master file and local file as compared to the current record keeping system under subdivision 284-E means that the local entity may be given access to information not previously provided.

Second, while all documents produced for the purposes of country-by-country reporting will remain confidential and will not be released by the ATO, there are new transparency initiatives which may assist MNEs to obtain limited information about their competitors. A recent unilateral initiative on the part of Australia, is the publication of a limited amount of tax information by the ATO of approximately 1500 large corporate taxpayers. The ATO is required to publish annually, from the 2013–14 income year, the Australian business number, total income, taxable income, tax payable, and amounts of petroleum resource rent tax and mineral resource rent tax payable. The entities which are listed are public and foreign owned entities reporting total income of A$100 million or more. Similar information is published about Australian owned and resident private companies with a turnover of more than A$200 million. This information has not previously been available.

3. What is the future of TP?

The recommendations in Actions 8–10 of the October 2015 OECD final BEPS report maintain the arm’s length principle as the most appropriate international standard to apply to TP. To this extent, they do little to reshape the TP rules; rather they merely modernize the already generally accepted and applied rules. Domestically, given the relatively new TP rules introduced in 2013, it could be argued that Australia is at the forefront globally in the adoption and implementation of the prevailing views on the operation of TP policies. By contrast, there have been few calls in Australia for the arm’s length principle to be replaced as the most appropriate international standard to apply to TP.

Also consistent with Australia’s recent approach to TP policy, it seems likely that the future of TP in Australia will remain closely aligned with the BEPS project out-

113 TAA1953, s. 3C.
comes. No doubt, however, the ATO, the judiciary, and potentially also Parliament will need to consider the inconsistencies which may arise between the domestic TP regime and the amended OECD TP guidelines, several of which have been raised in this branch report. Australia has also been proactive in relation to compliance and reporting requirements as evidenced by the implementation of country-by-country reporting. Given the sophistication of Australia’s tax administrative body, it is likely that the data collected will be increasingly acted on.
Summary and conclusions

The analysis in this report provides an overview of the Austrian transfer pricing (TP) legislation as well as its implementation, both in general and with specific reference to some relevant topics.

As described in section 1, Austria has well-defined TP rules. It is worth highlighting that the arm’s length principle applies not only to cross-border transactions but also to domestic ones.

Moreover, the Austrian Ministry of Finance (MoF) also provides extensive guidance on the interpretation and application of these provisions, as well as mechanisms to prevent and resolve TP disputes. In general, a “substance over form” approach is often followed by the Austrian tax administration. Additionally, full reliance on the OECD transfer pricing guidelines (TPG) is found in most cases.

This full reliance on the work of the OECD, to which Austria intensively contributes, together with an analysis of the Austrian TP practice with specific reference to the topics reviewed under the base erosion and profit shifting (BEPS) Actions 8–10, carried out in section 2, provides an indication that it is reasonable to expect a nearly full implementation of the newly developed OECD guidance by the tax administration.

In detail, as far as the guidance on topics related to intangibles is concerned, Austria already includes many concepts developed by the OECD and will most probably embrace the newly developed ones. Exceptions may, however, occur with reference, for example, to some topics related to cost contribution agreements (CCAs).

The guidance on “risk and capital”, as well as that on “high risk transactions”, based on the analysis below, will also be useful for both Austrian taxpayers and the tax administration, although some relevant questions will arise.

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The reporters would like to thank Martin Bonner, transfer pricing adviser with Deloitte Vienna, for his invaluable contribution to the drafting of this report.

1 See section 2.2 below.
2 See sections 2.3 and 2.4 below.
Moreover, the newly introduced legislation on TP documentation requirements will bring new challenges for Austrian taxpayers (as well as for the tax administration), as described in section 2.5. However, it remains to be hoped that these challenges, in the long run, will constitute an advantage for both actors, who will work in a more transparent environment. These advantages, nevertheless, will result only from the development of an environment characterized by cooperative compliance mechanisms, as well as investments in capacity and knowledge building.

Therefore, in the end, it may be assumed that the BEPS project will undoubtedly reshape the way TP rules operate in Austria. These changes will necessarily provide, on the one hand, room for clear practice, as well as, on the other hand, broader coverage and more potential for controversy.

These issues will urgently require the implementation of mechanisms which should enable the efficient and effective prevention and resolution of any dispute between taxpayers and the tax administration, as well as between the tax administrations of different countries. The implementation of better mechanisms of cooperative compliance, as well as procedures enabling a faster and more binding mutual agreement process, may therefore be suggested.

Finally, the tax authorities will be required to further invest in capacity and knowledge building, as well as in speedy mechanisms between states to avoid and/or eliminate double taxation within a reasonable time. It is also necessary to avoid one-sided interpretations of the arm’s length principle by states and to ensure a harmonized implementation of the OECD proposals between countries.

1. Current TP regulation and practice in Austria

In Austria, the internationally accepted principle of dealing at arm’s length, which governs the determination of the taxable income of associated enterprises as well as the profit allocation between permanent establishments (PEs), is incorporated in section 6 paragraph 6 of the ITA, according to which prices for cross-border services and the cross-border supply of goods between associated companies and head office and PEs must be at arm’s length. Thus, the allocation of the taxable profits between associated companies broadly follows the OECD principles as laid down in articles 7 and 9 OECD model convention. The scope of section 6 paragraph 6 ITA is defined broadly. It applies in case of a transfer of assets held in an Austrian trade or business/PE to a trade or business/PE abroad, where (a) the taxpayer owns the foreign trade or business or (b) the taxpayer holds an interest in a partnership or (c) the taxpayer and a foreign corporation are related by way of a shareholding of more than 25 per cent or (d) both trades or businesses are managed or under the control of the same persons or where the same persons are able to influence the management or control of both the domestic and foreign trade or business. Under such circumstances the transfer prices have to meet the arm’s length standard. The same principles apply for the transfer of a trade or business or a PE and consequently in all cases where the transfer takes place from abroad to

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3 See section 2.6 below.
4 Einkommensteuergesetz (also referred to as ITA).
Austria. Additionally, section 8 paragraphs 1 and 2 of the CITAT provide a legal basis for the determination of intercompany transfer prices and profit adjustments for corporations. The provision establishes that a hidden capital contribution should not increase a corporation’s income and that a hidden profit distribution should not reduce its income. Though the law itself does not provide for a definition of hidden profit distribution and capital contribution, it is generally accepted – based on settled jurisprudence – that the arm’s length principle applies in a similar way in order to assess whether and to what extent remuneration is influenced by shareholder interests. If the transfer price between related parties does not meet the arm’s length criteria, a primary adjustment is made in line with article 9, paragraph 1 of the OECD model tax convention. This means that the adjusted transfer price is reflected in the taxable profit of the Austrian entity.

Section 4 paragraph 1 and section 5 ITA, as well as section 8 paragraphs 1 and 2 CITA, provide the legal basis for the secondary adjustments. According to section 4 paragraph 1 and section 5 ITA, the taxable profit must be determined under the rules of double-entry bookkeeping. If it turns out that the deviation from the arm’s length principle was the result of an error, the profit adjustment would be treated as mere profit correction by way of booking a receivable. Only if the corresponding TP liability is not accepted by the foreign related entity is the secondary adjustment realized through a hidden profit distribution according to section 8 paragraph 2 CITA. In this regard, applicable withholding taxes have to be taken into account. In specific cases, although a taxpayer is generally free to choose the structure of the transactions in place with its related parties, the general principles related to tax evasion and abuse of law set by the Federal Tax Code (BAO) should be considered. Among these principles, a “substance over form” approach is embedded. Therefore, in many circumstances, Austria takes the economic view of a transaction to be relevant, rather than adopting a purely formalistic approach.

5 Körperschaftsteuergesetz (also referred to as CITA).
6 Hidden profit contributions are considered as contributions for the benefit of the corporation that are caused by a shareholder, but do not result in the granting of shares or similar rights and therefore do not meet the requirements under corporate law (see Ressler and Stürzlinger in Lang, Rust, Schuch and Staringer, KStG (Linde, Vienna 2016), s. 8, para. 44).
7 Hidden profit distributions are considered as distributions of assets (tangibles or intangibles), as well as benefits, to shareholders which would not have been made to unrelated parties (see VwGH, 29 March 1989, No. 85/13/0074). However, specific criteria should be fulfilled (see KStR 2013, No. 568, 575, and 593).
8 In detail, the scope of s. 6 para. 6 ITA and s. 8 paras. 1 and 2 CITA may on the one hand be overlapping and on the other hand be slightly different. For a detailed analysis of the legal basis see Lahodny-Karner, Transfer pricing in domestic and international tax law (Konzernverrechnungspreise im nationalen und internationalen Steuerrecht), Vienna 1988, pp. 33 and 72 et seq.; for the definition and examples in particular with reference to comprehensive jurisdiction see Corporate Income Tax Guidelines (Körperschaftsteuerrichtlinien), chapters 11 and 12.
9 Austrian TPG, para. 321.
10 Ibid., para. 326.
11 Ibid., para. 327.
12 Ibid., para. 332.
13 Bundesabgabenordnung (BAO).
14 BAO, ss. 21–24.
15 BAO, s. 21.
16 See Ritz, BAO (Vienna: Linde, 2014), s. 21, paras. 6 et seq.
Therefore, TP rules in Austria allow for both upward and downward adjustments to the tax base of resident companies, hence qualifying not only as anti-avoidance rules, but also as rules allowing a fair allocation of taxing powers between different countries. Moreover, the arm’s length principle should be followed not only in cross-border transactions, but also in domestic transactions. In order to provide guidance on the application of the arm’s length principle, the Austrian MoF\textsuperscript{17} published the Austrian TP guidelines in 2010 (Austrian TPG).\textsuperscript{18} These guidelines, which are binding only upon the tax administration and not upon tax courts and taxpayers, are mainly based on the OECD TPG; the latter become even more relevant in the case of conflict between the text of the two documents.\textsuperscript{19} The Austrian TPG provide guidance on the following specific topics: multinational group structures (including the general application of the arm’s length principle, as well as TP methods and some specific intra-group transactions);\textsuperscript{20} multinational PE structures;\textsuperscript{21} documentation requirements;\textsuperscript{22} TP audits (including TP adjustments and dispute resolution procedures);\textsuperscript{23} and tax planning via base companies (i.e. a more general part providing guidance on countering tax avoidance and tax evasion).\textsuperscript{24} Based on the general principles developed by these guidelines, an accurate functional analysis (i.e. the analysis of functions performed, risks assumed and assets employed by the related parties involved in the transaction) is a key element in order to determine the arm’s length nature of a transaction.\textsuperscript{25}

Additionally, the MoF offers its guidance on specific international tax matters, in the form of publicly available responses to specific cases brought up by taxpayers and/or tax inspectors, by means of the so-called express answer service (EAS).\textsuperscript{26}

Finally, in Austria some mechanisms to reduce and resolve TP disputes are available. As far as mechanisms to reduce TP disputes are concerned, taxpayers have the opportunity (a) to request a unilateral advance ruling\textsuperscript{27} by way of an official notice of the competent tax office (binding on the tax administration) concerning transactions that have not yet taken place or (b) to request a bilateral advanced pricing agreement (APA)\textsuperscript{28} based on the MAP provision of the applicable double tax treaty. As far as mechanisms to resolve TP disputes are concerned, it is worth

\textsuperscript{17} Bundesministerium für Finanzen (also referred to as BMF).
\textsuperscript{19} Austrian TPG, para. 3; see also Damböck, Galla and Nowotny, Verrechnungspreisrichtlinien (Vienna, Linde 2012), para. K 9.
\textsuperscript{20} Austrian TPG, Part 1.
\textsuperscript{21} Ibid., Part 2.
\textsuperscript{22} Ibid., Part 3.
\textsuperscript{23} Ibid., Part 4.
\textsuperscript{24} Ibid., Part 5.
\textsuperscript{25} See rosar in Bernegger, Rosar and Rosenberger, Handbuch Verrechungspreise (Vienna, Linde 2012), p. 112.
\textsuperscript{26} Express Antwort Service (EAS).
\textsuperscript{27} BAO, s. 118. These rulings are available not only for TP cases, but also for cases involving business restructuring and group taxation.
\textsuperscript{28} Bi- or multilateral agreements are referred to as MAP APAs (“advance pricing arrangements under the mutual agreement procedure”) by the OECD: OECD TPG, s. 4.123 and annex to chapter IV, Guidelines for conducting advance pricing arrangements under the mutual agreement procedure.
mentioning that, apart from the availability of any MAP which may be available under a specific applicable double tax treaty, Austria also has implemented the EU Arbitration Convention.29

2. The impact of the BEPS project on TP

2.1. Introduction

As far as TP topics are concerned (i.e. BEPS Actions 8–10),30 neither the MoF nor the Austrian tax administration has provided an official opinion on the impact that the project will have in Austria.

In general, Austria has been intensively involved in the work of the OECD and provided its feedback and point of view on most of the topics discussed within the BEPS project. Moreover, the Austrian tax administration often includes in its practice approaches developed by the OECD. This is based on the view that the OECD TPG reflect the harmonized view of OECD countries on how they interpret the arm’s length principle under article 9 of the OECD model tax convention contained in their bilateral tax treaties. This view is derived from the Vienna Convention on the Law of Treaties.31 Furthermore, as mentioned above, the Austrian TPG are based on the OECD TPG, which become even more relevant in the case of conflict between the texts of the two documents.

Therefore, it is reasonable to expect that the new guidance developed by the OECD under the work on TP topics,32 included in the new OECD TPG, will become relevant for Austrian tax administrations and taxpayers. To this end, administrative or legislative changes will most probably not be required in order to implement changes in Austria’s regulations and practice as a consequence of the outcomes of the BEPS project.33

A relevant question would be whether the new guidance will apply only to transactions taking place after the implementation of the new OECD TPG34 (hence, by means of a “static approach”), or rather retrospectively, to transactions started before this point in time (hence, with a “dynamic approach”). The answer

29 Convention 90/436/EEC on the elimination of double taxation in connection with the adjustment of profits of associated enterprises; see also information letter of the Austrian tax authorities: BMF, 31 March 2015, Verständigungs- und Schiedsverfahren nach Doppelbesteuerungsabkommen und EU-Schiedsübereinkommen.
33 With the exception of the Transfer Pricing Documentation Act that has already been enacted and aims for the domestic implementation of BEPS Action 13.
34 The OECD Council has approved the amendments to the OECD TPG introduced by BEPS Actions 8–10 on 23 May 2016 (see http://www.oecd.org/tax/oecd-council-approves-incorporation-of-beps-amendments-into-the-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations.htm, last visited on 31 August 2016).
to this question will largely depend on whether the new OECD guidance is considered as including new concepts or as clarifying the concepts of the arm’s length principle as included in section 6 paragraph 6 ITA. When analysing the outcome of the BEPS project relating to TP topics and considering unofficial discussions with members of the tax administration as well as recent developments in tax audits, the answer to this question seems to be going in the direction of a dynamic use of the new OECD TPG.\textsuperscript{35} Moreover, according to the Austrian TPG, domestic law will – in case of doubt – be interpreted in line with the current version of the OECD TPG.\textsuperscript{36} However, this approach could be criticized from a constitutional perspective.\textsuperscript{37}

Therefore, the following sections will provide clarifications on when and whether the developments in the TP area suggested by the OECD BEPS project will be implemented in Austria, with reference to specific topics.

### 2.2. Challenges of transactions with intangibles

#### 2.2.1. Definition of intangibles

Austria does not provide a specific definition of intangibles for TP purposes. The Austrian income tax guidelines provide the following as examples of intangible goods: trademark rights; copyrights; rights of publishing; non-protected inventions; concessions; formulation; knowhow; rights to use such rights and assets; options; software; and similar rights and assets without legal character such as goodwill, etc.\textsuperscript{38} These examples, however, are only valid for general income tax purposes and not for TP purposes.

Therefore, as far as the arm’s length principle of intangibles is concerned, the OECD TPG are considered as providing useful guidance on the definition of intangibles. Moreover, due to this reliance of the tax administration on the OECD’s views on TP topics, it may be expected that the new guidance provided by BEPS Actions 8–10 will be considered as relevant in Austria.

An interesting question on this topic could be how the OECD’s newly introduced definition of intangibles will interact with Austrian domestic legislation (i.e. both tax law and other fields of law), as well as with international agreements. Although the OECD has clearly specified that the definition is not relevant either for the application of article 12 or for customs purposes,\textsuperscript{39} it is still debatable what the domestic relevance of this definition will be.

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\textsuperscript{35} Loukota, “OECD puts an End to the Cost Sharing Principles in Cost Contribution Arrangements”, SWI 2016, 151.
\textsuperscript{36} Austrian TPG, para. 19.
\textsuperscript{38} Income Tax Guidelines 2000, No. 625.
2.2.2. Transactions with intangibles

Austria does not have specific guidance on identification of transactions involving intangibles for TP purposes.

In general, there are two ways of transferring intangible property rights: by sale (with contribution in cash or in kind) or by licensing or leasing.

In practice, after identifying the intangible transferred, licensed or leased, it will need to be established whether this transfer, licence or lease is embedded in another transaction (e.g. by means of a so-called “package deal”) or not. Moreover, the Austrian TPG underline the need to perform a benefit test, thereby assessing that the licensee derives a real benefit from the licence.

The Austrian TPG also specify that the royalty rate might be identified within a range of values whereby the minimum rate is defined by reference to the licensor’s costs, while the maximum rate is defined by reference to the licensee’s profits; hence, the licensee should be left with some profits deriving from the licensed intangible assets.

When dealing with royalties from trademarks, the Austrian TPG specify that a distribution company cannot be charged such royalties, since the purchase price of the products already includes the brand value. This view is in line with the OECD guidance developed under BEPS Actions 8–10.

As far as the TP methodologies to assess the value of the transactions involving intangibles are concerned, no specific guidance is provided. In general, any reference to available and reliable comparable uncontrolled transactions (by means of the application of the comparable uncontrolled price (CUP) method) will be considered as relevant. However, in the absence of available and reliable information on comparable uncontrolled transactions, the intra-group compensation for transactions involving intangibles should be defined by reference to the other methods provided by the OECD TPG.

For this purpose, the use of the profit split method is considered as a meaningful tool by the Austrian TPG. However, careful consideration should be paid to the fact that the Austrian TPG have explicitly rejected the determination of royalty fees by reference to the profits realized by the licensee.

The guidance provided on these topics by the OECD work on BEPS Actions 8–10 (to some extent already implemented within the Austrian TPG) will most probably be considered as relevant for their interpretation by the Austrian tax administration. For example, the use of financial valuation techniques (by reference, e.g.

41 Austrian TPG, para. 108.
42 Ibid., para. 105.
43 See also EAS 2349, BMF, 4 September 2003; Macho, Steiner and Spensberger, Verrechnungspreise kompakt² (Vienna, Linde 2014), case study 22.
45 Austrian TPG, para. 110.
46 Ibid., para. 109.
47 See, for example, the above-mentioned non-chargeability of royalties from trademarks to distribution entities, as well as the preference for CUP and the profit split method when pricing transactions involving intangibles.
to the discounted cash flow method), introduced under the new OECD TPG, is already generally accepted in Austria.

### 2.2.3. “Substance-over-form” approach toward intangibles

The Austrian TPG do not provide specific guidance on the topic of the “substance over form” approach related to intangibles from a TP perspective. However, as mentioned above, Austrian general principles embed a substance-over-form approach. Therefore, the Austrian tax administration does not limit its analysis to investigating the legal ownership of intangibles, but rather assesses whether someone other than the legal owner has control of the assets, based on the so-called “principle of attribution of assets for tax purposes”.

Moreover, it is worth underlining that, in the opinion of the tax authorities, the intra-group remuneration should consider which entity contributes to the enhancement of the value of an intangible. This could lead to the situation where a sales entity contributing APM activities in order to develop the market should not only receive a routine remuneration, but should participate in the residual profit deriving from the exploitation of the intangibles.

Therefore, entitlement to intangibles related returns should be assessed with reference to the above-mentioned general principles.

As far as the new guidance provided by BEPS Actions 8–10 is concerned, with specific reference to the analysis of functions related to development, enhancement, maintenance, protection, and exploitation (DEMPE functions) of intangibles, no official position has yet been taken by the Austrian tax administration. However, in the light of the above-mentioned general principles related to the substance-over-form approach, as well as the above-stated reliance of the Austrian view on the OECD guidance, these newly developed principles will most probably soon be embraced in Austria.

However, some questions will necessarily arise in the future on these topics. For example, as far as the concept of “substance” for TP purposes is concerned, the BEPS Actions 8–10 have provided, on the one hand, more relevance for the concept (referring to the analysis of the “delineation of the actual transaction undertaken” as a key element of a TP analysis, leaving the legal arrangements as only the starting point of this analysis), and, on the other hand, more indication of what this concept might be (by reference, for example, to a more structured and defined analysis of the risk factor, to the DEMPE functions for the allocation of intangibles related returns, as well as to the role of capital).

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48 See s. 1, above.
49 BAO, s. 21.
50 BAO, s. 24.
52 Advertising, promotion and marketing activities.
Nevertheless, when referring to the DEMPE analysis, although it is quite clear that this would not necessarily lead to the attribution of intangibles related returns to one specific entity of the group, but rather to each single entity contributing to the important value-creating DEMPE functions, a best practice approach in order to perform such an analysis would still need to be fully assessed and the role of some tools which might prove to be useful to this end (e.g. the RACI\textsuperscript{55} model) would still need to be clarified.

2.2.4. Comparability and group synergies

The Austrian TPG do not provide specific guidance either on comparability factors related to intangibles or on group synergies.

As far as comparability is concerned, the general principles of the Austrian TPG, in the light of the guidance provided by the OECD TPG, should be observed. In general, Austrian tax administrations apply the comparability analysis \textit{in sensu stricto}, hence expecting full comparability of the transactions.\textsuperscript{56} Therefore, the CUP method may not always be used when pricing intangibles.

Group synergies are, \textit{inter alia}, relevant elements of the comparability analysis. The Austrian TPG do not extensively deal with this topic. However, in the context of intra-group financial transactions, it is explicitly mentioned that the credit-worthiness of a subsidiary may be influenced by the credit rating of the overall group it belongs to.\textsuperscript{57} Hence, it seems that the Austrian tax administration may tend to recognize the existence of so-called “implicit support”. Consequently, group synergies could be considered as relevant as well.\textsuperscript{58} This would be in line with the approach suggested by the OECD TPG (both before and after the amendments suggested within the BEPS project)\textsuperscript{59} as well as by some relevant international court cases.\textsuperscript{60}

Finally, another relevant comparability factor further analysed by the BEPS project is the existence of location specific advantages. On this topic, according to the view of some representatives of the Austrian tax authorities,\textsuperscript{61} location savings deriving from the relocation of routine activities should remain at the level of the principal. To this end, it is argued that, in most cases, the relocation is performed due to strong competition in the market and the related savings will be passed on to customers in the form of lower prices.

\textsuperscript{55} Responsible, accountable, consulted, and informed.

\textsuperscript{56} Austrian TPG, para. 22.

\textsuperscript{57} \textit{Ibid.}, para. 89.

\textsuperscript{58} See also Macho, “Lizenzzahlungen für die Nutzung des Konzernnamens – is it worth the trouble?”, taxlex 2015, 173.


\textsuperscript{60} In favour of the relevance of the “implicit support”, see \textit{General Electric Capital Canada Inc. v. Her Majesty the Queen} (Federal Court of Appeal, 15 December 2010, 2010 FCA 344); German Federal Tax Court, 21 December 1994; German Federal Tax Court, 29 October 1997; Australian Federal Court, 23 October 2015, [2015] FCA 1092; for a contrasting view, see Finnish Supreme Administrative Court, 3 November 2010, KHO 2010:73.

\textsuperscript{61} See Macho in Macho, Steiner and Spensberger, \textit{Case Studies Verrechnungspreise kompakt} (Linde, Vienna 2014), p. 216.
In general, the new guidance provided by BEPS Actions 8–10 on the topics discussed above is also expected to be enforced by the Austrian tax administration. However, as far as the relevance of group synergies is concerned, it would be necessary to identify when a deviation from the “separate entity approach” was justified for the sake of group interest to be taken into account. In this respect, as mentioned above, Austria recognizes the existence of implicit support in its existing guidance. Additionally, the debate on location specific advantages might generate contrasting views with developing countries.

2.2.5. **Hard-to-value intangibles**

Austria does not explicitly refer to the topic of hard-to-value intangibles within its guidelines.

When dealing with transactions involving intangibles, in general, an *ex ante* approach should be followed. However, in some circumstances, an *ex post* approach could be considered, depending on the question of what independent parties would have agreed upon. Hence, in cases involving hard-to-value intangibles, it may be expected that the conditions agreed upon between the related parties would include some specific provisions in the agreements, in line with the suggestions provided by the new OECD guidance.

In practice, the design of an acceptable error range for the gap resulting from the application of the *ex ante* approach versus the application of the *ex post* approach might be required in order to provide more certainty in the application of these concepts.

2.2.6. **CCAs**

The Austrian TPG provide extensive guidance on the topic of CCAs, defined as contracts agreed between multinational group companies, in order to perform and/or receive services, which are rendered through collaboration to the common benefit, over a longer period. This guidance is, to a large extent, in line with the OECD TPG.
In order for a CCA to be recognized by the Austrian tax administrations, the agreement needs to respect the following two conditions:
(a) to pursue the mutual and common interests of the participants;\(^{69}\)
(b) to be in writing with proper documentation.\(^{70}\)

Each participant needs to receive a mutual benefit from its participation in the CCA;\(^{71}\) hence, the value of the participants’ contributions must be in line with the arm’s length principle.\(^{72}\)

The allocation key used in order to allocate the costs among the participants to the CCA should be determined based on the actual needs and benefits derived by each participant from the CCA.\(^{73}\)

It is worth mentioning that the Austrian TPG specify that no mark-up should be applied to the expenses shared in a CCA.\(^{74}\) Moreover, it seems that an “active involvement” by all the participants in the CCA is not required, since contributions entirely in cash are allowed.\(^{75}\)

In order to assess whether intra-group services can be subject to the conclusion of CCAs, it seems that the services provided should not belong to the “core” activities of the service provider. The answer to the question of whether the services can be regarded as “core” activities might be determined based on the analysis of the share of the services within the whole value chain (e.g. with reference to the proportion of costs of rendering the services in relation to total costs of the company).\(^{76}\)

Finally, as for the conditions for entrance of new participants into the CCA, withdrawal of current participants from the CCA, or termination of the CCA, the Austrian TPG specify that payments for failed research should also be considered.\(^{77}\) To this end, no clear guidance is available dealing with contributions of different parties upon the establishment of a CCA.

Up to now, it has not been possible to assess with certainty whether the Austrian tax administration will fully rely on the amendments proposed within the OECD work on BEPS Actions 8–10. Indeed, as mentioned above, the Austrian tax administration has established that contributions to a CCA should be valued at cost (hence, without the application of any profit element, e.g. mark-up).\(^{78}\) Moreover, contributions entirely in cash are accepted, thus excluding the need for an active involvement of all participants to a CCA. These views may be in contrast with those introduced by the OECD, which seem to move away from the classical cost sharing concept in favour of a “value sharing” concept and may not find a legal basis in Austrian tax law. Based on the analysis by a former representative of the Austrian MoF, it is clarified that the OECD TPG, being an interpretation of article 9 of the OECD model tax convention, can only limit tax authorities in taxing profits rather than giving them new taxing rights. For this reason, at the moment,

\(^{69}\) Ibid., para. 114.
\(^{70}\) Ibid., para. 115.
\(^{71}\) Ibid., para. 116.
\(^{72}\) Ibid., para. 118.
\(^{73}\) Ibid., para. 122.
\(^{74}\) Ibid., para. 113.
\(^{75}\) Ibid., para. 114.
\(^{77}\) Austrian TPG, para. 125.
\(^{78}\) Ibid., para. 113; EAS 1699, BMF 1 September 2000.
the Austrian tax authorities may not be entitled to adjust profits in order to include a profit element in CCAs.79

2.3. Risk and capital

The Austrian TPG do not provide guidance on the specific topic of risk and capital. However, according to general tax law in Austria, income should be allocated to the entity bearing the commercial risk and thus enabled to use market opportunities.80 In this respect, the guidelines to the Austrian Income Tax Act provide that the legal conditions are only decisive if the economic circumstances do not contradict them.81 Consequently, profits are attributable to the entity that actually performs the relevant business activities82 and is, therefore, the beneficial owner of the profits.83 This is true also for income derived from capital.84

In light of the above-mentioned general principles of substance over form, as well as the reliance of the Austrian view on the OECD guidance, the newly developed OECD views on the topic will most probably soon be included by the Austrian tax administration.

However, also on this topic, some questions might be relevant. For example, on the role of capital in the future, it now appears clear that taxpayers should consider not only issues related to thin capitalization, but also the question of whether a company is overcapitalized.85 Moreover, as far as the future role of “cash boxes” is concerned, the OECD has clearly indicated that they should gain no more than a risk-free return.86 In this regard it is worth mentioning that in the case of financing PEs, it was already disputed in 1997 whether they should receive a routine service remuneration or a higher risk-adjusted remuneration.87 Consequently, the firm statement regarding “cash boxes” by the OECD might raise some issues when implemented in practice. For example, it may be questioned how to define the specific risk-free return in an objective and coordinated way or, further, how to address cases of negative interest rates (therefore ultimately resulting in the attribution of losses to an entity with limited functions). Finally, it is doubtful whether the risk-free return is in line with the application of the arm’s length principle: in other words, the attribution of a risk-free return to an entity holding only the legal ownership of an intangible may still attribute a considerable amount of profit to that entity. A better approach to resolving this issue would be the assessment of...
the remuneration of such an entity on a cost-plus basis, in view of its functions as a mere service provider for the other group entities performing the important DEMPE functions.

2.4. High-risk transactions

2.4.1. CUP and quote prices for cross-border commodity transactions

The Austrian guidance on commodity pricing and the use of quotes in order to implement the CUP method is very limited.

In one opinion statement, the Austrian tax authorities have established that the commodity price of a good may not be a suitable CUP if the production level is different or other characteristics of the goods are different and the differences are not sufficiently identifiable and assessable.\(^88\)

Since guidance on commodity pricing is quite rare, some findings may be derived from the guidance on the applicability of quotes for benchmarking financial transactions. As far as the broad use of quotes to price transactions when applying the CUP method is concerned, in the case of intra-group loans, quotes from banks defining interest rates may be considered valid in Austria in some circumstances. However, the views on this topic are very contrasting.\(^89\)

The OECD’s developments on this topic out of the work on BEPS Actions 8–10 could be a useful tool which may be taken into account in Austria to provide clear guidance. However, the practical application of this newly developed guidance will still need to be tested and it will most probably generate issues which may not be undisputed between different players.

2.4.2. Intra-group services

The Austrian TPG provide extensive guidance on the topic of intra-group services.\(^90\) This guidance is, to a large extent, in line with the OECD TPG.

The first step to assessing the arm’s length nature of an intra-group service is the performance of a benefit test. Based on this test, it needs to be assessed whether the recipient receives a real benefit from the services. To support such a benefit test, business and commercial justifications, as well as appropriate documentation, need to be provided. Typical examples of non-chargeable services are duplicated service and shareholder services. The Austrian TPG provide an extensive list of shareholder expenses which are not chargeable,\(^91\) as well as a list of chargeable services.\(^92\) The examples of shareholder activities are similar to those in the OECD TPG. However, some additional examples are provided: costs of the supervisory board and executive board,\(^93\) costs for consolidated financial

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\(^{88}\) EAS 813, BMF, 22 February 1996.

\(^{89}\) Austrian TPG, para. 88; Philipp, Loukota and Jirousek, Internationales Steuerrecht, para. I/3 B; VwGH 18 December 1990, 89/14/0133; BMF 29 October 2007, EAS 2898, BMF, 29 October 2007.

\(^{90}\) Austrian TPG, paras. 74–86.

\(^{91}\) Ibid., para. 85(a).

\(^{92}\) Ibid., para. 86(b).

\(^{93}\) Ibid., para. 85(a).
statements,\textsuperscript{94} and costs for IT systems such as SAP, which are only needed by the subsidiary because of the group affiliation. Consequently, the interpretation of the term “shareholder activities” may seem to be broader in the Austrian TPG than in the OECD TPG.

The second step in assessing the arm’s length nature of an intra-group service is the determination of the arm’s length compensation for the service. In general, the Austrian tax administration prefers the allocation of services via direct charging. However, when the application of such direct charging cannot produce reliable results or would require unreasonable administrative efforts, indirect charging could be used.\textsuperscript{95} For this purpose the selection of an appropriate allocation key will be highly relevant; hence, the Austrian TPG provide some examples of useful allocation keys in the chapter regarding CCAs that may also be applicable for the indirect charge of services, e.g. units, material costs, machine hours, headcount, salaries, added value, invested capital, EBIT and revenue.

Moreover, as far as the appropriate TP method is concerned, when the CUP method cannot be reliably applied, the cost plus method might prove useful.\textsuperscript{96} To this end, the cost base should include all the relevant costs incurred by the service provider, both direct (e.g. employees’ salaries, employees’ bonuses, employees’ pensions, employees’ travel and subsistence costs, as well as supporting costs) and indirect (e.g. costs related to the office facilities as well as other overheads). As far as the profit element is concerned, although in some cases a mere cost charging may be considered,\textsuperscript{97} most of the time the Austrian tax administration may expect the application of a mark-up. The measure of such mark-up, in the case of routine services, would be in the range of 5 to 15 per cent.\textsuperscript{98} Moreover, the 3 to 10 per cent mark-up identified by the work of the EU Joint Transfer Pricing Forum on low value-adding intra-group services\textsuperscript{99} may also be considered as useful. However, neither measure of mark-up is considered a safe harbour; hence, an analysis of the nature of the services provided will still be required in order to justify the arm’s length determination of the profit element applied.

Finally, in order for the intra-group services to be charged, a detailed indirect service charge agreement should be concluded between the parties. The agreement has to include at least the following elements: a determination of type and scope of the specific service, the nomination of the parties to the contract, the calculation scheme for the service charges, a declaration of the allocation key, the maturity date, as well as a clarification of measures in case substantial facts change over time.\textsuperscript{100} It also has to be well documented that no multiple charges occur within the MNE group.\textsuperscript{101}

\textsuperscript{94} Ibid., para. 85(b).
\textsuperscript{95} Ibid., para. 75.
\textsuperscript{96} Ibid., para. 76.
\textsuperscript{97} Ibid., para. 80; cases in which no mark-up might be charged include, e.g. services that are not related to the core activities of an MNE group, but represent ancillary services.
\textsuperscript{98} Ibid., para. 77.
\textsuperscript{100} Austrian TPG, para. 82; see also VwGH, 8 July 2009, No. 2007/15/0036 on the deductibility of management fees.
\textsuperscript{101} Ibid., para. 83.
The newly introduced guidance by the OECD BEPS Actions 8–10 on low value-adding intra-group services will most probably be considered as valid also by the Austrian tax administrations. However, some clarifications on the measure of the mark-up suggested by the OECD (i.e. 5 per cent) as well as on the nature of such profit element (i.e. as constituting a safe harbour or not) will be required. Also additional guidance on the procedural implementation might be needed, i.e. how taxpayers should “opt-in” for the simplified approach to low value-adding intra-group services.

2.4.3. Profit splits in the context of value chains

The Austrian TPG do not provide extensive guidance on the topic of profit splits in the context of value chains. The guidance provided by the OECD within its TPG as well as through the BEPS project is and, most probably, will be relevant in Austria as well. Therefore, the follow-up work of the OECD on this topic is eagerly awaited.

2.5. TP documentation

2.5.1. Country-by-country reporting (CbCR)

The new Transfer Pricing Documentation Act (VPDG) was enacted in August 2016, Inter alia, the law introduces the CbCR model legislation as proposed by the OECD. In this regard, the law requires the preparation of CbCR already for the fiscal years starting on or after 1 January 2016 for multinational groups having a consolidated revenue above €750 million. The content of the CbCR should be identical to that provided in the tables compiled by the OECD in its guidance to BEPS Action 13.

In general, an Austrian ultimate parent entity is obliged to submit CbCR to the Austrian tax authorities. Additionally, in certain circumstances (e.g. if the ultimate parent is situated in a country where it is not obliged to file CbCR or the country of the ultimate parent does not have the obligation to transmit CbCR to Austria) an Austrian constituent entity could be appointed by the Austrian tax authorities to be obliged to file CbCR.

In January 2016, Austria signed the Multilateral Competent Authority Agreement on the Exchange of CbCR (MCAA) and agreed therewith to automatically exchange the data generated from the CbCR with the tax authorities of the other

102 Only general guidance on the use of the profit split method is provided under Austrian TPG, paras. 39–49.
103 EU-Abgabenänderungsgesetz 2016, BGBI I 77/2016.
104 In cases where an Austrian entity assumes the filing responsibility for its foreign ultimate parent company, CbCR has to be submitted only for fiscal years starting on or after 1 January 2017. Austrian ultimate parent companies have to file CbCR electronically via “FinanzOnline” within 12 months after the last day of the relevant fiscal year.
participating jurisdictions.\textsuperscript{106} In this respect, the VPDG states that CbCR will be shared with the other tax jurisdictions 15 months after the last day of the specific fiscal year under scope.\textsuperscript{107}

Finally, it is worth mentioning that for an intentional and grossly negligent breach of obligations regarding CbCR, the VPDG foresees penalties up to €50,000.\textsuperscript{108}

In general, the introduction of CbCR could potentially introduce more transparency into the system. However, taxpayers could face an enormous compliance burden, especially in the first years of introduction of this new requirement. In particular, the numerous SMEs\textsuperscript{109} that do not use any aggressive tax structure leading to BEPS are unreasonably affected. The usefulness of the information provided still needs to be proved, as well as its relevance for TP assessment. Additionally, many other issues will need to be carefully reviewed and addressed. For example, the confidentiality of the data provided to other tax authorities must be ensured at the level of all the tax authorities involved. Also, the use of such information needs to be discussed.

\subsection{2.5.2. Master and local files}

In Austria, the procedural legal requirements are stipulated in the Federal Fiscal Code (FFC). According to section 115 paragraph 1 FFC, the tax authorities will independently identify the facts and circumstances relevant for the tax assessment, where necessary in cooperation with the taxpayer.

The FFC does not explicitly provide for an obligation to prepare TP documentation. This is why before the VPDG entered into force in 2016, Austria’s tax law did not establish any explicit obligation for standardized TP documentation. However, for cross-border transactions and foreign relationships, Austrian taxpayers were required by legal doctrine and jurisprudence to cooperate with the tax administration to a larger extent than in merely domestic situations. Furthermore, representatives of the tax authorities are of the opinion that chapter V of the OECD TPG may serve as interpretative guidance as to which specific TP documentation obligations may be derived from general provisions of the FCC referring to bookkeeping and documentation requirements for taxpayers, as well as for the decision about what evidence can be requested from taxpayers in fulfilling their duty to cooperate. Thus in its daily business, the Austrian fiscal administration demanded TP documentation in line with chapter V of the OECD guidelines even before the VPDG was enacted. It is worth mentioning that this view may be considered as being enhanced by the VPDG which now explicitly stipulates that the general obligation to document the TP system of an MNE company according to the FFC

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\textsuperscript{107} VPDG, s. 11; please note that in the first year, CbCR will only be shared with the other tax jurisdictions within 18 months after the last day of the fiscal year that starts on or after 1 January 2016.
\textsuperscript{108} It should be noted that the penalty can be imposed per offender and the total amount of the penalties in an individual case may therefore be substantially higher than €50,000. A merely negligent submission of incorrect data is not subject to penalties.
\textsuperscript{109} Small and medium-sized entities.
\end{flushleft}
still is in place, which is relevant for Austrian companies that are outside of the scope of the VPDG.

Based on the Austrian VPDG, for all fiscal years beginning from 1 January 2016, an Austrian constituent entity of an MNE group is obliged to file standardized TP documentation including a master file and a local file, if its revenue exceeds €50 million for two consecutive fiscal years; conversely, if the revenue falls below the threshold for two years in a row, the documentation obligation ceases.\textsuperscript{110} Notwithstanding this, a master file has also to be submitted, if another MNE group entity has to prepare it according to the legislation of its own jurisdiction.\textsuperscript{111}

The content of the master file and the local file will be set by a decree which has, so far, only been published in a draft version. Based on this draft, the content is derived from the OECD work conducted under BEPS Action 13.\textsuperscript{112} The documents can be prepared either in English and in German.\textsuperscript{113}

The master file and local file need to be submitted only upon request from the tax authorities after the corporate income tax return has been filed. The taxpayer will need to submit documentation in response to such a request within 30 days. The filing of the corporate income tax return is in general due on 30 June of the following year. However, for taxpayers that are officially represented by an Austrian tax adviser, a deadline extension until 31 March of the second following year may generally apply with specific exceptions.

The new documentation standards will most probably improve the quality of the description of the TP systems enforced by the taxpayers, as well as providing the tax administration with useful tools to oversee and understand the overall picture behind transactions between related entities. Nevertheless, also in this case, many relevant questions will arise about the future implementation of these standards.

2.5.3. Compliance costs

According to an estimate of the Austrian tax authorities, the compliance costs in the first year of the new documentation requirements will be approximately between €200,000 and €400,000 on average per entity.\textsuperscript{114} An estimate of the compliance costs for the Austrian tax authorities was also published, amounting to €2 million.\textsuperscript{115} Consistently, it is the common opinion that Austrian groups as well as Austrian entities belonging to foreign groups will have to make increasing efforts in the future in order to meet the new compliance regulations. Also the experience in practice shows that many MNEs have already started to invest time and resources in the establishment of a coordinated documentation process.

\textsuperscript{110} VPDG, s. 3, para. 2.
\textsuperscript{111} Ibid., s. 3, para. 3.
\textsuperscript{112} See also Holzinger and Bonner, “Checkliste – Regierungsvorlage zum Verrechnungspreisdokumentationsgesetz”, ecolex 2016, 619.
\textsuperscript{113} VPDG, s. 10, para. 1.
\textsuperscript{114} BMF, Explanatory notes to the VPDG, p. 2.
\textsuperscript{115} Ibid., p. 1.
2.6. TP-related measures in other BEPS actions and other measures against BEPS

Austria has a number of measures against BEPS, both related and unrelated to TP topics. This section highlights the situation in Austria on the implementation of the OECD proposals other than BEPS Actions 1–15 (excluding BEPS Actions 8–10 and 13, analysed in the previous sections) and places particular emphasis on TP topics.

As far as BEPS Action 1 is concerned, the EU VAT Directive applies to Austria and is already implemented into domestic law. No further developments can be highlighted on this topic so far. However, as far as TP issues related to the digital economy are concerned, it would be challenging to “align transfer pricing outcomes with value creation” in the case of businesses operating in the digital economy. Indeed, the global value chain and key value drivers of these businesses may materially deviate from those of more “classical” industries. Hence, further developments in this area are also eagerly awaited in Austria.

As far as BEPS Action 2 is concerned, Austria already has specific provisions to counter hybrid mismatch arrangements. Based on section 10, paragraph 8, CITA, dividend income is not exempt from Austrian corporate income tax if a payment is tax deductible in the source country. It is not yet known whether these provisions will be amended as a result of the final OECD BEPS recommendations, which contain, to some extent, deviating suggestions.

With reference to BEPS Action 3, Austria does not have implemented controlled foreign company rules. However, profits might be allocated according to economic circumstances, based on the above-mentioned substance-over-form approach.

As far as BEPS Action 4 is concerned, in 2014 Austria has introduced specific measures aimed at limiting the deductibility of interest (and royalty) payments. Based on section 12, paragraph 1(10), CITA, no deduction for interest and royalty payments made to a foreign related party is allowed if the income is not “sufficiently” taxed (i.e. if it is subject to tax at an effective rate of less than 10 per cent) at the level of the recipient. Moreover, although Austria does not have specific rules limiting the deductibility of interest expenses based on a fixed ratio, some court cases have confirmed that the debt–equity ratio of an entity should be in line with the arm’s length principle.\(^{116}\) It is not yet known whether further rules will be implemented as a result of the final OECD BEPS recommendations.

As far as BEPS Action 5 is concerned, the legislation on automatic exchange of advance rulings and advance pricing agreements (APAs) between tax authorities within the EU has been enacted.\(^{117}\) In this regard, it is worth mentioning that data will be made available to all Member States and the European Commission via a central register.

\(^{116}\) For example, VwGH, 18 October 1989, 88/13/0180.

\(^{117}\) In reaction to the November 2015 update of the EU directive regarding mandatory automatic exchange of information in the field of taxation (Council Directive amending Directive 2011/16/EU as regards mandatory automatic exchange of information in the field of taxation), Austria has enacted the implementation of the amendments into the EU-Amtshilfegesetz, within the framework of the EU-Abgabenänderungsgesetz 2016, see BGBl I 77/2016.
With regard to Action 6, the OECD has made several proposals. As a first part of the minimum standard, the states should include a clear statement in their treaties, declaring that the treaty intends to avoid creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance.\textsuperscript{118} This is not new to Austria’s tax treaty policy and is already implemented in over 30 treaties.\textsuperscript{119} Secondly, states should also include other anti-abuse rules in their treaties.\textsuperscript{120} It is noteworthy that the Austrian tax authorities are of the opinion that domestic anti-abuse rules are already applicable at the level of bilateral tax treaties.\textsuperscript{121} As a simplification in respect with a coherent implementation of anti-abuse rules, a multilateral treaty instrument might be useful.

With reference to BEPS Action 7, there are many indications that in Austria commissionaire arrangements may trigger the existence of agency PEs, based on the Austrian TPG\textsuperscript{122} as well as the view of the Austrian MoF.\textsuperscript{123} As far as BEPS Action 11 is concerned, the Austrian Ministry of Finance has established the predictive analytics competence centre in order to support the risk management of the tax authorities leveraging the possibilities of big data and quantitative methods.\textsuperscript{124} With reference to BEPS Action 12 it should be indicated that Austria has implemented the adopted EU Directive on the automatic exchange of tax rulings.\textsuperscript{125}

As far as BEPS Action 14 is concerned, Austria is one of the countries committed to binding arbitration. The future developments on this topic will be relevant for both Austrian taxpayers and the tax administration, inter alia, in order to address present and future controversies in the TP area. In this regard, it is worth mentioning that Austria has also implemented the EU Arbitration Convention.\textsuperscript{126}

Concerning a multilateral tax treaty as proposed in BEPS Action 15, representatives of the Austrian tax authorities have already outlined the welcome benefits of such an instrument.\textsuperscript{127}

\textsuperscript{118} OECD, Action 6: Preventing the granting of treaty benefits in inappropriate circumstances, p. 21.


\textsuperscript{120} According to BEPS Action 6, LOB and PPT regimes should be implemented; see OECD, Action 6: Preventing the granting of treaty benefits in inappropriate circumstances, p. 21.

\textsuperscript{121} KStR 2013, para. 1232; Loukota, “Internationale Steuerplanung und Treaty Shopping”, ÖStZ 1990, 2; see also the same opinion of the Supreme Court: VwGH 26 July 2000, 97/14/0070, 9 December 2004; for deviating views see e.g. Ritz, BAO, s. 22, para. 17.

\textsuperscript{122} Austrian TPG, paras. 172, 176 and 236.

\textsuperscript{123} EAS 3232, BMF, 19 August 2011.

\textsuperscript{124} Setnicka, “Konzeption und Aufbau des Predictive Analytics Competence Center im BMF”, taxlex 2016, 322.

\textsuperscript{125} The adoption of the Directive 2011/16/EU on administrative cooperation in the field of taxation through the Directive (EU) 2015/2376 has been implemented into domestic Austrian tax law within the EU-Amtshilfegesetz and the VPDG.

\textsuperscript{126} See note 34.

2.7. Can BEPS work in favour of MNEs?

The OECD’s work under the BEPS project has mainly focused on providing suggestions and proposal to counteract BEPS phenomena carried out by taxpayers, especially MNEs. As in many other countries, the proposals have led to developments in Austrian tax law that will burden MNE taxpayers with substantially higher compliance efforts in the near future. As well as increased compliance requirements, MNE representatives are worried about one-sided approaches by domestic tax authorities that may potentially lead to double taxation. For example, as far as the new guidance provided under BEPS Actions 8–10 is concerned, the newly introduced amendments to the OECD TPG may, on the one hand, provide more uncertainty in the application of TP rules and in the interpretation of the arm’s length principle. However, on the other hand, these amendments will potentially clarify numerous issues currently leading to disputes between taxpayers and tax administrations, as well as between the tax administrations of different countries.

In this regard, the OECD’s developments under BEPS Action 14 should be aimed at generating efficient solutions to these issues, by providing taxpayers with useful tools to reduce disputes and develop a higher level of cooperative compliance with tax administrations. Moreover, this will necessarily require increasing investments by the tax administration in capacity and knowledge building for their resources in order to enable a fast and non-bureaucratic method of dispute resolution and avoidance of double taxation.

BEPS Action 13 will also introduce a more transparent environment for both taxpayers and tax administrations. Although the new documentation requirements may lead to the above-mentioned new challenges for taxpayers, these may to some extent prove useful by providing tax administrations with a clearer picture of their business and the assessment of their transfer pricing policies, hence potentially limiting the scope for disputes between the various actors involved. For example, a more organized risk assessment by the tax administration will undoubtedly favour MNEs that act in a virtuous way. However, as mentioned above, this should be coordinated with the establishment of mechanisms aimed at increasing cooperative compliance.
Summary and conclusions

The Belgian tax code contains few legal provisions regarding transfer pricing (TP). The key provision is article 185(2) of the domestic tax code which lays down the arm’s length principle under domestic law. The tax authorities take the view that the OECD comments, and specifically those relating to Actions 8–10 of the base erosion and profit shifting (BEPS) report, do not need to be transposed into a new law and are immediately applicable. However, the BEPS report has led to the publication of new laws, including one on the new three-tier TP documentation requirements developed in the BEPS report on Action 13.

Although case law on TP cases involving multinationals (MNEs) is almost non-existent, the European Court of Justice has ruled on the compatibility of two Belgian legal provisions with EU law. The absence of TP litigation can be explained by the extended use of unilateral advance tax rulings which provide upfront certainty to MNEs over the TP methods and the margins used by their Belgian entities.

The introduction of the economic ownership of intangibles to the detriment of the legal ownership as well as the obligation to allocate income from the exploitation of intangibles to group companies which have performed functions, used assets and assumed risks in the development, enhancement, maintenance, protection and exploitation (DEMPE) of those intangibles could influence the approach of the tax authorities in the future. It remains to be seen how the courts will perceive this new paradigm in a civil law-based country which puts an emphasis on the terms of contracts. However, the Ruling Commission is much more open to taking the economic ownership of assets into account in its TP rulings. Therefore, the OECD emphasis on the DEMPE functions should not disturb the Commission. Moreover, the returns on financing transactions are already scrutinized and should be commensurate with the functions performed and the risks incurred by the lender.

As far as comparability and synergies are concerned, Belgium is at the forefront not only with its “excess profit” rulings but also with detailed rulings on the deductibility of guarantee fees and the allocation of central purchasing volume discounts. In those areas, Belgium has anticipated the BEPS conclusions.

Regarding hard-to-value intangibles, the Ruling Commission is already using the profit split method prudently and not as the preferred method when examining
the profit attributable to the exploitation of intangibles. Even with very specific ruling applications, the Ruling Commission checks the methodology by doing its own comparable searches.

The OECD considers that rendering intra-group services is a high-risk transaction because it contends that it can be used to erode profits. The BEPS report updates its existing guidelines on this topic without bringing in any major modifications. Tax inspectors already examine whether the payor benefited from actual services and paid an arm’s length consideration based on an acceptable TP method. The Belgian Ruling Commission has issued numerous rulings on intra-group services and its positions are well known since those rulings are published. Most of the time, the applied TP method is a transactional net margin method (TNMM) with a cost-plus as profit level indicator. The mark-up normally ranges between 3 per cent and 8 per cent according to the type of services.

Most of the section of the BEPS report relating to low value-adding services is devoted to a new “elective simplified approach” which allows groups to apply a safe harbour cost plus 5 per cent approach with very few administrative hurdles. The definition of low value-adding services is perfectly in line with that used by the Ruling Commission and the tax authorities. Belgium used to apply a similar safe harbour rule until the European Commission considered it a harmful tax measure that should be abolished. It remains to be seen how Belgium will implement this new approach in the future.

In the framework of services, the Ruling Commission has accepted for years that “disbursements” are cross-charged at cost without requiring a mark-up to be added. Disbursements are costs incurred by an entity of the group for goods or services which are allocated and cross-charged to other group members without adding any mark-up. Indeed, the group members could have acquired those goods or services directly from the third party supplier at the same market conditions. The OECD now takes the same view on those disbursements and this will reinforce the position of the Ruling Commission.

Regarding the use of the profit split method, the Ruling Commission has been prudent and its rulings are likely to be in line with the final OECD recommendations which should be issued in a final report soon.

The major change relating to the TP aspects of the BEPS report concerns the introduction of compulsory three-tier TP documentation. Until 2015, there was no obligation to draw up or file any TP documentation, although the tax authorities encouraged taxpayers to prepare documentation in order to facilitate TP audits. Belgium recently voted a law requiring qualifying taxpayers to prepare documentation in order to facilitate TP audits. Belgium went beyond the OECD recommendations by requiring qualifying taxpayers to file an extensive local file as soon as a Belgian entity carried out cross-border intra-group transactions for more than €1 million.

This initiative shows once more that Belgium wishes to appear as the best in class while at the same time being a small economy that needs to attract foreign investors. Other countries which participated in the work on the BEPS report may take a “pick and mix” approach to the recommendations of the BEPS report and appear more attractive than Belgium from a tax perspective.
1. Current TP regulation and practice in Belgium

For decades, Belgium has adhered to the OECD TP guidelines without having any legal provision in this respect. The tax authorities became really active about TP as a result of aggressive TP audits performed in surrounding countries leading to requests for correlative adjustments in Belgium. The authorities issued their first regulations in 1999 requesting their tax inspectors to focus on TP and to apply the OECD principles in this respect. In addition, in 2002, a new tax ruling practice was introduced by law allowing the issuance of binding rulings, including on TP matters.

After introducing the arm’s length principle in Belgian domestic law in 2004, a special TP investigation team was formally and officially set up within the tax administration in 2006 with the purpose of auditing large MNEs and monitoring whether they applied the OECD principles adequately.

1.1. Statutory rules

In 2004, article 185 of the Income Tax Code (ITC) was expanded to include the arm’s length principle in Belgian tax law for the first time. Article 185(2) of the ITC allows for a unilateral adjustment to the Belgian tax basis if the arm’s length principle is not respected, similar to the primary adjustment of article 9 of the OECD model tax convention. Conversely, when an adjustment has been performed by foreign tax authorities, a Belgian taxpayer can request a downward (corresponding) adjustment from the Belgian tax authorities in order to avoid double taxation of the same profit. Article 185(2) only applies between related parties to their cross-border transactions.

According to the tax authorities, domestic transactions are governed by article 26 of the ITC. Article 26 of the ITC provides authority for the taxable profits of enterprises in Belgium to be increased when the authorities can demonstrate that any profit transfers were “abnormal or gratuitous benefits” granted to individuals or companies established in Belgium or abroad. This does not apply if the benefits transferred are subject to tax in the hands of the recipient. Since the ITC does not provide a definition of “abnormal or gratuitous benefits”, case law took over and ruled that “abnormal” referred to “that which is not ‘in the natural order of things’ or not consistent with common practice”. This does not match the arm’s length principle, despite a denial from the authorities.

In addition, the tax authorities can make use of other more general provisions in the ITC to challenge transfer prices. For example, when an unjustified expense has been incurred, the general rules on the deductibility of business expenses are invoked to disallow it. Furthermore, the ITC contains so-called “anti-abuse provisions” that tackle artificial inbound or outbound profit shifting.

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1.2. Administrative regulations

On 28 June 1999, administrative regulations were issued relating to TP. The regulations are broadly based on the OECD TP guidelines. They urge tax inspectors to carry out in-depth TP audits where the taxpayer fails to show “documentary evidence” that efforts have been made to fix arm’s length inter-company prices. Consequently, taxpayers may benefit from preparing a defence file upfront, substantiating their TP methodology. In addition, the regulations underscore the importance of conducting a proper functional analysis and refer to a list of generic functional analysis questions.

In 2000, the tax authorities issued regulations on the application of the European Arbitration Convention and, in 2006, they issued regulations on TP audits and documentation. The regulations on the documentation aspects were merely the transposition of the approved EU code of conduct on TP documentation as recommended by the EU Joint Transfer Pricing Forum.

In September 2016, the authorities issued draft regulations regarding profit attribution to permanent establishments (PEs). Those regulations provide details on the allocation of the profit between the head office and the branches of the same legal entity, much along the lines of the 2008 and 2010 OECD reports on that matter. They explain the scope of the old version of article 7 of the OECD model convention (as used in most Belgian treaties) compared to that of the new article 7. The regulations emphasize the importance of internal transactions and provide numerous examples.

Most TP agreements between taxpayers and the authorities are concluded through the Ruling Commission which is composed of inspectors specializing in TP and who may issue binding rulings. Bilateral or multilateral advance rulings (APAs) are concluded on the basis of the mutual agreement procedure (MAP) under the relevant tax treaties.

1.3. Case law

To the best of the reporter’s knowledge, no court has ever ruled on the application of the arm’s length principle according to article 185(2) of the ITC. However, the Constitutional Court has ruled repeatedly that the articles of the ITC (such as article 26 in combination with article 49) leading to double taxation did not breach the equality and non-discrimination principles laid down in the Constitution.

The decisions of the European Court of Justice also have a great impact on TP. In this respect, landmark cases are the SGI case in which the European Court ruled that the more stringent rules applicable to foreign companies in article 26 of

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5 European Court of Justice, decision C-311/08 of 21 January 2010, OJ, C63/8 of 13 March 2010.
the ITC did not infringe EU law while, in the *Siat* case,\(^6\) the Court ruled that article 54 of the ITC (an anti-abuse provision regarding some payments made to low-tax jurisdictions) did violate EU law because its wording was too vague to grant legal certainty to the taxpayers.

Recently, the European Commission started an infringement procedure against various rulings, including Belgian rulings, on the ground of potential prohibited state aid.

2. The impact of the BEPS project on TP

2.1. Introduction

Representatives of the Belgian tax authorities were among the most active in discussing and preparing the several BEPS reports within the OECD. According to the well-established viewpoint of the authorities,\(^7\) the OECD TP guidelines are immediately enforceable in Belgium since they only comment on and illustrate the arm’s length principle embedded in article 9 of the OECD model. Accordingly, the recommendations of Actions 8–10 of the 2015 BEPS report are deemed to apply in Belgium as soon as they are officially approved by the OECD Council,\(^8\) which occurred on 23 May 2016. Some officials even contend that those recommendations apply with retroactive effect; this will not enhance legal security for taxpayers.

Other recommendations of the BEPS report require legislative changes, either through the ratification of the multilateral agreement provided in Action 15 of the BEPS report or through domestic legislation. The law of 1 July 2016 introduced the requirement to prepare and file TP documentation in the form of CbCR as well as a master file and a local file. Before that law, there was no legal obligation to prepare and/or file contemporaneous TP documentation.

The increased “substance-over-form” approach of the BEPS report has not surprised the business community. The commensuration of income with value creation has already been implemented for years by the Ruling Commission in its binding rulings. However, the community foresees the negative impact of the different anti-abuse provisions introduced (and the combination of them) including their introduction of very vague and subjective criteria, and regrets the absence of a mandatory and binding arbitration provision in the multilateral instrument discussed in Action 15 of the BEPS report, as well as the significant administrative burden and costs entailed by CbCR. It expects an increase in the number of disputes relating to double taxation.

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\(^6\) European Court of Justice, decision C-318/10 of 5 July 2012, OJ, C287/2 of 22 September 2012.

\(^7\) S. 26/48 of the tax authorities’ commentaries to the ITC and regulations dated 28 June 1999 (AAF/98-0003) on TP to which a summary of the OECD TP guidelines is annexed.

\(^8\) On 23 May 2016, the OECD Council approved the amendments to the TP guidelines, as set out in the BEPS report on Actions 8–10, Aligning transfer pricing outcomes with value creation and the BEPS report on Action 13, Transfer pricing documentation and country-by-country reporting.
2.2. Challenges of transactions with intangibles

2.2.1. Definition of intangibles

The ITC does not contain a definition of intangibles. Usually, one looks at the accounting law to find a substitute. Accounting law is supposed to define what should be recorded as intangible fixed assets but it limits the definition to an exhaustive list of items to be considered as intangibles for accounting purposes. Those items are the following:

- R&D expenses;
- concessions, patents, licences, knowhow, trademarks and similar rights;
- goodwill; and
- down payments for intangible fixed assets.

Similarly, article 12 of the OECD model defines the term “royalties” as “consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematographic films, any patent, trademark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience”.

The new definition of intangibles introduced by the OECD in its BEPS report conflicts with that of Belgian accounting law as goodwill is not always considered as an intangible by the OECD\(^9\) but should be taken into account when transferring other assets of the enterprise to establish the arm’s length price. Such a conflict is not a problem for the OECD as those legal definitions of intangibles are irrelevant for TP purposes.\(^10\)

2.2.2. Transactions with intangibles

Belgian legislation is based on civil law principles. This means that, for legal purposes, only the legal owner can exercise all rights related to an asset, whether tangible or intangible, unless some of those rights are transferred contractually to another party. Legally speaking, economic ownership is not recognized under civil law. Some rights related to an asset such as the “usufruct” (a sort of “life interest”) do not correspond to economic ownership.

For TP purposes, the Ruling Commission has already recognized the concept of economic ownership when examining intra-group transactions and the TP methods proposed and when valuing the prices of transactions envisaged by the taxpayer.\(^11\) To the best of the reporter’s knowledge, no Belgian court has ever ruled on the recognition of the economic ownership of an asset, whether or not for TP purposes.

Since Actions 8–10 of the BEPS report would be considered by the tax authorities as the practical application of the arm’s length principle mentioned in article 185(2) of the ITC, the emphasis placed by the OECD on value creation by each enterprise of the group and on the actual behaviour of the parties rather than on the


\(^10\) See ibid., 6.13 and 6.29.

legal ownership of intangibles\textsuperscript{12} will probably be adopted by the tax authorities for TP purposes.

\textbf{2.2.3. “Substance-over-form” approach towards intangibles}

For 10 years, the tax authorities, either during TP tax audits or through advance tax rulings, have emphasized the importance of the “substance-over-form” principle.

During tax audits, the Belgian taxpayer often claims a limited risk profile in order to limit the level of its taxable remuneration in Belgium. This requires a thorough functional analysis which is audited by tax inspectors. In cases where the Belgian entity is the entrepreneur, the authorities check whether the return left with the other related parties is commensurate with the actual functions and risks assumed by those entities. Not only contracts but also the actual behaviour of the parties are examined. Discrepancies could lead to adjustments.

Tax rulings do require an upfront functional analysis and a benchmark study to justify the TP method(s) and the margins attributed to each entity involved in the ruling request. Although the legal ownership of tangible and intangible assets is important, the Ruling Commission examines the allocation of the functions, the risks and the use of the (in)tangible assets\textsuperscript{13}. Since rulings are advance rulings, i.e. before the actual transactions take place, the Commission cannot check whether or not the allocation of functions, risks and intangibles described in the ruling request matches the actual behaviour of the parties. However, under Belgian tax law, if the actual behaviour of the parties and the way they carry out the transactions do not correspond to what was described in the ruling request, the ruling is not binding upon the tax authorities and it loses any usefulness.

Since the OECD principles embedded in Action 8 of the BEPS report are moving from a focus on the legal owner to a focus on each group member which performs functions, uses assets or assumes risks that are expected to contribute to the value of the intangibles, it is expected that the tax authorities will also modify their attitude in the same way as from 2016. The authorities are likely to examine closely the assignment of the DEMPE\textsuperscript{14} functions among the group entities. This change could have a significant impact on Belgian companies owning intangibles as well as on Belgian sales entities of foreign groups which could possibly develop commercial intangibles and be forced to recognize additional profit relating to the development of these intangibles. In this respect, the tax authorities have carefully studied the US landmark \textit{GlaxoSmithKline} case where the key issue concerned the allocation of the US profit between the legal owner (the UK parent company) and the economic owner of some alleged commercial intangibles (the US sales subsidiary).\textsuperscript{15} The tax authorities are not yet auditing commercial entities based in Belgium to examine whether or not they have become the economic owners of commercial intangibles.

\textsuperscript{12} See report on Actions 8–10, \textit{op. cit.}, 6.32.
\textsuperscript{14} Development, enhancement, maintenance, protection and exploitation of an intangible.
\textsuperscript{15} \textit{GlaxoSmithKline Holdings (Americas) Inc. & Subsidiaries v. Commissioner of Internal Revenue}, TC no. 5750-04, filed on 2 April 2004. The text of the lawsuit can be found in \textit{Tax Management Transfer Pricing Report}, 14 April 2004, no. 23, pp. 1119 et seq.
Since Belgian tax law is based on legal ownership under civil law, it is highly probable that the move from an emphasis on the legal ownership to that on the economic ownership will be limited to the TP field. It is very unlikely that Belgian tax law will be modified in this respect.

2.2.4. Comparability and group synergies

Synergies were explicitly recognized by the tax authorities before the BEPS report, particularly by the Ruling Commission. From a TP perspective, synergies mean advantages stemming from the fact that a company belongs to a group and can benefit from advantages that an independent company would not obtain.

The OECD does not give any precise definition of synergies and nor does it explain how to measure and price them. Synergies are discussed in the framework of the profit split method, including in its public discussion draft on “the revised guidance on profit splits” of 4 July 2016, but it is difficult to see the usefulness of this term in determining whether the profit split is the best TP method.

Synergies have also been recognized in Belgium through the so-called “excess profit rulings”.16 These rulings are delivered by virtue of article 185(2) of the ITC, which deals with cross-border transactions of companies or branches belonging to an MNE. This article provides a downward adjustment: when a company is taxable on profits on which another company could be taxed or has already been taxed, the taxable income of the first company is adjusted in an appropriate manner, as if the agreed conditions between the two companies were those which would have been agreed between two independent companies.

Because a Belgian company benefits from synergies and other intangibles (a client list, a distribution network, etc.) for which it does not pay any consideration, it will generate additional profits stemming from those “received” intangibles. Because an independent company would not benefit from those intangibles and in order to respect the arm’s length principle, the Belgian entity requests, in an advance ruling, the tax exemption of the portion of the profit stemming from the exploitation of those “received” intangibles.

The granting of those rulings was explicitly based on paragraph 1.10 of the OECD TP guidelines which reads as follows:

“The arm’s length principle is viewed by some as inherently flawed because the separate entity approach may not always account for the economies of scale and interrelation of diverse activities created by integrated businesses. There are, however, no widely accepted objective criteria for allocating the economies of scale or benefits of integration between associated enterprises.”

The “excess profit” rulings are presently being challenged by the European Commission which takes the position that they constitute prohibited state aid, based on its own definition of the arm’s length principle which does not match that of the OECD. Belgium has filed an appeal against the Commission’s decision.

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The second area where synergies are explicitly recognized in Belgium is the area of financial transactions, specifically in respect of an implicit and/or explicit guarantee given by the parent company to one of its affiliates. The question is to determine whether a subsidiary always benefits from the creditworthiness of the ultimate parent of the group when negotiating a loan from a related party or a third party and whether it is allowed to pay a guarantee fee to the parent company if the latter takes on an explicit engagement to guarantee the reimbursement of the loan if the affiliate fails to do so. The implicit guarantee toward the lender who lends the money to an affiliate stems from the fact that the borrowing subsidiary belongs to an MNE and, indirectly and to a certain extent, benefits from the creditworthiness of the parent company. This implicit guarantee is therefore a synergy stemming from the fact that the affiliate belongs to the group without any actual transaction being undertaken by the group. The explicit guarantee is a formal engagement from the parent company to reimburse the loan taken by a subsidiary if the latter does not reimburse its loan.

Several ruling requests were filed with the Ruling Commission about the arm’s length price of a guarantee fee when the parent company was granting an explicit guarantee. The Ruling Commission heavily relied upon the Canadian landmark GE case to take a position. In that case, the US-based parent General Electric Capital Corporation (GECUS) (with an AAA credit rating) guaranteed debt securities issued by a Canadian subsidiary GECC (with a BB credit rating on a stand-alone basis) in consideration for a guarantee fee equal to 1 per cent per annum of the principal amount of debt securities outstanding during a year. The deduction of this guarantee fee was disallowed by the tax authorities because this explicit guarantee had no economic benefit for the Canadian subsidiary as it already enjoyed an implicit guarantee. According to the Canadian tax authorities, the parent company would never allow a group affiliate to default on its debt because this would damage the parent’s own AAA credit rating and increase its borrowing significantly. Due to this implicit guarantee, GECC would have had the same credit rating as its ultimate parent and could have borrowed at the same interest rate without the explicit guarantee.

The court held that the factor of “implicit guarantee” was relevant in an arm’s length analysis under the TP rules. It applied a “yield approach” comparing the interest rate GECC would have paid with and without GECUS’s guarantee. The Tax Court found that GECC’s credit rating (with implicit support but without the guarantee) was at most BBB-/BB+ (and not AAA) and that the 1 per cent guarantee fee satisfied the arm’s length test.

In its BEPS report on Actions 8–10, the OECD is adopting the same reasoning as the Canadian tax court concerning group synergies. No payment is required when a subsidiary obtains incidental benefits attributable solely to its being part of

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a larger MNE group. However, when a material advantage is obtained as a result of deliberate concerted group actions, a consideration should be paid.\textsuperscript{20} It is regrettable that the examples of group synergies given by the OECD are limited to a central purchasing function generating volume discounts and to a guarantee fee. There are other types of group synergies which can create benefits to group companies, as the Belgian “excess profit rulings” illustrated. For those synergies, it would have been interesting to know the OECD viewpoint as far as the potential consideration was concerned.

2.2.5. Hard-to-value intangibles

Pursuant to the BEPS report on Actions 8–10, Belgium did not take any specific measures regarding hard-to-value intangibles. It remains to be seen whether the tax authorities will apply the recommendations mentioned in the report regarding hard-to-value intangibles, particularly the use of \textit{ex post} results to possibly challenge the valuation \textit{ex ante} of an intangible under certain circumstances and when some thresholds are exceeded. Outside the TP context, it is generally accepted that the tax authorities may not interfere in the management of the taxpayer’s business and challenge the assumptions taken at the time a taxable transaction is decided. Moreover, case law largely demands that the authorities look at the time the transaction took place and not when the results of the transaction were known some years later (usually when a tax audit is taking place). It remains to be seen whether, for the sole purpose of valuing a hard-to-value intangible, the tax authorities and/or the courts will change their attitude.

When examining the few tax rulings dealing with hard-to-value intangibles, the question of whether or not a related party took into account the valuation uncertainty in pricing the transaction is dealt with (a) when parties use a valuation method like the discounted cash flow approach\textsuperscript{21} or (b) by limiting the binding character of the ruling to a period of maximum five years. In the first case, the discounted cash flow can be based on projected results but with an adjustment after a few years to take into account the actual profits whether or not with a retroactive effect.

In some rulings, the valuation of the intangible is based on the acquisition price paid to a third party in the recent past (comparable uncontrolled price (CUP)) with an adjustment of the value based on a valuation carried out by an external expert.\textsuperscript{22} Taxpayers often use external databases like RoyaltyStat to value intangibles when comparables are available.\textsuperscript{23} In other rulings, the residual profit method is used when no comparables are available.\textsuperscript{24}

\textsuperscript{20} Aligning Transfer Pricing Outcomes with Value Creation, Actions 8–10, Paris, OECD Publishing, 2015 Final Reports, 5 October 2015, 1.157 and 1.158. This confirms the OECD position mentioned under 7.13 of the OECD TP guidelines.
The OECD recognizes the usefulness of economic valuation techniques for transactions involving the transfer of intangibles or rights in intangibles. Although not excluding other methods, the application of income-based valuation techniques, especially valuation techniques premised on the calculation of the discounted value of projected future cash flows derived from the exploitation of the intangible being valued, is considered as useful.

The OECD concedes that using a valuation based on the actual future income does not exactly match the attitude of third parties. “Although in some cases an uncontrolled party may mitigate its individual risks through agreed variations in prices, this generally does not result in the other party sharing in the outcomes of its business activities or sharing in its risks.”

However, when related parties value an intangible on the basis of future actual outcomes, they share the risks associated with the business of the party realizing the future outcomes.

Based on the OECD TP guidelines and a specific EU experts report on the valuation of intellectual property, the EU Joint Transfer Pricing Forum issued a discussion paper on the use of economic valuation techniques in TP. This discussion paper sets up the theoretical framework of valuation techniques. Further developments on the practical implementation of those techniques are expected in the coming months and will certainly inspire the tax authorities and Belgian taxpayers.

### 2.2.6. Cost contribution agreements (CCAs)

CCAs are seldom initiated in Belgium. This does not mean that Belgian companies do not participate in them but that those CCAs are agreements entered into outside Belgium and are governed by foreign tax law. Mostly, the main contributors are non-Belgian affiliates. There are a few rulings on this matter.

To the best of the reporter’s knowledge, there is no published Belgian court decision concerning CCAs.

Tax audits of CCAs with Belgian members are guided by the recommendations of Chapter VIII of the OECD TP guidelines. The amendments brought by Action 8 of the BEPS report will probably not increase the use of CCAs in Belgium. The main concern regarding the report relates to the requirement that contributions of the members of the CCA be commensurate with their proportionate share in the expected benefits. This premise will furthermore increase disputes about valuation with the tax authorities. There are circumstances when a valuation at cost is more appropriate, as for the use of research centres in the case of agreements concluded with third parties.

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26 See OECD TP guidelines, 9.94.
29 See e.g. Ruling 2013.326 dated 3 September 2013.
For CCAs on services not creating intangibles, the EU Joint Transfer Pricing Forum issued some recommendations on CCAs in June 2012 addressing some critical practical issues faced by multinationals using CCAs.\(^{30}\) The view of the Forum was clearly focused on sharing the costs and is based on the reasoning that, for these kinds of services, their value is not much greater than their cost.

### 2.3. Risk and capital

Since the tax authorities apply the OECD TP guidelines as they are modified over time, it is to be expected that they will apply the new OECD approach, which aligns the returns with the value creation and which comprises measures to ensure that inappropriate returns will not accrue to an entity solely because it has contractually assumed risks or has provided capital. As requested by the OECD, it is to be expected that the authorities will put less emphasis on the contractual arrangements where the actual behaviour of the related parties deviates from those contractual arrangements, and if the legal owner of the assets does not carry out important functions, assume the most significant risks and enhance the value of its assets.

Whereas Belgium has a civil law-based tradition to focus on legal agreements and on respect for the legal obligations of the parties,\(^ {31}\) the BEPS report will undoubtedly lead to a more economic approach to TP in Belgium and to a more economic analysis of intra-group transactions.

Regarding the returns on capital, the tax authorities have long experience starting with the audits of Belgian coordination centres (intra-group treasury companies benefiting from a specific tax regime which has now been abolished) and with the intra-group finance companies which succeeded them. Thorough tax audits focus on the arm’s length consideration but also on whether the returns of those finance companies are commensurate with the functions and the risks of the transaction being examined.\(^ {32}\)

### 2.4. High-risk transactions

#### 2.4.1. CUP and quoted prices for cross-border commodity transactions

Commodity transactions are based on prices quoted on commodity exchanges. To the best of the reporter’s knowledge, there has not been any published court decision or any tax ruling on the TP aspects of commodity transactions. Belgium not being a country rich in commodities, agreements usually involve Belgian entities as buyers of commodities.

It is expected that any deviation from the quoted price or any item added to the quote under any qualification whatsoever would be carefully examined by the authorities.

\(^{30}\) Report on cost contribution arrangements on services not creating intangible property (IP), DOC: JTPF/008/FINAL/2012/EN, 7 June 2012.

\(^{31}\) Based on the landmark *Brepols* case, Cassation, 6 June 1961, Pasicrisie, 1961, I, p. 1082.

Intra-group services should be examined on the one hand when the Belgian entity provides the services and on the other hand when it is the beneficiary of the services.

Profits generated by rendering services are not defined as such in the ITC but they undoubtedly fall under the definition of taxable profits by virtue of article 24 of the ITC. With regard to services at international level, profits from services are only taxable in the residence state of a company unless the services are rendered in another contracting state through the presence of a PE. However, in some treaties, Belgium has deviated from this rule and provided that the furnishing of services is deemed to constitute a PE (the so-called “services PE”) in certain circumstances.33

Belgium has a long tradition in concluding agreements with taxpayers regarding intra-group services. The first formalization of those agreements is embedded in the regulations of 1996 regarding service centres.34 In many cases, the cost plus method was encouraged, with a mark-up ranging from 5 per cent to 15 per cent. Unlike the USA,35 Belgium has rarely agreed on an invoicing of the costs without a mark-up for low value-adding services.

When those regulations were considered as a harmful tax measure by the European Commission, they were abolished and replaced by formal advance tax rulings based on the OECD principles pursuant to the Law of 24 December 2002. Except for very high value services, the most commonly used TP method was and still is the cost plus method. Except for stewardship expenses, most direct and indirect costs are included in the cost basis. In many rulings, the Ruling Commission requires in addition that net financial costs and net exceptional costs be recharged at cost, which is not indicated in the OECD TP guidelines.36 The Commission justifies this requirement by the wish to avoid those costs totally offsetting the taxable mark-up.

Another issue which is important in Belgium in the framework of low value-adding services is the cross-charging of “disbursements”. Disbursements are costs incurred by an entity of the group for goods or services which are allocated and cross-charged to other group members without adding any mark-up. Indeed, the group members could have acquired those goods or services directly from a third party supplier. The goods or services would be charged by the third party supplier to one company of the group at market price and the billed entity would simply allocate the goods or services between the group members and cross-charge the costs billed by the supplier. Therefore, no value-adding service would be performed by the group entity cross-charging the costs. For “disbursements” the Ruling Commission accepts the cross-charging of those costs without a mark-up.37

See for more detail C. Devillet and X. Van Vlem, Enterprise Services, subject 1 of the IFA Congress 2012, Boston (USA), Belgium report, pp. 145–147.


See Services cost method, Treasury Regulations, s. 1.482-9b.

See e.g. Ruling 2015.167 dated 13 May 2015.

The OECD has always had some issues with the cross-charging of costs without a mark-up and has taken the view that every service should be remunerated as independent enterprises would want to make a profit when rendering services. It is obvious that independent enterprises are not cross-charging expenses at cost to other companies as they are never part of an MNE. The position of the OECD was slightly more flexible in sections 7.34 to 7.37 of the guidelines. Those comments remained unchanged in the final report on Action 8 of the BEPS report and should be considered as reinforcing the Belgian Ruling Commission’s position.

As far as the level of the mark-up is concerned, the applicant for the ruling has to demonstrate the arm’s length nature of the range on the basis of comparables. Rather than applying a range, the Ruling Commission normally agrees on a fixed percentage. Sometimes low value-adding services can be marked up with 3 per cent. Sometimes, when several services are rendered by the applicant, the Commission recommends a single average rate for all services.

When the Belgian entity is the beneficiary of the intra-group services, the services are usually rendered to all group companies and the costs are allocated between the beneficiaries, including the Belgian entity. The type of costs being charged, the amounts as well as the allocation keys are carefully examined by the tax authorities. There is no compulsory allocation method; it is up to the taxpayer to justify it on a case-by-case basis.

Payments made to obtain services are deductible if they respect the arm’s length principle according to article 49 of the ITC. There are some anti-abuse provisions which increase the burden of proof for the taxpayer which wants to deduct the expenses for the payment of services. The main articles in this respect are articles 54 and 198(10) of the ITC.

Obviously, the taxpayer must not only prove that services are actually rendered but also that the Belgian entity obtains a benefit from those services. There are still court decisions confirming that some taxpayers are unable to prove that services for which they paid were actually rendered. Those cases do not concern MNEs. Many of the latter conclude tax rulings so that they have the legal certainty that the costs and the mark-up will not be challenged by the Belgian tax authorities during a subsequent tax audit.

The following three recent rulings dealing with a Belgian applicant as the service provider are interesting to mention.

A Belgian company carries out different support services, including the coordination of all internal IT projects and the reporting of all activities of the division to the parent company, public relations, marketing and legal services, and the management of a centralized customer service department. In view of the limited risk profile of the service provider, a TNMM method with a “full cost mark-up” as profit level indicator is used to determine its remuneration. A benchmark study had been carried out by the applicant resulting in a median of 6 per cent mark-up, which was in line with the mark-up arrived at by the Ruling Commission through

39 See Cassation (1st Chamber N.), 15 October 2015, R.G. no. F.140161.N.
its own benchmark study. Moreover, the net financial costs and net non-recurring costs should be cross-charged at cost.40

In another recent ruling, for similar support services, the Ruling Commission accepted a cost plus 6 per cent with a prohibition on deducting interest charges from the mark-up. The TNMM method was used with a full cost mark-up as PLI.41

Sometimes the cost plus method is accepted but the remuneration of the service provider is determined in a specific manner. In a 2015 ruling, the provider of unspecified services was entitled to 15 per cent of the profit expected from all contracts as determined on day one of the transaction (in order to give it a financial incentive to be efficient), in addition to the reimbursement of its operating costs, net financial costs and net non-recurring costs. In any case, a mark-up of 5 per cent on all operating costs would form the minimum remuneration of the service provider for tax purposes.42

A new element introduced in Action 8 of the BEPS report is the acceptance of a safe harbour regime for low value-adding services. The OECD has always been reluctant to accept safe harbour rules. In its guidelines, the organization devotes 5 paragraphs to the benefits of safe harbour rules and 21 paragraphs to their disadvantages.43 Therefore, the introduction of a safe harbour regime for low value-adding services is a new strategy for the OECD.

The new definition of low value-adding services is not surprising and corresponds to the definition used in Belgium by the Ruling Commission. The services are of a supportive nature, are not part of the core business of the enterprise, do not require the use of valuable intangibles and do not involve the assumption of significant risks. The type of services falling and not falling under this definition are also in line with the position of the Belgian tax authorities.44

It remains to be seen how the tax authorities will integrate this new safe harbour regime into their TP approach, which is exclusively based on comparables to prove the arm’s length nature of the compensation. This new regime will be welcomed by companies as it will simplify the TP policy and documentation requirements. The recent Belgian law on TP documentation,45 and particularly the section related to the local file, does not mention whether or not the use of this safe harbour regime should be documented in any way.

2.4.3. Profit splits in the context of value chains

When facing MNEs with a highly integrated value chain, the tax authorities, and especially the Ruling Commission when examining tax ruling requests, look at the TP method(s) used by the taxpayer. Often, the profit split method is used when a

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43 OECD TP guidelines, chapter IV, section E, Safe harbours, 2010 version, which has been replaced by a more flexible version dated 16 May 2013.
valuable intangible is part of the value chain. Sometimes the residual profit method is used when one company is using an intangible or the profit split method is used when two or more companies own high-value intangibles.\textsuperscript{46} Exceptionally, the CUP method is used when comparables are available or when a valuable intangible has recently been acquired from a third party, offering a reference price which, after a value adjustment for the period between the acquisition and the transaction being contemplated, can be considered as an arm’s length price.

The following rulings are a good illustration of the position of the Ruling Commission.

The first ruling is a case where the CUP method has been used in order to value intangibles. The applicant wanted to obtain a confirmation from the Ruling Commission that the royalty percentage for the royalty embedded in the sales price of the product (incorporating the new technology) was at arm’s length. This royalty percentage was necessary to claim a patent box deduction.

For wholesales, internal CUP data are available to determine the percentage of the embedded royalty which amounts to a median of 7.5 per cent in this case. For sales at retail level, external CUPs are sought via external databases used by the applicant of the ruling (LexisNexis and TP Cut) and confirmed by a benchmark study via TP Catalyst performed by the Ruling Commission. The median percentage was 5 per cent in this case.\textsuperscript{47}

In the second ruling, the valuation of the intangible was arrived at through the use of the residual profit method after deduction of a profit for routine activities.

The Ruling Commission agreed that the percentage of royalties, embedded in a new technology in the medical device sector, was at arm’s length in order to qualify for the patent box deduction. In order to determine the return attributable to the new technology compared to existing technologies, the method of residual profit was used after deduction of the profit attributable to the sale of similar devices not including that new technology by third parties. The remuneration for the new technology was based on approaches using anticipated benefits and based on the market.\textsuperscript{48} Under the benefit approach, one calculates the profit generated by the new technology compared to the profits of independent comparables performing the activity of producing and selling similar devices which use a more common technology. Under the market-based approach, one looks for transactions between third parties for similar technologies. The applicant used the RoyaltyStat database to arrive at an interquartile range which was in line with the royalty percentage under the anticipated benefit approach.\textsuperscript{49}

In the third ruling, a profit split method was used. In the framework of the patent box deduction, two companies were involved in the exploitation of different patents embedded in a product. To compute the profit from this exploitation attributable to each company, the profit split method was used. The allocation of profit


\textsuperscript{47} Ruling 2015.689 dated 26 January 2016.

\textsuperscript{48} Based on 6.29 and 6.23 of the 2010 OECD TP guidelines.

was based on the costs incurred by each company for the sales of products in which the patents were embedded. The percentage attributable to each of the two companies was applied to the actual sales revenue of the products.\(^{50}\)

On 4 July 2016, the OECD released a discussion draft on “the revised guidance on profit splits”. Its key theme is that a profit split method is appropriately applied only where the relevant activities are highly integrated or reflect unique and valuable contributions by both parties to the intercompany transaction, and should not be used solely because a one-sided method may be difficult to apply under the particular circumstances. The discussion draft outlines two variations of the profit split method: a split of anticipated profits and a split of actual profits. The reporter considers that both profit split methods have their merits and that all depends on the facts of each situation to determine which method would have been chosen by independent parties. It remains to be seen whether or not the OECD will take the numerous comments made on the draft into account in its final report.

As Belgium will automatically endorse the final guidelines stemming from the final report and is a country with significant pharmaceutical activities and sophisticated industrial R&D, the final text will be crucial for both enterprises and tax authorities.

2.5. TP documentation

Until 2015, Belgian tax law did not require taxpayers to prepare contemporaneous TP documentation. Consequently, there were no penalties for any absence of readily available TP documentation. However, Belgium did implement the code of conduct on transfer pricing documentation for associated enterprises in the European Union (EU TPD) through regulations dated 14 November 2006.\(^{51}\) Those regulations describe how a TP tax audit should be conducted and also the type of questions and documents to be requested in the framework of such tax audits. Surprisingly, although regulations are an internal document of the tax administration for the attention of its tax inspectors only and have no binding effect outside the administration, they were also addressed to taxpayers, which were encouraged to prepare robust TP documentation in anticipation of future TP tax audits.

2.5.1. CbCR

Belgium took the opportunity of the implementation of Action 13 of the BEPS report to introduce a legal obligation\(^{52}\) for taxpayers to prepare contemporaneous three-tier TP documentation as from 2016. The TP documentation comprises CbCR, a master file and a local file. Concerning CbCR, the law uses the model legislation included in the CbCR implementation package which forms annex IV to the revised chapter V of the OECD TP guidelines,\(^{53}\) adds some definitions for the

\(^{50}\) Ruling 2012.090 of 19 February 2013.


\(^{52}\) Programme Law of 1 July 2016, op. cit.

sake of clarity and completes the implementation package with additional provisions but without departing from the rationale of the OECD. The law has not yet transposed the European directive of 2011 on the exchange of fiscal information between Member States.

Article 54 of the new law determines the content of CbCR: it should comprise the 11 pieces of information (revenue, profit before tax, taxes, share capital, number of employees, etc.) as well as a list of the Belgian constituent entities with the precise nature of their activities (13 types of activity are mentioned) as provided in the model template for CbCR under annex III to chapter V of the new OECD TP guidelines.

CbCR should be filed electronically by the Belgian ultimate parent entity of a group that has gross consolidated group revenue of at least €750 million as reflected in the consolidated financial statements during the year preceding the reporting year. A reporting template has been drawn up in a Royal Decree. Each Belgian constituent entity should notify the tax authorities whether or not it is either the ultimate parent company or the surrogate parent entity or neither, by the last day of the reporting year (and for the first time in 2016).

The filing of CbCR should occur no later than 12 months after the last day of the reporting period concerned of the MNE. The filing obligation starts as of the accounting year beginning from 1 January 2016.54

Article 56 of the law explicitly states that CbCR should be used to evaluate the risks relating to TP and other risks associated to BEPS or for economic or statistical analyses. No TP adjustments may be exclusively based on CbCR, although the report can be used in the framework of additional tax investigations which can lead to TP adjustments.

Belgium will exchange CbCR on the basis of either the bilateral tax treaties or the Convention on Mutual Administrative Assistance in Tax Matters55 or the future multilateral instrument to modify bilateral tax treaties.56 Concerning the exchange of CbCR between tax authorities, the law of 2016 does not provide any specific obligations to the tax authorities in order to guarantee the strict confidentiality of the information included in the CbCR. This creates a major concern for MNEs.

2.5.2. Master and local files

The above-mentioned law of 1 July 2016 introduces the requirement for each Belgian constituent entity to draw up and file a master file as well as a local file.

2.5.2.1. The master file

The purpose of the master file is to give the tax authorities an overview of the MNE in order to assess the presence of significant risks regarding the TP policy of each

54 The parliamentary works to the law of 1 July 2016 mention that the first filing relating to the 2016 reporting year should not occur before 1 October 2017 “in order to allow a correct management of the CbC reports” (Doc. Parl., Chambre des représentants, no. 54-1875/001, p. 58).
56 Action 15 of the BEPS report.
Belgian constituent entity. The content requirements for the master file are closely aligned with those put forth by the OECD and include:

- the nature of its global business operations;
- a list of the intangible assets and a description of the group’s TP policies related to R&D and intangibles;
- intra-group financial transactions;
- the consolidated financial and tax statements of the group;
- the overall TP policies; and
- the global allocation of income and economic activity.

The exact content is provided in a Royal Decree. Some other items are added to the list, such as an organizational structure of the group or existing unilateral APAs and other tax rulings relating to the allocation of income among countries. The above-mentioned content requirements are in line with the EU TP documentation (EU TPD) recommended in the EU code of conduct and which was applied by Belgium until 2015.

2.5.2.2. The local file

As regards the local file, Belgium is going beyond the OECD’s requirements by requesting the filing of two forms: one that needs to contain general information on the local entity, and a second form that focuses on detailed information on the TP applied between the local entity and foreign group entities.

The first form should include information on the organizational structure of the Belgian entity (e.g. directors, shareholders, subsidiaries) and on the nature of the activities of the local entity as well as an overview of the transactions with related parties.

The second form should comprise, for each business unit, the following data on intra-group transactions (a materiality level of €25,000 per transaction may be applied):

- the nature of the activities;
- aggregated data on the transactions made by the business unit on the one hand with other entities of the group and on the other hand with third parties over three financial periods;
- sales to and purchases from non-residents for inventory, intangible fixed assets, tangible fixed assets, financial fixed assets and commission for services;
- the TP method used for each flow along the lines of what is mentioned in annex II to chapter V of the BEPS report on Action 13;
- details on cross-border financial transactions: interest from loans, interest from cash poolings, interest from commercial debts, guarantee fees, (re)insurance premiums, derivatives;
- details on any other cross-border transactions;
- profit allocation with PEs; and
- a list of CCAs, rulings and internal reinsurance contracts. A copy of the documents may be attached if the taxpayer so wishes.

This second form should only be prepared and filed if the intra-group cross-border transactions of any Belgian business unit exceeded €1 million during the financial year concerned. Representatives of the Belgian entities concerned have already
complained about the significant additional administrative burden entailed by this second form.

2.5.2.3. Filing obligation for the master file and the local file

The obligation to file a master file as well as a local file will be imposed on every Belgian group company that, on the basis of the Belgian financial statements related to the accounting period preceding the last accounting period, exceeds one of the following criteria:

- operational and financial revenue of €50 million (excluding non-recurring revenue);
- a balance sheet total of €1 billion;
- 100 full-time equivalent employees (on an average annual basis).

The timing of the filing is different for the two files. The master file should be filed within one year after the closing date of the consolidated financial statements of the group while the local file must be filed together with the tax return of the Belgian entity relating to the same accounting year. However, the second form of the local file should be filed only for financial years starting on or after 1 January 2017. The filing will take place electronically.

Penalties ranging from €1,250 to €25,000 can be imposed by the tax authorities if the Belgian entities do not fulfil their legal obligations concerning the TP documentation, including CbCR.

2.5.3. Compliance costs

The CbCR is not a document supporting the TP policy or the TP methods or the contracts of an MNE. Therefore, it should not be considered strictly speaking as being part of the TP documentation of a group. CbCR has been recommended by the OECD mainly to “make it easier for tax administrations to identify whether companies have engaged in transfer pricing and other practices that have the effect of artificially shifting substantial amounts of income into tax-advantaged environments”.

In other words, the OECD hopes that tax authorities will be informed of entities having few employees but generating significant revenue subject to low taxation so that they can start TP investigations in a more focused manner. However, for MNEs, there are multiple reasons for a mismatch between revenue and the number of employees. The benefit of tax incentives granted by some countries for specific activities such as R&D is one of them.

Because the tax authorities lack sufficient resources to start cross-border TP investigations, the OECD has compelled MNEs to provide a huge quantity of information to the authorities. However, it has not provided safeguards to avoid an inappropriate use of the data provided. MNEs expect a significant increase in the number of additional tax assessments and related double taxation.

The additional administrative costs relating to the gathering of the requested information could divert MNEs from their core business while they will not gain any benefit from it. The OECD has not recommended replacing current domestic

requirements for TP documentation by the three-tier approach so that each country is free to add the OECD filing to its existing documentation requirements. Moreover, MNEs had expected that, as compensation for all additional constraints contained in the BEPS report, a mandatory and binding arbitration provision would be added to the multilateral instrument discussed in Action 15 of the BEPS report, allowing the removal of double taxation within a fixed timeframe. The OECD had promised this to MNEs which unanimously repeated their wish to see a mandatory and binding arbitration provision within the MAP procedure in order to reduce the legal uncertainty and the number of cases of double taxation, but the OECD did not obtain the necessary consensus on this matter, so that, in the final BEPS report, the mandatory and binding arbitration provision is only optional, while many anti-BEPS measures such as all anti-abuse provisions or the new TP approach linking profits to value creation will be enforced.

2.6. TP-related measures in other BEPS actions and other measures against BEPS

There are TP-related measures in other BEPS actions as in Action 1, Addressing the tax challenges of the digital economy. The main issue seems to be whether or not the state of residence of clients who purchase tangible or intangible goods or services over the internet from a non-resident seller who has no physical presence whatsoever in that state, is entitled to tax part of the profit generated on those sales. In most countries, those sales are already subject to VAT or a sales tax.

According to the OECD, there is no need to search for specific ways to tax profits generated by the digital economy as these are part of the overall economy and cannot be ring-fenced for tax purposes. The OECD believes that BEPS in the digital economy will be adequately tackled by other BEPS measures, such as the broadening of the definition of PE or the anti-abuse provisions or the DEMPE functions and the control over risks relating to intangibles. This also seems to be also the opinion of senior officials from the tax authorities at present.

Part of Action 7 of the BEPS report relates to the attribution of profits to PEs. On 4 July 2016, a discussion draft was released and comments from interested parties have been published. The draft report does not bring any changes to the authorized OECD approach (AOA) of profit attribution to PEs. It applies the AOA approach, taking into account the prerequisite that each entity should be rewarded according to the actual significant functions performed, the risks borne and the assets held.

In September 2016, the tax authorities released draft regulations on the 2010 version of article 7 of the OECD model and the OECD commentary on the attribution of profits to PEs. Those draft regulations do not take the impact of the BEPS report on the attribution of profits to PEs into account.


2.7. Can BEPS work in favour of MNEs?

TP-related BEPS actions and their information gathering initiatives will inevitably force MNEs to pay even more attention to the compliance requirements and to prepare more detailed TP documentation. This is particularly true for the delineation of the functions and risks associated with intangible assets since the focus has moved from legal ownership to economic ownership. It is not clear at this stage whether or not Belgian MNEs will receive any benefit from the BEPS report.

3. What is the future of TP?

Since 2015, the OECD has adopted an “inclusive framework approach”. All decisions of the OECD being taken by consensus and not by a formal vote, the non-members had to agree on the text of the BEPS report in order to reach a consensus. As a result, many measures are a compromise between the OECD member states and the non-members, including the BRICS countries. Sometimes unclear positions are taken and huge interpretation problems may be expected over some imprecise recommendations or various options made available (for example, regarding anti-abuse provisions). This may lead to more situations of double taxation and to many more tax disputes.

Belgium will implement the actions of the BEPS report over time. However, the tax authorities take the position that Actions 8–10 do not need to be transposed into a new law and are immediately applicable.

Since Belgium has a long history of binding advance tax rulings, many MNEs present in Belgium request tax rulings to obtain legal certainty about their TP policy. One may expect an increase in tax ruling applications as a result of the lack of clarity of some recommendations of the BEPS report.
Summary and conclusions

The Bolivian regulations for transfer pricing according to Law No. 549, including modifications to corporate income tax (IUE), became effective as of the year 2016. The regulations established the principle of full competition, the applicable methods for adjustments or reappraisals including the “sixth method” and the possibility for the tax administration to suggest other linking criteria when transactions have not been carried out under the arm’s length principle. They also establish a formula to determine the range of value differences, briefly describing each one of the six detailed methods in the Act, and the manner of determining the range difference value based on the calculation of a lower and upper limit, making adjustments where the value lies outside this range. As a result the applicable procedure for the verification and determination of adjustments to be made by the tax administration has been laid down, as well as the applicable procedure for related services.

The National Tax Service has regulated the operating and formal framework for these, establishing the obligation for taxpayers to submit a transfer pricing report (EPT) and an informative operations affidavit for transactions between related parties (electronic form 601), defining the minimum content to be included in the EPT, as well as the thresholds for their presentation and the manner in which they need to be delivered and/or form 601.

Concerning base erosion and profit shifting (BEPS), the specific subject has not been addressed by the tax authorities. As of today there is no formal statement which would allow the criteria to be incorporated or proposed within the internal regulations to be elucidated, or the principles which would allow the possibility of facilitating the inclusion of the action plans in compliance with OECD guidelines. However, it is important to emphasize that even though there are no actions or specific regulations concerning BEPS in Bolivia, the tax regulations address some aspects which come close to these detailed actions.

In the near future the aim and focus should be to achieve the effective consolidation and implementation of the enacted regulations. It is clear that there are some pending actions that must be carried out, such as establishing to what extent the

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guidelines given by international agencies (the OECD and the UN) will be recognized in the Bolivian legal system as an auxiliary means of interpretation. The clarifications and/or additions needing to be made concern the following:

- a set of criteria or a list should be established in order to identify countries with low- or no-tax jurisdictions;
- a major explanation of the methods of assessment established in the regulations, also determining the parameters and guidelines for introducing methods different from the traditional ones set out there;
- limiting or shifting the burden of proof in transfer pricing issues;
- complementing the regulation of advance pricing agreements (APAs), Bolivian APAs and mutual agreement procedures (MAPs);
- adding secondary and bilateral adjustments in transfer pricing matters;
- specifying the possibility of analysis from the perspective of the counterparty to the transaction and not the local taxpayer, and requirements for doing this;
- specifying the use of comparables given the impossibility, for lack of local information, of obtaining comparables;
- clarifying the interaction or priority in the assumptions of the tax regulation of the IUE for operations between related companies to which the transfer pricing regulations apply;
- reviewing the formulae of established value in the rules so that the results and the method of calculation are not affected by extreme values.

The main challenge for Bolivia is the need to develop its transfer pricing regulations as well as the importance of providing proper training for the tax administration’s personnel and taxpayers in order to avoid arbitrariness. The participation of specialists of the private sector within the transfer pricing commission created should also be permitted in order to allow participants other than the tax authorities and the Ministry of Economy and Finance, as these are the bodies in charge of regulating and developing the regulations and should be called on to resolve or correct identified flaws.

Concerning BEPS actions and transfer pricing regulations, Bolivia has included in its internal regulations certain principles or approaches towards the implementation of the guidelines established by the OECD and the plans of action. It is clear that if Bolivia aspires to include these guidelines in its domestic tax system, it will be essential to develop internal regulations to that effect in order to achieve correct compliance, as well as ensuring that the information requested is in line with international requirements and that the consolidation does not involve major compliance costs for multinational companies (MNEs).

1. Current transfer pricing regulation and practice in Bolivia

After a tax reform (Law No. 843) was enacted with the purpose of simplifying the tax system in the 1980s, about a decade later Bolivia incorporated the first reference to transfer pricing regulations through Law No. 1606 by creating a tax applicable to income generated by companies (IUE). This regulation included the first definition of an arm’s length principle solely applicable to local branches of
foreign companies incorporated in Bolivia, establishing that companies related to other local or foreign companies had the obligation to prepare their accounting records in a separate manner in order to determine and differentiate what was deemed to be Bolivian sourced income. The regulation also established a linking criterion for legal entities that participated in management, control, administration bodies or that possessed capital in another company, and in the same way when a third party fulfilled the same conditions in two or more companies.

This basic design of the transfer pricing regulations was neither regulated nor fully developed so as to achieve a means of correct implementation; thus Law No. 516 on Investment Promotion was issued in the year 2014, establishing the design of a norm aimed to create transfer pricing regulations. The regulation was later amended by means of Law No. 549 by including modifications and additions to section 45 of the IUE. The newly enacted regulations established the principle of full competition, specifying the registration of accounting information in a separate manner so as to determine the results from a Bolivian source, defining a general principle of relationship linked with section 9 of the tax agreement model of the OECD, including the willingness to make adjustments and/or reappraisals when the agreed value was not in accordance with economic reality, or if it caused a reduction in tax in Bolivia, thus empowering the tax administration to assess such a transaction value.

The regulations also detail the applicable methods for adjustments and reappraisals. The methods mentioned are traditional ones included in the OECD guidelines; a price-based comparison (comparable uncontrolled price (CUP) method), gross profit (resale price method and cost plus method), or operating profit (transactional profit split method and transactional net margin method). Additionally they include the notorious transaction price in transparent markets method, better known as the “sixth method”, which may be applicable to the purchase/sale transactions of companies listed on transparent markets. The regulations include a provision for when it is not possible to determine the transaction value by any of these methods. Another method may be applied depending on the economic nature and reality of the operations. Reference may also be made to the General Customs Act, in the event of reasonable doubt in the submission of transfer pricing surveys to determine whether the relationship has or has not influenced the execution price of the transaction value.

The tax administration has a 12-month period to complete an audit and, if deemed necessary, this term may be extended for six additional months with the authorization of the highest authority. Law No. 549 sets forth that such an authorization could even extend the term for up to 12 months, meaning that a period of two years could be employed in order to carry out audits in operations involving related parties for transfer pricing regulation purposes.

Law No. 549 was later regulated by Supreme Decree No. 2227 issued on 31 December 2014. This regulation has picked up some of the guidelines of the OECD in establishing its six linking criteria. Some of its characteristics are listed as follows: (a) a linking effect without the consideration of a minimum percentage of participation; (b) a linking presumption when there are transactions with countries of low or no taxation (tax havens) without the existence of a list of the countries in question; (c) family linking which includes the fourth degree consanguinity and the second, and affinity to the second, degree; and (d) the possibility of the
tax administration suggesting other linking criteria when the transactions have not been carried out under the arm’s length principle.

The Supreme Decree also establishes a formula to determine the range of value differences, briefly describing each one of the six detailed methods in the Act, detailing the applicable procedure for the verification and determination of adjustments to be made by the tax administration, as well as the applicable procedure for services between related parties and the creation of a transfer pricing technical committee.

The National Tax Service, by means of Board of Director’s Normative Resolution No. 10-0008-15, dated 30 April 2015, has regulated the operating and formal framework of these regulations, establishing the obligation for taxpayers to submit an EPT and an informative operations affidavit between the related parties (electronic form 601), defining the minimum content to be included in the EPT, as well as the thresholds for the EPT’s presentation and the way it needs to be delivered and/or form 601 as the case may be, the determination and verification of adjustments by the tax administration and the applicable sanctions in the event of non-compliance.

In the Supreme Decree the tax administration establishes the manner of determining the difference value based on the calculation of a lower and upper limit, prices being adjusted where they lie outside these so that less IUE has become payable; the adjustment is determined on a mid-range or medium value set based on the initially set lower and upper values.

The effective date to implement the detailed regulations corresponds to the tax period ended as of 30 September 2015, for which the effective submission of the EPT with form 601 was to be completed during the 2016 tax period, within the deadline established for filing the IUE tax return.

As the transfer pricing regulations were effective as of the year 2016 in Bolivia, there are some pending issues to be regulated and clarified. The tax administration does not have a defined basis regarding the audit criteria that should be employed as their officials are still undergoing a training process intended to enforce the revisions to the EPT and form 601 to be submitted by taxpayers subject to the regulation.

2. The impact of the BEPS project on transfer pricing

2.1. Introduction

Before the enactment of the Transfer Pricing Act, international tax provisions were of no use or relevance whatsoever for tax and governmental authorities, considering that Bolivia enforced a firm source principle with a network of seven bilateral agreements to avoid double taxation, including the Andean Community decision. As a result, judicial and administrative courts had issued rulings that were contrary to international guidelines and jurisprudence, resulting in unfavourable and discouraging scenarios.

The recently enacted transfer pricing regulations may seem to be the light at the end of the tunnel as they could follow the criteria under the guidelines established
by the OECD in various fora and in the form of documents drafted in order to promote the regulations.\(^1\) Also, considering that the development of the domestic regulation pertaining to international tax is very basic, reference to OECD criteria to ensure a correct use of international tax principles seems reasonable, as does following the guidelines of the United Nations; the task of defining to what extent these guidelines can be used is pending, as Bolivian tax regulation does not address them as sources of the right to tax.

With regard to BEPS, although the specific subject has not been addressed by the tax authorities, as of today there is no formal statement which would allow the elucidation of the criteria to be incorporated or proposed within the domestic regulations, principles which would allow the possibility of facilitating the inclusion of the action plans in compliance with the OECD guidelines. However, it is important to emphasize that even though there are no actions or specific regulations concerning BEPS in Bolivia, the tax regulation addresses some aspects which are similar to the detailed actions. Nevertheless, the reporter emphasizes that further regulations need to be developed and that extensive training is needed by both the tax authorities and taxpayers in international tax regulations.

Regarding transfer pricing regulations specifically, as the regulations are quite recent, many aspects of the BEPS actions were not included. However, as mentioned above, from a personal point of view, there are some similar features which could be considered to be within the guidelines of the OECD Action Plan and these could be addressed according to the guidelines established for the writing of this present report.

### 2.2. Challenges of transactions with intangibles

#### 2.2.1. Definition of intangibles

The tax regulations have not issued a definition of intangibles such as that proposed by the BEPS actions, in implementing a broad and clear definition of intangibles applicable in transfer pricing regulations.

Ruling 578 details an approach to the definition of intangibles, by citing brands, patents, licences, non-patented technical knowledge and other knowledge of a similar nature in Bolivia.

#### 2.2.2. Transactions with intangibles

Transfer pricing regulations do not include specific regulations related to operations involving intangibles. In the EPT, it is specified in the functional analysis that the criteria for the estimation of royalties for intangibles is to be detailed in the financial information, without further reference being made to it.

The IUE tax regulations consider as non-deductible expenses the depreciation of goodwill, brands and other intangible assets of a similar nature, unless a price has been paid to acquire them. In those cases, they may be depreciated over a period of five years. Regarding the configuration of expenses, their deduction may be admitted in the first tax year or they may be distributed proportionally during the

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1 Memoire 2015 of the Eighth Bolivian Tax Law Conference.
first four years after the beginning of the company’s commercial activities, and may not exceed 10 per cent of its paid capital.

At the date of writing this report, no specific regulation had been developed for the transactions with intangibles referred to in the BEPS Action Plan.

2.2.3. “Substance-over-form” approach towards intangibles

If it is understood that “substance over form” can be identified as a provision of anti-abuse in Action 8, allowing the tax administration to recategorize operations and contract terms and conditions that differ from reality, the reference in the tax regulation is not specifically related to operations with intangibles, although these matters are dealt with in the tax and the transfer pricing regulations.

The Tax Code establishes that when legal forms which are inappropriate or atypical of the economic reality of the facts recorded are implemented, the tax rule could be applied in order to disregard these forms, this being a principle of a general anti-evasion rule which in most cases has been applied wrongfully by the tax administration and rectified by the judicial authorities.

Regarding transfer pricing and pursuant to the above, the tax administration can value the implementation of operations between related parties according to the full competition principle, making adjustments and/or proceeding with reappraisals if the agreed form does not reflect the economic reality, regardless of the legal form used, if that form would result in reducing the tax burden. This is how such operations, which do not lie within the range of value differences, can result in the determination of a new price or value of the commercial and/or financial operations, following the detailed methods in the transfer pricing regulations. Likewise, in the same way it is authorized to carry out adjustments to costs, expenses, deductions, income, utilities or losses, and any other concept of IUE determination, as well as to determine whether there were linking criteria in the operations detailed in the EPT and form 601 which were not valued at market prices, carrying out the necessary corresponding adjustments.

In the reporter’s view, for a correct implementation of the anti-abuse rules, specifically of substance over form, it is necessary to establish clear criteria for assessment in the domestic regulations or at least to allow reference to criteria accepted by international tax law following OECD or UN guidelines in order to avoid arbitrariness by the tax administration and taxpayers.

2.2.4. Comparability and group synergies

The Bolivian tax regulation and transfer pricing rules do not detail procedures intended to identify the synergies in a business group.

2.2.5. Hard-to-value intangibles

There is no proper method for valuing intangible assets which are difficult to assess in the Bolivian regulation. As pointed out in section 2.2.2, the value of the intangible is accepted as long as a current price is actually paid and once the current price of the intangible has been accepted for determining it as a deductible expense of the IUE.
Regarding transfer pricing, actions for intangibles have been neither established nor implemented, and nor have the assessment and comparability of hard-to-value intangibles by the use of Actions 8 and 10.

2.2.6. Cost contribution agreements

Bolivian tax regulations and transfer pricing rules do not regulate cost contribution agreements specifically related to intangibles; however, there is a reference which is not aimed specifically at these but at the identification of service delivery by the parent company, which will be discussed below.

2.3. Risk and capital

Transfer pricing regulations do not include specific rules of risk transfer and excess capital distribution to use in determining the performance of the creation of value generated by such risk or capital, made by setting aside the contractual definitions concerning the risk approval or capital contributions.

For the purpose of determining that operations are comparable, the regulatory decree establishes that the following aspects referring to risk must be taken into account, as long as they are economically relevant:

• responsibilities taken by the parties related to the objective analysis of operations identifying the assumed and considered risks, in the case of assets used;
• the contractual terms from which operations are derived taking into account the responsibility, risks, and benefits assumed by each contracting party.

In addition, in the functional analysis section of the EPT, transactions, contracts or agreement details which govern the relationship between the parties, describing the activities carried out, the assets used and the risks assumed by both parties, together with what was established previously, are requested.

As shown, the regulation asks that information about such operations be given, as long as they are economically relevant, without establishing criteria as to the amount or scope, on the understanding that operations which do not reflect economic reality may be subject to reassessment by the tax administration. In this reporter’s view, this allows the criteria for appraisal of this type of operation to be very subjective, it thus being essential to make and define reasonable rules and criteria for the appraisal and comparability or, in other words, to allow reference to international agency criteria.

2.4. High-risk transactions

2.4.1. CUP and quoted prices for cross-border commodity transactions

The addition of the sixth method set out in the transfer pricing regulations denominated Argentino (as it employs many features from the Argentinian regulation) makes a lot of sense given the country’s reality and characteristics, as Bolivia is basically an exporter of raw materials and commodities.

In the light of this, the regulatory decree establishes that in operations involving the import and/or export of goods, where an international broker operates (or not)
as a third party unconnected to the goods’ origin or destination, transparent international market prices must be used, derived from a publicly quoted stock exchange on the date on which the commodity was shipped.

The method as it is regulated is difficult to implement, some complementary aspects being pending. Among the most important are: (a) consideration of a certain contractual date as the agreed date on which the business and the price (long-term contracts) was established; (b) homogenizing prices or discounting certain components increasing the price of commodities in Bolivia, such as premiums, quality settings, logistics costs, among others; and (c) sources of information for obtaining comparable prices.

2.4.2. **Intra-group services**

Intra-group services are defined in a specific section in the regulatory decree establishing that these types of services are related to management, legal, accounting, financial, technical and other services which should be assessed pursuant to the following criteria:

- when it is possible to individualize the service received or the quantification of the determining factors of the amount paid, the payment will be related in a direct way to the area which corresponds to the contracting parties;
- when it is not possible to individualize the service received or to quantify the determining factors of the amount paid, the total compensation will be distributed between the contracting parties according to the corresponding amount considering the nature of the service, the circumstances in which it was delivered and the benefits obtained or to be obtained by the contracting parties.

Regardless of the above, a condition that the delivered services be effectively delivered and linked to the taxable activity is detailed in the tax regulation referring to the IUE.

2.4.3. **Profit splits in the context of value chains**

The Bolivian tax and transfer pricing regulations do not include any reference to the distribution methods of results related to the identification and effects on value chains; however, the profit split method is provided for in Bolivian regulations and the OECD guidelines could be applied to this particular case.

2.5. **Transfer pricing documentation**

2.5.1. **Country-by-country reporting**

In the scope of Action 13 concerning the automatic exchange of information, specifically related to the country-by-country report, with the recent enactment of the Transfer Pricing Act, the master and local file are added to the electronic information through form 601 for operations between related parties. As of today, there is no certainty about the inclusion of a country-by-country report; the reporter understands that, from the perspective of Bolivia, which has implemented the source
principle of taxation, the main concern for the local tax administration will be solely to identify solely the income which is generated and/or is created in the Bolivian territory. Thus its efforts will be focused on identifying such operations in order to evidence whether they correspond to market values and are subject to corresponding adjustments.

With regard to the exchange of information, the identified section inquires about the powers of the tax administration and the type of information to be requested, limiting the information exchange referring to financial operations, considered another important aspect for the purpose of the country-by-country report. The Bolivian Tax Code establishes the confidentiality obligation, offering certain information solely for economic, socio-political purposes and for the preparation of official statistics.

Regarding treaties to avoid double taxation, Bolivia has signed bilateral treaties which include an exchange of information section with the following jurisdictions: the United Kingdom, France, Spain, Germany and Sweden. One of the key issues at the time of implementing this section is determining which is the competent authority to carry out the exchange of information. In the light of the recent enactment of the transfer pricing regulation, the tax authorities must provide the necessary actions for the implementation of the exchange of information with those countries with which they have entered into treaties and develop the adequate regulatory changes in order to allow the exchange of information with other countries with which it has not signed treaties. It is also necessary to analyse in a more objective manner requests of automatic information pursuant to Action 13.

In principle it is possible that some multinational entities located in Bolivia may provide the information necessary for the preparation of a country-by-country report by their parent companies in their home countries, even though there is no such provision in Bolivian regulations.

2.5.2. **Master and local files**

As mentioned above, for the purposes of the master and local files, the transfer pricing regulations include the obligation to prepare the EPT and the informative affidavit of operations between related parties (DDJJ). In order to provide a better understanding of these, the report will detail in Table 1 which information each one requires.

The obligation to file the previous documentation is triggered pursuant to the ranges given in Table 2.

The EPT must be presented in physical and digital form along with the DDJJ of the IUE tax within the deadline established in the tax regulation and pursuant to the range detailed above. It must also include the proof of submission of the DDJJ sent through the webpage of the National Tax Service. In the remaining cases, taxpayers must keep the documentation to show that the operations with related parties were carried out at market prices or that the necessary adjustments were made in case an audit is carried out by the tax administration.
Table 1. Information required by the EPT and the DDJJ

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<thead>
<tr>
<th>EPT</th>
<th>Type of information</th>
<th>Content</th>
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<tr>
<td></td>
<td>Transfer pricing survey</td>
<td>Correlative index</td>
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<td></td>
<td></td>
<td>Executive summary</td>
</tr>
<tr>
<td></td>
<td>Informative affidavit of operations between linked parties (DDJJ)</td>
<td>Functional analysis: related parties’ background, types of linking, economic activities, commercial strategies, transaction and contractual agreements details, financial and profitability information</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Functional analysis: operation quantification, determination and description of the assessment method used, selection and establishment of the comparable, establishing the value difference range, descriptive analysis of the results of the implementation of the method, necessary adjustments if applicable</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Conclusion: explanation of the adjustment made or why no adjustment was necessary</td>
</tr>
<tr>
<td></td>
<td>Physical format written in Spanish (Latin) language expressed in local currency (bolivianos)</td>
<td>Electronic form to be uploaded to the tax administration website</td>
</tr>
</tbody>
</table>

Table 2. Ranges triggering the information obligation

<table>
<thead>
<tr>
<th>Transfer pricing information</th>
<th>Lower limit</th>
<th>Upper limit</th>
</tr>
</thead>
<tbody>
<tr>
<td>EPT – DDJJ</td>
<td>&gt;US$2.16 million</td>
<td></td>
</tr>
<tr>
<td>DDJJ</td>
<td>&gt;US$1.01 million</td>
<td>&lt;US$2.16 million</td>
</tr>
<tr>
<td>Support documentation without submission to the tax administration</td>
<td>&gt;US$1 million</td>
<td>&lt;US$1.01 million</td>
</tr>
</tbody>
</table>
The Housing Development Unit (UFV) is a benchmark that shows the daily evolution of prices and is calculated based on the consumer price index (CPI) published by the National Statistics Institute (INE).

2.5.3. Compliance costs

Considering that the transfer pricing regulations came into effect starting in the tax year 2015 and that the submission of the EPT and DDJJ 601 was carried out during the year 2016, there is no reference to the cost of compliance of using these regulations or to the use of the BEPS plan related to Action 13.

The compliance costs lie basically in the contracting of surveys for drafting the EPT or DDJJ 601, or otherwise the contracting or training of internal personnel for the drafting of the requested transfer pricing surveys because the regulation does not establish that the EPT should be made by a specialist firm or agency.

An important reference parameter regarding the effect of compliance cost is established by the fines for non-compliance of the referred information to transfer pricing established by the tax administration, as shown in Table 3.

Table 3. Fines for non-compliance

<table>
<thead>
<tr>
<th>Breach</th>
<th>UFV fee</th>
<th>US$ equivalent</th>
</tr>
</thead>
<tbody>
<tr>
<td>No physical presentation of the EPT within the established deadline</td>
<td>5,000</td>
<td>1,600</td>
</tr>
<tr>
<td>No submission of the EPT and/or DDJJ 601 within the established deadline</td>
<td>5,000</td>
<td>1,600</td>
</tr>
<tr>
<td>Submission of the EPT out of deadline</td>
<td>2,500</td>
<td>800</td>
</tr>
<tr>
<td>Submission of the EPT and/or the DDJJ 601 out of deadline</td>
<td>2,500</td>
<td>800</td>
</tr>
<tr>
<td>Submission of the EPT with mistakes, incomplete information, regulation non-compliance</td>
<td>2,500</td>
<td>800</td>
</tr>
<tr>
<td>Submission of the EPT and/or DDJJ 601 with mistakes, incomplete information, regulation non-compliance</td>
<td>2,500</td>
<td>800</td>
</tr>
</tbody>
</table>

* The Housing Development Unit (UFV) is a benchmark that shows the daily evolution of prices and is calculated based on the consumer price index (CPI) published by the National Statistics Institute (INE).

2.6. Transfer-pricing-related measures in other BEPS actions and other measures against BEPS

As detailed above, the development of the recent enactment of the transfer pricing regulations has not had a major influence of the BEPS final actions and reports, but their criteria are met in a general manner, with the transfer pricing regulations approximating to the action plans. In the opinion of this reporter, the benefit of the implementation of these types of actions must be established in the Bolivian domestic regulation, ignoring the collection criteria of the tax administration or the demands of developed countries for a major procurement of tax collection. This is the reason why the tax authorities were reluctant to adopt international tax criteria; thus the enactment of a Transfer Pricing Act becomes an important starting point.
allowing this scenario to change in the future as long as there is a certain opening up by the tax authorities, with qualified personnel working jointly with the taxpayer for the consolidation of the transfer pricing regulations, adding those aspects which are still pending legislation or complementing the effects of correct compliance with the regulation.

The main questioning of the actions taken by the G20 and the OECD is posed by the degree of participation in developing economies or in the Bolivian case of countries which are mainly importers of capital and exporters of raw material. From that point of view compliance with and the use of action plans or any action of this scope makes implementation by these countries very difficult.

In the particular case of Bolivia, where the source principle is deeply rooted, implementing the economic reality with strict tax collection objectives and unfavourable rulings in the international tax manner, makes the outlook rather uncertain with regard to the power of influence or compliance in the matter of BEPS according to the established guidelines, pending a major and better development of the tax regulation in the international tax scope.

2.7. Can BEPS work in favour of MNEs?

The need to comply with the transfer pricing regulations recently enacted has led Bolivian companies to implement the criteria and experience of their central offices, where they already have developed and deeply rooted international tax principles; in the same way, the hiring of specialist firms for the preparation and compliance with required information (EPT and DDJJ 601) has been sought. In most cases, such experiences have been oriented to comply with Action 13 in the matter of information requested from branch offices domiciled in Bolivia.

This seems to be a favourable aspect of BEPS for MNEs and especially for countries such as Bolivia for the unification of criteria in the information to be given and the experience gained by better developed legislation in this matter, favouring compliance as well as providing relevant criteria at the time of assessment of the operations between linked parties, supporting them in an appropriate manner so as to avoid adjustments by tax administrations.

3. What is the future of transfer pricing?

With the recent enactment of the transfer pricing regulations in Bolivia following OECD guidelines, the near future should be aimed and focused on achieving the effective consolidation and implementation of the enacted regulations. As mentioned above, the obligation to comply with these regulations entered into effect in the year 2016; thus we must wait for the tax administration to begin audits pursuant to the training of the personnel it has taken on for this purpose.

It is clear that there are some pending aspects that must be carried out, such as establishing to what extent the guidelines given by international agencies (OECD and UN) will be recognized in the Bolivian legal system as an auxiliary means of interpretation. For that matter, at a first glance at the recently enacted regulations and
before an in-depth look at many aspects of the Bolivian domestic regulations, the reporter deems it important – for the purposes of a better implementation of these regulations – that clarifications and/or additions be made regarding the following:

- establishing criteria or a list in order to identify countries with low- or no-tax jurisdictions;
- developing methods of assessment established in the regulation, and also determining the parameters and guidelines to the effect of introducing other methods different from the traditional ones planned in the regulation;
- limiting or shifting the burden of proof in transfer pricing issues;
- complementing the regulation of APAs, Bolivian APAs and MAPs;
- adding secondary and bilateral adjustments in transfer pricing matters;
- specifying the possibility of analysis from the perspective of the counterparty to the transaction and not the local taxpayer, and the requirements for doing this;
- specifying the use of comparables given the impossibility for lack of local information in obtaining them;
- clarifying the interaction or priority between assumptions in the tax regulation of the IUE for operations between related companies in the transfer pricing regulations;
- reviewing the difference range formulae of established value in the rules so that the effect of the values and the manner of calculation are not affected by extreme values.

The main challenge for Bolivia, as pointed out above, is the need to develop its transfer pricing regulations as well as the importance of providing proper training to tax administration personnel and the taxpayers in order to avoid arbitrariness. Also, the participation of specialists of the private sector within the transfer pricing commission created should be achieved in order to allow participants other than the tax authorities and the Ministry of Economy and Finance, as they are in charge of regulating and developing the pending aspects, and should be called on to resolve or correct the flaws identified in the regulations.

Concerning BEPS actions and the transfer pricing regulations, Bolivia has included in its domestic regulations certain principles or approaches towards the implementation of the guidelines established by the OECD and the determined plans of action. It is clear that if Bolivia aspires to include these guidelines in its own tax system, it will be essential to develop the domestic regulations in order to achieve correct compliance. It will also be necessary to ensure that such information is in line with the international requirements and that the effects of the consolidation do not involve major compliance costs for MNEs.
Addendum

According to what was established in section 3 on the future of transfer pricing, the issuance of a specific regulation detailing a list of criteria in order to understand which countries should be deemed to be countries with low- or no-tax jurisdictions was pending. This omission was overturned with the issuance of Supreme Decree No. 2993, dated 23 November 2016, which determined two conditions that had to be met in order for a country or region to be considered as a low- or no-tax jurisdiction. The conditions specify that: (a) the countries be identified as non-cooperative countries or regions according to the OECD; and (b) that they are listed in four or more lists of non-cooperative countries pursuant to publications issued by South American countries.

Supreme Decree No. 2993 also established that the tax administration, pursuant to an administrative regulation, had to detail a list of those countries and regions deemed to be or considered as low- or no-taxation jurisdictions. In that regard, on 13 January 2017, by means of board of directors’ Resolution No. 101,700,000,001, the Servicio de Impuestos Nacionales set forth a list of 76 countries and regions considered – for all tax purposes – as such jurisdictions. The list has a significant effect on local companies that carry out business and/or commercial transactions with entities domiciled in those countries or regions. Consequently, operations carried out with entities domiciled in those jurisdictions detailed in the list need to be analysed as if they were carried out between related parties, and thus need to be reported in the annual EPT to be filed and detailed in electronic form 601. Additionally, the board resolution determines that if the domestic tax authorities enter into an information exchange agreement with a tax administration detailed in those jurisdictions, such countries or regions may be excluded from the detailed list.
Summary and conclusions

Brazil does not follow the OECD’s transfer pricing (TP) guidelines for multi-national enterprises. Brazil is not a member of the OECD and is not bound to the application of the guidelines, either by means of international conventions, or by virtue of its domestic legislation.

Brazil’s first TP legislation was enacted in 1996 and has remained in force since then. Despite relevant subsequent amendments, with the enactment of new methods for both imports and exports the spirit of the legislation has remained substantially the same, aiming at balancing the need for tax collection and simplicity of the tax system.

Like other developing countries, Brazil still struggles in terms of institutional capacity, although significant improvements have been observed in the operation of the tax authorities in recent decades. As Brazil’s position on Actions 8–10 implies, the Brazilian tax authorities still do not feel prepared to shift to the guidelines paradigm. As the present report addresses, the application of Brazilian TP legislation is much simpler than the application of the methods set forth by the guidelines. As they are currently applied, the Brazilian methods imply a more “rough justice” to the detriment of the case-specific approach of the guidelines. This approach is considered by the Brazilian tax authorities as compatible with Brazilian international obligations under article 9, it being relevant to mention that Brazil has never agreed to include article 9(2) of the OECD model in its tax conventions.

As per Law No. 9,430/1996, Brazilian TP rules have a twofold anti-avoidance intent. Brazilian TP legislation is applicable not only to imports and exports of products, services and rights, in controlled transactions, but also to intercompany loans and to any and every import and export uncontrolled transaction between a Brazilian resident (either an individual or a legal entity), and residents in low-tax jurisdictions, or in jurisdictions whose domestic legislation provides for secrecy of corporate ownership.
Brazilian legislation adopts the predetermined profit margin under the equivalents of the resale and cost plus methods, deviating from international standards. The Brazilian approach, named “fixed margins”, is only concerned with the profits of the Brazilian entity, the amount of profits to be paid to the other entities of the group being irrelevant. The so-called “fixed margin” does not take into account the global profit of the multinational company (MNE). Nor does it disregard intra-group transactions. Hence, it should not be confused with formulary apportionment (FA). The fixed margins approach is essentially a transactional approach.

As a consequence of its domestic legislation, Brazil occupies a very particular position with regard to Actions 8–10 of the BEPS project. Footnote 1 of the Actions 8–10 final report may well be read as a blank cheque for Brazil to cherry pick the recommendations on TP. It is clear that the BEPS project only managed to obtain a weak commitment from Brazil on Actions 8–10. Therefore, the adherence to TP measures is a much more challenging topic in Brazil than in other countries, as even the tax authorities’ perception on the issue is unknown. While in other countries the adoption of the measures of Actions 8–10 is, in the worst-case scenario, a matter of democratic debate before the legislature – with the tax authorities defending the adoption of the measures of Actions 8–10 – in Brazil the OECD’s concept of value creation still lacks a sponsor in Congress.

The BEPS project has a great potential to reshape TP rules and practices around the globe, as it provides for relevant amendments to the OECD guidelines, which are adopted by a significant number of countries worldwide. BEPS Actions 8–10 resort to the concept of “value creation”, understanding as such the place where assets are used, risks are assumed and functions are performed. This is the fundamental principle underlying the solutions presented to problems formerly unresolved, such as the allocation of synergy gains and the problematic valuation of intangibles.

The main impact of this concept is the transfer of taxing rights to states where highly skilled personnel and valuable technologies are located. The concept ignores the importance of the market for the creation of value, being a biased interpretation of the arm’s length standard which cannot be inferred from its wording.

For the future, one should expect controversy on the conceptual impossibility of footnote 1. While the G20/OECD’s intention is that Brazil should adopt the TP legislation in line with international experience, Brazil is expected to defend the sufficiency of its heterodox regime. In the short run the wording of note 1 may well be read as a blank cheque for the Brazilian tax authorities to cherry pick the BEPS Actions 8–10 final report.

1. Current TP regulation and practice in Brazil

Brazil does not follow the OECD’s TP guidelines for MNEs and tax administrations. It is not a member of the OECD and is not bound to the application of the guidelines, either by means of international conventions, or by virtue of its domestic legislation.

Brazil’s first TP legislation was enacted in 1996 and has remained in force since then. Despite relevant subsequent amendments, with the enactment of new methods for both imports and exports – which will be duly described in the following sec-
tions – the spirit of the legislation has remained substantially the same, aiming at balancing the need for tax collection and the simplicity of the tax system.

Like other developing countries, Brazil still struggles in terms of institutional capacity, although significant improvements have been observed in the operation of the tax authorities in recent decades. As Brazil’s position on Actions 8–10 implies, the Brazilian tax authorities still do not feel prepared to shift to the guidelines paradigm. As the present report addresses, the application of Brazilian TP legislation is much simpler than the application of the methods set forth by the guidelines. As they are currently applied, the Brazilian methods imply a more “rough justice” to the detriment of the case-specific approach of the guidelines. This approach is considered by the Brazilian tax authorities as compatible with Brazilian international obligations under article 9, it being relevant to mention that Brazil has never agreed to include article 9(2) of the OECD model in its tax conventions.

1.1. Scope of the legislation

As per Law No. 9,430/1996, Brazilian TP rules have a twofold anti-avoidance intention. Brazilian TP legislation is applicable not only to imports and exports of products, services and rights, in controlled transactions, but also to intercompany loans and to any and every uncontrolled import and export transaction between a Brazilian resident (either an individual or a legal entity), and residents in low-tax jurisdictions, or in jurisdictions whose domestic legislation provides for the secrecy of corporate ownership.

With respect to controlled transactions, article 23 of Law No. 9,430/1996 establishes that TP legislation will be applied to transactions of a Brazilian legal entity with: (a) its foreign parent company; (b) its branch, if domiciled abroad; (c) the individual or legal entity resident or domiciled abroad, whose capital ownership characterizes it as its parent or affiliate; (d) the legal entity domiciled abroad which is characterized as its subsidiary or affiliate; (e) a legal entity, domiciled abroad, if the legal entity and the company domiciled in Brazil are under common corporate or administrative control or if at least 10 per cent of their capital is held by a common person or entity; (f) the individual or legal entity resident or domiciled abroad, which, together with the legal entity domiciled in Brazil, holds a participation in or capital of a third entity, characterizing them as parent companies or affiliates thereof; (g) the individual or legal entity resident or domiciled abroad, which is its partner in a consortium or condominium, as defined by Brazilian law; (h) the individual resident abroad who is a relative or spouse of any of its directors, or controlling partners or shareholders; (i) the individual or legal entity resident or domiciled abroad, which enjoys exclusivity, as its agent, distributor or dealer, for the purchase and sale of goods, services or rights in transactions with the Brazilian company; and (j) the individual or legal entity resident or domiciled abroad, in relation to which the Brazilian company enjoys exclusivity, as its agent, distributor or dealer for the purchase and sale of goods, services or rights.

1 The position will be described in section 2 below.
2 See e.g. CARF, Judgment No. 108-09,763, decided on 13 November 2008; Judgment No. 1401-000,801, decided on 12 June 2012. However, the tax treaty concluded with Germany (27 June 1975) was denounced by the German authorities on 7 April 2005 due to disagreements that include TP issues.
With respect to uncontrolled transactions, Brazilian legislation adopts a blacklist of jurisdictions, along with privileged tax regimes, provided by the Brazilian tax authorities, to which TP rules are mandatorily applicable. Therefore, TP legislation also covers uncontrolled transactions carried out between a Brazilian resident and a resident in a listed jurisdiction or a beneficiary of a privileged tax regime.

Except for the case of commodities, as explained below, Brazilian TP legislation does not impose a “best-method rule”. When a method is chosen from any of the methods available in Brazilian legislation, the same method must be applied consistently to the same product or transaction in the same fiscal year, as the evaluation occurs on an annual basis. However, different methods may be applied to transactions involving distinct products or services, or to transactions involving the same product or service, but occurring in different fiscal years.

There are different methods for export or import transactions. The methods concerning the import of goods, services or rights are the comparable independent price method (PIC); the resale price less profit method (PRL); the production cost plus profit method (CPL); and the quotation price on imports method (PCI). For exports, the methods applicable are the export sales price method (PVEx); the resale price method (rPM); the purchase or production cost-plus tax and profit method (CAP); and the quotation price on exports method (PCEX).

See IN No. 1,037 of 4 June 2010. The listed jurisdictions are Andorra; Anguilla; Antigua and Barbuda; Aruba; Ascension Island; the Commonwealth of the Bahamas; Bahrain; Barbados; Belize; Brunei; Bermuda; Campione d’Italia; the Channel Islands (Alderney, Guernsey, Jersey and Sark); the Cayman Islands; the Cook Islands; the Republic of Costa Rica; Curacao; Cyprus; the Commonwealth of Dominica; Djibouti; Gibraltar; Grenada; Hong Kong; Ireland; Kiribati; Labuan; Lebanon; Liberia; Liechtenstein; Macau; Madeira; the Maldives; the Isle of Man; the Marshall Islands; Mauritius; Monaco; Montserrat; Nauru; Niue; Norfolk Island; Panama; the Pitcairn Islands; French Polynesia; Qeshm Island; American Samoa; Western Samoa; San Marino; Saint Helena; Saint Lucia; Saint Martin; Saint-Pierre and Miquelon Islands; Saint Vincent and the Grenadines; the Seychelles; Singapore; the Solomon Islands; Swaziland; the Sultanate of Oman; Tonga; Tristan da Cunha; the Turks and Caicos Islands; Vanuatu; the United Arab Emirates; the British Virgin Islands; the United States Virgin Islands.

IN No. 1,037/2010 also includes the following as privileged tax regimes: Austria’s regime for legal entities incorporated as holding companies; Denmark’s regime applicable to legal entities incorporated as holding companies which do not carry out substantive activities; Iceland’s regime applicable to legal entities incorporated as international trading companies (ITCs); Malta’s regime applicable to legal entities incorporated as ITCs and international holding companies (IHCs); the Netherlands’ regime applicable to legal entities incorporated as holding companies which do not carry out substantive activities; Spain’s regime applicable to legal entities incorporated in the form of Entidad de Tenencia de Valores Extranjeros (ETVEs); Switzerland’s regimes applicable to legal entities incorporated as holding companies, domiciliary companies, auxiliary companies, mixed companies and administrative companies whose tax treatment results in the incidence of the income tax of legal entities (IRPJ) combined being less than 20 per cent, according to the federal, cantonal and municipal legislation as well as the arrangements applicable to other legal forms of incorporation of legal entities, by rulings issued by tax authorities, resulting in the incidence of combined IRPJ of less than 20 per cent, according to the federal, cantonal and municipal legislation; the US regime applicable to legal entities incorporated as limited liability companies (LLCs), whose membership is made up of non-residents which are not subject to federal income tax; and Uruguay’s regime regarding legal entities incorporated in the form of financial investment companies (Safis) until 31 December 2010.

Unlike the OECD guidelines, in the Brazilian RPM, the fixed margins described below are used, instead of resorting to comparables.
Based on the main features of these methods, they can be divided into four groups: (a) comparable uncontrolled price (CUP) methods (PIC and PVEx); (b) resale price methods (PRL and RPM); (c) cost-plus methods (CPL and CAP); and (d) commodity methods (PCI and PCEX).

1.2. CUP methods: PIC and PVEx

Through CUP methods, the transactions are deemed to be adequate if the prices and conditions of the operation are equivalent to other transactions between independent parties. The Brazilian methods that follow this approach are the PIC and the PVEx, for import and export transactions respectively.

According to article 18(I) of Law No. 9,430/1996, the PIC is defined as the weighted arithmetic average of the prices of identical or similar goods, services or rights, in the Brazilian market or in other countries, related to the purchase and sales transactions undertaken by the company concerned or third parties under similar payment terms. Only similar transactions between uncontrolled parties should be taken into consideration.

In the case of internal comparables, article 18(10)(I) of Law No. 9,430/1996 requires that operations for calculation purposes represent at least 5 per cent of the value of import transactions subject to TP control undertaken by the legal entity in the period concerned, with respect to the type of good, right or imported service. Regarding external comparables, article 18(10)(II) of Law No. 9,430/1996 establishes that the operations for calculation purposes should correspond to the independent prices of transactions carried out in the same calendar year of the respective operations of imports subject to TP control.

Even though the Brazilian legislation does not impose a best method, revoked Normative Ruling (Instrução Normativa (IN)) No. 38, of 30 April 1997, issued by the Brazilian Revenue Service (Receita Federal Brasileira (RFB)) was intended to limit taxpayers’ choices, by stating that either the PIC or the CPL should be adopted in cases where the importer company had acquired goods, services or rights to be used as an input for another good, service or right. The Taxpayers’ Council (Conselho de Contribuintes) decided that the RFB’s interpretation should not modify or impose obligations not provided by the legislation. Therefore, article 4(1) of IN No. 38/97 was overruled because this provision was deemed unlawful.6

For export transactions, the Brazilian CUP method, PVEx, may be applied. Article 19(3)(I) of Law No. 9,430/1996 defines the PVEx as the arithmetic average of the sales prices of exports made by the company to other customers, or another domestic company which exports identical or similar goods, services or rights, during the same period of calculation of the tax basis of income tax and under similar payment conditions. As in the PIC, only similar transactions between uncontrolled parties should be taken into account.

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Unlike the PIC, the Brazilian legislation does not permit in the PVEx internal comparability with respect to analogous transactions with uncontrolled parties made by the company concerned as exports.

1.3. Fixed margins

The Brazilian legislation adopts predetermined profit margins under the equivalents of the resale and cost plus methods, deviating from international standards. The Brazilian approach named “fixed margins” is only concerned with the profits of the Brazilian entity, the amount of profits to be paid to the other entities of the group being irrelevant. The so-called “fixed margin” does not take into account the global profit of the MNE, and nor does it disregard intra-group transactions. Hence, it should not be confused with FA. The fixed margins approach is essentially a transactional approach.

The profit margins taken into consideration are established according to “the economic sector, line of business or, even more specifically, according to the kind of goods or services dealt with, to calculate the parameter price”.7 In other words, regarding the application of the relevant arm’s length principle (ALP) based methods, the legislation may adopt different “levels of specificity”8 in order to establish distinct margins. The fixed margins can be determined either by economic sector (distinguishing e.g. extraction or production of raw materials, manufacturing and services) or more specifically with reference to the relevant activities of the MNE. For example, Brazilian legislation adopts a differentiation per industry into types of products. As will be described below, for the PRL, while the margin for pharmaceuticals and the pharmaceuticals sector is 40 per cent, the margin for chemicals is 30 per cent.9

According to the UN practical model, the more accurate, numerous and specific are the margins, the more likely the chances are that they will correspond to a consensus concerning reality, as perceived by the players involved. In some cases, depending on the diversity of goods and services exported and imported by the country, the existence of many different margins may not be necessary.10 The amount and the specificity of the fixed margins are deemed to be a policy decision, which may vary according to the characteristics of the state’s economy.11

As the ALP should be observed, the margins fixed by law may be replaced, but this should be based on market research, which could be either carried out by the tax administration, or purchased from third parties, and the percentage established should be adjustable. As stated by article 20 of Law No. 9,430/1996, the Ministry of Finance can reasonably determine the profit margins to be applied. The Brazilian

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8 Ibid., para. 10.2.9.3.
9 See IN No. 1,312, 28 December, art. 12. See also UN, Practical Manual, at 373, para. 10.2.9.3.
10 UN, Practical Manual, at 372, para. 10.2.9.1.
11 Accordingly, “[e]ach country should determine, according to its specific circumstances, the amounts involved and types of goods and services, how specific the margins should be and whether more margins are merited. Besides, a country may combine different levels of margin specifications if it seems appropriate; it may set forth some general margins for a line of business in addition to more specific margins for some goods” (UN, Practical Manual, at 373, para. 10.2.9.4).
legislation does not prescribe that the market research should be previously submitted to discussion with the economic groups to which they will be applied. IN No. 1,312/12 permits the modification of the percentages, ex officio or upon request of a representative professional association of an economic sector.

Even though the Brazilian approach applies fixed margins and not a range of profit margins, one cannot interpret them as inflexible. The only reasonable interpretation of the fixed profit margins is that the margins set forth by the legislation are rebuttable. The taxpayer should be entitled to bring arguments in favour of an ALP margin in the transaction described probably being different from the margin assessed by the tax administration, or not falling within the range of margins provided.

Unlike what is presented in the Brazilian chapter by the Brazilian tax administration, the “unavoidable” outcome “that some Brazilian enterprises will be taxed at (higher or lower) profit margins not compatible with their profitability”, which would be due to the fact that “the fixed margin method applies regardless of the cost structures of taxpayers”, cannot be accepted as a “weakness” of the method. Such an understanding would imply admitting that Brazilian legislation does not follow the ALP.

However, not only may the ALP be inferred from the Brazilian tax legislation, but it is also included in every single tax treaty signed by Brazil. Therefore, if the tax authorities’ interpretation is adopted, then the allegedly “unavoidable” outcome of the methods applied would clearly violate provisions of the Brazilian tax system and would undoubtedly be in breach of the international agreements signed by Brazil.

In order to respect both domestic legislation and also tax treaties, the fixed margins should be rebuttable in order to be compliant with the ALP. The Brazilian tax administration still does not share this perspective, and the Brazilian TP legislation has been deemed compatible with Brazilian tax treaties, with no further need to consider the fixed margins as rebuttable presumptions. Even though the 2012

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12 Ibid., para. 10.2.7.2.
14 Brazil currently has double tax conventions with the following countries (date of signature noted): Japan (24 January 1967); France (10 September 1971); Belgium (23 June 1972, amended 20 November 2002); Denmark (27 August 1974); Spain (14 November 1974); Sweden (25 April 1975); Austria (24 May 1975); Italy (3 October 1978); Luxembourg (8 November 1978); Argentina (17 May 1980); Norway (21 August 1980); Ecuador (26 May 1983); the Philippines (29 September 1983); Canada (4 June 1984); Hungary (20 June 1986); Czechoslovakia (now the Czech Republic and Slovakia) (26 August 1986); India (26 April 1988); Korea (Republic) (7 March 1989); the Netherlands (8 March 1990); China (5 August 1991); Finland (2 April 1996); Portugal (16 May 2000); Chile (3 April 2001); Ukraine (16 January 2002); Israel (12 December 2002); Mexico (25 September 2003); South Africa (8 November 2003); Venezuela (14 February 2005); Peru (17 February 2006); Trinidad and Tobago (23 July 2008); and Turkey (16 December 2010).
15 See e.g. CARF, Judgment No. 108-09,763, decided on 13 November 2008; Judgment No. 1401-000,801, decided on 12 June 2012. Not surprisingly, the tax treaty concluded with Germany (27 June 1975) was denounced by the German authorities on 7 April 2005 due to disagreements that also include TP issues.
amendment to the text of Law No. 9,430/1996 clearly indicates that margins may be revised, this has not been the practice in Brazil.

While this is the Brazilian tax authorities’ position, taxpayers have not challenged the fixed margins. It is true that previous legislation set forth burdensome documentation requirements for any application for revision of margins, which made any such request virtually infeasible. Nevertheless, this legislation is no longer in force, which could offer taxpayers and the tax administration the opportunity to discuss industry-specific margins. The fact that this has not occurred so far may be considered the major weakness in Brazilian practice.

Moreover, the reporters would like to point out another failure of the fixed margins approach as presently existing in Brazilian practice. There is scant evidence concerning the methodology employed to reach the fixed margins. Since no one can convincingly argue that the margins are (un)reasonable, this opacity implies a clear lack of legitimacy of the presumption itself. Therefore, the Brazilian present practice may not be considered as a final solution, but rather a methodology under construction. Further development would require the treatment of the margins as rebuttable presumptions for the taxpayer and the promotion of the transparency of the data collected and employed, thus allowing control of the presumption.

On the other hand, the adoption of the fixed margins can present many benefits. If the fixed margins are applied according to the ALP and based on an appropriate methodology, the advantages of the fixed margins are immediate: 16 (a) they may avoid the need for specific comparables; (b) they can be applied both by tax administrations and by companies without the need for technical knowledge on specific TP issues, which is a scarce human resource both for companies and tax administrations in developing countries; (c) they grant legal certainty to taxpayer, since this is an ex ante objective alternative, not relying on further subjective analysis; (d) they reduce costs for both tax administrations and taxpayers, since they diminish the need to empirically determine gross margins in a comparability analysis; and (e) they privilege competition between enterprises in the state, submitting them to the same tax burden.

In short, the Brazilian TP legislation can certainly be compatible with the ALP and could be seen as an important tool to circumvent the feasibility issues present in the current OECD guidelines. The present Brazilian practice is not a final solution, but should be seen as an alternative under construction, which demands further corrections.

1.4. Resale price methods: PRL and RPM

Resale price methods demand the existence of three parties: the seller in one country; the purchaser in another country (both belonging to the same group); and a third independent party which acquires from the purchaser. The objective parameter lies in the transaction between the purchaser and the third independent party. In this sense, the comparability does not concern the price of other operations, but the resale profit margin. The Brazilian methods that follow this approach are the PRL and the RPM, for import and export transactions respectively.

16 UN, Practical Manual, at 370, para. 10.2.7.1.
In 2012, Law No. 9,430/1996 was amended by Law No. 12,715. The previous legislation had established for the PRL only two margins, 60 per cent (in the case of goods imported and used in production) or 20 per cent (in all other cases of import transactions). Current legislation sets forth different fixed margins per economic sector.

According to article 18(II) of Law No. 9,430/1996, as amended, the fixed profit margins under the PRL are applicable over the weighted arithmetic average of the sale prices of goods, rights or services imported in Brazil under similar payment terms, regardless of the location of the production process, calculated as follows:

- the net sale price corresponds to the weighted arithmetic average of the sale of the good, right or service produced, minus the unconditional discounts granted, taxes and contributions on sales and commission and brokerage fees paid;
- the percentage share of the asset, right or service imported in the total cost of the good, right or service sold is the ratio between the weighted average cost of the good, imported duty or service and the total weighted average cost of the good, right or service sold, calculated in accordance with the company’s cost sheet;
- the participation of the good, right or service imported in the sale price of the good, right or service sold is obtained through the application of the percentage above to the mentioned net sales price;
- the profit margin depends on the fixed margin in the economic sector of the legal entity subject to TP control, and on the participation of the good, right or service being imported in the sale price of the good, right or service sold, calculated as above;
- the parameter price is the difference between the value of the participation, as defined above, and the mentioned profit margin.

As paragraph 12 of article 18 of Law No. 9,430/1996 provides, under the PRL, the profit margin is determined according to the activities of the companies, as follows: (a) 40 per cent for pharmaceuticals, tobacco products, optical, photographic and cinematographic instruments and equipment, dental-medical machinery, instruments and equipment, extraction of petroleum and natural gas, and petroleum products; (b) 30 per cent for chemicals, glass, cellulose and paper products and metallurgy; and (c) 20 per cent for the remaining sectors.

If the legal entity carries out activities in more than one sector, paragraph 13 of article 18 of Law No. 9,430/1996 establishes that the profit margin used should correspond to the sector of activity for which the imported good is destined. If the same imported good is resold and used in the production of one or more products, or if the imported good undergoes different production processes in Brazil, the final parameter price will be the weighted average of the values obtained by applying the PRL method, according to each respective destination, as set forth by paragraph 14 of article 18 of Law No. 9,430/1996.

Furthermore, as per paragraph 15 of article 18 of Law No. 9,430/1996, in the case of use of the PRL method, a good imported in one year and resold only in a subsequent year will be subject to the PRL of the year in which the good is sold. However, this rule only makes sense if the year of resale is close to the year of the import. In a different situation, the risk that prices in the year of resale do not correspond to those charged in the year in which the good was acquired may arise.
With respect to resale price methods for export transactions (RPM), Brazilian legislation sets forth two different methods. Item II of paragraph 3 of article 19 of Law No. 9,430/1996 establishes the wholesale price in the country of destination less profit method (PVA), which is defined as the arithmetic average of the sales prices of identical or similar goods in the wholesale market of the destination country, in similar conditions of payment, minus the taxes included in the price charged in that country and 15 per cent profit margin on the wholesale price. The other method is the retail price in the country of destination less profit method (PVV). According to item III of paragraph 13 of article 19 of Law No. 9,430/1996, the PVV is the arithmetic average of the sales prices of identical or similar goods in the retail market of the destination country in similar conditions of payment, minus the taxes included in the price charged in that country and a 30 per cent profit margin on the retail price.

Despite the division according to wholesale and retail prices, Brazilian legislation does not define a wholesale or a retail transaction. Two interpretations are possible. The distinction may be based on the quantity in order to determine the transaction’s nature. In this sense, while a wholesale transaction would be characterized by large operations, the retail market would be identified by transactions carried out on a small scale. The alternative would be to resort to a functional criterion to distinguish wholesale from retail transactions. This scrutiny would consider the characteristics of the purchaser of the good. If the good is resold, there is a wholesale operation even if the transaction involves small quantities. On the other hand, a retail transaction would be characterized by exclusively targeting the final consumer of the good, even if this involved a significant amount.

Although both interpretations may seem acceptable, the adoption of the fixed profit margin indicates that the functional criterion would be the most appropriate for the purposes for which it is intended. The reason for establishing a higher fixed margin for retail transactions is related to the fact that transactions to final consumers are generally burdened with a higher margin. Without intermediaries, the final price for a given product is provided by the “final seller”. On the other hand, the reseller necessarily imposes a profit margin on the price paid to the previous seller, as the reseller also aims to profit from the transaction. Therefore, it seems more reasonable to resort to the functional criterion to distinguish wholesale from retail transactions.

Regarding adjustments of the parameter price, there is a paradox in IN No. 1,312/2012. While for PVA and PVV transactions many issues may be considered in the adjustment of the price (e.g. quantity, assurance advertising, brokerage, packaging, freight and insurance), for PRL operations only adjustments related to terms are possible. However, if such adjustments arise from the need for compliance with the ALP, it does not seem reasonable to prevent taxpayers from making those adjustments in the application of the PRL.

1.5. Cost-plus methods: CPL and CAP

Cost-plus methods are based on the costs incurred by the supplier of goods or services in a controlled transaction related to goods or services supplied to an affiliated purchaser, plus an appropriate profit margin (“cost plus mark-up”), aiming at establishing an adequate profit in the light of the functions performed and the mar-
ket conditions. The Brazilian methods that follow this approach for import and export transactions are respectively the CPL and the CAP.

According to item III of article 18 of Law No. 9,430/1996, the CPL is defined as the weighted average cost of production of identical or similar goods, services or rights, plus taxes and fees levied on the export in the country where it was originally produced, and a 20 per cent profit margin, calculated on that cost. As the CPL takes into consideration identical or similar products based on their function, quality and business reputation, the costs can vary significantly. Therefore, the adoption of a fixed profit margin may imply significant distortions, given that, in the case of similar products, the arm’s length price may not be achieved even if the cost of production is adjusted consonantly with the differences between the good, service or acquired right and what is being used as a parameter, as set forth in paragraph 7 of article 15 of IN No. 1,312/2012. Bearing the CPL’s limitations in mind, the reporters believe that the use of similar products as a parameter should only be adopted if there is no identical product and solely when one has the ability to make the adjustments to the profit margins that this alternative engenders.

With respect to the cost components, Brazilian legislation only includes the costs incurred in the production of the good, service or right. Paragraph 5 of article 15 of IN No. 1,312/2012 establishes as cost components the acquisition cost of raw materials, intermediate products and packaging materials used in the production; the cost of any other goods, services or rights applied or consumed in production; costs related to human resources in production, including direct supervision, maintenance and safekeeping of the production facilities and their related charges incurred, required or accepted by the legislation of the country of origin; the costs of rental, maintenance, repairs, depreciation, amortization or depletion of goods, services or rights applied in production; and the value of reasonable losses in the production process, permitted by the tax legislation of the country of origin of the good, service or right. Therefore, the cost of production corresponds to historical costs, because it is based on costs effectively incurred, without further adjustments.

As Brazilian legislation adopts historical costs, it may be argued that there is a lack of compatibility with the ALP. Although historical costs are simpler and there is the possibility of checking their results, they are affected by any cost oscillation. As a consequence, any modification to the production process influences the cost, in such a way as to be transferred to the purchaser. This does not correspond to what independent parties would do. In uncontrolled transactions, (in)efficiency directly affects the profit margin of the seller and not the price paid by the purchaser. Moreover, historical costs can only be calculated a posteriori, which means that the circumstances of what independent parties would do are not followed because the conditions are already known.17

In this sense, it may seem reasonable to challenge the applicability of paragraph 5 of article 15 of IN No. 1,312/2012 in light of the ALP. The planned costs would

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be more appropriate given that these are the costs that are expected to become effective. In this case, besides the consideration ex ante of the transaction conditions, the purchaser will not be affected by producer (in)efficiency.18

The CAP is defined by item IV of paragraph 3 of article 19 of Law No. 9,430/1996 as the arithmetic average of the costs of acquisition or production of exported goods, services or rights, plus taxes and contributions levied in Brazil and a 15 per cent profit margin on the sum of the costs plus taxes and contributions. Unlike the CPL, besides the possibility of using the cost of production and the cost of acquisition, the parameter is based on the costs of the products exported by the company and not on identical or similar ones. Furthermore, the circumstances of the transactions that are used as reference are irrelevant because the CAP only considers the average cost.

1.6. Commodities methods: PCI and PCEX

Given the peculiarities of the Brazilian TP methods for commodity transactions, which allows approximations with the so-called “sixth method”, they will be explained below in section 2.4.1, in contrast with the use of such methods in other systems and with the OECD’s perspective on the issue.

2. The impact of the BEPS project on TP

2.1. Introduction

Brazil holds a very particular position with regard to Actions 8–10 of the BEPS project. In the executive summary of the BEPS Actions 8–10 final report we read that:

“[This Report] represents an agreement of the countries participating in the OECD/G20 BEPS Project. For countries that formally subscribe to the Transfer Pricing Guidelines, the guidance in this Report takes the form of amendments to the Transfer Pricing Guidelines. Therefore this Report also reflects how the changes will be incorporated in those Guidelines.”

The statement is then followed by a footnote, according to which:

“Brazil provides for an approach in its domestic legislation that makes use of fixed margins derived from industry practices and considers this in line with the arm’s length principle. Brazil will continue to apply this approach and will use the guidance in this report in this context. When Brazil’s Tax Treaties contain Article 9, paragraph 1 of the OECD and UN Model Tax Conventions and a case of double taxation arises that is captured by this Treaty provision, Brazil will provide access to an MAP in line with the minimum standard of Action 14.”

18 See Baumhoff, op. cit. (322).
Two main concerns arise as to the interpretation of this note. First, its purpose is not immediately obvious. It seems to provide for an exception or a clarification to the paragraph of the main text. However, the main text refers to “countries that formally subscribe to the Transfer Pricing Guidelines”, explaining how the final report is expected to affect the guidelines. Curiously enough, Brazil is not bound to apply the guidelines.

The obvious conclusion would thus be that, if the final report aims at providing amendments to the TP guidelines and Brazil does not “formally subscribe” to these guidelines, then the content of the final report is not relevant for the application of Brazilian TP legislation. As there is no further commitment to adhering to the OECD guidelines in the BEPS project, no exception or clarification regarding Brazil should be needed in this context. Hence, as Brazil does not subscribe to the guidelines, specific treatment should be provided to cover the Brazilian situation, and that is the purpose of the note.

Secondly, the very wording of note 1 is troublesome. The statement that “Brazil will continue to apply this approach” could be read as a concession or a commitment of the G20 to not bothering Brazil on the issue of its fixed margin approach. Conversely, the subsequent sentence (“and will use the guidance in this report in this context”) could be read as a commitment by Brazil to adapting its legislation to BEPS measures. The immediate interpretation would thus be that Brazil is committed to adapting its legislation as long as this does not imply abandoning the fixed margin regime.

However, the feasibility of adapting the Brazilian approach to the BEPS project’s measures on TP is doubtful. As most of these measures are related to the application of the functional analysis, it is shrouded in mystery how such changes should affect the fixed margin regime. It appears that adapting the fixed margins approach to functional analysis is not even conceptually possible.

Therefore, a plausible conclusion seems to be that the wording of note 1 is pure diplomatic language. Even though ambiguous language is not optimal for legal purposes, the ability to use sufficiently ambiguous terms so as not to be committed to an excessively rigid and perhaps undesirable position is deemed to be the quintessence of diplomacy. One refers to “constructive ambiguity”¹⁹ to describe a situation where negotiating parties, foreseeing the impossibility of consensus, deliberately resort to ambiguous language so as to reach an agreement. By doing so, each party may claim to have obtained concessions on the contentious topic – even though, at the end of the day, no consensus is reached at all. On the other hand, the agreement on the empty expression is useful to enable progress on other items under negotiation.

In the case in question, it may be concluded that note 1 was crucial for Brazil’s adherence to the BEPS project as a whole. Even if, at the end of the day, no significant progress on TP was achieved at all, Brazil has committed itself to many other significant measures set forth by the project.

Constructive ambiguity does not resolve problems, but rather postpones them. It still remains to be seen how relevant the Brazilian divergences will be for the BEPS project’s purposes and how significant the pressure will be on the Brazilian legislature to converge Brazil’s TP rules with those of other OECD countries. In

the short run the wording of note 1 may well be read as a blank cheque for the Brazilian tax authorities to cherry pick the BEPS Actions 8–10 final report. Nevertheless, the analysis carried out in the subsequent items shows that there is still no sign of legislative amendments related to Actions 8–10 in Brazil.

2.2. Challenges of transactions with intangibles

2.2.1. Definition of intangibles

TP legislation in Brazil is applicable to payments related to intangibles, other than royalties and payments for technical, scientific, administrative or similar assistance. Therefore, not only the definition of intangibles but also of royalties and payments for technical, scientific, administrative or similar assistance is relevant for TP legislation.

Law No. 11,638, 28 December 2007, amended Law No. 6,404, 15 December 1976, establishing in article 179, item V, that intangibles are defined as rights related to incorporeal assets which are used in the maintenance of the company or are used within this purpose.

In Brazilian legislation, the term “royalties” is used to designate income arising from the use, fruition or exploitation of rights, such as (a) the right to collect or extract vegetal resources; (b) the right to research and extract mineral resources; (c) rights relating to inventions, processes, manufacturing formulae, trademarks and industry intellectual property; (d) the author’s right, unless the income is earned by the author himself. Payments for technical, scientific, administrative or similar assistance, on the other hand, should be interpreted as payments in which the transfer of technology is implied (knowhow).

As provided in paragraph 9 of article 18 of Law No. 9,307/1996 and article 55 of IN No. 1,312/2012, royalties and payments for technical, scientific, administrative or similar assistance are excluded from the scope of the TP rules. This statement may lead to the conclusion that the TP rules are applicable to export transactions of intangibles as the provision only excludes payments made abroad. Even so, the reporters are not aware of any TP dispute regarding export transactions of intangibles.

2.2.2. Transactions with intangibles

In practical terms, Brazilian legislation deals with the issue of transactions with intangibles by denying or significantly limiting the deduction of royalties and payments for technical, scientific, administrative or similar assistance. Even though this approach is a serious violation of taxpayers’ rights (indeed unconstitutional), it could be seen as an effective means to combat BEPS.

As a general rule, article 74 of Law No. 3,470 of 28 November 1958 provides that these payments can be deductible up to a maximum of 5 per cent of the turnover so derived. The fixed percentage limit depends on the type of underlying royalty, product or industry involved, considering its essentiality, and other restrictions may apply as well. This limit is set by the Brazilian Ministry of Finance.

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20 Law No. 4,506/64, art. 22.
21 Ministry of Finance, Ordinance No. 436, of 30 December 1958 (PMF No. 436/58).
Royalties from licensing patents and trademarks are deductible within the limits set by PMF No. 436/58, if the contract is registered with the Brazilian Central Bank and with the National Institute of Industrial Property (INPI). In the case of payments from a Brazilian branch to its head office abroad, deductibility is not permitted. Royalties arising from the licensing of patents and trademarks are deductible if the payment made from the Brazilian company to its foreign controller is within the deductibility limits in PMF No. 436/58 and is based on a registered contract, as described above (article 50 of Law No. 8,383, 30 December 1991).

The deductibility rule for knowhow payments is subject to a similar regime. The only difference lies in the need to register the contract with the INPI before the registration with the Central Bank of Brazil (article 52, items (a) and (c), of Law No. 4,506/1964). As in the deductibility regime for royalties from licensing patents and trademark, payments from a Brazilian branch to its head office abroad are not deductible, but payments from the Brazilian company to its foreign controller should follow the same deductibility limits as are found in PMF No. 436/58.

With respect to other intangible transactions, i.e. excluding royalties and payment for technical assistance operations, TP rules are applicable. In these cases, questions arise regarding the difficulty of applying the methods, depending on the nature of the intangible. Although in the international scenario intangibles transactions have already presented applicability problems, given the fixed margin methods, the situation is even more difficult under the Brazilian regime.

The applicability of the CUP methods (PIC and PVEx) depends on the existence of previous transactions (purchaser’s perspective) in the good, which are rarely available. In intangible transactions, the conditions of the current transaction are probably not the same as those of previous transactions. At the same time, the resale price methods (PRL and RPM) may not be appropriate for intangible transactions, as intangibles are not acquired for resale, but always for use. In some cases, intangibles could be considered as input for the production of goods and services and PRL could be applicable, but this is not always evident. Moreover, cost-plus methods (CPL and CAP) are difficult to apply when there are trade secrets involved, which may be the case with intangibles related to processes and products.

2.2.3. “Substance-over-form” approach towards intangibles

The restrictive Brazilian legislation with respect to deductibility of expenses related to intangibles does not entail significant tax strategies that would demand a substance-over-form approach towards intangibles. Therefore, there is no example of such treatment in legislation or case law. If the current regime is maintained, there is no reason to believe that such an approach will become necessary.

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22 Art. 71, sole paragraph, (f), of Law No. 4,506/1964, and IN No. 005/74.
2.2.4. Comparability and group synergies

The fixed margin approach is not able to provide for mechanisms to identify group synergies in the application of TP rules. As the cost structure of the taxpayer is mostly irrelevant, and the fixed margins do not allow functional analysis, synergy gains would not be detected by the fixed margin regime.

The only possible solution for detecting synergy gains would be shifting to the BEPS project interpretation of functional analysis. As note 1 implies that Brazil is not willing to do so, it could be deemed conceptually impossible to adapt the Brazilian fixed margins to the recommendations of the BEPS project on group synergies.

In fact, adjustments concerning synergy gains are not even allowed under article 9 of the OECD model convention (MC). The ALP does not take synergy rents into account. The OECD MC does not entitle either the source or the residence state to make any sort of adjustment with reference to synergy intangibles.

Article 9(1) of the OECD MC sets forth that any profits which would “have accrued to one of the enterprises, but, by reason of those conditions [common control conditions], have not so accrued, may be included in the profits of that enterprise and taxed accordingly”. The ALP fails to take these rents into consideration, in the sense that they are not allocated to any of the entities under consideration: this is precisely the “inherent flaw” of the ALP. At arm’s length, synergy rents would have accrued to this or that enterprise.

Article 9(2) does not cover synergy rents either. In the wording of the OECD MC, the adjustment can be made if profits “so included are profits which would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises”. Again, a synergy rent would not have accrued between independent parties, so states cannot make adjustments to take synergy rents into consideration.

In summary, the approach towards synergy gains is the consequence of an ambulatory interpretation intended by the BEPS project, which is not in line with the wording and spirit of article 9, as already criticized elsewhere.25

2.2.5. Hard-to-value intangibles

As may be inferred from sections 2.2.1, 2.2.2 and 2.2.3, Brazil has not adopted any measure aimed at hard-to-value assets. As the tax treatment of intangibles for TP purposes is very incipient, hard-to-value intangibles are beyond the foreseeable outcome of the application of the current methods.

2.2.6. Cost contribution agreements (CCAs)

CCAs in Brazilian legislation should be expected to receive the same treatment as intra-group services, as described in section 2.4.2 below.

25 This argument has been further developed in L.E. Schoueri, “Arm’s Length: Beyond the Guidelines of the OECD”, 69 Bulletin for International Taxation 12, December 2015, pp. 690–716.
2.3. Risk and capital

Again, the only possible solution to applying the risk and capital measures of the BEPS project would be shifting to functional analysis. These proposals will also be included in the category of conceptually impossible measures, if the intention is to retain fixed margins. One may even question whether such an adoption would be desirable from a Brazilian perspective, as the approach towards risk and capital allocation emphasizes the importance of assets used, risks assumed and functions performed for value creation, not taking into account the importance of the size of the demand.

In any case, the Brazilian system counts on limits to the deductibility of interest, which significantly limits the ability of companies to shift risk and capital to low-tax jurisdictions. These limits are reproduced in section 2.6 below, as they are closer to BEPS Action 4 and are not properly measures on TP – even though they are important for a comprehensive analysis of the Brazilian tax system.

2.4. High-risk transactions

2.4.1. CUP and quoted prices for cross-border commodity transactions

The Brazilian methods for commodity transactions follow the trend in emerging countries of adopting a variation of the method currently known as the “sixth method”.

Following the experience of Argentina, which created a specific method aiming at avoiding the use of traders in the export transactions of certain commodities, many countries such as Uruguay, Ecuador, Mexico, Peru, etc.
Guatemala, Honduras, the Dominican Republic, Ukraine and Brazil also enacted variations of the sixth method. Although these methods are usually referred to under the same denomination, each country’s domestic legislation has its own peculiarities.

The sixth method in those countries has as a common aspect its applicability to export or import transactions of commodities between controlled parties in which there is a trader involved or for which there is a comparable price internationally quoted by a transparent market. The sixth method can be described as a variation of the CUP method, through which the transaction price is determined taking into account not the circumstances of the operation, but quotations from stock exchanges.

Another feature that can be attributed to the sixth method is that, in general, the price used is a publicly quoted price in a transparent market on the date of shipment of goods and not on the date when the parties agreed on the transaction. Furthermore, unlike in the application of the guidelines’ methods, the possibility of adjustments is rarely permitted and, even where it is allowed, tends to be limited to certain aspects.

The main concern of the OECD with the sixth method “relates to the divergence that may arise between the conditions under which the publicly quoted prices are quoted”. Accordingly, the conditions of the actual transactions “may imply that the publicly quoted price may not be the arm’s length price”. Therefore, there would be the risk of incompatibilities with the ALP because, for example, the data used for the transaction, the place of delivery, the stage of processing and also the nature of the commodity may differ. In short, according to the OECD, as “the treatment of the transactions may diverge” from the ALP, “transactions may be over- or under-taxed and double taxation or double non-taxation may occur”.

Even though the OECD had established in the report Transfer Pricing Comparability Data and Developing Countries that the sixth method could be an appropriate anti-abusive approach for transactions involving tax havens, in the final reports of Actions 8–10 of the BEPS project, the G20/OECD incorporated the sixth method in the CUP. This inclusion implies the possibility of using internationally quoted prices, provided there are comparability adjustments. Therefore, the BEPS project adds characteristics to the sixth method that are not necessarily present in the variations adopted elsewhere.

34 See Cottani, op. cit.
35 See Jain, op. cit. (172).
37 See Cottani, op. cit.
39 Ibid.
In Brazil, Law No. 12,715/2012 amended Law No. 9,430/1996, introducing new methods for commodity import and export transactions: PCI and PECEX, respectively. Even though Law No. 9,430/1996 had already provided for the applicability of TP rules for uncontrolled transactions with jurisdictions on the blacklist41 (e.g., tax havens) and the use of fixed profit margin, the singularity of the Brazilian legislation demonstrated its limitations in the case of commodity transactions. Before the enactment of Law No. 12,715/2012, taxpayers could choose any method for these operations. As a consequence, despite the possibility of applying internationally quoted prices through the Brazilian CUP methods (PIC and PVEx), taxpayers could opt for other methods, especially when the fixed margins would be more favourable than the real market ones.

As from the publication of Law No. 12,715/2012, taxpayers can only apply PCI and PECEX for operations involving commodities subject to quotation on commodity and futures exchange markets. The introduction of PCI and PECEX does not affect the non-existence of the best method rule in the Brazilian legislation with respect to the other kinds of transaction. The compulsory nature of PCI and PECEX constitutes an exceptional TP control scheme for commodities.

Both PCI and PECEX are defined as daily average values of the price of goods or rights subject to quotation on a commodity and futures exchange market (Law No. 9,430/1996, articles 18-A and 19-A). The prices of imported/exported goods declared by individuals or legal entities resident or domiciled in Brazil will be compared with the quoted price of these goods, as set out in commodity and futures exchange markets, adjusted by the “average premium market”, on the date of the transaction.

Despite the absence of a definition of the expression “average premium market” in Law No. 9,430/1996, paragraph 6 of article 16 of IN No. 1,312/2012, amended by IN No. 1,458/2014, defined the “average premium market” as the value resulting from positive or negative market valuation, to be added to or deducted from the international exchange market quotation, in order to obtain the price paid by the importer. This provision also clarifies that changes in quality, characteristics and content of the substance of the goods sold should also be considered.

Besides the average premium market, IN No. 1,312/2012 allows adjustments related to the differences between the net amount received by the seller and the variables that are considered in the specific commodities and futures exchange market, such as the cost of transport to the port of destination and the climate influences in the characteristics of the good.

Absent quoted prices, the price of the goods can be compared with the prices obtained from independent data sources provided by internationally recognized research institutions, listed by the RFB. In the case of PECEX, comparison can also be made with prices set by agencies or regulatory bodies and published in the Federal Official Gazette.

Even though there is room for adjustments in some cases, such adjustments do not amount to those required by a functional analysis modelled after the guidelines. Therefore, it may be concluded that, as currently applied, the Brazilian sixth method is not in line with the recommendations of the BEPS project with respect to

41 See section 1.1 above.
the subject. There have been no further amendments to legislation to adapt the commodity method to Actions 8–10.

2.4.2. Intra-group services

According to the position of the RFB, expenses related to cost-sharing agreements are deductible provided that: (a) the expenses correspond to the payment for goods effectively received or services effectively rendered; (b) the expenses are necessary, usual and normal (general criteria for the deductibility of expenses in Brazil) considering the activities of the company; (c) the sharing follows reasonable and objective criteria, previously agreed, in a formal contract signed between the parties; (d) the sharing criteria are consistent with the effective expense of each company and with the global price paid for goods and services, following general accounting principles; (e) the company that centralizes the acquisition of goods and services deems as expenses solely its due share, according to the sharing criteria.

According to the RFB’s position, PIC and CPL are the applicable methods, if the provisions of the contract are inconsistent with the features of a cost-sharing agreement, being considered as such: (a) the division of costs and risks inherent to the development, production and acquisition of goods, services and rights; (b) that the contribution of each company is consistent with the individual benefits expected or effectively received; (c) the determination of the benefits which will be specifically received by each entity of the group; (d) the provision of a reimbursement, comprising the costs related to the effort or sacrifice incurred in the realization of the activity, without profit margin; (e) the collective nature of the advantage offered to all entities of the group; (f) the remuneration for the activities, irrespective of its effective use, being sufficient for these activities to be made available to the other entities of the group; (g) an agreement to such conditions that any company, under the same circumstances, would be interested in signing the contract.

If the activities set forth in the cost-sharing agreement are carried out by a foreign third party which is not an entity of the economic group, payments related to the cost-sharing agreement are subject to withholding taxation.

Both in the case of application of PIC and CPL and in the case of application of the tax authorities’ understanding, the outcome will be compliant with the ALP. There is no further development regarding cost-sharing or cost contribution arrangements aimed at changing practices or regulations as a result of the BEPS project.

2.4.3. Profit splits in the context of value chains

Brazil does not provide for special rules concerning the application of TP rules to the value chain of the MNE. There is no method under Brazilian legislation which could be deemed similar to the profit split method, and no measure aimed at the profit split mechanism is expected in Brazil.

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42 Solução de Consulta no. 8, 1 November 2012.
2.5. TP documentation

Action 13 of the BEPS project re-examined chapter V of the OECD guidelines in order to improve the “standards for transfer pricing documentation”. This documentation has three objectives: (a) to ensure the taxpayer’s appraisal of its compliance with the ALP; (b) to provide the tax authorities with the relevant information to carry out a TP risk assessment; (c) to provide tax administrations with the appropriate information to apply in a TP audit. According to Action 13, there is a need for a standardized approach. In this sense, a three-tiered approach has been developed, basing it on the following main documents: (a) country-by-country reporting (CbCR); (b) a master file; and (iii) a local file.

One of the OECD concerns is related to the balance between sufficient information for tax authorities and compliance costs. As mentioned in Action 13, some developing countries require additional data, alleging that they need information related to “party interest payments, royalty payments and especially party service fees”, in order to “perform risk assessment”, as well as, in some cases, to “obtain information on the global operations of an MNE group headquartered elsewhere”.

2.5.1. CbCR

CbCR is directly related to information regarding the “aggregate tax jurisdiction-wide information”. Therefore, CbCR includes reporting of income allocation, taxes paid, aspects of the “location of economic activity among tax jurisdictions in which the MNE group operates” and a list of all the public administrations for which financial information is dispatched.

CbCR is claimed not to be for the tax authorities’ use in TP adjustments, “based on a global formulaary apportionment of income”. On its own, CbCR does not indicate any evidence of (in)appropriate transfer prices. Instead, CbCR is relevant for “transfer pricing risk assessments purposes”, the evaluation of “BEPS related risks” and also for “economic and statistical analysis”.

It is doubtful whether the ancillary obligations under CbCR are compatible with the Brazilian National Tax Code. According to the Code, ancillary obligations should be within the scope of tax collection or tax auditing (article 113, paragraph 2). The obligations pursuant to CbCR are not aimed at tax collection or tax auditing, but at collecting data for the purposes of economic and statistical analysis.

The National Tax Code sets forth limits for the enactment of tax legislation. Article 113 allows the tax administration to create additional obligations for taxpayers, provided that they are relevant to the auditing and collection of taxes. The power to institute fines and penalties can only be exercised within this scope.

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44 Ibid., at pp. 12–17. Available at http://dx.doi.org/10.1787/9789264241480-en.
45 Ibid. at p. 10.
46 Ibid. at p. 16.
47 Ibid. at p. 16.
48 Ibid.
However, CbCR demands a power which is not immediately within the scope of the provision, as traditionally conceived. The proposal does not aim at creating obligations in the interest of tax auditing and tax collection, but transfers part of the burden of gathering information relevant for the purposes of tax policy from the tax authorities to the taxpayers.

It is not immediately obvious whether such a measure could be enforced by means of fines and penalties under the Brazilian National Tax Code – and, as a consequence, whether the measure could, in fact, be enforced under that Code. However, a broadened interpretation of the term “in the interest of tax auditing and tax collection” could be sufficient to comprise measures similar to those set forth by CbCR, provided that the tax administration does not have access to the relevant information by other means. It is relevant to note that article 113 also limits the ability of tax authorities to redundantly require information to which they already have access by other means.

As per the application of its universal taxation system, Brazilian legislation already requires MNEs to report the profits of their controlled foreign companies (CFCs) abroad, although these requirements are much less detailed than those provided by CbCR. It is also relevant to note that, unlike the CbCR requirements, the current obligations are related to tax collection and tax auditing and not merely aimed at tax policy.

2.5.2. Master and local files

The master file is expected to provide a bird’s eye view, establishing the “global economic, legal, financial and tax context” of the MNE group’s TP practices. In-depth information concerning transactions is not required. The master file’s scope is to furnish “a high-level overview of the MNE’s global operations and policies”. This information should be available to all tax authorities involved. The local file is intended to provide data regarding the transactions in certain jurisdictions. The information present in the local file should supplement the master file, guaranteeing that the taxpayer’s TP positions are compliant with the ALP. Controlled transactions between domestic affiliated and associated enterprises are the focus of the local file.

Both the master file and the local file are directly related to the need to carry out TP analysis in the light of the methods presented in the OECD guidelines. Given Brazilian legislative peculiarities, such as the fixed profit margins and the sixth method, the information requirements in Brazilian domestic law are not as detailed as those present in Action 13. In the light of Brazilian legislation, the TP documents required are purchase and sale documents such as invoices and receipts; and

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51 Ibid. at 15. Available at http://dx.doi.org/10.1787/9789264241480-en.

52 Pereira Valadão, op. cit.
accounting and tax books that may prove the cost of production of the items evaluated; the reports on quoted prices, if applicable.53

2.5.3. Compliance costs

As may be inferred from the described methods, the existence of the local and master files will be mostly irrelevant for the application of TP legislation in Brazil. As the Brazilian methods are all one sided, and as Brazil has never adhered to corresponding adjusting in its double tax conventions, the taxation in the other jurisdiction is not relevant for the application of TP legislation.

In the current Brazilian regime, the additional requirements on TP documentation, if adopted, are expected to substantially increase compliance costs, with no significant impact on generating information for tax administrations. Brazilian legislation, despite its flaws, was designed to be easily applicable and, therefore, its documentation requirements are less burdensome than those found elsewhere. Subjecting Brazilian taxpayers to additional compliance costs could be relevant for the application of the TP legislation of other countries, but will not enhance the application of TP methods in Brazil.

2.6. TP-related measures in other BEPS actions and other measures against BEPS

There are significant intersections between Actions 8–10 and Actions 3 and 4. TP legislation should be faced in the context of the existing CFC rules as well as of the limits to interest deductions. The Brazilian legislation provides relevant examples for both cases.

With regard to Action 3, Brazilian legislation provides for the worldwide taxation of the profits of an enterprise. Even though there is a significant deemed credit regime, there is no possibility of deferring taxation until the distribution to the Brazilian parent company. Under the current no-deferral universal taxation regime, there is no need for actual CFC rules, since the situation of abuse envisaged by such rules is not present. According to the BEPS Action Plan, “[o]ne of the sources of BEPS concerns is the possibility of creating affiliated non-resident taxpayers and routeing the income of a resident enterprise through the non-resident affiliate”. Law No. 12,973/14 does not allow such a situation. If Action 3 aims to strengthen CFC rules, the Brazilian legislation is surely a case where there is no space for “strengthening”.

In Action 3, any form of standardization proposed by the BEPS project would demand that Brazil “weakens” its current regime, and not the contrary. There is no evidence for concluding that the Brazilian government is willing to do so. In any case, it must be clear that the Brazilian rules are not an anti-abuse regime, but

rather a general regime, applicable to any and every Brazilian company carrying out activities through subsidiaries abroad. The Brazilian universal taxation regime was conceived to comprise TP adjustments, it being possible to apply TP rules so as to determine the profits of the Brazilian company and of its foreign subsidiaries.

Also Action 4 presents measures that may be relevant for TP. BEPS Action 4 includes rules which limit the level of interest expense or debt in an entity with reference to a fixed ratio. Examples of these rules include debt to equity ratios, interest to earnings before interest, tax, depreciation and amortization ratios and interest to assets ratios.

As per Law No. 12,249/10, interest paid or credited by a Brazilian source to an individual or a legal person resident abroad is deductible only to the extent that it is deemed necessary for the economic activity of the Brazilian company (article 24). To comply with this requirement, there is a debt to equity fixed ratio that limits the deduction of interest.

In the case of controlled cross-border transactions, interest expenses are only deductible if the debt value does not exceed twice the value of the Brazilian company’s equity (article 24(II)). If the foreign company holds shares in the Brazilian company, the debt value cannot exceed twice the value of the participation of the foreign company in the Brazilian company’s equity (article 24(I)). If the foreign individual or legal entity is located in a tax haven or is under a privileged tax regime, the debt value cannot exceed 30 per cent of the equity of the Brazilian company (article 25).

In any case, there is also a constructive ownership rule, whereby if the Brazilian company pays interest to more than one individual or legal entity abroad, the limitation applies, taking the sum of the debt values into account (article 24(III)).

It is reasonable to conclude that since 2010 Brazil has adopted rules that can be deemed even more restrictive than those suggested by the BEPS project, considering the express discrimination against tax havens and privileged tax regimes not mentioned in Action 4.

In this scenario, considering the existence of a no-deferral universal taxation regime and the limitation on shifting risk and capital by means of payment of interest expenses, along with the fixed margins regime, there is very little incentive for taxpayers to explore TP transactions in the Brazilian system.

2.7. Can BEPS work in favour of MNEs?

The BEPS project is mostly one sided, its main concern being clearly with enhancing tax authorities’ power and access to information. Through this approach, it can by no means work in favour of MNEs, but it could be less harmful to MNEs. For this purpose, it is important that the exercise of this enhanced power does not imply violations of taxpayers’ rights. Among the violations that should be avoided is the excessive burden arising from the requirement for redundant information.

However, because Brazilian documentation requirements for TP purposes are much simpler than those from other countries, the reporters are not aware of any example of the Brazilian tax authorities exchanging information with other countries for the purposes of applying the TP rules.
3. What is the future of TP?

The BEPS project has a great potential to reshape TP rules and practices around the globe, as it provides for relevant amendments to the OECD guidelines, which have been adopted by a significant number of countries worldwide. BEPS Actions 8–10 resort to the concept of the place of “value creation”, understanding as such the place where assets are used, risks are assumed and functions are performed. This is the fundamental principle underlying the solutions presented to problems formerly unresolved, such as the allocation of synergy gains and the problematic valuation of intangibles.

The main impact of this concept is the transfer of taxing rights to states where highly skilled personnel and valuable technologies are located. The concept ignores the importance of the market for the creation of value, being a biased interpretation of the ALP, which cannot be inferred from its wording.

The new interpretation transfers taxing rights to capital exporting countries, mainly those which are engaged in technology and production of intangibles, to the detriment of capital importing countries, whose enterprises play a very small role in the value chain.

As described, the BEPS project has only managed to obtain a weak commitment from Brazil in Actions 8–10. Therefore, adherence to TP measures is a much more challenging topic in Brazil than in other countries, even though the tax authorities’ position on the issue is unknown. While in other countries the adoption of the measures of Actions 8–10 is, in the worst-case scenario, a matter of democratic debate before the legislature – with tax authorities defending the adoption of the measures of Actions 8–10 – in Brazil, the OECD’s concept of value creation still lacks a sponsor in Congress.

For the future, we should expect controversy on the conceptual impossibility of note 1. While the G20/OECD’s intention is that Brazil adopts TP legislation in line with the international experience, Brazil is expected to defend the sufficiency of its heterodox regime.
Summary and conclusions

Bulgaria has recently joined the inclusive framework for BEPS implementation but since then it has not amended its transfer pricing (TP) legislation to address any BEPS-required measures.

Bulgarian TP legislation is generally in line with the OECD TP guidelines and no significant deviations from these are to be found. Thus, the impact of the BEPS project on Bulgarian TP legislation would be limited to implementing domestically all modifications to the OECD TP guidelines arising from the BEPS project’s outcomes.

In particular, Bulgarian TP legislation should be amended to provide a more sophisticated approach to intangibles. This would include (a) the introduction of a more detailed definition of intangibles; (b) the provision of detailed rules on recognition of transactions with intangibles; (iii) improvement in the rules on the valuation of hard-to-value intangibles; and (d) the inclusion of group synergies in the comparability analysis. Other TP aspects of transactions with intangibles such as the “substance-over-form” approach are already implemented in Bulgarian legislation through the required comparability analysis which should be based on the functions performed, assets used and risks assumed by each company from the multinational group (MNE).

Certain TP issues such as cost contribution agreements (CCAs) or TP documentation will need to be addressed in the TP legislation. Currently, these issues are addressed only in the non-binding TP guidelines of the National Revenue Agency and, therefore, are not part of legislation. This causes confusion among taxpayers as to their obligations in terms of transactions with related parties and is often a source of dispute between the tax administration and taxpayers.

In terms of intra-group services, the Bulgarian TP legislation meets the standards imposed by the BEPS project. Thus, Bulgarian law provides sufficient rules both in respect of the identification of actual provision of intra-group services and the determination of arm’s length remuneration for such services. The non-binding
TP guidelines of the National Revenue Agency go even further in this direction and specify a profit margin at 3–8 per cent which could be considered to be at arm’s length.

Similarly, the Bulgarian tax rules on risk and capital in effect exclude inappropriate results from the contractual allocation of risk and capital and ensure that the return of each of the related parties matches its actual contribution, as required by the BEPS project.

Lastly, the provisions of the Bulgarian TP legislation on the application of TP methods could be improved to cover more sophisticated cross-border transactions such as commodity transactions or transactions with intangibles. Even though Bulgaria has implemented all the TP methods authorized by the OECD, the level of their implementation is not sufficiently elaborate to address all the implications arising from such complicated transactions. Due to the lack of detailed legislation certain TP methods such as the profit split method or the transactional net profit method, which could be very useful in assessing complex transactions, are rarely used in practice.

As far as TP documentation is concerned, the National Revenue Agency has taken the view in its non-binding TP guidelines that companies should prepare TP documentation which is in line with the requirements of the code of conduct on TP documentation for associated enterprises in the European Union, i.e. it should comprise a master file for the entire MNE group and a country-specific file for Bulgaria. However, the legislation does not provide an obligation for this TP documentation model to be followed and further amendments to the legislation will be required to ensure that the BEPS project standards are met.

The implementation of the BEPS project in Bulgaria, however, will not go beyond the EU developments in this area. As an EU Member State Bulgaria has to implement the BEPS measures in an EU compliant manner and it is expected that a new EU law ensuring the common approach of Member States to BEPS-related measures will be adopted soon. Therefore, it is likely that Bulgaria will not undertake unilateral measures to implement BEPS solutions, but will follow a coordinated EU approach.

1. Current TP regulation and practice in Bulgaria

The Bulgarian TP regulations apply to both domestic and cross-border transactions between related parties. These transactions should be based on the arm’s length principle provided under article 15 of the Corporate Income Tax Act (CITA). If the related parties carry out their commercial and financial relations on terms which deviate from the terms which would apply between unrelated parties, the tax authorities may adjust the tax results and levy tax on the terms which would have arisen between such parties.

Under article 116(2) of the Tax and Social Security Procedural Code (TSSPC) each company has the burden of proving that the price agreed in a transaction with a related party is the market price, or, if not, the reason for deviation from the market price. The market price is the amount without value added tax and excise duties
which would be paid under the respective conditions for identical or similar goods or services in a transaction between unrelated persons.\footnote{1}{§1(8) TSSPC.}

The market price can be determined only by applying the TP methods set out by the TSSPC, namely:
\begin{itemize}
\item[(a)] the method of comparable uncontrolled prices (CUP);
\item[(b)] the method of the market prices (corresponding to the resale price method);
\item[(c)] the method of the increased value (corresponding to the cost-plus method);
\item[(d)] the profit split method;
\item[(e)] the transactional net profit method.\footnote{2}{§1(10) TSSPC.}
\end{itemize}

The application of these TP methods is governed by Ordinance H-9 of 14 August 2006 issued by the Minister of Finance, which defines the comparability analysis to be carried out when applying the methods, the hierarchy between the different methods, the conditions for application of each particular method and the factors to be considered in applying each method. In addition, Ordinance H-9 provides specific rules for use of the TP methods in respect of intra-group services and intangibles. In general, Ordinance H-9 follows the OECD TP guidelines.

There is only limited case law of the Bulgarian courts in respect of TP disputes and there are no significant precedents. The Bulgarian courts confirmed that the OECD commentary is binding based on the Vienna Convention on the Law of Treaties: this application of the OECD commentary is important for disputes related to article 9 of the OECD model.

The Bulgarian National Revenue Agency has also developed TP guidelines which are publicly available. These guidelines are based on the OECD TP guidelines and are designed for internal training purposes within the tax administration – they may not be regarded as binding for the tax authorities or as administrative practices to be applied by the tax authorities in tax audits. Nevertheless, the guidelines are indicative of how the tax administration interprets the TP legislation.

2. The impact of the BEPS project on TP

2.1. Introduction

Bulgaria has officially expressed its intention of participating in the implementation of the BEPS project. On 30 March 2016, the Bulgarian government approved the joining of the inclusive framework for BEPS implementation.

Subsequently, on 6 June 2016, the Bulgarian government authorized the Minister of Finance to inform the General Secretary of the OECD that Bulgaria was willing to join the inclusive framework for BEPS implementation. In a press release the Bulgarian government stated that following the joining of the inclusive framework Bulgaria will participate in the implementation of standards in the area of tax treaties and TP, as well as in the process of developing a monitoring system for the
implementation of the four minimum standards already agreed by OECD and other elements of the BEPS package.

The Bulgarian tax authorities initiated preparations for participation in the BEPS project even before the official decision of the Bulgarian government. In October 2015 the Bulgarian National Revenue Agency procured external TP training for its tax officers, which also covered certain focal points of the BEPS project.

2.2. Challenges of transactions with intangibles

2.2.1. Definition of intangibles

Even though transactions with intangibles are covered by the Bulgarian TP regulations, Bulgarian law does not provide a definition of intangibles. However, elements of the notion may be inferred from the provisions of Ordinance H-9 and the non-binding TP guidelines of the National Revenue Agency.

Under §1, item 3 of Ordinance H-9 the term “products” for TP purposes includes goods and intangibles. Thus, intangibles are products other than goods, i.e. products without physical substance. These intangible products:
- should be transferable to or usable by another person;\(^3\)
- could be acquired from another person or created internally;\(^4\)
- may represent intellectual property (patents, formulae, processes, knowhow, trademarks, etc.);\(^5\)
- can be transferred or provided on a stand-alone basis or together with other services or products;\(^6\)
- could be incorporated into other products.\(^7\)

Similarly, the non-binding TP guidelines of the National Revenue Agency define an “intangible” as any tradable product without physical substance, the creation of which involved intellectual work or significant marketing activities. The guidelines provide the following non-exhaustive list of the types of intangibles:
- patents, knowhow, computer programs, drawing and models;
- copyright over works of literature, science and art;
- trademarks and trade names, distribution networks, client lists, unique names, symbols or images.

The definition of intangible assets under the applicable accounting standards could also be useful guidance for TP purposes. The accounting standards applicable in Bulgaria are the International Financial and Reporting Standards (IFRS) and the National Accounting Standards (NAS).

International Accounting Standard 38 (Intangible Assets), part of the IFRS, provides rules for the recognition of intangible resources such as scientific or technical knowledge, the design and implementation of new processes or systems, licences, intellectual property, market knowledge and trademarks (including brand names and publishing titles). Within the scope of this standard fall intangible items such

\(^3\) Art. 56(1) Ordinance H-9.
\(^4\) Art. 56(2) Ordinance H-9.
\(^5\) Art. 57(2) Ordinance H-9.
\(^6\) Art. 57(3) Ordinance H-9.
\(^7\) Art. 57(4) Ordinance H-9.
as computer software, patents, copyright, motion picture films, customer lists, mortgage servicing rights, fishing licences, import quotas, franchises, customer or supplier relationships, customer loyalty, market share and marketing rights.

Under this standard in order to be recognized as an intangible asset, the intangible item should be (a) identifiable, (b) controlled by the company and (c) subject to expectations that future economic benefits will flow to the company from it. If an intangible does not meet these conditions it will not be recognized as an intangible asset.

Similarly, under Accounting Standard 38 (Intangible Assets), part of the NAS, to qualify as an intangible asset, the intangible should be an identifiable non-financial resource acquired and controlled by the entity:

(a) which does not have physical substance, although it may be contained in a physical substance;
(b) which has substantial significance upon its use;
(c) where economic benefits are expected from its use.

In this respect, the TP guidelines of the National Revenue Agency explicitly clarify that there could be intangibles which do not have any balance sheet value, but still might have a significant market value. In the view of the tax authorities such intangibles would be considered covered by the Bulgarian TP regulations and arm’s length terms should be agreed for the transfer or use of such intangibles.

Another useful reference for defining intangibles is the definition of royalty payment under the CITA, although it is not the intangibles, but the payment connected with such intangibles, that is defined. Thus, under the CITA a royalty payment is a payment of any kind received as a consideration for the use of, or the right to use, any copyright of scientific, artistic or literary work, including cinematographic films and television films and recordings for transmission by radio or television or software; any patent, trademark, industrial design or utility model, drawing, plan, secret formula or process, as well as for the use of, or the right to use, industrial, commercial or scientific equipment, or information concerning industrial, commercial or scientific experience.

2.2.2. Transactions with intangibles

Ordinance H-9 contains limited rules about the identification of transactions with intangibles. Under these rules the following circumstances should be examined in order to identify a transaction with intangibles and to determine its subject matter and content:

- ownership of the intangibles;
- the nature of the intangibles which are the subject of the transaction (patents, formulae, processes, knowhow, trademarks, etc.);
- the means of transfer or provision of the intangible – on a stand-alone basis or together with other services or products;
- the conditions under which the related party uses the intangibles – granting a right to use the intangibles (licence), sale, distribution of products in which the intangibles are incorporated, etc.\(^8\)

\(^8\) Art. 57 Ordinance H-9.
Once the subject matter and the content of the transaction with intangibles are determined, it should be considered whether the intangibles are transferred or used without remuneration or against an arm’s length remuneration.

If the intangibles are transferred or used by a related party without remuneration, this transaction would be considered as tax abusive under the CITA.\textsuperscript{9} In such a case the tax authorities are allowed to adjust the tax liabilities of the related parties to those which would have arisen if an arm’s length consideration had been agreed. Pursuant to the non-binding TP guidelines of the National Revenue Agency in such situation the tax authorities should (a) identify the intangibles owned by the company; (b) prove that the company has ensured an advantage/benefit to the other companies within the MNE group by providing the intangibles to them; and (c) determine the arm’s length compensation that should be due for such advantage/benefit.

If the intangibles are transferred or used by a related party against remuneration, the arm’s length character of the remuneration will depend on two main factors:

- the economic benefits expected by the user of the intangibles in the form of additional profit or cost saving resulting from the acquisition and/or the use of the intangible (main factor); and
- the possibility for the owner of the intangible to recover its costs related to the acquisition or the creation of the intangible and to achieve a reasonable rate of return (additional factor).\textsuperscript{10}

Similarly, the non-binding TP guidelines of the National Revenue Agency suggest that any compensation due in a transaction with intangibles should be linked to the benefits received from the intangibles:

- the companies within the MNE group which are expected to derive financial benefits (operational profit) from the intangibles should pay royalties to their legal owner for their use;
- the companies within the MNE group which need and use the results from any research and development activity carried out by another entity from the group should pay the costs of such activity.

2.2.3. “Substance-over-form” approach towards intangibles

The Bulgarian TP regulations have clearly adopted the substance-over-form approach towards intangibles. Ordinance H-9 requires an assessment of functions, risks and assets based on which the economic role of the company within the MNE group can be identified and the profit of the entity can be determined by reference to the profit which an independent company would have derived in comparable economic conditions. As a result, it could be possible for a company within the MNE group which has contributed to the value of the intangible to be compensated for its contribution, if, in a comparable situation, an independent company would have received such compensation.

Under Ordinance H-9 the comparability of transactions between related parties and transactions between unrelated parties should be tested against, among other things, the functions which the persons participating in the compared transactions

\textsuperscript{9} Art. 16(2)(2) CITA.
\textsuperscript{10} Art. 56 Ordinance H-9.
should carry out, taking into account the assets used and the risks assumed as well as the conditions of comparable transactions.\textsuperscript{11}

The actual assumption of risks for the purposes of the comparability analysis is subject to additional analysis which goes beyond the legal ownership of assets (including intangibles).

The assumption of risks is assessed based on:

- the conformity of the actual conduct of the parties with the agreed allocation of risks;
- the financial resources for covering the potential losses arising from the assumed risks;
- the management or operational control of each of the parties in relation to the economic activity which creates the risks.

When companies from the MNE group have contributed to the value of the intangibles, if comparable transactions are identified, then the arm’s length compensation to be paid by the legal owners of the intangibles should be determined by applying either the CUP method or the method of market prices (corresponding to the resale price method).

On the other hand, if no comparable transactions are identified, the compensation to be paid to the companies from the MNE group by the legal owner of the intangibles should be determined by applying the profit split method.

The profit split method distributes the aggregate operational profit or loss realized in transactions between related parties in a way that would be undertaken by independent parties performing comparable functions. The aggregate operational profit or loss is the sum of the operational profits or losses realized by any of the related parties as a result of a transaction or transactions between the related parties and the subsequent transactions with unrelated parties for products and services, where each of the related parties in the chain of transactions has contributed to the value of the product or the services.

The distribution of the aggregate operational profit or loss between the related parties should be carried out on the basis of the relative share of contribution of each entity in such profit or loss. The relative share of contribution should be determined based on the functions performed, the risks assumed and the assets used.\textsuperscript{12}

In terms of intangibles, an assessment of the nature and the amount of the expenses for creation and maintenance of the intangible could be used to determine the relative contribution of each entity.\textsuperscript{13}

\textbf{2.2.4. Comparability and group synergies}

The comparability analysis provided by Ordinance H-9 does not explicitly require that MNE group synergies should be taken into account in the way envisaged by the report on Actions 8–10. Thus, any benefits obtained by the MNE group as a whole, which are not available to independent companies, such as combined purchasing power, economies of scale, increased borrowing capacity, etc., are outside the scope of the comparability analysis under Ordinance H-9. Similarly, any detri-

\textsuperscript{11} Art. 6 (1)(2) Ordinance H-9.
\textsuperscript{12} Art. 35 Ordinance H-9.
\textsuperscript{13} Art. 59 Ordinance H-9.
ments to the MNE group as a whole such as bureaucratic barriers would not be considered as a factor in the comparability analysis.

It may be considered that group synergies could be taken into account in the comparability analysis due to the requirement of Ordinance H-9 that the economic conditions are considered. Economic conditions are not defined by the law and the non-binding TP guidelines of the National Revenue Agency include, for example, the level of the value chain on the market (wholesale or retail). However, a broader interpretation needs to be applied in order for group synergies to be taken into account in the comparability analysis to the extent that they are considered to fall within economic conditions. This approach has not been tested in practice and the conservative approach from the Bulgarian tax authorities so far has not provided indications of any such direction.

2.2.5. Hard-to-value intangibles

No specific measures as required by BEPS have been introduced in the Bulgarian legislation in terms of hard-to-value intangibles.

Nevertheless, Ordinance H-9 contains specific rules for determination of arm’s length prices for such intangibles. Pursuant to these rules, where at the time of the transaction a high level of uncertainty in respect to the value of the intangible exists and the transfer prices are determined based on anticipated results, the tax authorities should determine whether all the relevant economic factors were taken into consideration. Such factors include all costs related to the exploitation of the intangible and the impact of any subsequent foreseeable events on the price.\(^{14}\)

Upon this determination the tax authorities can make comparability adjustments due to the existence or lack of contractual clauses protecting against risks resulting from subsequent non-foreseeable events which would have been agreed between unrelated parties. Such clauses include (a) protective price clauses such as variable royalty rates depending on the volume of the sales; (b) clauses for the short-term effectiveness of the contract; and (c) clauses for renegotiation of prices.\(^{15}\)

In any case, the tax authorities may not make any subsequent adjustments to a price which has been determined based on anticipated results for the sole reason that the anticipated results have not been achieved due to an event which could not have been foreseen at the time of determination of the price. Companies are not allowed to make such adjustments either.\(^{16}\)

2.2.6. CCAs

There is no framework for CCAs under the Bulgarian TP legislation. However, Bulgaria recognizes such arrangements and the non-binding TP guidelines of the National Revenue Agency explicitly address CCAs.

Under these guidelines, a CCA is an arrangement between related companies for the purpose of sharing the resources necessary, among other things, for the

\(^{14}\) Art. 60(1) Ordinance H-9.

\(^{15}\) Ibid.

\(^{16}\) Art. 61 Ordinance H-9.
development of intangibles, which will result in economic benefits for the companies. Based on the CCA companies will be able to share the costs and the risks of the creation of an intangible and to determine its use.

Only companies which are party to a CCA may use the intangibles which are the subject of the agreement. Any third party should pay an arm’s length consideration to the parties to the arrangement.

The participants in the CCA need to determine (a) the allocation of costs arising from it and (b) the contribution of each participant.

In line with the OECD TP guidelines, the allocation of the costs should correspond to the share of each participant in the profits or the anticipated savings. This could be determined by reference to various criteria such as profit per unit of production, turnover or profit of the participants, personnel, etc.

The contribution of each participant should be determined based on the amount which would be due between unrelated entities under comparable conditions. Typically, the participants contribute by providing development facilities, experts, specific intangible assets, etc. In such cases the contribution is calculated based on the costs incurred by the respective participants, although it could also be calculated based on the market value of the participation rather than on the costs incurred.

Each participant in the CCA should act as an independent company and contribute to the results of the arrangement in compliance with its profit expectations. To that end it should be considered whether:

- the respective participant could actually use the intangible created based on the CCA;
- the costs defined as its contribution to the arrangement are actually incurred;
- the incurred costs are actually related to the CCA;
- all costs incurred for the purposes of the CCA are properly reflected.

Additional issues would arise from the entry of a new participant in the CCA or the exit of an existing participant. Under the non-binding TP guidelines of the National Revenue Agency, the new participant should pay an entrance fee for access to the intangible developed so far and the exiting participant should be entitled to compensation for the contribution made.

2.3. Risk and capital

The provisions of Bulgarian tax legislation address the TP issues related to risk and capital in line with the requirements of Actions 8–10 of the BEPS report.

The Bulgarian TP rules recognize contractual allocation of risk only if the allocation reflects the economic reality, i.e. if it is supported by the actual business activities of the parties. The identification of the risks actually assumed by the parties should be carried out based on the comparability analysis under Ordinance H-9.

Under Ordinance H-9 the risks actually assumed should be determined based on:

- the conformity of the actual conduct of the parties with the contractually agreed allocation of risks;
- the financial resources necessary to compensate potential losses as a result of the assumed risk;
- the management or operational control of each of the parties over the business activity from which the risk arises.
On the basis of this analysis the functions of each company from the MNE group in the examined transaction may be defined and the arm’s length remuneration corresponding to these functions can be determined.

Where a related party solely provides capital to other companies within the MNE group, its returns on the provided capital would be limited only to compensation for the actual financial risk assumed. Under the CIT any borrowing or lending should be at the arm’s length interest rate determined according to market conditions taking into account all the quantitative and qualitative specifics of the transaction: the nature, amount and currency of the resources provided, and the period of the provision thereof; the type, amount and liquidity of the collateral security; the credit risk and other risks related to the transaction; the profile of the borrower; as well as all other conditions and circumstances influencing the rate of interest. Premium returns resulting from investment risks beyond the control of the lender are excluded from the arm’s length interest rate definition.

Any borrowing or lending at interest rates diverging from the arm’s length interest rate, including interest-free loans or other temporary gratuitous financial assistance would be regarded as tax abusive under the CITA. In such a case the tax authorities may adjust the cash flows of the intercompany financing to what would have been agreed between unrelated parties.

Similarly, any interest exceeding market levels could be regarded as hidden profit distribution if accrued or paid to a shareholder or related party. Any interest expense which represents hidden profit distribution could be (a) tax non-deductible, (b) taxed as dividend and (c) subject to administrative sanction at 20 per cent of the expense.

The above tax rules on risk and capital in effect exclude inappropriate results from the contractual allocation of risk and capital and ensure that the returns of each of the related parties match their actual contribution.

2.4. High-risk transactions

2.4.1. CUP and quoted prices for cross-border commodity transactions

The Bulgarian tax legislation does not have specific provisions on the application of the CUP method in case of cross-border commodity transactions in the light ofActions 8–10 of the BEPS report. Without such specific provisions, the general rules of Ordinance H-9 would address only partly the TP implications arising from cross-border commodity transactions and further legislation would be needed to implement the requirements of the BEPS project.

Under Ordinance H-9 the CUP method can be applied to commodities as this method is generally applicable to all goods. Ordinance H-9 requires the CUP

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17 §1, item 32 CITA.
18 Art. 16(3) CITA.
19 §1, item 5(a) CITA.
20 Art. 26(11) CITA.
21 Art. 27(2)(2) CITA.
22 Art. 267 CITA.
method to be applied only based on comparable transactions between unrelated parties;\(^\text{23}\) transactions on international or domestic commodity exchanges at quoted prices could be regarded as comparable if quoted prices are ordinarily used to establish prices between independent parties in the industry concerned.

If the CUP method is to be applied to a transaction with commodities, the comparability analysis under Ordinance H-9 should cover all the main economic characteristics of the compared transactions outlined in Actions 8–10 of the report relevant to the proper determination of the arm’s length price: the physical characteristics of the commodities, contractual terms such as quality, volumes, delivery terms, currency exchange risks and time schedules. The description of the relevant economic characteristics is not exhaustive as Ordinance H-9 requires that any other factors which could influence the price be considered. These could include specific factors relevant for the determination of the quoted prices such as standard specifications on the basis of which commodities are traded on the exchange.

Ordinance H-9 does not provide rules in respect to the pricing date when the arm’s length price for transactions with commodities is determined by a reference to a quoted price. Under the general rules of Ordinance H-9 all TP methods should be applied based on data about comparable uncontrolled transactions which have been carried out either (a) in the year of the controlled transaction or (b) in another time period with identical economic conditions influencing the pricing of the transactions.\(^\text{24}\) These rules entitle the tax authorities to challenge the pricing date specified by the parties and determine another pricing date when, in the view of the tax authorities, the economic conditions of this other pricing date are similar to those of the reviewed transaction between related parties.

2.4.2. *Intra-group services*

The Bulgarian TP rules ensure the identification of the actual provision of intra-group services and determination of arm’s length remuneration for the provision of these services in line with the BEPS project.

The provision of intra-group services is governed by the following Bulgarian tax law provisions:

- the tax anti-abuse rule of the CITA under which the accrual of any remuneration or compensation for services which have not been actually rendered is regarded as tax abusive;\(^\text{25}\)
- the general rule of the CITA on the deduction of costs in the determination of taxable profits which prohibits tax deduction of expenses not related to the activity of the taxpayer;\(^\text{26}\)
- the hidden profit distribution rules of the CITA which define hidden profit distribution as, among others, any amounts which are (a) not related to the economic activity of the taxpayer or (b) exceeding the market levels, which are accrued, paid or distributed in any form to the shareholders or their related parties, with the exception of dividends.\(^\text{27}\)

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\(^{23}\) Art. 5 Ordinance H-9.

\(^{24}\) Art. 14(1) Ordinance H-9.

\(^{25}\) Art. 16(2)(4) CITA.

\(^{26}\) Art. 26(1) CITA.

\(^{27}\) §1, item 5(a) CITA.
In practice, there are three non-arm’s length scenarios in respect of the TP of intra-group services in the MNE group: (a) when no services have been actually rendered or the rendered services are not related to the economic activity of the recipient but remuneration for services has been paid; (b) when the services have been rendered but no remuneration is due or paid; or (c) the services have been rendered and the remuneration is due or has been paid, but the remuneration has not been set at arm’s length terms.

Under the first scenario, the accrual or payment of remuneration or compensation to a related party for the rendering of intra-group services, where the actual rendering of the services may not be substantiated by the companies, could trigger adverse tax consequences for both the service recipient and the service provider. In the worst-case scenario, if the payment for the non-substantiated services is regarded as a hidden profit distribution, all the expenses of the service recipient will be non-tax deductible, and the service recipient could be subject to administrative sanctions at the amount of 20 per cent of these expenses and the income of the service provider will be taxed as dividend (no dividend exemption would apply).

To substantiate the rendering of the intra-group services, both the service provider and the service recipient should be able to demonstrate that the service provider actually performed the services. This would include providing documents (a) to evidence the activities carried out by the service provider in performance of the services (e.g. delivery documents, performance acceptance statements, technical documentation, etc.) and (b) to evidence that the service provider has the capacity to provide these services (e.g. sufficient personnel, equipment, financial resources, etc., depending on the type of services provided). If no such documents are provided the tax anti-abuse provisions of the CITA could be triggered.

Even if the performance of the intra-group services by the service provider is proved, the provided services should be related to the economic activity of the service recipient. The CITA does not provide a test when the services would be considered related to the economic activity of the recipient and the courts make assessment on a case-by-case basis. The non-binding TP guidelines of the National Revenue Agency indicate that the intra-group services would be related to the economic activity of the service recipient if the provision of the services ensures an economic or a commercial benefit for the service recipient and improves the recipient’s business position. In the view of the National Revenue Agency this would be the case if an independent enterprise would have agreed to pay for the receipt of such services from another enterprise or would have incurred the costs in performing this activity itself.

If the provided services are not related to the economic activity of the recipient, the expenses incurred for such services will either be tax non-deductible under the general tax deductibility restrictions rule of the CITA or qualified under the CITA as a hidden profit distribution. The non-binding TP guidelines of the National Revenue Agency provide examples of such services: (a) services which duplicate services provided by third parties or are performed as an activity by the service recipient itself; and (b) services which are actually used by the shareholders of the service recipient for shareholder activities (e.g. shareholder meetings, issuing of shares in the shareholding entities, participation by the shareholders in the supervisory boards of other subsidiaries, reporting requirements of the shareholders, including consolidation of reports, raising funds for acquisition of participation in entities, etc.).
Certain intra-group services based on a retainer or “on call” arrangement could be regarded as actually rendered if it could reasonably be expected that an independent person under comparable circumstances would incur constant costs to ensure the permanent availability of the provider to perform the services when needed. In the National Revenue Agency’s view, an independent person would not be willing to incur such constant costs if:

- the potential need for the service was too remote in time or was unlikely to arise;
- the advantages of ensuring the future provision of the services were negligible or non-existent;
- the services in question could be provided easily and speedily from external providers without the need for such arrangements.

Similarly, the provision of services for which no remuneration is due would be regarded as tax abusive. In such a case the tax authorities might adjust the tax results and levy tax based on terms which would have arisen between unrelated parties, i.e. arm’s length remuneration.

Under the third scenario where the services are actually rendered, but the agreed remuneration has not been set at arm’s length terms, the tax authorities can also intervene. If the agreed remuneration is below the arm’s length level, the tax authorities may adjust it to the arm’s length level. If the agreed remuneration exceeds the arm’s length level, the excess amount could be considered as hidden profit distribution and, in addition to being tax non-deductible and taxed as dividend, be subject to an administrative sanction at a rate of 20 per cent.

Under Ordinance H-9 in the case of intra-group services the arm’s length terms of the services should be determined by using either the CUP method or the method of the increased value (corresponding to the cost-plus method), or a combination of both. If the use of these methods does not lead to a result which would have been achieved in customary commercial or financial relations between independent parties in comparable circumstances other TP methods could be used.

The arm’s length price for the provision of intra-group services could be determined by using either a direct or indirect approach. The price will be determined by using a direct approach if the particular service is provided to one or more persons and it can be directly established what part of the service has been received by each of the persons as well as the value of that part of the service. The price will be determined by using an indirect approach if the service is provided to two or more persons and (a) no determination through a direct approach is possible or (b) determination of the price through a direct approach for each separate recipient requires administrative expenses for the MNE group which are not equivalent to the benefits of the service. Indirect determination of the price is not allowed when services identical to the intra-group services are provided to third parties and these services represent significant part of the activity of the service provider. In such a case the price for the intra-group services should be determined by reference to the price of the services charged to the third parties.

29 Art. 53(2) Ordinance H-9.
30 Art. 55 Ordinance H-9.
In the case of indirect determination the part of the total price of the services due by each recipient would be calculated based on a certain allocation key chosen by the MNE group such as sales revenues, number of personnel, invested capital, etc.\textsuperscript{31}

The non-binding TP guidelines of the National Revenue Agency indicate that a profit mark-up of between 3 and 8 per cent on the expenses is likely to be considered determined at arm’s length. Any mark-up deviating from these rates would be subject to a detailed analysis by the tax authorities to determine the reasons for the deviation.

2.4.3. Profit splits in the context of value chains

The Bulgarian TP legislation has implemented both the profit split method and the transactional net profit method which could apply to MNEs’ value chains.

The profit split method could be applied to MNEs’ value chains when:

- the transactions between the companies of the MNE group cannot be valued separately due to their interrelations;
- no comparable transactions between unrelated parties can be identified and no comparability adjustments can be made;
- unique and high-value intangibles are used and no comparability adjustments can be made;
- in other cases when comparability does not allow the application of the CUP method, the method of the market prices (corresponding to the resale price method), or the method of increased value (corresponding to the cost-plus method).

The profit split method requires the distribution of the aggregate operational profit or loss realized in transactions between the entities that are part of the MNE group similarly to what would be undertaken by independent parties performing comparable functions. The aggregate operational profit or loss is the sum of the operational profits or losses realized by any of the companies within the MNE group as a result of a transaction or transactions with other companies of the MNE group and the subsequent transactions with unrelated parties for products and services. The operational profits or losses of each company of the MNE group will be included in the aggregate operational profit or loss when the company contributed to the value of the product or the services provided subsequently to the unrelated parties.

The distribution of the aggregate operational profit or loss between the companies of the MNE group under the profit split method should be carried out on the basis of the relative share of contribution of each entity in such profit or loss. The relative share of contribution should be determined based on the functions performed, the risks assumed and the assets used by the entity.

The distribution of the aggregate profit can be carried out on the basis of expected future profits. The valuation of the expected future profits should be determined based on market data available at the conclusion of the related party transaction.

There are two methods which can be used to distribute the aggregate operational profit: contribution analysis and remaining profit analysis.

\textsuperscript{31} Art. 54(1) Ordinance H-9.
Under the contribution analysis method, the aggregate operational profit is distributed based on the relative share of the functions carried out by each company in the MNE group, taking into consideration the market data for distribution of such profit between unrelated parties in comparable conditions.

Under the remaining profit analysis method, the aggregate operational profit is distributed in two stages: (a) the profit is distributed in such a way as to guarantee an ordinary return for the functions carried out by companies from the MNE group without considering the intangibles used and (b) the remaining profit, attributable to the intangibles used, is distributed between the companies of the MNE group based on the relative value of the intangibles used by each of them.

### 2.5. TP documentation

#### 2.5.1. Country-by-country reporting

Bulgaria has not yet implemented legislation which follows the OECD country-by-country reporting implementation package and there are no annual TP reporting requirements for companies.

While there is no obligation of annual reporting of transactions with related parties for TP purposes, in the case of a tax audit the tax authorities can request the audited company to provide all the information or documents for related party transactions. Such information or documents could be related to:

- the legal relationships between the companies of the MNE group;
- the methods used to determine the transfer prices, including a description of the methodology used, accounting treatment, and an explanation of the economic conditions upon which the prices have been determined;
- the assets used by the companies of the MNE group, the functions performed and the risks assumed in relation to the examined transactions;
- the actual conduct of the related parties under their transactions.

Under article 116(2) of the TSSPC each company of the MNE group has the burden of proving that its transactions with related parties are set at arm’s length terms. However, the legislation does not provide for any specific obligation as to what TP documentation should be held by a company and, therefore, the company is free to determine the content of its documentation itself. The non-binding TP guidelines of the National Revenue Agency suggest that the TP documentation to be prepared by the MNEs should generally follow the requirements of the code of conduct on TP documentation for associated enterprises in the European Union (EU TPD), i.e. it should comprise a master file containing information for all enterprises from the MNE group and a country-specific file for Bulgaria. However, the legislation does not provide an obligation to follow this TP documentation model.

The entire TP documentation should be in Bulgarian for Bulgarian tax purposes. If any document is prepared in a foreign language, it should be accompanied by a Bulgarian translation from a licensed translator. If the company does not provide a translation, the tax authorities could arrange a translation at the expense of the company.
2.5.2. Master and local files

As noted above, Bulgarian legislation does not provide rules on the scope and content of the TP documentation. Under the non-binding TP guidelines of the National Revenue Agency the TP documentation of the MNE group for Bulgarian tax purposes should follow the requirements of the code of conduct on TP documentation for associated enterprises in the European Union (EU TPD) and should consist of two parts: 32

- one set of documentation containing common standardized information relevant for all EU group members (the “master file”); and
- one set of standardized documentation containing specific information for Bulgaria (the “country-specific file”).

The non-binding TP guidelines of the National Revenue Agency provide for the following content of the master file:

- the identification and legal form of all the companies from the MNE group;
- a description of the capital structure of all companies from the MNE group;
- a description of other circumstances necessary to qualify the companies as related parties;
- a description of the organizational and operational structure of the MNE group;
- a description of the economic activity and the business strategy within the MNE group;
- a general description of the transactions between the companies of the MNE group: the nature of the transactions (supply of goods, intangibles, services, financial instruments) and the value of the transactions;
- a general description of the functions, the assumed risks and the intangibles used by the companies of the MNE group and any amendments from the previous tax period;
- ownership of intangibles (patents, trademarks, knowhow, etc.);
- the intra-group TP policy of the MNE group;
- a list of CCAs, advance pricing arrangements and court decisions related to the TP in the MNE group;
- other information which is important for the application of the arm’s length principle.

The country-specific file should contain (a) a description of the activity, functions and risks of the local company (e.g. legal form, description of its economic activity, business strategy, list of transactions with related parties, description of these transactions, description of own intangibles, description of intangibles received from related parties, description of functions and risks assumed by the company, etc.); (b) methodology for TP of the local company (description of the method used, the reasons for the use of this method, description of internal or external comparable transactions, description of the sources of information, costs base used in the applied method, comparable profit margins, etc.); and (c) information on advance pricing arrangements or intergovernmental agreements related to the local company.

32 Resolution of the Council and of the representatives of the governments of the Member States, meeting within the Council, of 27 June 2006 on a code of conduct on transfer pricing documentation for associated enterprises in the European Union.
In any case it should be considered that while this scope of the TP documentation is not mandatory for the company, it will be accepted by the tax authorities. Other types of TP documentation would be reviewed by the tax authorities on a case-by-case basis.

2.5.3. Compliance costs

Given that (a) the Bulgarian legislation has not provided for any standard content of the TP documentation and (b) the TP documentation differs between companies, it is difficult to assess either the current compliance costs or the future impact of the country-by-country reporting on such costs in Bulgaria.

The Bulgarian tax authorities have already considered the effect of the compliance costs on the conduct of the companies. The non-binding TP guidelines of the National Revenue Agency indicate that to avoid situations where the costs for preparation of TP documentation exceed the amount of the potential tax obligation, no detailed TP documentation should be provided for transactions below the following threshold values:

- BGN 200,000 (approximately €102,258) when the subject matter of the transaction is supply of goods;
- BGN 200,000 (approximately €102,258) when the subject matter of the transaction is supply of services;
- BGN 400,000 (approximately €205,516) when the subject matter of the transaction is provision of intangibles;
- BGN 400,000 (approximately €205,516) when the subject matter of the transaction is provision of a loan (the threshold applies to the interest under the loan and not to the loan amount).

Further, the non-binding TP guidelines of the National Revenue Agency consider that no detailed TP documentation should be prepared by companies which have:

- an average number of personnel of fewer than 10 people; and
- an annual turnover of not more than BGN 3,900,000 (approximately €1,994,038) and/or a value of the assets of not more than BGN 3,900,000 (approximately €1,994,038).

In the above cases, companies should prepare simplified TP documentation. However, simplified TP documentation will not apply and companies should prepare detailed TP documentation when their profit margin is at least 20 per cent lower than the average for the industry for the last three years before the transactions analysed.

If similar de minimis rules are preserved in the course of implementation of country-by-country reporting in Bulgaria, it is not expected that the reporting will have a significant impact on TP compliance costs in Bulgaria.

2.6. TP-related measures in other BEPS actions and other measures against BEPS

Bulgaria has not yet implemented any specific TP-related measures in other BEPS actions and other measures against BEPS. This is due largely to the fact that Bulgaria, as an EU Member State, has to implement the BEPS measures in an EU law compliant manner and it is expected that new EU law, ensuring a
common approach by all Member States in respect of BEPS-related measures, will be enacted soon.

In particular, in January 2016 the EU Commission introduced its anti-tax avoidance package, which contains, among other things, a draft anti-avoidance directive proposing common minimum solutions for the implementation of the BEPS measures and a proposal for a directive implementing the country-by-country reporting envisaged by the BEPS project. In its communication of 28 January 2016 for the introduction of the anti-tax avoidance package, the EU Commission has expressed its position that the Member States should develop a common approach to BEPS-related measures, which should include, \textit{inter alia}, minimum standard measures to be implemented in every Member State. In the view of the EU Commission this should be done through the legal instruments of EU law which would ensure that BEPS-related measures were implemented in a coordinated manner in all Member States.

Against this background, it is clear that Bulgaria will not undertake unilateral measures to implement BEPS solutions, but would rather wait for the development of a coordinated approach across the EU.

\subsection*{2.7. Can BEPS work in favour of MNEs?}

In Bulgaria there is no mechanism which would allow MNEs to benefit from the information collected by the tax authorities as a result of the BEPS required reporting.

In particular, under article 72(1) of the TSSPC the following tax-related information in respect to any particular taxpayer is regarded as confidential:

- bank accounts;
- amount of income;
- amount of accrued, assessed or paid taxes;
- any data for commercial activity, the value and the type of the assets and liabilities as well as assets which are regarded as trade secrets;
- any data which are received, certified, prepared or collected by the tax authorities and contains any of the information specified above.

The tax authorities are prohibited from disclosing this confidential information with very limited exceptions, such as when (a) the information is available in public registries, (b) the tax authorities publish this information for public claim enforcement purposes, or (c) the tax authorities disclose this information to the authorities of another country based on an exchange of information mechanism. This prohibition would in practice preclude any possibility for the tax authorities to automatically exchange information with MNEs for domestic TP purposes.

\section*{3. What is the future of TP?}

The BEPS project will influence Bulgarian TP legislation only to the extent that the BEPS project is implemented at an EU level. While Bulgaria acknowledges the BEPS objective of combating aggressive tax planning globally so that double non-taxation or reduced taxation at international level is prevented, the objective of
Bulgaria (a relatively low-tax jurisdiction) will naturally be to prevent any non-taxation or reduced taxation at the domestic level. As a result, Bulgaria would most probably be unwilling to modify its TP legislation in respect of any BEPS-related measures which could lead to reduced taxation in Bulgaria unless such modification was required by EU law. Thus, the future of TP in Bulgaria will be closely related to TP developments in the EU.

In this respect, what could be expected as a future development of the Bulgarian TP legislation is the implementation of any EU requirements, if adopted, for (a) minimum BEPS-related measures, (b) country-by-country reporting, and (c) the elimination of any loopholes or mismatches between the TP legislation of Member States, which could be exploited by MNEs to reduce tax liabilities.
Summary and conclusions

The Canadian government has been vigilant in protecting its tax base, having implemented transfer pricing (TP) rules, including substantial documentation requirements, and other measures targeting base erosion and profit shifting (BEPS) well in advance of the OECD’s work on the BEPS project. The Canadian government recently affirmed its commitment to the BEPS project in its 2016 budget, announcing several initiatives related to TP including the implementation of country-by-country reporting and the immediate application of the OECD’s recommended revisions to the interpretation of the arm’s length principle.

Canada’s current TP legislation requires Canadian residents and non-residents carrying on business in Canada to demonstrate that their transactions with non-arm’s length non-resident parties are conducted on terms and conditions that would have prevailed if they were dealing at arm’s length. The rules permit Canada’s tax authorities not only to adjust non-arm’s length terms and conditions but, in certain circumstances, also to recharacterize a transaction that non-arm’s length parties would not have entered into for the purposes of determining income tax consequences. Significant penalties may apply where a taxpayer is subject to a TP adjustment and has not kept proper contemporaneous documentation.

There is limited jurisprudence regarding the application of Canada’s TP rules; however, the approach taken by Canadian courts in applying the arm’s length standard has been to apply it focusing on the price (or other term or condition in question) but in the context of all other existing circumstances, including other non-arm’s length circumstances. This is significant in that it requires advantages and limitations arising from being a part of a multinational enterprise (MNE) to be taken into account. Questions remain regarding the impact of this approach, such as in the context of large group pricing, as well as whether the approach is harmonious with the view of the arm’s length principle in other jurisdictions.

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This report was prepared with the invaluable contributions of Stephanie Dewey, Associate, Baker & McKenzie (Toronto), as well as with the assistance of Chris Raybould, Director of Economics, and Mark Tonkovitch, Senior Associate, each of Baker and McKenzie (Toronto).
For its part, the Canada Revenue Agency (CRA), which administers Canada’s income tax legislation, generally follows the OECD TP guidelines when interpreting Canada’s TP rules. The government of Canada and the CRA have taken the position that changes in the guidelines may be applied without legislative amendment if they conform to the legislated arm’s length standard. This approach of administrative change without legislative amendment adds significantly to the uncertainty faced by MNEs, although it allows Canada to act quickly. However, the issue is particularly sensitive in instances where there is disagreement regarding whether the guidelines are actually consistent with Canada’s legislation and general legal principles. Other BEPS measures will, however, require extensive legislative change if they are to be implemented. One example is in the context of intangibles, where taking a “substance-over-form” approach or looking back to value hard-to-value intangibles would be inconsistent with the emphasis Canadian courts have placed on form over substance.

Although Canada remains committed to the BEPS project, its full impact in Canada is not yet known. As a result of its proactive and mature approach to BEPS, Canada may be slow to act, if it acts at all, on certain new BEPS and TP measures. For instance, in addition to its substantive and documentary TP rules, Canada has in place thin capitalization rules that limit the extent to which non-residents can extract profits from Canadian subsidiaries in the form of deductible interest (instead of after-tax dividends), as well as foreign affiliate dumping rules aimed at preventing MNEs from using Canadian subsidiaries to invest in foreign affiliates in a manner that erodes the Canadian tax base. Canada will need to continue its close study of the interaction between existing Canadian rules and the proposed new initiatives to determine how best to proceed with implementing the results of the BEPS project.

In the short-term, MNEs with operations in Canada should prepare for more TP controversies as a result of the increased scrutiny and uncertainty resulting from the BEPS project. The Canada Revenue Agency has already given TP a higher priority in its audits and obtained more funding in that regard. In the long term, however, it is hoped that the greater global consistency resulting from the worldwide implementation of BEPS project will lead to increased certainty, predictability and efficiency in tax matters for MNEs.

1. Current TP regulation and practice in Canada

Canadian residents, as well as non-residents carrying on business in Canada, are required to comply with Canada’s TP legislation as set out in section 247 of the Income Tax Act (ITA). There is limited jurisprudence regarding the application of these rules. Generally, the CRA, which administers the ITA, follows the OECD TP guidelines. The CRA has issued a variety of non-binding guidance documents (e.g. information circulars, interpretation bulletins, and TP memoranda) that set out its views on topics related to TP.

Under Canada’s TP legislation, taxpayers must be able to demonstrate that their transactions with non-arm’s length non-resident parties are conducted on terms and conditions that would have prevailed if they were dealing at arm’s length. The
CRA has the authority to adjust prices or other terms and conditions of transactions for income tax purposes to the extent they are not consistent with what arm’s length parties would have agreed to. Moreover, the CRA also has the authority to recharacterize a transaction for the purposes of determining the income tax consequences of the transaction if the transaction is one arm’s length parties would not have entered into and it was entered into primarily to obtain a tax benefit.

Proper contemporaneous documentation is an important aspect of a taxpayer’s compliance efforts in Canada. Should the CRA make an adjustment to a taxpayer’s transfer prices that exceeds the lesser of CAD 5 million or 10 per cent of the taxpayer’s gross revenue, the CRA may impose a TP penalty of 10 per cent of the TP adjustment. Penalties do not apply, however, if the taxpayer has made reasonable efforts to determine and use arm’s length transfer prices for income tax purposes. Canada’s TP rules note that contemporaneous documentation that contains the legislatively prescribed content is only a minimum standard (and is not necessarily sufficient to avoid penalties). This documentation requirement contemplates the disclosure of relatively detailed information about, among other things, the taxpayer’s business operations and financial results. In addition, economic analysis supporting the arm’s length nature of the terms and conditions of the intercompany transactions is essential to meet the documentation requirement.

To aid the CRA in its TP enforcement activities, a taxpayer is required to file an information return (form T106) if it enters into transactions with an aggregate value of CAD 1 million or more during the taxation year with non-arm’s length non-resident parties. The information that must be reported includes, among other things, the identities of the counterparties, the nature and quantum of the transactions, the TP method applied, and the existence of contemporaneous documentation. There are late filing, failure to file, and false statement or omission penalties that may apply with respect to form T106.

TP disputes can be resolved in a number of ways. These include the normal appeals process, including potential litigation, competent authority negotiations under one of Canada’s many bilateral income tax treaties, and/or through the advanced pricing agreement procedure. Each of these avenues has different ramifications and costs.

The CRA has given TP a high priority in its tax audits, which accords with the CRA’s ongoing shift to risk-based audit techniques (in view of the potential for extremely large tax adjustments in the TP context). As a result, TP has become one of the areas of most concern to MNEs with operations in Canada.

2. The impact of the BEPS project on TP

2.1. Introduction

The Canadian government affirmed its commitment to the BEPS project in its 2016 budget, announcing several initiatives related to TP. In particular, and as is consistent with Canada’s role in the OECD and general reliance on the OECD TP guidelines, the Canadian government proposed to (a) implement country-by-country reporting for MNEs with total annual consolidated group revenue of
€750 million or more for taxation years beginning after 2015, and (b) to apply the recommended revisions to the interpretation of the arm’s length principle in the OECD TP guidelines. A notice of a ways and means motion including proposed legislation to implement country-by-country reporting was tabled on 21 October 2016.

With respect to the revised OECD TP guidelines, the Canadian government is of the view that the most recent changes to the interpretation of the arm’s length principle are generally consistent with the CRA’s current practice. As such, the CRA has stated that such changes will be applied immediately to any open taxation years, subject to two exceptions where work is ongoing and Canada has not yet taken a position: (a) the proposed simplified approach to low value-adding services, and (b) “cash boxes”. To the extent that these (and other) measures are not consistent with the arm’s length principle codified in section 247 of the ITA, legislative amendments may be required before they can be implemented.

While the CRA may expect to see taxpayers challenging the purported direct effect of the revised OECD TP guidelines in the absence of legislative amendments, some taxpayers have already begun to see CRA activity on this front in the audit context.

2.2. Challenges of transactions with intangibles

2.2.1. Definition of intangibles

There is no exhaustive definition of intangibles in Canada. Rather, a broad and principled approach is generally applied to items on a case-by-case basis. BEPS may help to bring clarity and consistency by providing defined guidelines.

In general, intangibles in Canada include goodwill, rights to use property (such as trademarks, patents and copyright), and other intellectual property (such as trade secrets and knowhow).

Identification of, and compensation for, knowhow is frequently an issue in Canadian TP audits, along with the possible application of withholding tax. The CRA describes knowhow as including special knowledge, skills or techniques considered beneficial in the conduct of a business. Such expertise may flow from experience, ability or research, and may be reflected in blueprints, drawings, specifications, plant layouts, designs, secret processes and formulae (see CRA, IT-303, Know-How and Similar Payments to Non-Residents, 8 April 1976 at paragraph 3).

2.2.2. Transactions with intangibles

There are numerous audit and appeals cases in Canada that deal with the transfer of intangibles. Two issues that commonly arise relate to the development of local intangibles through marketing, and unbundling composite transactions to price intangibles separately.

Where an MNE engages in marketing in Canada, the CRA generally assumes that such marketing results in local intangibles. The CRA takes the position that local distributors who bear the costs of marketing activities would usually be expected to share in the return from the marketing intangibles (see CRA, IC 87-2R, International Transfer Pricing, 27 September 1999 at paragraph 148).
The CRA may unbundle transactions consisting of a number of different properties and/or services that have been packaged together for a single price in a number of circumstances, including where the CRA is of the view that the bundling (a) results in a price that is different from that which would have been established had the properties and/or services been sold on an individual basis (e.g. where the overall price can only be evaluated by determining the values of the separate components, for which there are comparables), or (b) may be disguising transactions that would be subject to increased non-resident tax or withholdings (CRA, TPM-06, Bundled Transactions, 16 May 2005).

Unbundling a transaction to assess withholding tax is of particular importance in the context of intangibles. For example, the price of a tangible property may be considered to include an embedded royalty fee where there is a significant price difference in the market price of an end product due to perceived value in the way tangible and intangible (commonly, trademarks) properties are combined, as in the case of a branded consumer product. In such a case, the CRA may allocate a portion of the price to royalties, which may be subject to Part XIII withholding tax. Bundling may also result in the imposition of TP penalties where the basis for the decision to bundle is not properly documented in the MNE’s contemporaneous documentation (CRA, TPM-06, Bundled Transactions, 16 May 2005).

2.2.3. "Substance-over-form" approach towards intangibles

In *Shell Canada Ltd v. Canada*, [1999] 3 SCR 622, the Supreme Court of Canada affirmed that, absent a specific legislative exception, the legal form of a transaction must generally be respected in tax cases. The CRA cannot assess a taxpayer based on the perceived “economic realities” of a transaction simply because the taxpayer could have entered into a different transaction with less advantageous tax consequences. A taxpayer’s conduct must, however, be consistent with the chosen legal form and documentation. The CRA can look through form in the case of a sham; that is, where the label applied by the taxpayer does not properly reflect the actual legal effect of the transaction.

The TP rules are exceptional, however, in that, in addition to permitting the CRA to adjust prices and the terms and conditions of a transaction, they give the CRA the authority to recharacterize a taxpayer’s transaction or series of transactions where certain conditions are met. More particularly, a transaction or series may be recharacterized for income tax purposes where it differs from the transaction or series that arm’s length parties would have entered into, unless the transaction or series cannot reasonably be considered to have been entered into primarily for bona fide purposes other than to obtain a tax benefit.

Although the TP rules allow the CRA to alter the taxpayer’s chosen legal form, the basis for the recharacterization must be the arm’s length standard (and not perceived substance). That is, the rules permit the CRA to substitute an arm’s length transaction for a non-arm’s length transaction, but not an arm’s length transaction for a different arm’s length transaction. Nonetheless, some of the CRA’s administrative policies relating to TP appear to be based on a substance-over-form approach. For example, while the CRA takes the position that its practice of unbundling transactions does not change the underlying nature of the transaction, this is difficult to accept.
Moreover, recent cases suggest Canadian courts may be placing a greater emphasis on economic substance. In a recent case under Canada’s general anti-avoidance rule (GAAR), *Global Equity Fund Ltd v. Canada*, 2012 FCA 272, the Federal Court of Appeal considered the economic realities of a series of transactions undertaken by the taxpayer in order to determine whether there had been a misuse or abuse of the business loss deduction rules. The Court concluded that because the taxpayer’s business loss was a “paper loss” only, and did not correspond to an actual economic loss or reduction in wealth, its deduction was denied by the GAAR. Although perhaps best interpreted as a conclusion that the legislative rationale underlying the business loss provisions contemplates an actual economic loss, the Court’s substance-over-form posture is notable.

### 2.2.4. Comparability and group synergies

Canadian courts have considered the benefits arising from synergies among members of an MNE. In *General Electric Capital Canada Inc. v. Canada*, 2010 FCA 344, the Federal Court of Appeal held that the implicit support provided by the taxpayer’s parent must be considered when determining the arm’s length value of the parent’s explicit guarantee of the taxpayer’s debt. In the tax years at issue, the parent charged the taxpayer a fee of 1 per cent of the face value of the taxpayer’s debt to provide an explicit guarantee. Previously, the parent had provided an explicit guarantee to the taxpayer at no cost. The CRA denied the taxpayer’s deduction of the guarantee fee on the basis that the parent provided nothing in return for the guarantee fee since the taxpayer already had the parent’s implicit support. The Court agreed that the parent’s implicit support had to be taken into account, stating that in applying the TP rules “[the] task in any given case is to ascertain the price that would have been paid in the same circumstances if the parties had been dealing at arm’s length. This involves taking into account all the circumstances which bear on the price whether they arise from the relationship or otherwise.” Nonetheless, the CRA lost the appeal as the evidence substantiated that the parent’s explicit guarantee raised the taxpayer’s credit rating beyond what it would have been with only the parent’s implicit support (i.e. the parent’s implicit support was not a substitute for an explicit guarantee).

In *Canada v. GlaxoSmithKline Inc.*., 2012 SCC 52, the Supreme Court of Canada took into account another transaction within the corporate group when determining the arm’s length purchase price of a product. The taxpayer, a drug manufacturer and marketer, purchased ranitidine (the active pharmaceutical ingredient in the brand name drug Zantac) from Adechsa SA, a related non-resident corporation, under a supply agreement. Another entity in the corporate group owned the Zantac trademark and patent and granted rights to the taxpayer under a separate licence agreement. Together, these agreements allowed the taxpayer to manufacture the drug and market it under the trademark Zantac. The licence agreement required the taxpayer to purchase the ranitidine from an approved supplier, of which Adechsa SA was one. The CRA reassessed the taxpayer on the basis that the taxpayer paid significantly more for the ranitidine it purchased from Adechsa SA than two generic drug manufacturers paid to arm’s length suppliers for the ingredient, arguing that a transaction-by-transaction approach must be taken in applying the TP rules. The Supreme Court disagreed, finding that the licence agreement was an
economically relevant characteristic and must be considered in the TP analysis. Considering the supply and licence agreements together, it was reasonable to consider that part of the amount paid for the ranitidine was linked to some of the rights and benefits under the licence agreement.

The decisions in *General Electric Capital Canada Inc.* and *GlaxoSmithKline Inc.* raise questions regarding the application of the arm’s length principle. Rather than assuming that the parties in a transaction are at arm’s length, so that all non-arm’s length circumstances are stripped away, the approach taken by the courts in these cases was to apply the arm’s length principle to the price in isolation, with all other circumstances — including non-arm’s length circumstances — remaining the same.

One significant implication of this prevailing approach arises in the context of large group pricing. That is, on the approach taken by the courts in *General Electric Capital Canada Inc.* and *GlaxoSmithKline Inc.*, that the ability of a group to obtain more favourable prices when acting in concert should arguably be taken into account when determining the arm’s length price of fees paid to a central procurement entity.

Large group pricing was considered by the Federal Court of Appeal in *Indalex Ltd v. Canada*, 88 DTC 6053, prior to the decisions in *General Electric Capital Canada Inc.* and *GlaxoSmithKline Inc.* In *Indalex Ltd*, the Court rejected the position that a non-arm’s length non-resident corporation procuring supplies for the corporate group should retain the benefit of the large volume discount. The taxpayer argued that centralizing procurement allowed the corporate group to obtain better prices from third-party suppliers. The Court found that the purchasing power of the procurement entity was due to the pooling of the purchasing power of a number of members of the corporate group. The procurement entity did not itself contribute to that pooled purchasing power, and so did not add any value.

Note that in *Indalex Ltd*, the taxpayer was the primary purchaser in the group. Although the Court did not expressly rely on this fact in reaching its conclusion, the question remains whether the result would have been different had the volume of purchases been more equal between members of the corporate group. It also remains to be seen whether the decisions in *General Electric Capital Canada Inc.* and *GlaxoSmithKline Inc.* may lead to a different result in a future case raising similar issues.

### 2.2.5. Hard-to-value intangibles

Canada has not yet adopted specific measures to improve the valuation of hard-to-value assets. Rather, the general TP principles apply.

In particular, Canada does not currently look back and reprice hard-to-value intangibles based on subsequent events. The CRA will, however, consider the factors and risks that a reasonable person with some knowledge of the industry would have taken into account at the time the intangibles were valued (CRA, IC 87-2R, *International Transfer Pricing*, 27 September 1999 at paragraph 149).

Should the CRA wish to take a retroactive approach to the valuation of hard-to-value intangibles in the future, legislative change would probably be required. This is because looking back to reprice a transaction is inconsistent with Canada’s legislated arm’s length principle. As acknowledged by the CRA, an agreement
between arm’s length parties would usually not be subject to adjustment as a result of subsequent events (CRA, IC 87-2R, International Transfer Pricing, 27 September 1999 at paragraph 149). Moreover, such an approach is contrary to the principle of form over substance as adjusting prices based on subsequent events would generally undermine an agreement that was actually entered into between the parties.

The CRA has provided some general guidance regarding the valuation of hard-to-value intangibles. Specifically, the CRA focuses on what both the transferor and the transferee would do to protect their respective positions, and is of the view that the parties should share the risks and benefits in most situations. Where the profitability of an intangible is uncertain, the CRA suggests that, in arm’s length circumstances, both the transferor and the transferee would probably insist on an agreement that either has a short term, includes a price adjustment clause, or sets variable royalty rates tied to profits. This is because, from the perspective of the transferor, it would not be desirable to permit the long-term exploitation of the asset in case it ended up being highly profitable, while from the perspective of the transferee, it would be risky to pay large amounts for the exclusive use of the asset over a long period of time when it might not end up being profitable (CRA, IC 87-2R, International Transfer Pricing, 27 September 1999 at paragraph 146).

2.2.6. Cost contribution agreements (CCAs)

CCAs have not been very controversial in Canada to date, in part because they are not particularly common. Canada’s normal TP rules apply to CCAs; however, if a CCA is a qualifying CCA, the taxpayer will not be subject to TP penalties in respect of TP adjustments that relate to the qualifying CCA.

The definition of a qualifying CCA in the ITA is consistent with the OECD’s guidance. Specifically, a qualifying CCA is defined to mean an arrangement under which “reasonable efforts” are made by the participants to establish a basis for contributing (and to contribute on that basis) to the cost of producing, developing or acquiring any property, or acquiring or performing any services, in proportion to the benefits which each participant is “reasonably expected” to derive from the arrangement (ITA, section 247(1) “qualifying cost contribution arrangement”).

While CCAs are frequently used in the context of the joint development of intangible property, the concept of a CCA is broad and has been recognized by the CRA to include a wide variety of arrangements, including pooling resources to acquire centralized services such as accounting, computer technical support or human resources, or the development of an advertising campaign (CRA, IC 87-2R, International Transfer Pricing, 27 September 1999 at paragraph 122).

A taxpayer is deemed not to have made reasonable efforts for the purposes of the definition of a qualifying CCA unless it has met certain documentation requirements. The CRA is of the view that qualifying CCA documentation should include the identity of the participants; the scope of the activities; the nature and extent of each participant’s effective ownership interest in the results of the activities; the manner or basis on which proportionate shares of expected benefits are to be measured; the rationale and any assumptions underlying the projections of expected benefits; the form and valuation of each participant’s contributions; the rationale and any assumptions underlying the valuation of each participants’ contributions;
the duration of the arrangement; the allocation of tasks and responsibilities; the procedures for entering or withdrawing from the arrangement, and the consequences thereof; and the policies and procedures governing balancing payments (CRA, IC 87-2R, International Transfer Pricing, 27 September 1999 at paragraph 194).

While each participant’s share of the benefits from a qualifying CCA should be determined by reference to the anticipated additional income or cost savings the participant expects as a result of participation in the arrangement, the CRA recognizes that such a direct estimate may not be possible in all cases. As such, the CRA permits participants to use allocation keys to indirectly determine the benefit, such as sales; units used, produced or sold; gross or operating profit; number of employees; or capital invested (CRA, IC 87-2R, International Transfer Pricing, 27 September 1999 at paragraphs 128 and 129).

Since CCAs are not particularly common or controversial in Canada, significant changes are not expected to the current regime as a result of the BEPS project.

Note that the deductibility of the costs of participating in a qualifying CCA is considered separately, so that costs may not be deductible even if justified under the definition of a qualifying CCA and the TP rules. Costs retain their character under the CCA for the purposes of determining whether they are deductible (CRA, IC 87-2R, International Transfer Pricing, 27 September 1999 at paragraph 131).

2.3. Risk and capital

Canada has not adopted (or announced an intention to adopt) any measures aligned with Actions 8–10 to control return on capital or compensation for the assumption of risk. In its 2016 budget, the government of Canada stated that it intends to wait to decide on a course of action for “cash boxes” (i.e. minimally functional entities holding high-value assets) until the OECD completes its work of clarifying the definition of such entities.

Denying returns or compensation to an entity that has provided capital or contractually assumed risks would be inconsistent with both the general approach of legal form over economic substance in Canada and Canada’s legislated arm’s length principle. As such, any action on these issues would probably require legislative amendments.

2.4. High-risk transactions

2.4.1. Comparable uncontrolled prices (CUP) and quoted prices for cross-border commodity transactions

Canada has not published a TP approach specific to commodity transactions. Rather, the arm’s length principle applies, with the CRA generally preferring the CUP method to determine prices. While the term “commodity” evokes thoughts of indistinguishable products in a deep and liquid market, rendering the buyer a mere price-taker, care must be taken not to over-generalize when using price quotes as CUPs. As with any CUP analysis, comparability is of paramount importance; all relevant facts must be considered and any necessary adjustments made before a quote can be used as a CUP.
In particular, an understanding of the market from which price quotes are drawn is critically important. Different commodities have different market structures and the use of quotes varies. For example, headline quotes for oil prices include, among other things, delivery at a specific geographic location for a specific grade. As a result, adjustments are necessary before the quote can be used as a reference point for a transaction taking place at a different location for a different grade. Other commodities with quoted prices may only represent a small portion of a market where much larger volumes are traded under contract. In those cases, the quoted price may bear little relation to what a particular buyer might actually pay for the commodity. For others, long-term contracts may include references to an index or quoted price as just one part of the formula used to determine the price of the commodity in question.

2.4.2. Intra-group services

The CRA has adopted the OECD’s two-step approach set out in Actions 8–10 of the report. Namely, the CRA will first consider whether intra-group services have in fact been provided, and only then will it assess the arm’s length charge for such services (CRA, TPM-15, Intra-group services and section 247 of the Income Tax Act, 29 January 2015 at paragraph 16). In addressing the first issue, the CRA will generally consider whether an independent enterprise in comparable circumstances would have either paid an outside enterprise to perform the service or performed the service itself (CRA, TPM-15, Intra-group services and section 247 of the Income Tax Act, 29 January 2015 at paragraph 20). One factor frequently examined by the CRA in making this determination is whether the services are already being performed by another member of the MNE or by an arm’s length party – duplication of services is generally not permitted (CRA, TPM-15, Intra-group services and section 247 of the Income Tax Act, 29 January 2015 at paragraph 37).

In addition, the CRA takes the position that it can look through an intra-group service fee in order to evaluate the deductibility of its component expenses for tax purposes in Canada under the general rules of the ITA – even in cases where the CRA agrees that the total amount of the service fee is equivalent to an arm’s length fee. If the CRA determines a portion of the service fee represents a non-deductible expense, the taxpayer will not be prohibited from paying it; however, its deduction as a business expense will be denied. Moreover, where the total amount of the service fee is an arm’s length amount, the CRA may take the position that the MNE does not have recourse to competent authority relief under the relevant tax treaty (see CRA, TPM-15, Intra-group services and section 247 of the Income Tax Act, 29 January 2015 at paragraph 44). The result is that the MNE may be subject to double tax (i.e. because the foreign recipient will have to include the amount in its income, but the Canadian payer will not be permitted to deduct it). This approach appears to be inconsistent with the general principle of legal form over economic substance. It also represents a strained characterization of the basis for the reassessment (as it is not clear that such a reassessment is purely a domestic adjustment, rather than one fundamentally based on the underlying non-arm’s length relationship). The defensibility of the CRA’s approach has not yet been tested in Canada’s courts.
With respect to low value-adding services, the federal government stated in its 2016 budget that it intends to await for further guidance from the OECD before taking a position. The CRA’s current approach is to require TP documentation supporting the fee for each service. Mark-ups on service fees for low value-adding or back-office services are frequently denied by the CRA.

2.4.3. **Profit splits in the context of value chains**

Currently, Canada does not have any specific rules for value chain analysis; rather, the general TP rules apply (i.e. the arm’s length principle). The CRA’s position is that it follows the OECD TP guidelines and taxpayers should select the most appropriate TP method in their particular circumstances. Where a traditional transaction method and a transactional profit method can be applied in an equally reliable manner, the preference is to apply the traditional transactional method over the transactional profit method.

The OECD has issued a discussion draft titled Revised Guidance on Profit Splits wherein it proposes to strengthen the guidance related to profit splits and, in connection with that guidance, to introduce value chain analysis. The new guidance on profit splits needs more clarity on when the profit split is and is not the most appropriate method. All entities within an MNE aim at contributing to the creation of value, otherwise they would not exist. The threshold question to determine whether the profit split method is the most appropriate is therefore not whether an entity performs functions, contributes assets, or assumes risks that are “important” (as this would be a very subjective criterion) and contributes to the creation of value (as this should be the expectation for any entity), or whether it is “integrated” (as this will be the case for most operations within an MNE). The threshold question should remain whether multiple parties to the controlled transaction make contributions that (a) exceed those of independent comparables and cannot be taken into account through comparability adjustments (i.e. are “unique”), and (b) are valuable. Both cumulative criteria are important, as the mere lack of comparables should not suffice to make a profit split the most appropriate method.

In addition, the discussion draft is unclear as to what the purpose of performing a value chain analysis would be. It identifies multiple purposes but they are the same as for the comparability analysis and functional analysis described in chapter I of the OECD guidelines, so introducing this concept into the OECD guidelines and risking increasing the compliance burden on taxpayers without a clear objective or purpose beyond those already addressed in the OECD guidelines.

While Canada generally follows the OECD TP guidelines, Canada’s TP rules are legislated and changes made to the guidelines do not automatically become law. To the extent that changes to the guidelines are inconsistent with Canada’s TP legislation, legislative amendment is required before the changes can be applied. If value chain analysis is added as an element to the (legislated) documentation requirements recommended by the OECD, it may require legislative action on the part of Canada to adopt them since the OECD guidelines are not law in Canada. If the OECD guidelines incorporate additional guidance on the application of profit splits, such guidance may be easier to implement since the methods for determining arm’s length transfer prices are not enumerated in Canadian legislation, but the
focus will remain on demonstrating that their application achieves an outcome consistent with the arm’s length principle.

The government of Canada stated in its 2016 budget that it intends to wait for the OECD to complete its work on a simplified approach to low value-adding services before taking a position.

2.5. TP documentation

2.5.1. Country-by-country reporting

The government of Canada announced that it would implement country-by-country reporting in its 2016 budget. On 21 October 2016, Canada’s Department of Finance tabled a notice of ways and means motion to implement this reporting (in addition to certain other measures proposed in the federal budget). The proposed legislation is consistent with the OECD’s guidance on Action 13.

Specifically, an MNE will be required to file a country-by-country report in Canada where the total annual consolidated group revenue of the MNE is €750 million or more and the MNE has an ultimate parent or a designated surrogate parent that is resident in Canada. A Canadian resident member of an MNE that is not the parent or surrogate will also be required to file a return in certain specified circumstances where the CRA is unable to obtain the information from the tax jurisdiction of the ultimate parent of the MNE.

The country-by-country report will be required to be filed with the CRA within one year of the end of the fiscal year to which the report relates. The legislative proposals refer to a prescribed form for country-by-country reporting; however, the details have not yet been released.

The legislative proposals also include a penalty for failing to file a country-by-country reporting form as and when required “knowingly or under circumstances amounting to gross negligence”. Where no demand has been served for the return contemplated by the new rules, the penalty will be CAD 500 per month for up to 24 months. If a demand has been served, the penalty will be CAD 1,000 per month.

If enacted as proposed (which is expected), country-by-country reporting will be required for taxation years that begin after 2015, with first exchanges of reports between tax jurisdictions expected to occur by June 2018.

In its 2016 budget, the government of Canada stated that, before any exchange with another jurisdiction, the CRA will formalize an exchange agreement with the other jurisdiction and ensure that it has appropriate safeguards in place to protect the confidentiality of the reports.

Note also that, in addition to Canada’s extensive bilateral treaty network, Canada is a signatory to the Convention on Mutual Administrative Assistance in Tax Matters, under which Canada will exchange tax information with other parties to the convention pursuant to the OECD standard.

2.5.2. Master and local files

Canada’s tax legislation already contains documentation requirements with respect to transactions between MNEs. Where the CRA makes an adjustment to a taxpayer’s
transfer prices that exceeds the lesser of CAD 5 million or 10 per cent of revenue, the CRA may impose a TP penalty of 10 per cent of the adjustment. Penalties do not apply, however, if the taxpayer has made reasonable efforts to determine and use arm’s length transfer prices for income tax purposes. The taxpayer will be deemed not to have made reasonable efforts where the taxpayer does not meet the legislated contemporaneous documentation requirements.

Currently, the contemporaneous documentation requirements do not require that documentation be split into master and local files. Rather, the requirements are with respect to the content of the documentation – not its form. Specifically, the documentation must be “complete and accurate in all material respects” pertaining to the property or services to which the transaction relates; the terms and conditions of the transaction and their relationship, if any, to the terms and conditions of any other transaction entered into between the participants; the identity of the participants and their relationship to each other at the time of the transaction; the functions performed, the property used or contributed, and the risks assumed by the participants; the data and methods considered and the analysis performed to determine the transfer prices, allocations of profits or losses, or contributions to costs; and the assumptions, strategies and policies that influenced the determination of the transfer prices, allocations of profits or losses, or contributions to costs. Taxpayers must provide their contemporaneous documentation to the CRA within three months of receiving a written request for that documentation, and failing to do so deems the taxpayer not to have made reasonable efforts to determine and use arm’s length transfer prices (see ITA, section 247(4)).

Moreover, a taxpayer is required to file an information return (prescribed form T106) if it enters into transactions with an aggregate value of CAD 1 million or more during the taxation year with non-arm’s length non-resident parties. The information that must be reported on form T106 includes the identities of the parties, the nature and quantum of the transactions, the TP method applied, and the existence of contemporaneous documentation. There are late filing, failure to file, and false statement or omission penalties that may apply with respect to form T106.

The government of Canada has not indicated that it intends to adopt master and local files, despite taking measures to adopt other OECD recommendations on Action 13. Should the government of Canada choose to implement the master file/local file approach to documentation, to the extent that information is required in addition to what is currently required by Canada’s tax legislation, legislative change would probably be necessary. Changes to the form (e.g. providing for specific forms that must be used to report the required information) could probably be accomplished administratively.

2.5.3. Compliance costs

Two elements of BEPS Action 13 in particular may lead to increased compliance costs for MNEs: (a) country-by-country reporting, and (b) the master file/local file approach to documentation.

Although compliance costs for MNEs operating in Canada are expected to increase as a result of Canada’s proposed country-by-country reporting requirements, the impact is not expected to affect all taxpayers equally. The parent
company will bear the greatest portion of the cost of compliance, so that MNEs headquartered in Canada will be most affected by Canada’s proposed country-by-country reporting legislation. Canadian subsidiaries of foreign headquartered MNEs may also face increased compliance costs in Canada where they are required to support the information gathering efforts of the parent company, or where the parent company is not in a compliant jurisdiction (such that a surrogate or local reporting is required).

The impact of the OECD’s proposed TP documentation requirements may not be as significant. This is because, as discussed above, Canada already has substantial TP documentation requirements in place that cover many, if not all, of the substantive requirements proposed by the OECD. Given Canada’s existing TP documentation requirements, Canada may not adopt the master file/local file format. While this may reduce or eliminate incremental costs of compliance in Canada, Canadian companies that are part of MNEs with operations in foreign jurisdictions facing new documentation requirements may still be affected.

2.6. TP-related measures in other BEPS actions and other measures against BEPS

The government of Canada has been vigilant in protecting its tax base and implemented a number of measures targeting BEPS well in advance of the OECD’s work on BEPS. As a result, Canada may be slow to act, if it acts at all, on other BEPS actions. Two primary regimes targeting BEPS in Canada that already exist are the thin capitalization rules and the foreign affiliate dumping rules.

The Canadian thin capitalization rules limit the extent to which non-resident entities can extract profits from their Canadian subsidiaries in the form of tax deductible interest instead of after tax dividends. The rules apply to both Canadian resident corporations, trusts and partnerships, and non-resident entities doing business in Canada. More particularly, the rules prohibit the deduction of interest paid in respect of a Canadian taxpayer’s debts to “specified non-residents” (non-residents with a significant interest in the Canadian taxpayer) that are in excess of 1.5 times the Canadian taxpayer’s “equity amount”. The regime also contains rules designed to capture back-to-back loans (e.g. where an arm’s length intermediary is interposed between two related entities). The determination of whether the rules apply to deny the deduction of interest is essentially an arithmetic exercise; the reasons behind the corporation’s debt to equity ratio are not relevant. Where the deduction of an interest expense is denied under the thin capitalization rules, it is permanently denied and cannot be deducted in another taxation year. The corporation is deemed to have paid the non-deductible interest to the non-resident recipient as a dividend and not as interest. As a result, the rate of withholding tax may differ under the relevant tax treaty. Note that Canada’s competent authority does not consider thin capitalization cases.

The foreign affiliate dumping rules are aimed at preventing foreign-controlled MNEs from using Canadian subsidiaries to invest in foreign affiliates (via debt or equity) in a manner that erodes the Canadian tax base (e.g. through the creation of an interest deduction or avoidance of withholding tax). Where the rules apply, the paid up capital of cross-border shares of the Canadian subsidiary or a related Canadian corporation may be reduced (i.e. reducing the amount
of capital that may be distributed tax free, as well as the corporation’s “equity amount” for the purposes of the thin capitalization rules) and/or there may be a deemed dividend to the foreign parent corporation (which will be subject to withholding tax).

Canada’s GAAR also applies to tax treaties, although its application is arguably limited following the Tax Court of Canada’s decision in *MIL (Investments) SA v. Canada*, 2006 TCC 460 (affirmed by the Federal Court of Appeal, 2007 FCA 236). In that case, the CRA argued that treaty shopping was abusive and the tax consequences otherwise determined under the chosen treaty ought to be overcome by application of the GAAR. The Court rejected this argument, finding that selecting a foreign jurisdiction with a favourable tax treaty in order to minimize tax was not, on its own, an abuse of the ITA or the treaty; rather, it was the use of the selected treaty in the circumstances that had to be examined in each case in order to determine whether there was abuse.

### 2.7. Can BEPS work in favour of MNEs?

It is difficult to foresee the full range of potential implications of the BEPS project at this point in time due to it being in the very early stages of implementation. The creation of a largely uniform cross-border system of reporting and taxation may, ultimately, increase certainty and reduce compliance costs for MNEs. Increased transparency may also improve public perception of MNEs’ compliance with tax laws. The realization of potential benefits will largely depend on how various jurisdictions choose to implement, interpret and enforce the new rules. In the short term, however, MNEs will probably face increased compliance costs and reporting complications as lawmakers, tax authorities and MNEs adapt to the new world order.

### 3. What is the future of TP?

It should go without saying that the current focus on BEPS and international tax by policy-makers, the mainstream media, and the general (voting) public, among others, will ensure that TP stays in the spotlight for some time to come. This will put more pressure on elected governments to act quickly, and on taxpayers to make greater efforts to support their tax structures.

Compounding the challenges for taxpayers is the early adoption of principles espoused in the BEPS action plans by some tax auditors in Canada – before implementing legislation has even been drafted. For example, BEPS Action 4 and Actions 8–10 have been used by the CRA to deny deductions for interest paid to foreign lenders on the basis that the foreign lenders lack sufficient substance and are not entitled to the income.

With the myriad of changes, speed of change, number of countries involved, and uncertainty as to what measures and standards each country will implement, as well as to the eventual interpretation of the new rules, the future is anything but certain. Ultimately, if the implementation of the BEPS action plans leads to greater global consistency in the rules and in their interpretation and application,
the potential for increased certainty and efficiency in dealing with tax matters exists, but only time will tell when or whether this laudable objective will be achieved.

What is certain at this stage is that the TP environment in Canada will change. There will be new challenges both from Canada and the foreign jurisdictions with which Canadian taxpayers transact. There will be greater scrutiny and an increased focus on substance, supporting documentation, and adherence to the legal agreements entered into by related parties. All this has the potential to lead to more TP tax disputes, at least in the short to medium term as MNEs and tax authorities worldwide adjust to new global standards. MNEs should ensure global coordination on TP matters, review their transactions and structures with greater care, prepare more robust TP documentation and anticipate increased scrutiny and challenges.
Summary and conclusions

Chilean transfer pricing (TP) regulations were adapted by the tax reform of 2012 to follow the OECD TP guidelines of 2010. The tax agency (SII) has made the TP study voluntary. However, annual sworn statement no. 1907 provides the SII with information on multinational company (MNE) cross-border operations. This has been complemented with sworn statement no. 1913, which although not addressing only TP matters, provides additional information.

Jurisprudence remains scarce. The courts have as yet only ruled on cases regarding procedural matters. The academic community and practitioners have begun to specialize in this issue (disregarded in practice before 2012).

The general formalistic approach of the legal legislation has been predominant. However, changes to the Tax Code may lead in the opposite direction. This may result in the better identification and differentiation of the economically relevant concepts of intangibles and services and their nuances. While civil regulations of interpretation of laws, contracts and concepts remain formalistic, anti-tax avoidance regulations have made a breakthrough change in formal paradigms. However, and this has been confirmed by the SII, these new rules do not apply to TP matters. This may lead practitioners, the SII and/or the courts retaining a formalistic view in this matter.

TP studies remain voluntary, except in the case of advance pricing agreements (APAs). The SII and the Customs Agency have issued the administrative circulars and resolutions needed to apply them. However, no APA has so far been concluded.

Although MNEs are beginning to assess risks and cost contribution compensation for TP matters, it remains an ongoing process. The SII has stated that new resolutions and sworn statements should be put in place before the year’s end, so as to comply with Chile’s commitments to the OECD. Other base erosion and profit shifting (BEPS) project actions, such as controlled foreign company (CFC) rules, thin capitalization regulations and others may contribute to global and coherent steps forward in the direction suggested by the OECD. Since Chile is more an investment-receiving than an investment-making country, the threshold
of €750 million may be reached by few MNEs in Chile. However, the SII has stated that this threshold may be reduced, so as to properly supervise the TP compliance of MNEs with headquarters in Chile.

Administrative resolutions on master and local files, as well as country-by-country reporting (CbCR), are expected to be issued by the SII before the end of 2016, to make them applicable in 2017 or 2018. The SII has stated that no legal change will be required to carry out these measures.

The absence of court cases, together with the absence of APAs and the ongoing addition of administrative sworn statements, makes it difficult for the reporters to estimate the cost that the TP reports, studies, sworn statements and supporting documentation may entail for taxpayers and the tax administration in processing the information, supervising it, applying fines or penalties or making challenges before the courts.

1. Current TP regulation and practice in Chile

Law No. 20,630/2012 improved the TP rules, aligning them with the OECD’s guidelines. The SII issued the corresponding circular and resolution. Resolution No. 14/2013 implemented the sworn statement no. 1907 for large and medium-sized taxpayers with related entities abroad, and all other taxpayers with operations with related entities in the previous year in excess of a certain amount.\(^1\) Law No. 20,780/2014 included all company or business restructuring involving cross-border services or assets.

Fines for non-compliance with the sworn statement were left unspecified by the SII, with no more provisions than those of no. 6 of article 41E of the Income Tax Law (ITL), which amounts to a considerable fine.\(^2\) Maliciously false misrepresentations can lead to fines of 300 per cent of the tax and imprisonment for up to five years. Resolution Ex. No. 14/2013 did not provide expressly for the procedure for an extension of up to three months provided by the law. This was addressed by Circular No. 29/2013 issued by the SII’s national director.

Circular No. 29/2013 established the main parameters to be followed in TP issues, including TP methods, norms of relationship with entities, the SII’s fiscalization faculties and others.

The SII issued Resolution Ex. No. 68/2013, which contains the administrative procedure for the APA. Joint Resolutions Ex. No. 54/2016 (for the SII) and Ex. No. 3637/2016 (of the SNA) were issued on 17 June 2016. It must be pointed out that the APA does require a TP study, with all its parts and sections (functional, industrial and economic analysis sections).

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1. The Resolution Ex. No. 14/2013 sets this floor limit at CL$500 million. The law does not exclude any taxpayer from this sworn statement, but the Tax Code grants the National Director some level of discretion when implementing legal provisions.
2. The fine for non-compliance goes from 10 to 50 UTA (index reflecting inflation), with limits on the taxpayer’s paid-in and effective capital. In addition, non-filing of the sworn statement is regarded by Circular No. 29/2013 of the SII as non-cooperation with the SII in its tax assessment activities, and is fined by 5 per cent of the difference established by the SII in the prices, values or profits in the transactions disputed by the SII.
There is a case where the taxpayer challenged a provision contained in Circular No. 29/2013, whereby the SII exceeds the legal term for the application of an extension of the TP sworn statement.3

Jurisprudence remains scarce. Most cases before the court have not dealt with the provisions of article 41E, but have addressed TP issues on the grounds of other norms, allowing the SII to determine taxation on the grounds of the profits gained in the industry.4

Circular No. 31/ 2016 contains fines for delay in the filing of the sworn statement. It clarifies and narrows down the fines applicable, depending on two factors: the time of non-compliance, and the number of operations.

2. The impact of the BEPS project on TP

2.1. Introduction

The SII is currently working on administrative procedures and forms to make CbCR a reality. The TP section of the SII has told the reporters that no legal changes will be required to implement CbCR. Since no. 6 of article 41E contains the taxpayer’s obligation to file “a declaration with the information required by the Service”, the question of whether more than one declaration (in the form of sworn statements) may be required has been addressed by the SII in interviews with the reporters.

Circular No. 29 and Resolution Ex. No. 14, both of the year 2013, as well as Circular No. 31 of 2016, have consistently stated and ruled that the legal mandate given to the SII by article 41E no. 6 of the ITL to require the taxpayer’s declaration of its TP operations and the legal faculties given by article 6A no. 1 of the Tax Code, together with the competent regional directors’ right to supervise, pursuant to article 6B of the Tax Code, will suffice to demand the master and local files, as well as CbCR. This could be accomplished by adding CbCR to the existing sworn statement no. 1907 or demanding that these reports be at the disposal of the SII in case of fiscalization.

This does not present an obstacle to the introduction of the compulsory submission of master files, local files and CbCR.

However, as pointed out in this report, article 41E no. 7 of the ITL, governing APAs, does require that a TP study be presented to the competent SII department (the chief of the international fiscalization department, subordinate to the sub-direction of fiscalization).

The academic reception has remained a work in progress; several universities have started in recent years to put on courses on TP (before 2012 very little attention was paid to the matter) and some articles and publications have appeared.5

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3 This administrative provision, contained in letter (B) of II(8) of Circular No. 29/2013, remains in force.
4 First Tax Court of Santiago, RIT GR-15-00335-2013.
5 The first book ever published was Los Precios De Transferencia Entre Empresas Relacionadas, whose first edition was published by Lexis Nexis, 2005. An article by Hugo Hurtado Araneda,
At the level of the taxpayer, there was some difficulty at the start (in 2012 onwards) in explaining this issue; many taxpayers viewed it as pricing control and, as such, as a kind of meddling or interference with the free market. However, every year there is an increase in the number of taxpayers willing to submit to the TP rules. Still lacking, however, is for taxpayers to adequately address the methodologies required to determine their TP operations. Many taxpayers are still relying on internal or external accountants with insufficient knowledge of TP issues, with resulting deficiencies in their declarations.

2.1.1. Definition of intangibles

Article 41E of the ITL does not provide a definition of intangibles for TP purposes. Moreover, the concept is not mentioned once in the wording of the disposition. Neither the tax courts nor the doctrine have attempted to clarify this issue.

However, there is no doubt that intangibles are capable of being transferred between associated parties in a cross-border transaction and therefore subject to assessment under the TP rules. The instructions of the SII on the matter (Circular No. 29/2013) recognize that cross-border transactions between associated enterprises and international reorganizations may include transactions with tangible property (goods), the provision of services and dealings with intangible property. As to the latter, the instructions mention some examples of what constitutes intangible assets, e.g. patents, brands and knowhow.

In this respect, since the introduction of the provision in the Chilean tax system, the SII has interpreted and applied article 41E following the OECD TP guidelines. Thus, for the application of TP rules it is reasonable to expect that the SII will understand this concept as defined by the OECD, i.e. “intangible property” includes the rights to use industrial assets such as patents, trademarks, trade names, designs or models. It also includes literary and artistic property rights, and intellectual property such as knowhow and trade secrets (chapter VI, OECD TP guidelines).

Commercial intangibles such as patents, knowhow, designs and models that are used for the production of goods or the provision of services, as well as intangible rights that are themselves business assets transferred to customers or used in the operation of business, are also included under the scope of article 41E of the ITL.

Now, bearing in mind the deletion of chapter VI of the OECD TP guidelines, the new guidelines introduced by the BEPS Actions 8–10 report, and the commitment of Chile to both the OECD and BEPS, it is reasonable to assume that in the application of its TP rules the SII will embrace these updated guidelines. These guidelines define an “intangible” as something which is not a physical asset or a financial asset, which is capable of being owned or controlled for use in commercial activities, and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances (OECD, Aligning transfer pricing outcomes with value creation, Paris, p. 67).
It is worth mentioning that the updated guidelines provide illustrations of different types of intangibles, some of which are not mentioned in the administrative regulations provided by the SII, i.e. rights under contracts and government licences, licences and similar limited rights in intangibles and goodwill and going concern value; these illustrations are expected to help the proper identification of intangibles for TP purposes.

As mentioned above, the adoption of the new guidelines will not necessarily be reflected in a modification of the applicable law, i.e. the amendment of article 41E of the ITL. New instructions on this matter will probably be issued by the SII to replace or amend the administrative regulations provided in Circular No. 29/2013 and sworn statement no. 1907.

2.1.2. Transactions with intangibles

In general, neither article 41E of the ITL nor the SII has established specific rules regarding the recognition of transactions with intangibles. Exceptionally, a special sworn statement must be filed by taxpayers that have entered into operations regarding derivatives with non-resident related parties. It is the reporters’ opinion that financial assets such as the latter do not constitute intangibles for TP purposes.

Therefore, the principal procedure for identifying transactions that could lead to TP issues is the sworn statement no. 1907.

Following the instructions provided by the SII through Circular No. 29/2013 and Resolution Ex. No. 14/2013, taxpayers resident in Chile that meet the requirements established therein and have carried out in the previous year operations or transactions with related parties resident abroad must submit a TP sworn statement (no. 1907).

Taxpayers obliged to submit this statement are those that meet one of the following requirements:

(a) those belonging to the segments “medium-sized business” or “large business”, and which during the previous year have carried out transactions with non-resident related parties;  
(b) those not belonging to these segments that have carried out transactions with parties resident in a jurisdiction included in the list mentioned in article 41D of the ITL (jurisdictions with preferential tax regimes);  
(c) those not belonging to these segments that have carried out transactions with non-resident related parties for sums exceeding CL$500 million.

The statement must mention the transactions and operations carried out with related parties abroad. There is a code list describing the nature of the operations, which includes transactions such as “revenue from licences, patents or use or enjoyment of other intangible assets, granted by the local taxpayer”, “sale of intangibles”, “payments for licences, patents or the use or enjoyment of other intangible assets granted by the non-resident related party”, and “purchase of intangibles”.

Another useful tool to identify transactions that are relevant for tax purposes are the sworn statements nos. 1912 and 1913. These have been mandatory for Chilean taxpayers since 2015. Sworn statement no. 1912 provides information regarding withholding taxes and payments and distributions made to non-residents. One of the items to be completed is the relationship between the payer and the beneficiary of the income.
Sworn statement no. 1913 provides information regarding a resident taxpayer’s overall tax characterization. Its purpose is to obtain qualitative information on the processes or operations that are relevant for the purposes of the characterization of large taxpayers in the management of tax compliance. Of most importance is the information on corporate structure, transactions with related companies, the structure of local and international financing, imports of capital goods and information that could be considered “confidential” schemes of strategic tax planning, plus data on those who participated in their design.

APAs between the SII and taxpayers constitute another useful resource to recognize transactions – including operations involving intangibles – that could generate concerns from a TP perspective. However, to this date not a single APA has been signed.

Although it is not expected that special rules or instructions addressed to identify transactions with intangibles will be issued in the future, the adoption of the TP documentation and CbCR provided in the BEPS Action 13 report will be certain to provide an added source of information for the tax authority to recognize transactions involving intangibles.

2.1.3. “Substance-over-form” approach towards intangibles

This question can best be observed in the praxis of the taxpayers; given the limited number of cases before courts and those still at administrative level, Chile has not yet reached a level of sophistication where it is able to establish progress towards best practice in this regard.

However, the reporters can state that, to the best of their knowledge, a more formal and legal approach has been taken, especially in the praxis. This is due to the formalistic orientation of Chilean legislation in general. References to intangibles are not so much made in the form of an economic approach to the substance of the concepts involved, but rather follow a formalistic approach. Article 565 of the Civil Code (CC) defines intangibles as “mere rights, as credits and active easements”. Article 19 et seq. of the CC establish the rules for the legal interpretation of concepts. Although articles 20 and 21 allow interpretation following the use of the word in a discipline, article 19 bars such an interpretation when the word is defined by express law. This does not help TP matters if it is taken into account that the OECD’s guidelines differentiate between intangibles and services, whereas the CC defines them as the same thing.

However, as pointed out previously in this report, the general anti-tax avoidance regulations contained in article 4bis et seq. of the Tax Code have led the tax courts to address the economic substance of operations when discussing general tax issues. This may lead both the SII as well as the tax courts to take a similar approach. However, in the absence of specific regulations for TP with regard to the form versus the substance of operations, no definite answer can be given in this regard. It must be pointed out that Circulars No. 65/2015 and No. 65/2016 (creating the Anti-Tax Avoidance Committee of the SII) have expressly stated that the TP regulations in article 41E are excluded from the application of the general anti-tax avoidance rules, since that article contains specific instructions on this matter.

6 Supreme Court, 14 September 2015, No. 31863-2015.

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This adds to the uncertainty with regard to the predominance of substance-over-form in these matters. General civil law does, however, contain norms that can increase the predominance of substance over form. In addition, and prior to the coming into force of the new anti-tax avoidance rules, the tax courts have asserted this position, overruling more formalistic approaches.

A catalogue of aggressive tax planning has been issued by the SII. It does not, however, have a binding nature; it is merely a reference to what the SII may consider tax avoidance. It has TP scenarios.

Although Circular No. 29/2013 of the SII, in its letter (c) (“contractual clauses”) of 3.2 (“comparability analysis”), raises the question of the difference between the written and the actual agreements, the wording may lead to the actual agreement as demonstrated by the parties’ conduct being applied only in the absence of written documents. This is contrary to the recommendations of the OECD. However, a systematic interpretation of Chilean law may preclude this interpretation of the wording of the circular.

Legal ownership of intangibles remains the key consideration for the parties’ remuneration. Article 59 of the ITL raises a withholding tax for payments for the use of a related party’s intellectual property from 15 per cent to 20 per cent, but this different tax rate is applied regardless of the amount of the payment or whether or not the owner of the intangible retains only the legal ownership thereof.

Article 31 No. 12 of the ITL, on the other hand, limits the tax deduction of expenses paid to related parties. This is, however, an objective rule, setting an absolute and objective cap for the tax deductibility (in the form of reducing the taxpayer’s net taxable profit) of the paying company, amounting to 4 per cent of the party’s operational expenses, regardless of whether or not these payments have taken account of other considerations, such as whether the party using or exploiting the intellectual property participated or not in the creation, development, enhancement, maintenance, protection and/or exploitation of the patent or trademark. This anti-tax avoidance rule is not applied when the company residing abroad is taxed by its state at a tax rate of at least 30 per cent (a legal provision complemented by the SII’s Circular No. 61/1997).

The implementation of the BEPS Action Plan has not yet led the Chilean administration to differentiate between tangible and intangible assets. No special legal definition of intangibles for TP purposes has been made. The SII’s Circular No. 29/2013 does differentiate between tangible and intangible assets (for example, for the comparability analysis), and it does make recommendations as to the most suitable TP methods according to this distinction (e.g. the comparable uncontrolled price (CUP) method for commodities, the cost plus method for services that do not involve the contribution of unique intangibles and the profit split methods for operations involving such intangibles, reflecting the party’s expenses in the R&D

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7 Supreme Court, 27 July 2015, No. 17,586-2014.
9 Aligning transfer pricing outcomes with value creation: guidance for applying the arm’s length principle, p. 39, 1.124, OECD, 2015.
10 Arts. 19 to 24 of the Civil Code contain a norm of interpretation for legal provisions. Art. 1545 et seq. of the same legislative body contain elements to construe and interpret contracts. With their application, the real and not merely the suggested will of the parties and their agreements can be ascertained. There is extensive literature and jurisprudence on this matter.
for such intellectual property, and operational expenses). However, these rules and this differentiation follow the article 41E provisions, as introduced by Law No. 20,630 in 2012.

Article 59 of the ITL reverts to Law No. 17,336 for the withholding tax of payments for the use and exploitation of intellectual property in general terms, thus distinguishing between tangible and intangible property, but article 41E of the ITL (which contains the TP rules) does not address the differences between them explicitly.

There has been no substantial change in the TP perspective in the analysis of the transactions where intangibles are involved. This may be explained by the few cases before the courts and at the administrative level, which limits not only the analysis of changes over time, but the treatment involving intangibles from a TP perspective.

Regarding intangibles, it must be noted that the SII’s Resolution Ex. No. 68/2013 does expressly demand that a taxpayer seeking to enter into an APA discloses the identity of the legal owners of the intellectual property involved in the operations which will be covered by the APA. The SII officials interviewed by the reporters have stated that no legal differentiation will be required to comply with the OECD’s recommendations, as contained in the BEPS Actions 8–10 report. Therefore, in the absence of special norms emphasizing substance over form, a formalistic view can be taken, which could be remedied by the introduction of legal definitions for these matters.

2.1.4. Comparability and group synergies

According to the BEPS Action 8 report MNE groups and the associated enterprises that comprise such groups may benefit from interactions or synergies among group members that would not generally be available to similarly situated independent enterprises. Such a case is usually reflected in the benefits derived, for example, from combined purchasing or borrowing power, combined and integrated computer and communication systems, integrated management, etc. In other circumstances, such synergies may result in negative effects.

Following the definition of intangibles provided in the above-mentioned report, group synergies should not be considered intangibles as they are not owned or controlled by an enterprise. In addition, group members should not recognize an intra-group service when the benefits and burdens result solely as a consequence of being part of an MNE group and without the deliberate concerted action of group members or the performance of any service or other function.

However, group synergies may have an effect on the determination of the arm’s length conditions for controlled transactions and should be addressed for TP purposes as comparability factors in all sorts of transactions, including those with intangibles.

This is not an issue that has been expressly addressed by the ITL or the SII. None of the current sworn statements (see section 2.1.2) are specifically designed to identify group synergies in the application of TP rules such as those described above. On the contrary, under the current state of administrative regulations, the recognition of intra-group services relies for the most part on whether the associated enterprise residing in Chile has received income or made payments in respect
of them. In most cases, the identification of group synergies will probably be the result of an assessment regarding payments made by an associated enterprise residing in Chile in respect of intra-group services.

In Chile, bearing in mind the few MNEs with their head office in the country, TP assessments will generally address payments made by subsidiaries or agencies residing in Chile to another member group company residing abroad. Usually these payments are considered expenses for tax purposes. Therefore, they reduce the taxable base of the payer.

In the opposite situation, it is not likely that the SII would dispute the recognition of income received by an associated enterprise residing in Chile simply because that income would be taxable. Of course, exceptions may exist as a result of the actions of the tax authority of another jurisdiction. Under article 9 of the corresponding double tax treaty, where this is applicable, if the tax authority of the other contracting state denies the existence of an intra-group service between the company or agency residing there and the associated service provider residing in Chile on the grounds that the benefit derives from a group synergy and not the actual provision of a service, the SII would be obliged to make the proper adjustment and not recognize the payment made to the service provider as income for tax purposes.

Nevertheless, as was said in respect of transactions with intangibles, the adoption of the TP documentation and CbCR provided in the BEPS Action 13 report will certainly constitute an added source of information for the SII to recognize group synergies that are relevant for TP purposes, especially in the cases of the few MNEs and associated enterprises residing in Chile that centralize functions which other group members benefit from and which do not form part of the core business of the MNE.

2.1.5. Hard-to-value intangibles

The application of TP rules in respect of transactions with intangibles is rare in Chile, i.e. there are no records of assessments of the SII (the information is classified), court decisions or APAs on the subject. This is because Chile is not a country with MNEs dedicated to the development, enhancement, maintenance, protection and exploitation of intangibles.

The Chilean economy relies mainly on the exploitation and exportation of natural resources, i.e. copper and other minerals, products derived from agriculture and seafood. Other important activities of Chilean companies within the Latin American region are related to construction and real estate investments and retail (consumption industry). Thus, transactions with intangibles considered as part of the main activities of Chilean businesses are unlikely, and transactions involving the transfer of hard-to-value intangibles are even more unlikely.

Transactions with intangibles would usually occur in connection with the sale of goods or the provision of services, and would constitute a comparability factor to take into consideration in determining the corresponding arm’s length prices.

Now, of course a scenario in which a transfer of hard-to-value intangibles from a Chilean resident enterprise to an associated enterprise abroad may occur. In this case, however, the SII may find it difficult to establish what developments or events might be considered relevant for the pricing of this type of transaction, and
the extent to which the occurrence of such developments or events, or the direction they have taken, might have been foreseen or have been reasonably foreseeable at the time the transaction was entered into.

The guidelines of the BEPS Action 8 report suggest that ex post outcomes can provide an indicator to tax administrations about the arm’s length nature of the ex ante pricing arrangement agreed upon by the associated enterprises. If the differences between the scenarios are not due to unforeseeable developments or events, those may constitute an indicator that the pricing arrangement agreed upon by the associated enterprises at the time the transaction was entered into may not have adequately taken into account the relevant developments or events that might have been expected to affect the value of the intangible and the pricing arrangements adopted. Therefore, an adjustment to the pricing of the transaction could be in order.

However, from a Chilean tax perspective such an approach may be in conflict with tax rules that limit the SII’s faculty to assess transactions. In this respect, article 200 of the Tax Code provides that the SII may liquidate a tax, revise any deficiency in its liquidation and charge additional taxes within a period of three years from the expiry of the legal deadline in which the corresponding tax payment should have been made.

What if the ex post outcomes relevant for the TP assessment take more than three years to occur? Under the current rules, the SII would be precluded from determining any TP adjustment. It remains to be seen how the SII will adopt this approach and resolve those cases that conflict with the tax rule in question.

Another factor to bear in mind is that even if the tax assessment is not precluded in a particular case, and considering the scant experience that exists in Chile in respect of this kind of transaction, information asymmetry between taxpayers and the tax administration, including what information the taxpayer took into account in determining the pricing of the transaction, may aggravate the difficulty faced by the SII.

In the opinion of the reporters a proper and reasonable manner to resolve these difficulties is promoting the execution of APAs between taxpayers and the SII. Until now, not a single APA has been signed between taxpayers and the tax administration. There are several arguments supporting the use of these agreements:

- The asymmetry of information between the taxpayer and the SII would be eliminated because it is the taxpayer that has to propose a TP arrangement and provide all the supporting information, including a TP study. In other words, it is up to the taxpayer to build up its case.
- The SII would have all the information that is relevant available to determine the foreseeability of the developments or events that taxpayers should reasonably have considered in their pricing.
- It is possible to have a multilateral APA between the taxpayer, the SII, and the tax administration of the jurisdiction of the associated enterprise acquiring the intangibles or the rights in them. From the SII’s viewpoint the insights of another tax administration, which may be more qualified or specialized on these matters, would provide more certainty regarding the determination of the arm’s length price.
- Finally, if the circumstances considered at the time of the agreement change, the SII, at its sole discretion and at any time, may terminate the agreement. The SII maintains its assessment faculties intact.
2.1.6. Cost contribution agreements (CCAs)

As has been mentioned in other parts of this report, since the introduction of the TP rules into the ITL, the SII has closely followed the recommendations provided in the OECD TP guidelines, which include guidance to ensure that CCAs cannot be used to circumvent the application of the arm’s length principle.

However, to the knowledge of the reporters there has not been a single case at administrative level in which TP rules have been applied to CCAs. The absence of court decisions on the matter does not help either in determining how the authorities have dealt with the matter in practice.

Now, bearing in mind the new guidelines introduced by the BEPS Action 8 report and the commitment of Chile to following them, it remains to be seen how the tax authority will adopt the recommendations contained therein. In this respect, as mentioned above, it is clear that no legal amendment will be necessary.

In the opinion of the reporters, the adoption of BEPS recommendations on the matter will not be an easy task for a number of reasons. First, while the proposed guidance establishes that the participant would have to establish arm’s length conditions for each individual contribution and expected benefit, practice shows that the contributions of CCA participants are almost always valued at cost. In arrangements entered into at arm’s length, cost is probably the most easily audited and verifiable measure of the contribution made by each party.

Secondly, it remains to be seen how the adoption of this guidance would affect CCAs entered into by MNEs for good commercial reasons. In those cases, the adoption of this guidance would probably imply replacing the practicality and certainty of agreements where ongoing contributions were valued at cost. Thus, it is reasonable to expect an increase in the compliance burden on MNEs.

Finally, taxpayers should expect amendments to Circular No. 29/2013, to Resolution Ex. No. 14/2013 and to the sworn statement no. 1907.

2.2. Risk and capital

As the OECD has stated, “A functional analysis is incomplete unless the material risks assumed by each party have been identified and considered”. 11 Risks are especially, although not exclusively, important in the case of the development, enhancement, maintenance, protection and exploitation of intangibles. The OECD has stated that legal ownership, or the costs incurred, is not the only benchmark for the compensation that entities of MNE companies should be entitled to. The risk assumed in these actions can be as, or even more, relevant than legal ownership. Action 8 indicates six steps for an adequate analysis of the risk in commercial or financial relations. 12 According to the OECD, risk management includes not only the assuming of risk, but being able to bear the financial consequences of the same risk. Article 41E of the ITL containing the entire TP legislation

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11 OECD/G20 BEPS project, Aligning transfer pricing outcomes with value creation: guidance for applying the arm’s length principle project, p. 21.
12 Step 1: identify economically significant risks with specificity; step 2: contractual assumption of risk; step 3: functional analysis in relation to risk; step 4: interpreting steps 1–3; step 5: allocation of risk; and step 6: pricing of the transaction, taking account of the consequences of risk allocation.
includes risks as one of the elements to be considered, as does Circular No. 29/2013 of the SII.

According to the meetings the reporters have had with SII officials, no legal change is envisioned to update the TP legal provisions with regard to risk and its compensation. The SII may, however, pursue an administrative approach, as well as defining the parameters established in terms of the actual assumption of risk, the control of the risk required and the capability to assume the risk. Indeed, the financial aspect of the risk and how to cover it is very important.

Although not expressly approached by the SII in the sworn statement no. 1907, some data relating to risk are included in sworn statement no. 1913 (section D contains information on the financial instruments and derivatives; among other things, the SII asks who determines the strategy, and requires an indication of whether the party bearing the risk is domiciled in a tax haven and whether any financial instruments, such as forwards or hedging, were used). The praxis has been to consider the risks in the TP studies, both in the contracts as well as the risks inherent in each industry and the economic risks of the region analysed.

Currently, the SII’s Circular No. 29/2013 remains the only administrative (or legal) provision giving express and direct instructions in this respect. However, other administrative rules have been put in place to determine the compensation between parties in this regard; sworn statement no. 1913 demands qualitative information about the taxpayers’ transactions that will be useful to ascertain the MNE’s policy on risk and capital.

Therefore, although not required explicitly, the praxis has been to analyse the risks in the direction suggested by the OECD, albeit not yet in the same detail.

2.3. High-risk transactions

2.3.1. CUP and quoted prices for cross-border commodity transactions

Chile, like many countries in the world, relies on commodity transactions as a relevant source of its economic activity. In this respect, the extraction and commercialization of copper and its derivatives is the most important economic activity of the country. Most of the government’s annual budget finances this programme and public policies in general depend on the financial results derived from the mining industry. In 2014 alone, 54.2 per cent of exports came from the mining industry with a value of US$41,041 million.\(^{13}\)

Chile is the main exporter of this mineral in the world. However, the participation of Codelco (state company) in this industry is approximately 32 per cent. The rest of the market is shared between private companies from Chile and abroad. Therefore, TP issues in respect of transactions related to this commodity and its derivatives within associated enterprises are an element that needs to be carefully taken into consideration by the SII in order to prevent situations of BEPS.

Although at the moment there are no administrative procedures, court decisions or APAs dealing with the appropriateness of a specific TP method in respect of

transactions with commodities, it is important to bear in mind that in the case of copper, i.e. the main commodity being exported abroad, a quoted price exists.

This quoted price is widely and routinely used in the ordinary course of business in the industry to negotiate prices for uncontrolled transactions comparable to controlled transactions, and therefore should be taken into consideration for the application of the CUP method, which would generally be an appropriate TP method for establishing the arm’s length price for this kind of transaction. Meetings between the SII and the reporters regarding this subject suggest that the approach recommended by the BEPS Action 8 report has already been adopted.

As to the importation of goods, which may include transactions with commodities, it is worth mentioning that this year a joint resolution between the SII and SNA was enacted. This resolution establishes coordination mechanisms, procedures and deadlines for the purposes of resolving requests for APAs, values or normal market returns in the case of imports of goods between related parties.

According to the SII, this is the first case in which a tax administration has pooled resources with the customs service to deal with TP matters that could derive from the importation of goods. If those goods have a quoted price, i.e. a price in an international or domestic commodity exchange market, it is expected that both authorities will consider it for the purposes of establishing the main conditions of the corresponding APA.

2.3.2. Intra-group services

The ITL and the regulations enacted by the SII do not provide for specific TP rules or procedures in respect of intra-group services. In this respect, as in most TP-related issues, the question of how to deal with this kind of transaction from a TP perspective is answered by following the OECD TP guidelines.

In this respect, the sworn statement no. 1907 contains a list of transactions including services such as administrative, technical, financial, logistics and management services, all of which the taxpayer is required to declare if a payment in respect of them has been made and/or received to/by a foreign associated enterprise.

The new guidance provided in the BEPS Action 10 report introduces an elective and simplified approach to determining whether the service charge is due (the benefit test) and calculating the arm’s length charge in the case of low value-adding services, e.g. accounting and auditing, human resources activities, regulatory issues, communications, information technology, legal services, tax support and administrative and clerical support.

If taxpayers choose the simplified approach to document low value-adding intra-group services, they only need to demonstrate that a benefit was received by the group members within the specific category of services, rather than specifying the precise benefits received by the latter. Once implemented, the simplified approach is likely to reduce the burden taxpayers face in preparing the documentation of low value-adding intra-group services.

Regardless of the above, it is the opinion of the reporters that the adoption of this approach by the tax authority may not have a significant impact. As mentioned in other parts of this report, Chile is not a country where headquarters or other

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14 Resolution Ex. SII No. 54 or Resolution Ex. SNA No. 3637, 2016.
intra-group service-provider enterprises of MNEs would usually reside. Transactions involving intra-group services will in most cases imply a payment by an enterprise (subsidiary or agency) residing in Chile to abroad. If the tax authority where the service provider resides has adopted the simplified approach, it is reasonable to expect that the SII may benefit from using fewer resources in assessing the corresponding transaction.

Intra-group management services and head office charges constitute a major concern for the tax authorities. Chile is no exception in this respect because excessive charges may constitute a major source of BEPS. In this respect, countries should be allowed to combine the introduction of these guidelines with the introduction of a threshold that, if exceeded, would permit the tax authority to require a full TP analysis, including a benefit test. Follow-up work on the design of the threshold and other implementation issues is expected to be completed before the end of 2016.

Questions remain as to how easy it will be for Chile to opt out of these guidelines because the threshold levels of charges have been met, or whether the SII will fail to adopt the rules because it believes the TP method (usually the cost-plus method) provided in the guidance is inadequate.

2.3.3. Profit splits in the context of value chains

Despite the fact that article 41E of the ITL and Circular No. 29/2013, following the OECD TP guidelines, accept the use of transactional profit split methods, i.e. the profit split method and the transactional net margin method, to the knowledge of the reporters there has not been a single administrative case or court decision in which the application of these methods has been analysed.

The lack of cases in which these methods have been applied may be explained by the fact that both the tax authority and taxpayers, following the OECD TP guidelines, have always considered these methods as a last resort. There is no indication at this date that the SII will change its mind on the matter. From conversations with the SII the reporters conclude that it is waiting for definitive guidelines to come out before adopting any position on the matter.

In this respect, the SII seems to agree that the structure of an MNE’s value chain also permits one-sided methods and that transactional profit splits are not necessarily appropriate merely because an MNE’s value chain covers multiple jurisdictions. One-sided methods in most cases would often be appropriate and many situations will not require a profit split to confirm the results of the one-sided method. If any amendment is ultimately introduced it will be done at an administrative level, i.e. Circular No. 29/2013 and sworn statements. No modification of the current law would be necessary.

According to the OECD TP guidelines the use of profit split methods is only appropriate where they are the most reliable method. The BEPS Action 10 report suggests that these methods are applicable to cases where there is a lack of reliable comparables to apply a one-sided method or, expressed alternatively, where both parties make “unique and valuable”, i.e. non-benchmarkable, contributions. In the reporters’ opinion, transactional profit split methods are not essentially any more useful for dealing with particular aspects of value chains. There are concerns
that the approach may be used to treat an MNE as a single and unique enter-
prise, and that too much reliance on transactional profit split methods in complex 
factual scenarios will lead to an inappropriate presumption that a transactional 
profit split is the best method in such circumstances. This primacy of the transac-
tional profit split method affects the most appropriate method analysis and disre-
gards the fact that even in complex factual scenarios other methods may be more 
appropriate.

Finally, it remains to be seen how the SII, taxpayers and domestic courts will 
react once the new guidelines are released. For the moment, no major changes are 
expected on this matter.

2.4. TP documentation

2.4.1. CbCR

The OECD has recommended that MNE headquarters with cross-border operations 
with other members in excess of €750 million issue CbCR. It considers a three-
tiered approach to TP documentation: a master file, a local file and CbCR. The 
CbCR will require aggregate tax jurisdiction-wide information on the global allo-
cation of the MNE’s income, the tax paid and, as the OECD has put it, “certain 
indicators of the location of economic activity”\(^\text{15}\) where the MNE performs its 
activities.

Chile has not yet required taxpayers to have master or local files. TP studies, as 
understood by the OECD TP guidelines, are not yet a legal or administrative 
requirement. The meetings held with the chief of the TP section of the SII and 
with the subdirector of fiscalization of the same agency allow the reporters to say 
that the master file, local file and CbCR will be addressed by administrative regula-
tions before the end of 2016. The CbCR should be in the form of a separate sworn 
statement, most likely to be issued separately from the sworn statements nos. 1907 
and 1913.

Given the high threshold for the submission of the CbCR (€750 million), not 
many companies with headquarters in Chile are expected to fall into that category, 
while most CbCR filed in Chile will be that of subsidiaries of parent companies 
abroad.

With regard to the automatic exchange of information, it can be reported that 
Chile’s tax treaties contain mechanisms for that purpose; those with the United 
States of America and with Argentina (neither of them, however, still in force) pro-
vide extensive provisions on the matter. In addition, Chile has signed the multilat-
eral treaty on the exchange of information for tax purposes. As a result of the 
meetings with the SII’s subdirector of fiscalization and with the chief of the TP sec-
tion of the same agency, it can be reported that extensive exchange of information 
procedures have been put in place to comply with the obligations assumed by Chile 
in this regard, particularly with countries like Mexico, Peru and other countries of 
the region.

\(^\text{15}\) OECD/G20, BEPS Project, Transfer pricing documentation and CbCR, Action 13.
2.4.2. Master and local files

According to the OECD’s guidelines, the master file “should provide an overview of the MNE group business, including the nature of its global business operations, its overall transfer pricing policies, and its global allocation of income activity”.\textsuperscript{16}

Chile has not yet required taxpayers to have master or local files. TP studies, as understood by the OECD guidelines of 2005 and 2010, are not yet a legal or administrative requirement (except for APAs, as mentioned in this report), much less reports or files of a more complex nature. However, and as again mentioned in this report, the SII’s officers in the TP section have informed the reporters that the master and local files will be in place before the end of 2016. According to this information, the administrative resolution should also be in place before the end of the year.

The form of these reports and files does not require any legal changes. According to article 6A no. 1 of the Tax Code, the national director of the SII can implement the tax legal norms in the form of these instructions. However, any interpretative issue of the norms contained in the law must be issued in the form of a circular, which must be subject to a previous and public consultation (second paragraph of the cited article 6 no. 1). Therefore, any norm regarding the issuance of these files and reports containing interpretations of article 41E of the ITL would have to be contained in such a circular, following this procedure. The form of the files is already contained in Action 13 of the OECD guidelines, in annexes I, II and III, correspondingly, of Action 13. As for the retention of documents supporting these reports, they should follow the rules established in article 16 et seq. of the Tax Code, pursuant to which taxpayers are required to keep contracts, accounting books and ledgers and correspondence up to the statute of limitation (normal time of three years, extendable to six in cases of tax evasion). Article 17 of the Tax Code requires that accounting books be kept in Spanish. However, documents supporting their content can be in a foreign language, which, in case of audit and as requested by the SII, must be translated into Spanish.

2.4.3. Compliance costs

The TP study, being still optional (except for entering into an APA), has reduced the cost of TP compliance.

No. 4 of article 41E of the ITL establishes a fine for non-compliance with the taxpayer’s obligation to provide the SII with all the documentation required. According to Circular No. 29/2013, this documentation includes:

- the sworn statement (included in form no. 1907, filed annually), with the accounting data and supporting information;
- other documents and data required by the SII. The SII has required all the accounting and legal documents and records which can prove the accuracy of the taxpayer’s statements and declarations. A process of notification and official summons is established in articles 59 et seq. of the Tax Code.

The penalty provided for is 5 per cent of the difference of the prices, values and profits in the TP operations supervised.

\textsuperscript{16} \textit{Ibid.}, p. 14.
Apart from this penalty, no. 6 of article 41E of the ITL contains a specific penalty, regardless of whether a difference in TP prices, values or profits is determined: a monetary fine of between 10 and 50 UTA,\(^{17}\) with a cap of 15 per cent of the paid-in capital or 15 per cent of its effective capital (whichever is higher); the single highest fine established in the tax legislation. Circular No. 34/2016 of the SII established a table to determine with more precision the effective amount of the fine applicable, depending on both the time of non-compliance and the number of operations. Circular No. 31/2016 of the SII repeats the data and documents legally required.

Taxpayers wishing to enter into an APA with the SII must first present a TP study. Pursuant to article 41E no. 7 of the ITL and Resolution Ex. No. 68/2013, taxpayers can enter into both bilateral and multilateral APAs. Data to be presented include the fiscal years to be covered by the APA (up to three years, renewable), the corporate structure of the taxpayer and its related entities, trial balance (an eight-column sheet), the legal owners of the intellectual property included in the operations, a copy of contracts, audited financial statements and APAs currently in force with other states, filed together with the request for the APA.\(^{18}\)

Since there is still no practical experience in APAs, their effective cost remains unclear.

2.5. TP-related measures in other BEPS actions and other measures against BEPS

Laws Nos. 20,780 of 2014 and 20,899 of 2015 included many BEPS-related regulations, most of which make reference to some extent to the TP rules, either with regard to relationship norms or arm’s length prices. Such are the cases of the thin capitalization rules, contained in article 41F, the CFC rules contained in article 41G and the preferential taxation regimes of article 41H, all of the ITL.

Article 41F, addressing thin capitalization rules (BEPS Action 3) establishes certain exceptions to the 35 per cent penalty tax in the case of finance projects, establishing as a condition, however, that the interest rates be at arm’s length, pursuant to the rules of article 41E of the ITL (TP regulations).

Article 41G, containing CFC rules (BEPS Action 3), establishes as one of the relationship standards the relationship rules provided for in article 41E.

Article 41H, containing preferential tax regime countries or jurisdictions, establishes that countries or jurisdictions will be regarded as preferential for tax purposes if their domestic legislation lacks TP rules that comply with OECD standards. All Chilean tax treaties contain exchange of information clauses, which include TP matters. Apart from article 9 of all its tax treaties, which contains the OECD guidelines on associated enterprises, articles of exchange of information are contained in article 26 of the tax treaties (which follow the OECD model). Moreover, Chile entered in 2016 into the multilateral agreement on exchange of information.

Domestic rules had also been modified in the years prior to the entry of Chile to the OECD, notably those of banking secrecy and reserves, allowing the SII to

\(^{17}\) UTA (Unidad Tributaria Anual) is an index reflecting inflation.

\(^{18}\) No. 2 of the SII Resolution No. 68 of 2013.
break this secrecy to supervise tax matters and implicit (not explicit) TP regulations more adequately.

As part of the combating of tax avoidance, Laws Nos. 20,780 of 2014 and 20,899 of 2015 marked a milestone in this area: article 4bis et seq. included for the first time general anti-tax avoidance rules. Pursuant to these provisions, the SII can challenge tax planning, piercing through legal forms and addressing the economic substance of transactions for tax purposes. Circular No. 65/2015, addressing these legal norms, makes explicit reference to TP issues.

2.6. Can BEPS work in favour of MNEs?

Chile, being a member of the OECD, is one of the many countries that has agreed to implement transparency and exchange of information for tax purposes from 2018 onwards.19 As to the BEPS project, in January 2016 the SII, along with 34 other tax administrations, signed a multilateral agreement that will for the first time allow the obtaining of an overview of the operations of MNEs, the territorial distribution of their income, their economic activities and the taxes paid in different jurisdictions.

There is no doubt that an important source of information for the SII will be provided by the TP documentation and CbCR. The latter, is expected to be implemented at the end of 2016.

According to the BEPS Action 13 report, TP documentation will provide tax administrations with the information necessary to (a) ensure that taxpayers give appropriate consideration to TP requirements in establishing prices and other conditions for transactions between associated enterprises and in reporting the income derived from such transactions in their tax returns; (b) provide tax administrations with the information necessary to conduct an informed TP risk assessment; and (c) provide tax administrations with useful information to employ in conducting an appropriately thorough audit of the TP practices of entities subject to tax in their jurisdiction.20

Now, as to the question of whether the BEPS platform would benefit MNEs with information that is in the possession of other countries, on several occasions the SII has denied the possibility of making such information available for taxpayers, including MNEs. In this respect, the SII has confirmed to the reporters that tax information exchanged with other tax administrations has the exclusive objective of providing all the information that is necessary in order to produce reliable risk assessments.

Despite the fact that taxpayers and MNEs will not have access to CbCR information, this does not mean they may not benefit from the relevant tax information of third parties. In this respect, article 41E of the ITL establishes that information regarding the criteria, the economic, financial and commercial reasons and the TP method applied upon which an APA was agreed may be available for the public. The only requirement for making this information public to other taxpayers is to have the authorization of the applicant.

3. What is the future of TP?

The SII has followed very closely the advances made by the OECD in TP matters, both as an individual subject and in connection with all the OECD BEPS action plans. Officials of the SII have informed the reporters that administrative changes are being considered. However, in the SII’s unofficial statements, it has informed the reporters that no legal amendments will be required to update the current TP regulations but rather they will be addressed at an administrative level. Therefore, it is expected that Circular No. 29/2013 will be modified in the not very distant future to reflect OECD recommendations, especially as regards functional analysis in the presence of intangibles and in the areas of service, particularly those hard to value, so as to comply with the BEPS Actions 8 and 9 reports.

Circular No. 29/2013 was a major step forward; in establishing clear parameters for the fines for non-compliance of the filing of sworn statement no. 1907, it both gave legal certainty to the taxpayers and enabled the SII to start a more active approach, demanding compliance, after a period when the main focus was to “get the system started” and to explain and make these new rules comprehensible to all taxpayers.

New sworn statements are helping the SII cross the information. Especially relevant is, as informed in this report, sworn statement no. 1913, which has to be filed within the same period as the tax return. Indeed, this sworn statement, requiring the taxpayer’s earnings before interest, taxes, depreciation and amortization, and its structure, including the information on corporate restructuring, complements sworn statement no. 1907. It is expected that the new sworn statements, containing the reports and the master and local files and CbCR, will complete the circle and align the Chilean regulations with those of the OECD.

Exchange of information is in place, especially with Mexico, Peru and, with the new tax treaty with Argentina, with the tax administration there as well.

TP issues do not seem to be waiting for the outcome of other BEPS-related regulations. CFC rules (contained in the BEPS Action 3 report and in article 41G of the ITL), exchange of information (bilateral and multilateral treaties), preferential tax regimes (contained in the BEPS Action 5 report and article 41H of the ITL) were implemented and included in the ITL in order to remedy a situation where Chile was lagging behind other countries and had hardly any rules on the subjects (thin capitalization was in article 59 no. 1, aspects of CFC rules in article 10 of the ITL and preferential regimes in article 41D of the ITL). Since the TP regulations have been implemented in effect only since 2013, no major innovations have been made at the legal level.

However, administrative measures, such as the new sworn statement no. 1913 and the Circular No. 31/2015 issued by the SII, show that there is willingness to update TP regulations. Furthermore, special programmes of fiscalization already put in place and which will be put in place by the SII (the details of which the SII has not made available for reasons of confidentiality) lead the reporters to expect some changes and updates in TP regulations and practices. Perhaps more precision in the concept of some services (such as the hard-to-value services) and of certain intangibles for tax purposes, perhaps in line with the OECD’s guidelines, would be required. However, jurisprudence could fill in the gap.
Addendum

As mentioned in the report, the SII did release a resolution for the implementation of the BEPS Action 13 report. The SII also mentioned the Convention on Mutual Administrative Assistance in Tax Matters (MAAT).

In line with what the SII’s authorities and officials had told these reporters, no change in the legislation was made in this matter. Resolution No. 126 of 27 December 2016 requires that the headquarters of MNEs submit CbCR. The threshold established by this resolution is €750 million in the 12-month consolidated financial results of the MNE.

The SII has enclosed detailed information to be provided, including for a delegate or substitute entity, when the headquarters in its country of residence is unable to provide the information, e.g. for lack of legislation.

The SII has chosen to obtain the information contained in what the OECD has called the “master file” from sworn statement no. 1913, to be filed at the time of the tax return, and that of the local file from sworn statement no. 1907. The CbCR, while filed separately in form no. 1937 (not in form no. 1907), will have the same deadline and fines for non-compliance as the local file, approximately USD25,000 with caps of 15 per cent of the paid-in capital and 5 per cent of the effective capital.

While article 41E of the ITL does not mention the concept of “group”, it does appear in annex 6 of the resolution. Article 96 of Law No. 18,045 (Securities Market Law) does define the concept of “group”. However, since this relationship is not established in article 41E, its applicability remains an open question.

Another issue has recently arisen. The SII has issued a letter to legal and audit firms, as well as general taxpayers, demanding that they submit:

(a) invoices in excess of USD30,000 (approximately);
(b) service contracts for their clients to the amount indicated in (a);
(c) the content of the services advice given in (a) and (b);
(d) other data.

This measure has been justified as part of compliance of with the BEPS Action 12 report, trying to establish an aggressive tax planning directory and to avoid the “selling” of aggressive tax “schemes”.

While the SII has access to invoices, this action gave rise to serious controversy, since it violates attorney–client privilege, as set forth in articles 231 and 232 of the Penal Code. The former penalizes a lawyer who maliciously discloses his client’s secrets. The penalties include suspension from the bar and pecuniary sanctions. Article 360 of the Civil Procedure Code recognizes this privilege and protects the attorney from being forced to testify.

The SII, perhaps by mistake, included a pecuniary fine for non-compliance with this requirement. Reaction has been diverse; while the attorneys’ association denounced it as a violation of attorney–client privilege, some attorneys have appeared before court to challenge this requirement, as they claim it is unconstitutional (article 19 (4) of the Constitution, right of privacy).

Since the SII has no right to require a disclosure in violation of attorney–client privilege, implementation of the BEPS Action 12 report in Chile would require legal amendments and not merely administrative norms. The controversy continues.
Summary and conclusions

This report discusses the development of transfer pricing (TP) regulations and practice in Chinese Taipei. In addition, it also introduces the recent actions that the Chinese Taipei Ministry of Finance (MOF) has actively taken in aiming to incorporate the concepts of BEPS Actions 8–10 and Action 13, particularly addressing the TP issues of intangible transactions and documentation requirements of country-by-country reporting (CbCR) and the master file, into the TP regulations in the near future.

1. Current TP regulation and practice

The regulations governing the assessment of profit-seeking enterprise income tax on non-arm’s-length TP have been in force since 30 December 2004 in Chinese Taipei. Except for immaterial related party transactions, extensive contemporaneous documentation is required. According to the TP guidelines, the enterprise must have a TP report and relevant documentation prepared when the annual income tax return is filed. If the enterprise meets the safe harbour threshold and does not prepare a TP report, the tax authority may still request “other supporting documents” as evidence of the arm’s length nature of the intercompany transactions. One example of other supporting documents is the parent’s or headquarters’ TP report, as long as this does not significantly vary from the concepts presented in the TP guidelines.

The MOF has released a letter ruling to further relax the safe harbour criteria. The rule applies for fiscal years ending December 2008 and later. The ruling states that the enterprise is not required to prepare a TP report if any of the following criteria are met:

(a) the total annual revenue (operating and non-operating) of the enterprise does not exceed TWD300 million;

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(b) the total annual revenue (including operating and non-operating) of the enterprise exceeds TWD300 million but does not exceed TWD500 million, and additionally (i) the enterprise does not utilize tax credits of more than TWD2 million in a particular year or a loss carryforward of more than TWD8 million for the preceding 10 tax years to reduce income tax or undistributed earnings surplus tax; and (ii) the enterprise, under the FHCL or BMAL, has no transactions with any overseas related parties (whether companies or individuals), or the enterprise has no transactions with overseas affiliated companies;

(c) the total annual controlled transaction amount is less than TWD200 million.

If the taxpayer does not qualify for the safe harbour, its documentation file must contain:

(a) a business overview;
(b) its organizational structure;
(c) a description of controlled transactions;
(d) a TP report, including: (i) an industry and economic analysis; (ii) a functions and risks analysis; (iii) the application of the arm’s length principle; (iv) a selection of comparables and related information; (v) a comparability analysis; (vi) the TP methods selected by the enterprise; (vii) the TP methods selected by related parties under the same control; (viii) the result of a comparables search under the best method of TP;
(e) a report of affiliated enterprises under article 369 of the Company Law;
(f) any other documents that have significant influence on pricing between the related parties.

In accordance with the OECD guidelines, the TP methods are as follows: comparable uncontrolled price (CUP), resale price, cost-plus, profit split, comparable profit and other methods prescribed by the MOF. However, the MOF does not follow the changes in the hierarchy of the methods in favour of the most-appropriate-method approach within the OECD guidelines.

From 2004 a taxpayer has had to disclose related party transactions and include the disclosure with the annual income tax return, pursuant to the TP guidelines. The disclosure generally includes:

(a) the investment structure;
(b) identification of related parties;
(c) the related party transaction amounts by type;
(d) the related party transaction balances;
(e) the related parties’ financial information, including total revenues, gross margins, operating margins and net margins;
(f) whether the enterprise has prepared TP documentation for that fiscal year.

The tax authority has issued safe harbour rules for related party transaction disclosures in two rulings. Both rulings provide that the enterprise must disclose related party transactions in its income tax return if the sum of its annual operating and non-operating revenue (total annual revenue amount) exceeds TWD30 million and meets one of the following criteria:

Tax Letter Rulings No. 09404587580 (for tax year 2005) and No. 09604503530 (for tax year 2006 and later).
(a) the enterprise has related parties outside the territory of Chinese Taipei (including the headquarters and branches);
(b) the enterprise utilizes tax credits of more than TWD500,000, or utilizes loss carryforwards of more than TWD2 million to reduce income tax or undistributed earnings surplus tax;
(c) the enterprise has a total annual revenue exceeding TWD300 million.

According to the TP guidelines, the taxpayer must have the TP report and relevant documents prepared when the annual income tax return is filed. If the tax return meets the requirements for certification, a tax certified public accountant has to note on the return whether the enterprise has prepared a TP report in accordance with the TP guidelines. The report is not required to be attached to the return upon filing.

In accordance with the guidelines, upon audit, the enterprise has to provide the Chinese Taipei tax authorities (NTA) with the report within one month. With the approval of the NTA, the submission deadline can be extended for one month in special circumstances.

Pursuant to the TP guidelines, up to 200 per cent of the tax shortfall could be imposed if assessed by the NTA, under certain circumstances.

Currently, no penalty relief regime is in place.

The statute of limitations is five years (commencing from the date following the expiry date of the period for payment of the tax) if the tax return was filed in a timely fashion, and seven years if not.

The MOF has issued a ruling that sets forth the circumstances under which a TP audit will be triggered, as follows:
(a) the gross profit ratio, operating profit ratio and net-income-before-tax ratio are below the industry average;
(b) the parent or headquarters reports profit at the global consolidated level, but the local affiliate reports a loss or much less profit than the industry average;
(c) the enterprise reports significant fluctuations in profit during the transaction year and in the two preceding years;
(d) the enterprise fails to disclose related party transactions in accordance with the related party transactions disclosure requirements;
(e) the enterprise fails to determine whether its related party transactions are within an arm’s length range and fails to prepare documents in accordance with the TP guidelines;
(f) the enterprise fails to charge related parties in accordance with the TP guidelines or charges an abnormal amount;
(g) the enterprise fails to provide the TP report in a tax audit;
(h) the NTA adjusted the TP of the enterprise, so the tax years preceding and subsequent to the year of a TP audit are also likely to be selected for audit;
(i) the enterprise has significant or frequent controlled transactions with related parties in tax havens or low-tax jurisdictions;
(j) the enterprise has significant or frequent controlled transactions with related parties entitled to tax incentives;

any other transaction fails to meet the arm’s length requirements in accordance with the TP guidelines.

In general, the likelihood of an annual tax audit is characterized as high because the NTA conducts corporate income tax audits with a high frequency.

The likelihood that TP will be reviewed as part of the annual corporate income tax audit is also characterized as high. All corporate income tax audits may include a request for and review of the documentation, as well as related supporting materials. In the past year, there has been increased activity by the NTA, especially with respect to requests to see documentation reports. In particular, companies conducting business through tax havens have attracted more scrutiny, along with those making losses.

The likelihood that the TP methodology will be challenged during the audit is high if any of the factors or circumstances listed below is present:

(a) if the tested party is the least-complex entity in a transaction;
(b) if different transactions are tested on an aggregate basis;
(c) if the denominator for calculating the profit-level indicator is one of the variables in the controlled transaction;
(d) if the use of intangible assets by related parties is not remunerated accordingly and fairly;
(e) if services provided to related parties are not remunerated accordingly and fairly;
(f) when the payment terms for accounts receivable are significantly longer between related parties than third parties, or when overseas deferred expenses are significant or out of the ordinary; in each case, the NTA considers these transactions a type of loan and expects interest income to be paid to the lender;
(g) if reasonable fee income is not received for acting as the guarantor for a related party.

2. The impact of the BEPS project on TP

2.1. Introduction

In Chinese Taipei, the MOF has established a special work force to research BEPS reports and collect relevant materials, including laws and regulations about the development of various BEPS actions in other countries. The MOF has held a series of consultation meetings since 2015 and collected comments on various BEPS action plans including BEPS Actions 8, 9, 10 and 13 from professors, associations and accountancy firms. Although there have been no amendments to the existing TP guidelines as of December 2016, it is expected that certain articles of the TP guidelines will be further amended in the near future to reflect the relevant BEPS actions related to TP. The following sections provide more detailed development and discussion regarding BEPS Actions 8, 9, 10 and 13.
2.2. Challenges of transactions with intangibles

2.2.1. Definition of intangibles

In Chinese Taipei, the definitions of intangibles prescribed under article 60 of the Income Tax Act and article 4 of the TP guidelines are not consistent.

The purpose of article 60 of the Income Tax Act is mainly to provide a limitation on the amortization of intangibles so that taxpayers can only report the amortization of specific intangibles limited to business rights, trademarks, copyrights, patents and other franchises that they acquired as a deductible operating expense within a given period of years (e.g. 10 years for business rights, 15 years for copyrights) based on the purchase costs. Amortization of intangibles other than business rights, trademarks, copyrights, patents and other franchises will not be deductible. The scope of intangibles under this article of the Income Tax Act is very narrow as it specifically provides a limitation for the purpose of expenses deductibility rather than providing guidance on how to evaluate intangibles or to determine a reasonable transfer price for an intangible asset transferred, particularly between two related parties.

Under article 4 of the TP guidelines, a long list of intangibles has been provided as follows:

“Business rights, copyright, patent, trademark, enterprise name, brand name, design or model, plan, secret formula, or information concerning industrial, commercial, or scientific experience or proprietary knowledge, all franchises’ online marketing, client data, and other rights that have property value.”

A clearer and more extensive definition of intangibles has thus been provided by article 4 of the TP guidelines than in article 60 of the Income Tax Act.

2.2.2. Transactions with intangibles

The regulations regarding transactions with intangibles are provided under article 5 of the TP guidelines, which include the transfer of intangible assets and the use of intangible assets. The transfer of intangible assets includes the sale, exchange, gift or other arrangement; and the use of intangible assets includes licences and sublicences provided for others’ use or other arrangements. The applicable TP methods for intangible transactions could be any of the following:
(a) the comparable uncontrolled transaction (CUT) method;
(b) the comparable profit (CP) method;
(c) the profit split method;
(d) other methods approved by the MOF.

In addition to the methodology used to determine the return for the intangible transaction, whether the parties involved are entitled to the return and how the return can be properly allocated/attributed to the parties in line with their respective contribution to the value of the intangibles are the two key issues. In July 2016 the MOF held a consultation meeting and invited professors of universities, associations, accountants and lawyers to discuss the development of BEPS Actions 8–10. The TP concepts of intangible below introduced by the OECD BEPS project
have been discussed and the MOF will consider further incorporating these into the TP guidelines:

(a) the return retained by an entity in the group will depend on the contributions it makes through DEMPE functions (development, enhancement, maintenance, protection and exploitation) to the value of an intangible relative to contributions made by other group members;

(b) if there is any mismatch between the transaction and contract arrangement, the TP assessment will be based on the real transaction rather than the written contract;

(c) the party bearing the risks should have the capacity to make the decision, exercise control over the risk and have the financial capacity to assume the risks;

(d) the return to mere funding may be limited to a risk adjusted return on capital.

In addition, in the current TP guidelines, one can allocate the return of an intangible transaction based on the level of functions performed and risks assumed by the respective parties.

Article 15 of the TP guidelines provides that:

“the degree of comparability of the foregoing intangible assets shall be assessed based on whether such intangible property is used for similar products or manufacturing processes within the same general industry or market, or has similar profit potential. The profit potential of intangible assets is measured by directly calculating the net present value of the benefits to be realized through the use or subsequent transfer of the intangible property, considering the capital investment and start-up expenses required, the risks to be assumed and other relevant considerations.”

Nonetheless, given the uniqueness of intangibles, it is challenging to find good comparable transaction data. The economic benefits to be realized through the use or transfer of the intangible may also not be able to be evaluated easily and objectively. This often leads to tax disputes between the tax authorities and taxpayers. Although the OECD BEPS final report suggests an ex post result approach to resolving the issue related to hard-to-value intangibles (HTVI), the detailed implementation process has not been provided in the final report. Considering that the tax uncertainty of taxpayers would increase if the ex post result approach were adopted, it was decided to hold off the implementation of the HTVI ex post result approach but to continue to observe the development of practices and experiences from other countries as well as the reference guidelines to be published by OECD going forward, if any, so that the MOF could further consider the feasibility of the ex post approach.

2.2.3. “Substance-over-form” approach towards intangibles

In Chinese Taipei, the substance-over-form approach is provided under article 12(1) of the Tax Collection Act where the NTA is authorized to recharacterize taxpayers’ transactions using a substance-oriented analysis. Article 12(1) of the Tax Collection Act specifically provides that “if a taxpayer abuses legal form to avoid the constituent elements of taxation and attain economic benefits equivalent
to normal transactions, such an action shall be termed tax avoidance; the tax assessment made by the tax authority shall be based on the existence of actual economic substance”.

Where intangible property rights are transferred to an intra-group-appointed enterprise to centralize control by management or to decentralize control to other enterprises of the group, this would be deemed as a type of business restructuring arrangement. The NTA will review the relevant documents of the business restructuring arrangement to clearly identify what the real transaction is and determine the economic substance of the transaction. If the form of the transaction arrangement is not consistent with the economic substance identified, the NTA will assess the transaction based on the substance identified and make an adjustment accordingly.

In addition, the TP guidelines also emphasize that the prices of related party transactions have to be set at arm’s length. Prices for transactions between related parties are deemed to be arm’s length only if they are similar to the prices charged between unrelated parties for transactions with similar terms and conditions and under similar circumstances. In order to determine whether transactions with related parties are made under similar conditions and circumstances to those of unrelated parties, the following factors have to be reviewed and considered:

(a) the characteristics of the assets or services;
(b) the functions performed;
(c) the risks assumed;
(d) the contractual terms;
(e) the economic environment and market conditions;
(f) business strategies;
(g) other factors affecting the degree of comparability.

Specifically, the functions performed and risks assumed by the taxpayer in the transaction to a great extent represent the economic substance of the taxpayer involved in that transaction.

When assessing the deductibility of a royalty payment out of Chinese Taipei to a foreign entity from a Chinese Taipei company, the current practice of Chinese Taipei is consistent with the recommendation of the BEPS final report, which specifies that legal ownership alone does not generate a right to the return generated by the exploitation of an intangible. One of the critical factors in determining whether the royalty payment is deductible or not is the economic substance of the transaction arrangement. Specifically, the NTA will review the role of the intangible owner, the level of contribution it makes and the risks it assumes related to the specific intangibles it owns to determine the substance of the transaction before the deductibility of a royalty payment is allowed.

Another example is where a Chinese Taipei headquartered company sends experienced employees to a group entity located in another country and uses the experience and expertise developed by the headquarters to build up the foreign entity’s production line for products to be sold in the local market. The foreign entity takes advantage of such experienced employees to drive its own domestic sales in the local market and earn a good profit. The NTA in practice used to disallow the expenses incurred by a headquarters for those expatriated employees. In recent years, the NTA, in many audit cases, has adjusted the headquarters’ taxable income based on the two scenarios after the review of functions provided by the expatriate employees and the level of the contribution to the local income made by those employees.
Scenario 1: the income derived from the local market is mainly contributed by the foreign entity itself, while the services provided by the expatriate employees are deemed routine without significant value added. Under this scenario, the adjustment made by the NTA will be based on the cost incurred for the expatriate employees plus a certain percentage of mark-up.

Scenario 2: the income of the foreign entity derived from the local market is mainly contributed by the expatriate employees. In this case, the NTA usually applies a royalty rate to impute a royalty income to be received by the headquarters from the foreign entity based on a certain percentage of its domestic sales in the local market. The adjustments based on domestic sales to a certain extent reflect the level of contribution made by the experienced employees.

2.2.4. Comparability and group synergies

According to paragraph 1 of article 8 of the TP guidelines, the following factors should be considered when determining the degree of comparability for an uncontrolled transaction or non-related party:

(a) the characteristics of the assets or services: (i) where tangible assets are the objects of the transaction, the physical features of the assets, their quality, their volume of supply, and whether any intangible assets are included; (ii) where intangible assets are the objects of the transaction, the form of transaction (i.e. licensing or sale), the type of asset, the duration and degree of protection under the laws, and the anticipated benefits from the use of the asset; (iii) where services are the objects of the transaction, the nature of the services and whether any intangible assets are included;

(b) functions performed, including (i) R&D; (ii) product design; (iii) procurement and raw material/supply management; (iv) manufacturing, processing and assembling; (v) marketing, distribution, inventory management, warranty, advertising and product services; (vi) transportation and warehousing; and (vii) operating management, accounting, finance, legal, credit, collection, training and personnel management services;

(c) contractual terms, including (i) the form of consideration charged or paid; (ii) transaction volume; (iii) the scope and terms of after-sale warranties provided; (iv) rights to renew or amend the contract; (v) the duration of the relevant licence or contract, and the rights of termination or renegotiation of the contract; (vi) agreement on provision of auxiliary or supplementary services between the transaction parties; (vii) the terms of delivery, such as FOB or CIF; and (viii) terms of credit and payment;

(d) risks assumed, including (i) market risks, such as risks of fluctuation in costs, demand, pricing and inventory level; (ii) risks associated with the success or failure of R&D activity; (iii) financial risks, such as fluctuations in foreign currency rates of exchange and interest rates; (iv) credit risks, such as risks in credit extension and collection; and (v) product liability risks;

(e) economic and market conditions, including (i) the similarity of geographic markets; (ii) the relevant size of each market and its potential for development; (iii) the level of the markets, such as wholesale or retail; (iv) the market share; (v) the extent of competition in each market, consumer purchasing power, the alternatives available to the buyers and sellers; (vi) government
regulations of the market; (vii) the status of the industry, such as whether it is an emerging industry or declining industry; and (viii) transportation costs;

(f) business strategies, including (i) strategies on innovation and new product development; (ii) risk aversion; and (iii) market penetration strategies;

(g) other factors affecting the degree of comparability.

Furthermore, article 15 of the TP guidelines provides that:

“The differences of the following factors shall be considered in evaluating the degree of comparability of the circumstances…:
1. the terms of the transfer, including the exploitation rights granted in the intangible assets, the exclusive or nonexclusive character of any rights granted, any restriction on use, or any limitation on the geographical area in which the rights may be exploited;
2. the stage of development of the intangible assets, including where appropriate, necessary governmental approvals, authorizations, or licences in the market in which the intangible assets are to be used;
3. rights to receive updates, revisions, or modifications of the intangible assets.
4. the uniqueness of the assets and the period for which they remain unique, including the degree and duration of protection afforded to the assets under the laws of the relevant countries;
5. the duration of the licence, contract, or other agreement, and any termination or renegotiation rights;
6. any economic and product liability risks to be assumed by the transferee; and
7. the functions to be performed by the transferor and transferee, including any ancillary or supportive services.”

The above factors as prescribed under the current Chinese Taipei TP guidelines are consistent with the OECD TP guidelines which were published before the BEPS project was initiated, although there is no specific discussion on whether group synergies should be included in the factors determining comparability or what processes should be followed to identify group synergies in the application of the TP rules. If required, group synergies can be considered as one of the instances among other factors affecting the degree of comparability as provided under item 7 of article 8, paragraph 1 of the TP guidelines.

2.2.5. HTVI

It is not always an easy task to evaluate the economic benefit of an intangible. Compared with a tangible goods transaction, it is also more difficult to identify a good comparable for an intangible transaction. When determining a good comparable for an intangible, see article 15 of the TP guidelines quoted above.

In addition, the article also provides that

“the degree of comparability of the foregoing intangible assets should be assessed based on whether such intangible property is used for similar products or manufacturing processes within the same general industry or market, or has similar profit potential. The profit potential of intangible assets is measured by directly calculating the net present value of the benefits to be realized through
the use or subsequent transfer of the intangible property, considering the capital investment and start-up expenses required, the risks to be assumed and other relevant considerations.”

The factors to be considered in determining the comparability under the CUT method are complex and information may not be easy to obtain. In practice, external databases may not provide sufficient data for both the taxpayers and the NTA to determine the reasonableness of a royalty payment or any compensation for the intangible transaction due to the uniqueness of intangibles. In addition, the economic benefits to be realized through the use or transfer of the intangible may not be able to be evaluated easily and objectively. A more independent and thorough evaluation mechanism should be established in the future so that there is a clear valuation method for both the NTA and taxpayers to follow. Although the OECD BEPS final report suggests an ex post result approach to resolve the issue related to HTVI, the detailed implementation process has not been provided in the final report. Considering that the tax uncertainty of taxpayers would increase if the ex post result approach were to be adopted, the MOF prefers to hold off the implementation of that approach but will continue to observe the development of practices and experiences from other countries, as well as reference guidelines to be published by OECD going forward, if any.

2.2.6. Cost contribution agreements (CCAs)

Currently the TP guidelines do not provide specific rules for a CCA regime. There is only a regulation provided under article 14 of “Guidelines for Determining Chinese Taipei Sourced Income under Article 8 of the Income Tax Act” where it introduces the concept of a CCA where the cost allocation under a R&D CCA can be exempt from being deemed as Chinese Taipei source income if certain conditions are met. Specifically, where a Chinese Taipei entity and a foreign entity are working on a technology development and both participants obtain the ownership of the intangibles together, and bear the expenses regarding such a technology development altogether based on the agreement (without any royalty payment embedded), such expenses can be deemed as non-Chinese Taipei source income and can be exempted from Chinese Taipei income tax accordingly. However, there is no specific rule governing how the CCA can be applied from a TP perspective.

2.3. Risk and capital

The Chinese Taipei TP guidelines do not provide any TP measures aligned with the Actions 8–10 report to control the return on capital or compensation for the assumption of risk. Nevertheless, in practice, if the taxpayer arranges a transaction with a related party located in a tax haven jurisdiction, the NTA needs to look into the details of such an arrangement and request the taxpayer to provide the business rationale behind the arrangement. Those entities having no substance will be disregarded. Profit will be attributed to entities having substance based on the results of functions and risk analysis.
2.4. High-risk transactions

2.4.1. CUP and quoted prices for cross-border commodity transactions

Currently Chinese Taipei TP guidelines do not provide a specific regulation governing transactions with commodities. Considering the nature of commodity transactions, both taxpayers and the NTA may use the CUP/CUT method (e.g. market rate) to benchmark the TP of the commodity.

2.4.2. Intra-group services

Intra-group service charges have been a hot tax topic in Chinese Taipei for years. During a tax audit, the NTA has been focused on whether intra-group services have in fact been provided and what the intra-group charge for such services should be. For a regional management expenses charge case, the NTA will closely review the documentation or any evidence to determine whether the services are really beneficial to the service recipient in Chinese Taipei. Relevant documents such as the service agreements specifically related to the service recipient in Chinese Taipei, the specific computation process for each service type, documents which show the nature of the services, the original expense vouchers/evidence documents and so on will be reviewed by the NTA.

In July 2016, as mentioned above, a consultation meeting was arranged by the Chinese Taipei MOF where representatives from universities, CPA firms and law firms joined the discussion with the MOF to discuss the development of BEPS Actions 8–10. Intra-group services is one of the topics discussed at the meeting.

Participants reached a consensus that the Chinese Taipei MOF could consider adopting the simplified approach suggested by the OECD while an amount threshold could be set. As a result, for a small amount of charges less than a certain threshold, the NTA may apply the 5 per cent mark-up as the reasonable TP policy so as to reduce the burden of both taxpayers and the NTA in preparing documentation. Above that threshold, the NTA could review the cases in more detail similarly to current practice.

In order to implement the simplified approach, the MOF has to set a scope of low value-added services and provide a clear definition of the nature of services to avoid disputes between the NTA and taxpayers going forward.

As for the withholding tax issue, although the OECD suggested applying withholding tax based on the profit earned by a service provider rather than on the gross service payment or compensation, such a suggestion would not be consistent with the current Income Tax Act. Subparagraph 3 of article 8 of the Income Tax Act specifically stipulates that “remuneration for services rendered” within Chinese Taipei is Chinese Taipei source income. If the foreign entity has no presence (a fixed place of business or a business agent) in Chinese Taipei, a withholding tax at 20 per cent will be levied on the Chinese Taipei sourced income in accordance with article 88 of the Income Tax Act. That is, the withholding tax basis is the remuneration for services according to the current Income Tax Act. An amendment to the relevant Income Tax Act will be required for the OECD’s suggestion which therefore would not be considered by the MOF.
In September 2009, the MOF provided the guidelines for determining Chinese Taipei sourced income under article 8 of the Income Tax Act, aiming to provide guidance on determining Chinese Taipei sourced income derived by foreign entities. According to the guidelines, if a service is rendered or a business is conducted entirely offshore by a foreign entity, the remuneration for the offshore service is not Chinese Taipei sourced income and therefore is not subject to withholding tax. The guidelines also provide that the foreign entity can document the “contribution ratio” representing the onshore and offshore services/business activities, namely a contribution analysis report in determining the level of contribution made onshore versus offshore. However, there is no clear guidance on the detailed process of a contribution analysis. In practice, the NTA would require the taxpayers to prepare documentation to substantiate the nature of services and the contribution made by the service provider during the service process for review before an approval was granted. This review and approval process would usually take more than a year; there have not been many applications over the past few years accordingly.

2.4.3. Profit splits in the context of value chains

The profit split method is one of the methods prescribed under the Chinese Taipei TP guidelines. It is applied particularly when the participants of related party transactions are involved in highly integrated activities so that the results of transactions cannot be reasonably evaluated separately.

Article 19 of the TP guidelines states that:

“The Profit Split Method prescribed in these Regulations refers to allocating the operating profit to each participant, which shall be calculated based on the contribution to the combined operating profits of all participants in the situation where the activities of the participants of the Controlled Transaction are highly integrated so that the profits or losses cannot be measured individually, or where each of the participants of the Controlled Transaction makes unique and valuable contributions in relation to the Controlled Transaction.”

In addition, “the residual profit, which is equivalent to the amount of the combined operating profit less the regular profit allocated to each participant, shall be divided based on each participant’s relative contribution to the intangible property in the relevant business activity”.

After determining the contribution of the value chain, taxpayers will be required to allocate the residual profit to participants based on their respective determined contribution. In practice, this profit allocation process is likely to trigger a tax dispute in relation to the year-end one off downward TP adjustment issue if the local Chinese Taipei entity needs to allocate its booked profit to its foreign affiliates, which could decrease the application of the profit split method in reality.

Specifically, according to subparagraph 5(5), paragraph 1, article 7 of the Chinese Taipei TP guidelines, “If the adjustment made would decrease tax liability within the territory of [Chinese Taipei], no adjustment shall be made”. This clause has been used by the NTA to disallow a one-off profit downward adjustment made by taxpayers.
Although the NTA granted an approval for one-off downward TP adjustment to a local company in a tax ruling in 2009, it has not released this ruling to the public and has emphasized that the approval was granted specifically to the applicant under special conditions. The NTA has further emphasized that no other companies may use this ruling to support their one-off TP adjustment applications. All true downward adjustments will be reviewed by the NTA on a case-by-case basis. Approvals may be granted based on the above private tax ruling if the following criteria are met:

(a) the factors affecting the transfer prices must be those arising from unexpected external factors (objective uncertainties) beyond the control of the applicant and affiliate(s) in the intercompany transaction;
(b) this adjustment (the adjustment-related intercompany receivables/payables) must be recorded in the applicant’s accounting books before the closing of the company’s financial accounts;
(c) the parties involved in the controlled transaction should reach an agreement on the terms of the transaction and all factors affecting the transfer prices in advance;
(d) the intercompany transaction results are consistent with the arm’s length principle of the TP regulation.

Currently the NTA tends to hold a very conservative position when dealing with the applications for one-off profit downward adjustment; therefore, it is expected that the approval process will require a few rounds of comprehensive discussion and lengthy communication with the NTA together with well-prepared supporting documents. In other words, it is very challenging to obtain the NTA’s approval for one-off profit downward adjustments.

Based on the above discussion, in order to avoid such tax disputes going forward, it would be helpful if the MOF could provide guidance to exclude the profit split method from falling into the scope of subparagraph 5(5), paragraph 1, article 7 of the guidelines.

2.5. TP documentation

2.5.1. CbCR

In Chinese Taipei, the MOF had established a special work force in year 2014 to research and collect relevant materials (including laws and regulations in other countries) about BEPS Action 13. A consultation meeting was held in March 2015 in order to collect comments from professors, associations and CPA firms on BEPS Action 13 for the amendments to the TP guidelines. It is expected that the MOF will amend the TP guidelines to implement the three-tier reporting structure suggested by OECD BEPS Action 13 in the near future.

BEPS Action 13 relies heavily on the existence of mechanisms for the automatic exchange of information. However, Chinese Taipei has neither joined the Convention on Mutual Administrative Assistance in Tax Matters nor signed the Multilateral Competent Authority Agreement (MCAA) for TP information exchange. The way to initiate the information exchange is conducted under a double taxation agreement (DTA). When receiving a request for exchange of information from
other countries, the MOF has to confirm that the following principles have been followed before the request can be accepted:

(a) the request should be based on a concrete fact, including the persons and specific duration involved;
(b) the request for information is limited to tax purposes only. It cannot be used for any other purpose;
(c) information is collectable under a general/routine process;
(d) information requested should be in relation to the years after the effectiveness of the respective DTA;
(e) both countries have to keep the information provided in confidence.

In addition, the MOF has enacted the guidelines for review of exchange of information requests in accordance with the DTA in order to specifically define the review and implementation process of exchange of information since 21 April 2016.

As of the end of November 2016, a total of 30 countries have effective DTAs with Chinese Taipei. Given that Chinese Taipei’s tax treaty network is limited compared with that of other jurisdictions, it would be helpful if Chinese Taipei could join the MCAA to expand the network with other tax jurisdictions which can facilitate Chinese Taipei exchanges of CbCR with other countries.

2.5.2. Master and local files

As discussed in the previous section, the MOF is in the process of drafting the amendments to the TP guidelines to implement the three-tier reporting structure as suggested by BEPS Action 13. There are TP documentation requirements already in Chinese Taipei. In addition to CbCR, it is expected that the MOF will amend the TP guidelines to cover the master file in the near future.

2.5.3. Compliance costs

BEPS Action 13 requires taxpayers to collect certain group financial and non-financial information by countries and provide more in-depth analysis on a group level basis. Multinational companies (MNEs) will need to arrange their personnel to manage the whole information collection process with various countries and conduct the analysis. The compliance costs for CbCR and the master file could be significant, including personnel education, data input and review processes, etc. in the first year of implementation. The compliance costs of an MNE could be also higher if the level of complexity of transactions or number of countries/entities involved is high. Therefore, it is also imperative that the Chinese Taipei MOF set an amount threshold to limit the scope of entities which need to submit the CbCR and master file.

2.6. TP-related measures in other BEPS actions and other measures against BEPS

Currently the MOF is still assessing the overall implications of the BEPS project. The Chinese Taipei TP guidelines have not yet been amended as of November 2016. Therefore, it is still too early to observe whether the TP developments in Chinese Taipei will be driven by any of the non-TP BEPS actions.
2.7. Can BEPS work in favour of MNEs?

The data gathered for CbCR could be valuable information not only from the NTA perspective but also from the taxpayer’s compliance perspective. For example, an MNE can leverage the data gathered and identify whether there is any mismatch between the profit allocation and the substance of entities. For a group entity having the minimum level of substance but earning a higher level of profitability, the MNE should revisit the operation, value chain and respective TP policy, etc. in order to determine whether there is any business rationale behind it and then properly document it for compliance purposes. If this is not the case, a transaction model restructuring or TP policy redesign should be considered. Such a practice would be helpful in improving overall tax compliance.

3. What is the future of TP?

As a conclusion, it is expected that the Chinese Taipei TP guidelines will be further amended in order to incorporate the concepts of BEPS Actions 8–10 and Action 13, particularly addressing the TP issues of intangibles transaction and the requirement for CbCR and the master file. It is expected that the future of TP in Chinese Taipei will largely be connected to the BEPS project’s outcomes.
Summary and conclusions

For developing countries, it has been a challenge to tackle aggressive tax planning structured by multinational companies (MNEs) with the objective of shifting profits to low-tax jurisdictions without having effective mechanisms to prevent it. The Colombian government, as one of the affected countries, has sought support from the OECD in order to strengthen its control of international taxation. In this way, Colombia started its participation within the OECD working parties, in the Global Forum on transfer pricing (TP) and in the Task Force on Tax and Development (TFTD) meetings.

In September 2013, Colombia became a partner in the base erosion and profit shifting (BEPS) project with the almost 80 developing countries that participated directly and indirectly in its construction. In particular, through representatives from its administration, Colombia actively participated in working party 6, on the taxation of MNEs, meetings, the OECD group in charge of developing the documents regarding Actions 8–10, on aligning TP outcomes with value creation, and Action 13, documentation. This was work in which Colombia shared its own experiences and made comments regarding each one of the documents analysed during the development of the BEPS project.

Once the official BEPS report was released on 5 October 2015, Colombia, as an active partner in the project, began analysing the rules to be implemented as part of its policy of alignment with international standards. In particular, given the new approaches proposed to the TP guidelines (Actions 8–10 and 13), it is important for Colombia to take the following into account during its implementation process:

(a) the application of the arm’s length principle based on the accurate delineation of the actual transactions between related companies. Taking into account that in Colombia the arm’s length principle has already been defined in the primary legislation (article 260(2) Colombian Tax Code (CTC)), this outcome will be used as an interpretation tool for TP discussion cases using the new OECD TP guidelines once chapter I of these guidelines has been amended;

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determination of the arm’s length price of transactions involving commod-
ities where the comparable uncontrolled price method (CUP) will generally
be the most appropriate method for the TP analysis. Commodity transactions
in Colombia have in some cases raised BEPS issues, among others: (i) sales
through intermediaries located in low-tax jurisdictions; (ii) commodity
sales through related traders where no contribution to the value chain is
identified; and (iii) commodity sales for less than quoted prices. This leads to
the need for Colombia to implement a specific rule in the TP regime (primary
and secondary legislation) with clear guidelines for both taxpayers and the
tax administration when analysing controlled transactions involving com-
modities;

addressing BEPS issues through the rules developed for the analysis of trans-
actions involving the transfer and/or use of intangibles. Colombia will be
able to use this BEPS outcome as an interpretation tool for TP discussion
cases using the new chapter VI of the OECD TP guidelines once this chapter
has been amended;

establishing the position of Colombia on implementing the simplified
approach to low value-adding intra-group services, which is part of the revi-
sions to chapter VII of the OECD TP guidelines made in the BEPS project;

application of the new guidelines designed for the analysis of the cost-sharing
mechanisms established by MNE groups in their cost contribution arrange-
ments (CCAs) and their consistency with the arm’s length principle. This
BEPS outcome will be used by Colombia as an interpretation tool for TP dis-
ussion cases through the use of the new OECD TP guidelines once chapter
VIII of these guidelines has been amended; and

implementation of the three-tiered standardized approach to TP documenta-
tion: local file, master file and country-by-country reporting (CbCR), which
requires that Colombia implement this new documentation in both primary
and secondary legislation.

Once it has analysed all the implications of the implementation of the TP outcomes
of the BEPS project, the government will propose the amendments required into
Colombian primary and secondary legislation. This process will be supported with
the use of the tools proposed for developing countries, which adopt the new TP
guidelines in order to mitigate the impact of these amendments on Colombia’s eco-
nomic and tax system.

Once the TP-related BEPS report is issued, the implementation phase will lead
developing countries to set priorities and processes to be followed in the adoption
of the BEPS project outcomes.

The adoption of the BEPS measures into the Colombian tax law on TP high-
lights Colombia’s interest in making a major advance in terms of the harmoniza-
tion process with international regulations, guidelines and standards. From the
overall TP law, it is seen that Colombia strongly supports the application of the
arm’s length principle and is committed to the OECD guidelines.

During the current BEPS stage, Colombia will maintain its policy of alignment
with international standards and the country will be committed to carrying out a
BEPS implementation phase in accordance with its own conditions and to continu-
ing to participate actively in the entire implementation process of the OECD work-
ing groups. Likewise, the country will have to maintain its capacity building policy, which must go hand-in-hand with regulatory measures and be supported by the assistance of experts from multilateral organizations.

Finally, the new proposals presented in the current tax reform project reflect the interest of the government in providing better tools to control intercompany transactions, to perform audit procedures based on technical aspects and to have a legitimate tax administration seeking compliance and strengthening mechanisms of dispute resolution such as advance pricing agreements (APAs).

1. Current TP regulation and practice in Colombia

The TP regime in Colombia follows the OECD TP guidelines. It has been in force in Colombia since the year 2004 and the main legal sources that have governed the TP regime have been as follows:

• TP legislation was first introduced in Colombia by Law 788 of 2002, later modified by Law 863 of 2003, which came into effect in 2004. Law 863 was regulated by Decree 4349 of 2004, which provided clarification mainly on documentation, returns and APAs. The articles introduced by Law 863 and applicable since taxable year 2004 were the following: 260(1), transactions with related parties; 260(2), TP methodology; 260(3), comparability criteria; 260(4), TP documentation; 260(5), adjustments; 260(6), low-tax jurisdictions; 260(7), costs and deductions; 260(8), TP information return; 260(9), APAs; 260(10), TP penalty regime;

• Law 1430 of 2010 added article 260(11), which reduced the maximum cap for applicable TP penalties for non-compliance with the TP rules applicable to documentation and information returns;

• in December 2012, the Colombian Congress approved the tax reform by Law 1607 of 2012, which replaced the previous TP rules and is the current TP regime in Colombia. Changes in the TP regime introduced by this tax reform were intended to achieve greater alignment and compliance with the OECD TP guidelines. Law 1607 was regulated by Decree 3030 of 2013, which provided detailed clarification on association, documentation, returns, APAs and penalties. The new TP articles introduced by Law 1607 and applicable since taxable year 2013 are the following: 260(1), association criteria; 260(2), transactions with related parties; 260(3), TP methodology; 260(4), comparability criteria; 260(5), TP documentation; 260(6), adjustments; 260(7), low-tax jurisdictions; 260(8), costs and deductions; 260(9), TP information return; 260(10), APAs; 260(11), TP penalty regime.

Law 1607 was an opportunity in Colombia to implement important changes regarding TP. The main changes introduced by this law are the following:

• the adoption of a definition of the term “arm’s length principle”, in line with article 9 of the OECD model and the OECD TP guidelines, whose application is mandatory for all transactions within the scope of the TP rules. The TP regime introduced by Law 863 of 2003 did not make express reference to the arm’s length principle; however, it stated that related party transactions had
to be carried out considering the prices and profit margins of comparable transactions with or between independent parties.

The TP rules in force governed by Law 1607 of 2012 continue to be grounded on the arm’s length principle. In fact, the new article 260(2) of the CTC introduced the definition of the arm’s length principle. Article 260(2) states:

“Taxpayers that carry out transactions with foreign related parties must determine, for income tax purposes, their ordinary and extraordinary revenues, their costs and deductions and assets and liabilities, considering the arm’s length principle in those transactions. The arm’s length principle will be understood as that in which a transaction between connected or related parties complies with the conditions that would have been used in comparable transactions with or between independent parties.”

The CTC allows the Colombian tax administration (Dirección de Impuestos y Aduanas Nacionales (DIAN)) to verify the application of the arm’s length principle in related party transactions, stating that

“[T]he tax administration, in performing its audit and control faculties, may determine, for tax purposes, the ordinary and extraordinary revenues, their costs and deductions and assets and liabilities generated in transactions carried out by taxpayers with foreign related parties, by means of determining the conditions used in comparable transactions with or between independent parties”;1

- the adoption of association criteria to define related parties;
- the introduction of a broader scope for transactions covered by the arm’s length principle. The new legislation applies the arm’s length principle also to related parties in Colombian free trade zones, permanent establishments and parties in low-tax jurisdictions;
- the enforceability of the rules regarding low-tax jurisdictions. Even though the list of low-tax jurisdictions depends on a decree and not on the law, once Decree 2193 was approved, the provisions set out in article 260(7) became enforceable:
  - any transaction between Colombian taxpayers and persons, enterprises, entities or companies located in low-tax jurisdictions will be subject to the TP regime and taxpayers that carry out such transactions must comply with the formal obligations of filing TP documentation (article 260(5) of the CTC) and information return (article 260(9) of the CTC). In this case, transactions with both related and unrelated parties must comply with the TP legislation;
  - in addition, taxpayers carrying out transactions that result in payments to persons, enterprises, entities or companies located in low-tax jurisdictions, must document and demonstrate the details of the functions performed,

1 CTC, art. 260(2), Transactions with related parties.
assets used, risks assumed and all costs and expenses incurred by the parties located in the low-tax jurisdiction that were necessary to carry out the activities that generated the payments performed by the Colombian taxpayers, in order to allow these payments to be considered as deductible;

• the introduction of the concept of permanent establishment based on article 5 of the OECD model;

• the clear adoption of the five recognized OECD TP methods. Law 1607 replaced the existing six methods with the five recognized OECD TP methods, as contained in the OECD TP guidelines. Article 260(3) of the CTC prescribes and defines the five TP methods, as follows: (a) CUP; (b) resale price method; (c) cost-plus method; (d) transactional net margin method; and (e) profit split method;

• the adoption and definition of the term “arm’s length range”. According to article 260(3) of the CTC, an arm’s length range may be obtained whenever taxpayers identify two or more comparable transactions which are equally comparable to the transaction carried out between related parties. The arm’s length range is a range of prices or profit level indicators, which may be adjustable by means of statistical tools, particularly the interquartile range when considered appropriate. Once the arm’s length range has been calculated, it is possible to determine whether related party transactions have complied with the arm’s length principle. If the prices or profit margins of the controlled transactions lie within the arm’s length range, these will be considered in accordance with prices or profit margins used in transactions between independent parties. Otherwise, if the prices or profit margins of the controlled transactions lie outside the arm’s length range, the median of this range will be considered as the arm’s length price or profit margin for the controlled transactions. Article 8 of Decree 3030 provides guidance on the calculation of the arm’s length range;

• the introduction of an explicit preference for internal comparables, where available, for the purposes of the TP analysis;

• the adoption of particular valuation measures for: (a) the acquisition of used assets; (b) the purchase and sale of unquoted shares or other assets which entail difficulties for purposes of comparability;

• regarding intra-group services, the introduction of the requirement that taxpayers demonstrate the real provision of the service and that the price charged for such a service complies with the arm’s length principle;

• the introduction of TP provisions governing business restructuring and CCAs;

• the adoption of specific measures for interest payments;

• the adoption of a new thin capitalization ratio of 3:1. Interest amounts related to debt transactions (with either related or independent parties) above that ratio are not deductible;

• the introduction of the requirement that financial and accounting information used in the TP analysis be certified by a public accountant;

• the acceptance of rollbacks for APAs in Colombia. The term of the validity for an APA is for the year in which it was approved, the previous year (rollback) and up to the three following years;
2. The impact of the BEPS project on TP

2.1. Introduction

For developing countries it has been a challenge to tackle aggressive tax planning structured by MNEs with the objective of shifting profits to low-tax jurisdictions without having effective mechanisms to prevent it. The Colombian government, as one of those affected countries, sought support from the OECD in order to strengthen its control of international taxation. In this way, Colombia started its participation within the OECD working parties, in the Global Forum on TP and in the TFTD meetings. Additionally, in September 2013, Colombia became a partner of the BEPS project with the almost 80 developing countries that participated in the construction of this project.

Once the official outcomes of the BEPS project were released, the implementation phase started and Colombia became an active partner in the project, analysing the rules to be implemented within its policy of alignment with international standards. In particular, given the new approaches proposed to the TP guidelines (Actions 8–10 and 13), it is important for Colombia to take the following into account in its implementation process:

(a) the application of the arm’s length principle based on the accurate delineation of the actual transactions between related companies. Taking into account that in Colombia the arm’s length principle is already defined in the primary legislation (article 260(2) CTC), this outcome will be used as an interpretation tool for TP discussion cases using the new OECD TP guidelines once chapter I of these guidelines has been amended;

(b) determination of the arm’s length price of transactions involving commodities where the CUP method will generally be the most appropriate one for the TP analysis. Colombia has identified the need to implement a specific rule in the TP regime (primary and secondary legislation) with a clear guideline for both taxpayers and tax administration when analysing controlled transactions involving commodities;

(c) addressing BEPS issues through the rules developed for the analysis of transactions involving the transfer and/or use of intangibles, Colombia will be able to use this BEPS outcome as an interpretation tool for TP discussion cases using the new chapter VI of the OECD TP guidelines once this chapter has been amended;

(d) establishing the position of Colombia on implementing the simplified approach to low value-adding intra-group services, which is part of the revisions to chapter VII of the OECD TP guidelines made in the BEPS project;

(e) application of the new guidelines designed for the analysis of the cost-sharing mechanisms established by MNE groups in their CCAs and their
consistency with the arm’s length principle. This BEPS outcome will be used by Colombia as an interpretation tool for TP discussion cases through the use of the new OECD TP guidelines once chapter VIII of these guidelines has been amended; and

(f) implementation of the three-tiered standardized approach to TP documentation: local file, master file and CbCR, which requires that Colombia implements this new documentation in both primary and secondary law.

In Colombia, there is a relevant interest from the business sector, from advisory firms specializing in tax matters and TP and from the academic community regarding the BEPS project, its outcomes and its implementation. In this regard, they have organized several conferences, congresses and meetings since 2015 where the main topic has been the BEPS project outcomes and their possible impact on Colombian legislation. One of the most relevant concerns from the private sector has been the new documentation that will be required for TP matters, in particular how the new documentation will be implemented in Colombia, what the increased compliance cost will be for taxpayers, what companies will be obliged to comply with the new master file and CbCR requirements and how easy it will be for small subsidiaries located in Colombia to obtain global information from the whole MNE.

2.2. Challenges of transactions with intangibles

2.2.1. Definition of intangibles

Colombia has not introduced any definition of intangibles in its CTC for tax purposes. Articles 74, 75 and 279 of the CTC regulate issues regarding the determination of the tax basis of intangible assets such as invention patents, brands, goodwill and copyright, among others.

On the other hand, there are some intangible definitions in the Colombian Trade Code and in the current Colombian generally accepted accounting principles (GAAP), which are mentioned below.

The Colombian Trade Code was first introduced in Colombia by Decree 410 of 1971. Articles 534 to 618 of the second title of the third book of the Colombian Trade Code refer to intellectual property (IP). These articles were modified by Decision 486 of 2000 of the Andean Community of Nations (CAN) and they are regulated by Decree 2591 of 2000 and by the External Circular No. 003 of 2003 of the Industry and Trade Superintendence which are the current rules applicable for IP matters in Colombia. Within this regulation for IP the following definitions are established:

- inventions: patents will be granted for inventions, whether of goods or of processes, in all areas of technology, provided that they are new, involve an inventive step and are industrially applicable;
- utility models: any new shape, configuration or arrangement of components of any device, tool, implement, mechanism or other object, or any part thereof, that makes for improved or different operation, use or manufacture of the object incorporating it, or which endows it with any usefulness, advantage or technical effect that it did not have previously, will be considered a utility model. Utility models will be protected by means of patents;
layout designs of integrated circuits: an integrated circuit means a product, in its final or an intermediate form, in which the elements, at least one of which is an active element, and some or all of the interconnections are an integral part of the body or surface of a piece of material, and which is intended to perform an electronic function. Layout design means the three-dimensional disposition, however expressed, of the elements, at least one of which is an active element, and the interconnections of an integrated circuit, or such a three-dimensional disposition prepared for an integrated circuit intended for manufacture. A layout design will be protected where it is original. The right to the registration of the layout design of an integrated circuit will belong to its designer. That right may be transferred by an *inter vivos* transaction or by succession;

industrial designs: the particular appearance of a product resulting from any arrangement of lines or combination of colours or any two-dimensional or three-dimensional outward shape, line, outline, configuration, texture or material that does not alter the intended purpose or use of the product will be considered an industrial design. The right to the registration of an industrial design will belong to the designer. That right may be transferred by an *inter vivos* transaction or by succession. The owners of the registration may be natural persons or legal entities;

brands: any sign capable of distinguishing goods or services on the market will constitute a brand. Signs that are susceptible to graphic representation may be registered as brands. The following signs, among others, may constitute brands:
(a) words or word combinations;
(b) images, figures, symbols, graphics, logotypes, monograms, portraits, labels, emblems and shields;
(c) sounds and aromas;
(d) letters and numbers;
(e) a colour within an outline, or a colour combination;
(f) the shape of the goods, their containers or their packaging;
(g) any combination of the signs or elements specified in the foregoing subparagraphs;

advertising slogans: an advertising slogan is understood to be the word, phrase or caption used to complement a brand;

collective brands are understood to be any sign that serves to distinguish the origin or any other common characteristic of goods or services from different firms that use the sign under the owner’s control;

certification brands are understood to be signs intended to be applied to goods or services the quality or other characteristics of which have been certified by the owner of the brand;

trade names are understood to be any sign that identifies an economic activity, an enterprise or a trading establishment. An enterprise or establishment may own more than one trade name. The trade name of an enterprise or establishment may be constituted among other things by its corporate designation, its business style or another designation entered in a register of traders or trade undertakings.
The current Colombian GAAP is regulated by Decree 2420 of 2015. Annex 1 of this decree adopted IAS 38, Intangible Assets\(^2\) of the IFRS\(^3\) and established the definition for intangibles as follows: “An intangible asset is an identifiable non-monetary asset without physical substance.” Under this accounting principle, an intangible asset must comply with three critical attributes:

- **identifiability:** an intangible asset is identifiable if (a) it is separable, i.e. is capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, identifiable asset or liability, regardless of whether the entity intends to do so; or (b) it arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations;
- **control:** an entity controls an asset whenever it has the power to obtain the future economic benefits flowing from the underlying resource, and to restrict the access of third parties to those benefits;
- **future economic benefits:** include activities from sales of products or cost savings or other benefits derived from the use of the asset by the entity.

### 2.2.2. Transactions with intangibles

Colombia has been aware of the need to deal with BEPS problems in transactions involving intangibles such as high payments to jurisdictions with low or no taxation on royalties, technical services and technical assistance. This was one reason that led the country, in its process of alignment with international standards, to introduce by Law 1607 of 2012 and Decree 3030 of 2013 specific regulations on the TP regime for analysing intangible transactions, as follows:

- **new article 260(4) of the CTC, introduced by Law 1607 of 2012, specifies the five comparability factors to consider when comparing transactions between related and unrelated parties. Those five comparability factors are aligned with those of the OECD guidelines. Depending on the appropriate TP method selected, the five comparability factors in article 260(4) are used to determine whether transactions are comparable or whether there are significant differences. These comparability factors are critical in the performance of an appropriate comparability analysis. Within these comparability factors, the legislation establishes specifically for intangibles to take into account the characteristics of the transactions, including, in the case of transferring an intangible asset or granting the right to exploit it, elements such as the type of asset (patent, trademark, trade name or knowhow), the duration and degree of protection and the profits expected to be obtained from its use;**
- **regarding documentation, the main information that is currently being requested for taxpayers to include in their TP documentation when carrying out transactions involving intangibles was established by article 4(2)(d) of**

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\(2\) International Accounting Standard – IAS 38 Intangible Assets. IAS 38 was issued in September 1998 and revised in March 2004.

\(3\) IFRS – International Financial Reporting Standards.
Decree 3030 of 2013, mainly a brief description of the main contractual terms, with regard to the development, enhancement, maintenance, protection and use of the intangibles and the indication of the compensation made directly or indirectly by the parties involved in the transfer of intangibles.

BEPS Action 8 worked on the development of TP rules for intangibles in order to prevent BEPS problems arising from the transferring of these assets within the group without compensation that meets with the arm’s length principle. Even though several changes were proposed to chapter VI of the OECD TP guidelines, these had not been included in the Colombian legislation, since the country had been expecting the final outcome of the intangibles project. Once the intangibles outcome of the BEPS project was delivered, Colombia was willing to adapt those principles. Colombia is waiting for the approval of the current Project Law No. 178/2016C in order to be able to introduce in its secondary legislation the outcome of Action 8 regarding intangibles, it is hoped in 2017.

2.2.3. “Substance-over-form” approach towards intangibles

The CTC does not contain any particular article that establishes a “substance-over-form” principle for tax purposes. Nevertheless, article 228 of the Constitution of the Republic of Colombia establishes the principle of the priority of the substantive right over the formal one when it discusses the actions of the administration of justice.

Likewise, in the current Colombian GAAP adopted by Decree 2496 of 2015, the following IFRS standards relate to substance over form:

- Annex 1(1) of Decree 2496 of 2015 adopted the Conceptual Framework for Financial Reporting issued by the IASB\(^4\) in 2010, which establishes in paragraph 4.6: “In assessing whether an item meets the definition of an asset, liability or equity, attention needs to be given to its underlying substance and economic reality and not merely its legal form”;
- Annex 1(1) of Decree 2496 of 2015 adopted the IAS 8, Accounting Policies, Changes in Accounting Estimates and Errors,\(^5\) which states in paragraph 10(ii)(b) the requirement to “(ii) reflect the economic substance of transactions, other events and conditions, and not merely the legal form”;
- Annex 1(1) of Decree 2496 of 2015 adopted the IAS 24, Related Party Disclosures,\(^6\) which establishes in paragraph 10: “In considering each possible related party relationship, attention is directed to the substance of the relationship and not merely the legal form”.

From a BEPS point of view, although Colombia was expecting the final outcome of the BEPS project, in the tax reform of 2012 approved by Law 1607 of 2012 and regulated for TP purposes by Decree 3030 of 2013 specific regulations on the TP regime for intangibles were introduced.

In this sense, primary legislation establishes in article 260(4) of the CTC the five comparability factors to consider when comparing transactions between

\(^4\) IASB: International Accounting Standards Board.
\(^5\) International Accounting Standard – IAS 8, Accounting Policies, Changes in Accounting Estimates and Errors. IAS 8 was reissued in December 2005 and has applied to annual periods beginning on or after 1 January 2005.
\(^6\) International Accounting Standard – IAS 24, Related Party Disclosures. IAS 24 was reissued in November 2009 and applies to annual periods beginning on or after 1 January 2011.
related and unrelated parties, which are aligned with the five comparability factors of the OECD TP guidelines. Depending on the appropriate TP method selected, the five comparability factors in article 260(4) are used to determine whether transactions are comparable or whether there are significant differences. Within these comparability factors, the third one is related to the substance-over-form principle which specifies that attention should be paid to “the contractual terms of the parties in relation to the economic reality of the transaction”.  

Additionally, for analysing transactions involving intangibles Decree 3030 of 2013 requires taxpayers to include in their TP documentation:

“a brief description of the main contractual terms indicating object, rights and obligations, term, geographical zone, exclusivity, among other, as well as the country or place where the related party with which transactions are being carried out has its intangibles. Additionally, a brief description of the conduct or practices being performed in the transactions regarding such intangibles.”

It is also required to perform a substance-oriented analysis, with a focus on how functions related to development, enhancement, maintenance, protection and exploitation of intangibles are assigned within the MNE group. Taxpayers must:

“describe the strategy of the group to which they belong, or the related parties abroad, in free trade zones or persons, enterprises, entities or companies located in low-tax jurisdictions with which transactions were carried out, with regard to the development, enhancement, maintenance, protection and use of the intangibles.”

Finally, if during the taxable year Colombian taxpayers participated in transactions involving the transfer of intangibles, they will have to indicate the compensation made directly or indirectly by the parties involved in the transfer.

In the current tax reform project, a rule has been included which proposes a limitation on royalty payments for intangibles. The proposal states that the payment of royalties to related parties abroad or located in Colombian free trade zones, corresponding to the exploitation of an intangible formed in the Colombian national territory, will not be deductible from income tax. It is also proposed that payments for royalties made during the taxable year, when the royalties are associated with the acquisition of finished products, will not be deductible.

2.2.4. Comparability and group synergies

The TP regime in Colombia does not provide any specific rule or mechanism to identify group synergies.

Regarding these types of circumstances, the only way to identify group synergies is through a functional analysis in which the taxpayer is required to state in the TP documentation:

7 CTC, art. 260(4), Comparability criteria in transactions between related and independent parties, no. 3.

8 Decree 3030/2013, art. 4(2)(d); content of supporting documentation, 27 December.
• a description of the corporate objects and of the activity or activities specifically carried out by the taxpayer. This should consist of a general description of the business, considering aspects such as activity or type of business, types of products or services sold, types of suppliers and customers and commercial aspects or policies that allow the terms of negotiation to be established with customers in connection with prices, volumes and deadlines, among other details;\(^9\)

• general information on commercial strategies: innovation and development of new products, market penetration, expansion or maintenance, business volume, credit policies, forms of payment, opportunity cost, quality processes, domestic and international certification of products or services, exclusivity and warranty agreements, among other aspects, to the extent that they relate to or have affected the transaction types analysed;\(^10\)

• a brief description of the functions performed by each of the parties to the transaction, specifying the economic relevance of the functions in terms of frequency, nature, remuneration and measurement of use.\(^11\)

Additional to the requirements described above, article 4 of Decree 3030 of 2013 also clarifies that the functions detailed in the analysis may include design, manufacture, assembly, R&D, services, procurement, commercialization, distribution, sales, marketing, advertising, transportation, financing, management and administration expenses, quality control or financial transactions.

2.2.5. Hard-to-value intangibles (HTVI)

Colombia, in its process of alignment with international standards, introduced, through Law 1607 of 2012 (article 260(4) CTC) and Decree 3030 of 2013 (article 4), specific regulations in the TP regime for the analysis of controlled transactions involving intangibles. Nevertheless, although the outcome of BEPS Action 8 has already been released, Colombia has considered it prudent to propose a new regulatory change in this regard once the tax reform project, currently in progress, has been approved.

Regarding the new HTVI orientation, a Colombian legislative modification would be required; however, the implementation package for this guideline has not been agreed in the OECD yet. Its adoption in the Colombian TP regime will then depend on the release of the guidance agreed among countries to implement the HTVI rules.

For the interpretation and discussion regarding TP as of this date, the OECD TP guidelines will still be used as an interpretation tool.

2.2.6. CCAs

The BEPS Action Plan in its Action 8 had the aim of ensuring that TP outcomes were in line with value creation for intangibles. Under this action plan it was

\(^9\) Decree 3030/2013, art. 4(2)(a), content of supporting documentation, 27 December.

\(^10\) Decree 3030/2013, art. 4(2)(b), content of supporting documentation, 27 December.

\(^11\) Decree 3030/2013, art. 4(2)(d), content of supporting documentation, 27 December.
required to update the guidance on CCAs.\textsuperscript{12} That mandate led to the revision of chapter VIII of the OECD TP guidelines with the aim of designing clearer criteria to determine whether the agreed terms among group members of the CCA are consistent with the arm’s length principle.

In Colombia a specific rule for CCAs was introduced by Law 1607 of 2012 through which these agreements must comply with the arm’s length principle.\textsuperscript{13}

Paragraph 2 of article 260(3) of the CTC specifies that in the case of intra-group services or CCAs between related parties, “taxpayers must demonstrate the actual provision of the service and that the amount charged or paid for such service is in compliance with the arm’s length principle”. Article 6 of Decree 3030 of 2013 further elaborates that the contributions made by each participant must be adjusted to those that an independent party would accept in comparable situations, considering the effective benefits on goods or services resulting from the CCA, and the real possibility of exploiting or utilizing, directly or indirectly, the assigned right.

Decree 3030\textsuperscript{14} also lists the information on CCAs that must be included in the TP documentation. In particular, taxpayers must:

“(a) Describe and demonstrate the annual costs or expenses incurred to carry out the activity to which the CCA relates, the form and value of the contributions made by each participant during the term of the arrangement. Supporting documentation should be available to the Tax Administration when requested.
(b) Identify the direct and/or indirect beneficiaries of the CCA, indicating name, tax identification number and country of residence or domicile.
(c) Specify the nature and significance of each participant’s actual share of the result of the activities to which the CCA relates, the scope of the specific activities and projects covered, the term of the arrangement, and the obligations and responsibilities derived from it.
(d) State whether any payment was made, other than the contributions relating to the CCA in order to generate the actual benefits from assets, services or rights obtained through it.
(e) Describe the allocation method, criteria, circumstances and adjustments, if any, reflecting the participation share and quantification of the benefits that are expected from the arrangement, comparing forecasts used to determine expected benefits \textit{vis-à-vis} the actual results.
(f) Describe the procedures for the adherence or withdrawal of a participant to or from the CCA and related consequences, as well as the procedures and consequences in case of termination.”

\textsuperscript{13} Law 1607/2012, art. 113, Methods to determine the price or margin in transactions with related parties, 26 December.
\textsuperscript{14} Decree 3030/2013, art. 6, cost contribution arrangements, 27 December.
Nevertheless, the new guidance for the analysis of CCAs under the framework set out in the BEPS report has been enhanced, ensuring that “CCAs are appropriately analysed and produce outcomes that are consistent with how and where value is created”\textsuperscript{15}. Colombia has not yet introduced any modification in its TP regime according to this BEPS outcome. In order to adopt new guidelines for the analysis of CCAs, Colombia will require an amendment of its secondary legislation once the tax reform project (primary legislation) has been approved in the Colombian Congress.

### 2.3. Risk and capital

The outcome of the BEPS Action 9 addressed the level of returns to funding provided by a capital-rich MNE group member, where those returns do not correspond to the level of activity undertaken by the funding company. The revised guidance also addresses the situation where a capital-rich member of the group provides funding but performs few activities. If this associated enterprise does not in fact control the financial risks associated with its funding (for example because it just provides the money when it is asked to do so, without any assessment of whether the party receiving the money is creditworthy), then it will not be allocated the profits associated with the financial risks and will be entitled to no more than a risk-free return, or less if, for example, the transaction is not commercially rational and therefore the guidance on non-recognition applies\textsuperscript{16}.

Regarding this BEPS outcome, Colombia has not yet adopted any TP measures. Currently, the only rule in Colombia to control the return on capital for TP purposes is regarding the treatment of interest payments. In particular, article 260(4) of the CTC provides a list of comparability criteria including the amount of capital, the repayment period, the risk rating of the parties, the existence and amount of guarantees, the solvency of the debtor and the interest rate. If the interest rate, considered together with the other elements related to the financial transaction under comparability analysis, are not at arm’s length, interest payments will not be deductible, to the extent that they are recharacterized as capital contributions and treated as dividends and not as loans or interest.

On the other hand, Law 1607 of 2012 introduced a thin capitalization rule\textsuperscript{17}, focusing on increasing enforcement control and restricting interest deductions in Colombia. This rule establishes that interest related to a debt transaction that exceeds the debt-to-equity ratio of 3:1 is non-deductible\textsuperscript{18}. It is important to point out that this provision is applicable to all debt transactions, whether with related or with independent parties.


\textsuperscript{16} Ibid., pp. 9–12 (2015).

\textsuperscript{17} Law 1607/2012, art. 109, Thin capitalization, 26 December.

\textsuperscript{18} CTC, art. 118(1), Thin capitalization.
2.4. High-risk transactions

2.4.1. CUP and quoted prices for cross-border commodity transactions

In Colombia, the commodity industry is a very important one, since the economy relies on a considerable share from the primary sector. Products such as coal, petroleum, nickel, other minerals, grains and other agricultural products make up part of the most important commodities in terms of production volumes and foreign trade.

Although an increasing number of Latin American countries are applying the so-called sixth method as an anti-abuse measure, Colombia has not implemented this sixth method or any other specific rule to control cross-border commodity transactions; currently the general TP rules apply to these types of transaction.

Colombia, however, is aware of the need for the country to have a specific rule within the TP regime that gives a clear guideline for both taxpayers and the tax administration when analysing commodity transactions between associated enterprises for the sole purpose of protecting the taxable base from undisclosed long-term contracts and negotiations; significant adjustments for discounts or deductions; potential manipulation of the quotation period and prices; and lack of information, among other things.

Likewise, controlled commodity transactions in Colombia have shown in some cases indications related to BEPS issues, among others: (a) sales through intermediaries in jurisdictions with low or non-taxation; (b) sales of a commodity through related traders where the performance of functions within the value chain is not evidenced; and (c) sales of the commodity at a price lower than the publicly quoted prices.

Therefore, Colombia, as a country fully engaged in the BEPS project, has closely monitored developments on this issue and has proposed a legislative amendment including the implementation of the outcome of the BEPS Action 10 in order to adopt the CUP method as the one which “would generally be an appropriate transfer pricing method for establishing the arm’s length price for the transfer of commodities between associated enterprises”.19

The proposed rule also contemplates the following guidelines according to the BEPS outcome: (a) quoted prices can be used under the CUP method, as a reference to determine the arm’s length price for the controlled commodity transaction; (b) reasonably accurate comparability adjustments should be made, when needed, to ensure that the economically relevant characteristics of the controlled and uncontrolled transactions are sufficiently comparable; (c) if the pricing date specified in any agreement between the associated enterprises is inconsistent with the actual conduct of the parties or with other facts of the case, tax administrations may determine a different pricing date consistent with those other facts of the case and what independent enterprises would have agreed in comparable circumstances (taking into consideration industry practices); and (d) when the taxpayer does not provide reliable evidence of the pricing date agreed by the associated enterprises in

the controlled transaction and the tax administration cannot otherwise determine a different pricing date, the tax administration may set the pricing date for the commodity transaction on the basis of the evidence available to the tax administration; this may be the date of shipment as evidenced by the bill of lading or equivalent document depending on the means of transport.

This legislative modification has been included in the tax reform project that is currently in the process of discussion in the Colombian Congress.

2.4.2. Intra-group services

Action 10 of the BEPS Action Plan instructs G20 and OECD countries to develop TP rules to provide protection against common types of base eroding payments, such as management fees and head office expenses. Within this mandate, the BEPS report introduced an elective, simplified approach for low value-adding services. In addition to that, it introduced some changes and clarifications to other paragraphs of chapter VII of the OECD TP guidelines.20

Colombia is aware of the BEPS problems that materialize in controlled transactions involving intra-group services, such as:
• lack of materiality related to payments for intra-group services;
• high amounts paid to low or non-taxation countries by concepts of services in which there is no real evidence of the functionality of the related party abroad;
• lack of reliable proof that demonstrates the cost base on which a mark-up is applied.

Regarding these, a specific rule was introduced in the Colombian TP regime to analyse intra-group services.21 Paragraph 2 of article 260(3) of the CTC intends to address those problems by specifying that for intra-group services, “the taxpayer must demonstrate the actual provision of the service and that the amount received or paid for such service complies with the arm’s length principle”. Through this provision taxpayers are required to provide supporting evidence related to (a) those services, (b) their actual provision, and (c) their market values, in order to deduct those payments in their income tax return.

In addition, article 5 of Decree 3030 of 2013 provides clear guidance as to the detailed information that taxpayers must include in their TP documentation, so the the tax administration can confirm that arm’s length payments have been made for material services received.

With regard to documentation requirements, article 5 of Decree 3030 of 2013 requires the taxpayer to:
“(a) Explain in the transfer pricing documentation how the services activity carried out implies economic or commercial benefits to the recipient that strengthens its commercial position, considering in all cases if in comparable situations, an independent party would have fulfilled the identified need by performing the activity itself or by recurring to a third party, as well as the form of remuneration under arm’s length conditions would the transaction have taken place between independent enterprises operating in

21 Law 1607/2012, art. 113, Methods to determine the price or margin in transactions with related parties, 26 December.
a free market, considering the point of view of both the service provider and the beneficiary. To this end, relevant factors include the value of the service for the recipient and the amount that a comparable independent party would have been willing to pay for that service in comparable circumstances, as well as the costs incurred by the service provider.

(b) Specify in the transfer pricing documentation if the compensation for each of the intercompany transactions carried out is in line with the arm’s length principle, identifying the agreements, forms or methods arranged between the parties that gave rise to the billing of the services.

(c) In the event that the compensation for the services rendered between related parties has been included in the price of other transactions, the taxpayer shall demonstrate that no additional cost or expense was billed for such services, in which case the pertinent and conductive information shall be available to the Tax Administration when requested.

In the event that a specific sum has been agreed in the terms of the services for their use and subsequent billing, the actual use of the services shall be documented.”

With this information, Colombia seeks to validate that the actual provision of services and related payments are in accordance with the arm’s length principle. Therefore, if no service is actually provided, under arm’s length conditions, no independent party would have paid for it.

Likewise, article 124 of the CTC establishes that management fees and administrative expenses paid to the head office or to its offices abroad are only deductible if a withholding tax has been levied on the whole payment.

On the other hand, regarding the elective simplified approach for low value-adding intra-group services introduced in the BEPS report, Colombia has not implemented it and has not yet proposed its implementation.

2.4.3. Profit splits in the context of value chains

The current Colombian legislation does not have any special rules concerning the application of TP rules to MNEs’ value chains. In some cases, when it is relevant for the analysis, it is not even easy for the party located in Colombia to disclose complete information regarding the contributions made by each member of the group to the MNE’s value chain.

As mentioned in the first section of this report, in Colombia the 2012 tax reform replaced the existing six methods with the five recognized OECD TP methods, as contained in the OECD TP guidelines. In this sense, the profit split method is recognized in the Colombian TP regime as one of the transactional TP methods to determine compliance with the arm’s length principle.

The profit split method allows for the application of the contribution and residual analysis. The profit split and residual profit split methods were modified by the 2012 tax reform (Law 1607), following OECD criteria, creating a single method which describes the process used in both of them, taking into account the fact that they are complementary to each other. The law provides a clear explanation of the approach for splitting profits: contribution analysis and residual analysis.
This method identifies the profits to be shared among related parties derived from the transactions in which they take part, and subsequently allocates these profits to those related parties over a valid economic base. The distribution of profits is performed in accordance with the proportions that would have been allocated if the related parties had acted as independent parties pursuant to the arm’s length principle and considering the volume of assets, costs and expenses assumed by each of the related parties in the controlled transactions.

Although this method is recognized in Colombia, only 0.3 per cent of the total controlled transactions are analysed by taxpayers through the profit split method due in some cases to lack of experience in the application of this method and in others to lack of the information necessary for the proper application of the method.

Colombia has not proposed any clarification to the application of the transactional TP method, in the context of global value chains, awaiting the final OECD guidance which is currently under discussion and expected to be finalized in the first half of 2017 according to the BEPS report.22

2.5. TP documentation

2.5.1. CbCR

The mandate of BEPS Action 13 was to re-examine TP documentation developing rules regarding TP documentation to enhance transparency for the tax administration, taking into consideration the compliance costs for business.23 The rules to be developed would include a requirement that MNEs provide all relevant governments with information needed on their global allocation of income, economic activity and taxes paid among countries according to a common template.

Colombia participated actively in the documentation BEPS work and it was expecting the final BEPS report to propose changes in the TP documentation requirements. Included in the current tax reform project is a proposal to implement the three-tiered standardized approach to TP documentation developed under BEPS Action 13 work.24

The implementation of CbCR in Colombia has the aim of adopting, through primary and secondary legislation, the relevant requirements included in the model legislation suggested by Action 13, the CbCR implementation package25 and in the guidance on the implementation of TP documentation and CbCR.26 The proposal presented in the current tax reform project has taken into account mainly:

• the recommendation that the first CbCR be required to be filed for MNE fiscal years beginning on or after 1 January 2016;
• the recommendation that all MNE groups must be required to file the CbCR each year except MNE groups with annual consolidated group revenue in the immediately preceding fiscal year of less than €750 million or a near equivalent amount in domestic currency;
• each ultimate parent entity of an MNE group that is resident for tax purposes must file a CbCR with respect to its reporting fiscal year or the entity resident in the domestic territory or resident abroad with a permanent establishment in the country that has been designated by the ultimate parent entity of an MNE group to file the CbCR.

CbCR may be exchanged between countries in accordance with the standards of automatic exchange of information, taking into account that the compliance with strict confidentiality, consistency and appropriate use of information must be ensured.

The Convention on Mutual Administrative Assistance in Tax Matters (MAC) was approved by the Colombian Congress through Law 1661 of 2013 and revised by the Constitutional Court in the judgment C-032 of 2014. In Colombia, the MAC has been in force since 1 July 2014 and has effect for fiscal years beginning on or after 1 January 2015 in accordance with article 28 of the Convention.

Colombia has also expressed its willingness to sign the Multilateral Competent Authority Agreement on the Exchange of CbCR (the CbC MCAA) but it has not signed it yet.

2.5.2. Master and local files

In Colombia, TP documentation requirements have been in force since taxable year 2004. With the introduction of Law 1607 of 2012, Colombian taxpayers that carry out transactions with related parties in accordance with articles 260(1) and 260(2) of the CTC, as well as Colombian taxpayers that carry out transactions with parties, whether related or not, located in low-tax jurisdictions in accordance with article 260(7) of the CTC, must comply with the preparation and filing of TP documentation (article 260(5) of the CTC) regarding each type of transaction in which they demonstrate the compliance of the TP rules.

Likewise, article 4 of Decree 3030 of 2013 provides the contents of TP documentation, which must include the following:
(a) an executive summary;
(b) a functional analysis;
(c) an industry analysis;
(d) an economic analysis.

Additionally, article 260(11) of the CTC establishes the TP penalty regime, which provides penalties applicable to infractions related to the TP documentation. Penalties are basically imposed for faults or infractions such as (a) extemporaneous filings, (b) non-filings, (c) errors and (d) omissions.

The provisions regarding TP documentation are in the process of being modified according to the outcome of BEPS Action 13. In Colombia, the implementation of the standardized master file and local file would be a very useful approach in order to obtain a global or holistic view of the MNE and the particular
understanding of the contribution of the local affiliate within the global MNE business strategy.

In this regard the modification of article 260(5) has been proposed in the current tax reform project, in which has been included as part of the TP documentation requirements to file not only the “local file” that is already in force in Colombia but also the “master file” with the relevant global information of the MNE group that will be a new requirement for Colombian taxpayers.

In order to be aligned with the standardized approach to TP documentation developed under BEPS Action 13, Colombia will also require the modification of its secondary legislation in order to regulate and detail the information that should be included by the taxpayer in the “master file” and in the “local file”.

2.5.3. Compliance costs

According to the above, in Colombia the three-tiered standardized approach to TP documentation developed under the BEPS work is not currently in force. Therefore, at this moment the country does not have information on how BEPS Action 13 has affected compliance and its cost for MNEs operating in Colombia.

It is important to mention that for Colombia it has been relevant within this process to take into account that the aims of the implementation of the three-tiered standardized approach to TP documentation are to adopt rules that will lead to more consistent TP compliance among countries and to establish a clear and widely adopted documentation rule that can reduce the compliance costs which could otherwise arise in a TP dispute.

2.6. TP-related measures in other BEPS actions and other measures against BEPS

In Colombia there are in force two measures that were introduced in 2012 with the aim of countering BEPS situations that had been identified at that time.

One was thin capitalization: before the 2012 tax reform, in Colombia there was a gap between the deductibility of interest and the non-deductibility of dividends. This led to companies financing most of their projects with debt, either through the use of subordinated loans with shareholders or collateral provided by foreign related parties. The result of these financing structures was that shareholders or related parties received the return on the investment via deductible interest, which is deductible in Colombia. At the same time it reduced the equity of the company for tax purposes, because in Colombia it was possible to pay taxes based on the net equity registered by taxpayers in the last day of the taxable year (the net equity is calculated as total assets minus total liabilities, so therefore debt may be used to reduce the net equity through higher liabilities).

As a result of this situation, the government introduced via the 2012 tax reform a thin capitalization rule which establishes that interest related to a debt transaction that exceeds the debt-to-equity ratio of 3:1 is non-deductible.27 It is important to point out that this provision is applicable to all debt transactions, whether with related or with independent parties.

27 Law 1607/2012, art. 109, added art. 118(1) of the CTC, Thin capitalization, 26 December.
The Colombian government introduced via the 2012 tax reform an anti-abuse clause for tax matters, through which it added articles 869, 869(1) and 869(2) of the CTC, where it is established that the assumptions that constitute abuse in tax matters in Colombia are:

(a) a transaction or series of transactions carried out between related parties;
(b) a transaction or series of transactions involving the use of tax havens;
(c) a transaction or series of transactions involving a special tax regime entity, a non-subject entity, an exempt entity or an entity subject to a non-ordinary income tax regime;
(d) where the price or compensation agreed or applied differs by more than 25 per cent from the price or compensation for similar operations at market conditions;
(e) where the conditions of the business or transaction omit a person, legal act, document or material clause, which would not have been omitted in similar commercially reasonable conditions if the transaction or series of transactions had not been planned or executed in order to obtain in an abusive manner a tax benefit for the taxpayer or for its related parties.

In the event of abuse occurring in the terms stated in the law, the tax administration will have the power to disregard the effects of the conduct constituting abuse and recharacterize them as if the abusive behaviour had not occurred. In this sense, the tax administration may issue the corresponding administrative acts in which it proposes to calculate the corresponding taxes, interest and penalties.

It is also important to mention that in the context of the BEPS project, the government has proposed, in the current tax reform project, which is in the process of discussion, the introduction of rules regarding the following BEPS outcomes:
- Action 1, Addressing the tax challenges of the digital economy;
- Action 3, Strengthening controlled foreign company (CFC) rules;
- Action 12, Requiring taxpayers to disclose their aggressive tax planning arrangements.

2.7. Can BEPS work in favour of MNEs?

As mentioned above, at this time Colombia does not have in force any rule within the context of the BEPS outcomes. Once the tax reform project is approved by the Colombian Congress, which is currently in the discussion phase, and once the new TP rules are applicable, the country will be able to identify whether the TP-related BEPS actions and the information gathering initiatives may actually benefit MNEs with information that is in the possession of other countries being used for their domestic compliance.

Nevertheless, according to several meetings with stakeholders and adviser firms specializing in TP matters in Colombia, two opposing opinions have been expressed regarding the new three-tiered standardized approach to TP documentation proposed by the government: on the one hand, concern regarding the potential increase in compliance costs that might materialize once the new TP documentation requirements are applicable; and on the other hand the possibility of achieving domestic compliance with less of a burden for parties located in Colombia, given that the information required will be standardized among countries and most of the newly required information will be supplied and filed by the parent entity and in the case of CbCR will be automatically exchanged by tax authorities.
3. What is the future of TP?

Once the outcomes of the BEPS project were officially launched, steps were taken towards its implementation phase. In the global context, the implementation will imply a new version of the OECD TP guidelines, modifying and replacing corresponding chapters of the guidelines according to the BEPS report, which indeed will indisputably cause a change in the TP provisions and practices among the countries that have fully engaged with the BEPS project.

Regarding the new approaches proposed for the TP guidelines (Actions 8–10 and 13), Colombia, as an active partner of the project, has been analysing the rules to be implemented within its policy of alignment with international standards, paying significant attention to issues such as: (a) the application of the arm’s length principle based on the accurate delineation of the actual transactions between related companies; (b) the determination of the arm’s length price of transactions involving commodities where the CUP method will generally be the most appropriate method for TP analysis; (c) addressing BEPS issues through the rules developed for the analysis of transactions involving the transfer and/or use of intangibles; (d) setting the position on implementing the simplified approach to low value-adding intra-group services; (e) application of the new guidelines designed for the analysis of the cost-sharing mechanisms established by MNE groups in their CCAs and their consistency with the arm’s length principle; and (f) implementation of the three-tiered standardized approach to TP documentation: local file, master file and CbCR.

In the current BEPS implementation phase, Colombia requires:

• assistance in the appropriate design of rule modifications according to the outcomes of the BEPS project (primary and secondary legislation);
• strengthening knowledge regarding valuation techniques of intangible assets (transfer and use) under the arm’s length principle based on the new guidelines;
• assessing the legal and technical requirements for the implementation of CbCR. In the process of aligning international standards and in this post-BEPS stage, it is very important for Colombia to obtain global information to design more effective risk assessment models and to understand the global transactions of MNEs and their global profit allocation to address BEPS problems with more certainty;
• in this new phase of implementation, it will be relevant for Colombia to maintain its capacity building policy programmes on complex TP issues in order to effectively understand and apply the outcomes of the BEPS project to the country’s own conditions. Additionally it will be important to adopt the toolkits which are currently being designed by the OECD, since they may resolve issues such as difficulties in looking for comparables, lack of global information on the structure and functioning of the MNE group and the treatment of payments that erode the tax base, which is vital to countering BEPS issues;
• to carry out meetings to inform Colombian taxpayers regarding the new rules and procedures that will be implemented in the TP regime.
Summary and conclusions

The future of transfer pricing (TP) depends on flexible legislation, actively supplemented by the decision-making practice of the administrative courts. There is no doubt that the basis of TP is the arm’s length principle. TP is commonly defined as the prices charged between related parties on their mutual transactions. The current flexible legal regulations for TP are sufficient for countering base erosion and profit shifting (BEPS) requirements; there are no fundamental changes that will directly affect the TP mechanism as a result of the new action plan. Changes in legislation will primarily concern the monitoring of transactions between related parties. The substance-over-form principle is a general application of a principle of Czech tax law. The administrative courts consistently look upon the sub-activities of the taxpayer as relatively independent, particularly if each activity can be materially and economically operated separately. TP documentation is not mandatory in the Czech Republic, and currently its mandatory introduction is not expected. However, it is in the interest of the entity to obtain sufficient evidence of the veracity of the transfer prices used.

In the optics of the Czech system it would be speculative to predict the development of domestic TP rules. In any case, the decision-making practice of the state authorities, based on rules formulated or revised in detail, will be in conformity with OECD requirements, as it has been (proportionately) so far, for the simple reason that administrative bodies and courts are accustomed to judging the issue according to international or European directives.

BEPS will most definitely bring new rules during its implementation. But it is not certain that it will change the current wording of the Czech provision of section 23(7) of the Act on Income Tax.

The ability to formulate very precisely the principle of TP rules indicates the readiness of the Czech courts to continue sensibly completing legislation in harmony with the requirements of modern international initiatives for the erosion of tax bases for internationally optimizing business groups.

The future of TP in the Czech Republic depends on whether the continuing belief that existing and, on the whole, traditional, flexible legislation, actively supplemented by the decision-making practice of the administrative courts, meets

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new requirements, or whether there should be an extensive codification of the mat-
ner following the example of certain other states. A substantial amendment and ex-
ansion of the text of existing legislation is more likely. According to Martin 
Jareš from the Czech Ministry of Finance, the Anti-TaxAvoidance Directive 
(ATAD) will require at least a major amendment of the Income Tax Act, in that 
“the main motivation of the BEPS project is the effort to tax profits in the place of 
actual economic activity”.1 Yet even before the BEPS initiative, Czech tax law 
was heading in the same direction. A separate question then is whether, at the same 
time, there will, or should also be, a substantial amendment to the brief but long 
accepted legislation on TP as part of the rules relating to the BEPS initiative.

1. Current TP regulation and practice in the Czech Republic

There is no doubt that the basis of TP in the Czech Republic is the so-called arm’s 
length principle, according to which any business transactions between related 
parties must be carried out as if they were realized by independent entities, i.e. 
under comparable price conditions to transactions between independent entities. 
This is the standard concept of “usual price”. TP2 is commonly defined as the 
prices charged between related parties on their mutual transactions.

1.1. Brief general binding legislation

Czech generally binding legislation is relatively laconic. Almost all written legisla-
tion on transfer pricing is concentrated in section 23(7) of Act No. 586/1992 Coll., 
on income tax. The application of this basic legislation is then substantiated, clar-
ified and supplemented by the decision-making practice of the administrative 
courts.

In the case of a transaction in which one party is a foreign entity, treaties on the 
avoidance of double taxation come into effect, with the OECD model and OECD 
commentary used as interpretative guidance for Czech legislation. However, in the 
view of the courts, OECD documents do not have the nature of legislation in the 
Czech Republic, but are considered as “soft law” (8 Afs 152/2005).

1.1.1. Related parties

Despite the laconic nature of generally binding legislation, and somewhat parado-
xically, related parties are not defined by law in general, but rather on a case-by-case 
basis, with a kind of list, describing specific criteria or even specific cases.

For the purposes of TP regulation, related parties are, pursuant to section 23(7) 
of Act No. 586/1992 Coll., on income tax, specifically:

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1 Central European Tax Forum, Prague, 9 September 2016.
2 Also known in Czech as “transfer prices” which is essentially a translation of the anglicism transferová cena.
“a) parties related by capital, where
   1. one party has a direct share in the capital or voting rights of the other
      party, or one party has a direct share in the capital or voting rights of more
      than one party, and this share is at least 25% of registered capital or 25%
      of voting rights of these parties, all these parties are considered parties
      directly related through capital,
   2. one party has an indirect share in the capital or voting rights of the other
      party, or one party has a direct or indirect share in the capital or voting
      rights of more than one party, and this share is at least 25% of registered
      capital or 25% of voting rights of these parties, all these parties are con-
      sidered parties related through capital,

b) otherwise related parties, namely
   1. where one party participates in the management or control of another party,
   2. where the same persons or next of kin participate in the management or
      control of other parties, these parties are considered otherwise related par-
      ties. Otherwise related parties does not include parties where one party is
      a member of the supervisory boards of both parties,
   3. controlling and controlled parties and parties controlled by the same con-
      trolling party,
   4. close parties,
   5. parties that have established a legal relationship primarily to reduce their
      tax base or increase tax losses.”

Related parties are therefore parties related by capital, parties related on the basis
of a personal element and otherwise unrelated parties between which a relationship
has been established for predominantly purely tax reasons.

According to the cited provision, the share of capital or voting rights in the tax
period or period for which a tax return is filed is calculated as the arithmetic
monthly average.

The law explicitly states that participation in the audit committee or similar
supervisory body and the performance of supervision for remuneration is not con-
considered as participation in the management or control of the given entity.

1.1.2. TP: principle of usual price

TP is understood to mean the prices charged for transactions between two tax-
payers related in an economic or personnel sense, or between entities which the law
views as such.

According to section 23(7) of Act No. 586/1992 Coll., on income tax, it prin-
cipally applies “[i]f the prices agreed between related parties differ from the prices
that would have been agreed between unrelated parties in normal business relations
under the same or similar conditions, and this difference is not satisfactorily justi-
fied, the tax base of the taxpayer shall be adjusted by the established difference.”

This tax adjustment will be carried out in accordance with the tax procedural
standard, Act No. 280/2009 Coll., the Tax Code, generally on the review of evid-
ence in the context of a tax audit. The taxpayer is thus informed of the difference
together with the audit findings, on which it may comment and put forward evi-
dence to substantiate that the transfer price was set correctly.
In the same provision, the Act states that “if the price that would have been
agreed between unrelated parties in normal business relations under the same or
similar conditions cannot be determined, then the price determined according to
legislation governing the valuation of assets shall be applied”. The price estab-
lished under special legislation is understood as the usual price pursuant to Act No.
151/1997 Coll., on the valuation of assets, i.e. as a rule the price determined by an
expert or the tax office itself.

The usual price is the price that would be obtained by selling the same or a sim-
ilar asset or by providing the same or a similar service in normal business relations
in the country on the valuation date. At the same time, all circumstances which
may affect the price are considered, though the amount does not reflect exceptional
market circumstances, the seller or buyer’s personal circumstances or the impact of
specific popularity.

The Act also stipulates that this review of TP does not apply:

“in case of the conclusion of a loan agreement (newly also precarium and bor-
rowing agreements) and in cases where the agreed amount of interest on a finan-
cial credit instrument between related parties is lower than the price that would
be agreed between unrelated parties, and the lender is a tax non-resident or
member of a business corporation that is a tax resident of the Czech Republic
or personal income taxpayer.”

1.2. More detailed implementing administrative guidelines

Administrative guidelines (i.e. D³ and GFD⁴ guidelines) are de jure intended for
tax authorities (offices). Tax administrators will find the necessary detailed rules of
These administrative guidelines are not legally binding for taxpayers and have the
nature of hierarchical guidelines by the senior authority addressed to the tax office
on how to proceed; however, they constitute the legitimate expectation of the tax-
payer that the tax office will be governed thereby. They are therefore binding for
tax offices and the taxpayer is entitled to call on the tax office to proceed in accord-
ance with them.

1.2.1. GFD guideline no. D-6 on a consistent approach to the
application of certain provisions of Act No. 586/1992 Coll., on
income tax, as amended

This guideline explicitly states that “for the purposes of assessing whether the
prices agreed between related parties in accordance with section 23(7) of the Act,
the tax office shall proceed, among other things, according to the principles enshrined
in OECD TP guidelines for multinational enterprises and tax administrations, in
particular the arm’s length principle”.⁵

³ Tax guidelines issued by the Ministry of Finance of the Czech Republic.
⁴ General Financial Directorate Guidelines.
⁵ Identically to the earlier guideline D-300.
According to the guideline, the arm’s length principle may “also be applied in the Czech Republic for a comparison of the conditions agreed or imposed between related parties and the conditions that would otherwise be agreed between independent enterprises”.

The guideline takes into account the laconic nature of generally binding legislation and states that “in addition to the aforementioned OECD Guidelines, relevant procedures are also detailed in separate Ministry of Finance and General Financial Directorate guidelines”.

1.2.2. Guideline D-332 Communication by the Ministry of Finance in respect of the application of international standards in the taxation of transactions between associated enterprises – TP

The guideline informs tax offices that TP (usual price) can be considered a “price” applied to transactions between two taxpayers related in an economic or personnel sense, or in the terminology of treaties on the avoidance of double taxation, the term “associated enterprises” is used. These prices must be set in the same manner as would be applied by entities that were not related in an economic or personnel sense (independent enterprises). Prices determined in such a way are prices determined on the basis of the arm’s length principle.

The guideline thus leads the tax administrator to proceed in accordance with the OECD TP guidelines when deciding whether parties are related and whether the transfer price was correctly determined. The OECD guidelines have therefore effectively entered Czech law, although they formally remained legally non-binding for Czech entities. This situation is not new and the real integration of OECD TP guidelines fundamentally spans the period from before BEPS. Realistically, the Czech tax administration cannot go against OECD principles in its interpretation in relation to the taxpayer; in the same way, it will be difficult for the taxpayer to seek a more favourable assessment than that indicated by OECD guidelines.

Other administrative guidelines govern the procedure for the issue of a binding ruling on the manner in which the price was agreed between related parties at the request of the taxpayer, before the price is called into doubt by the tax administrator, or the extent of documentation that can be used as evidence of the correctness of the set relationship between entities.

In practice, both tax offices and taxpayers are governed by the cited guidelines. However, the taxpayer need not be so, without having to challenge the legality of the guideline. The guideline is not legally binding for the taxpayer and it has a primarily informative value on how the tax office will proceed.

1.3. General compliance of domestic rules with OECD requirements

Examining whether transfer prices are determined in accordance with the arm’s length principle is principally carried out by a comparison with how the same (comparable) transaction would be concluded and implemented by independent entities. If differences affecting the price of goods, services or the provision of rights are found, which often happens in practice, section 23(7) of the Income Tax Act allows a taxpayer to “satisfactorily justify” the difference.
The Czech arm’s length principle is in essence identical in content with the arm’s length principle defined by the OECD and UN. It is commonly stated that “in case of the application of the arm’s length principle in the sense of Article 9 of the OECD Model, the most difficult problem in determining the tax base is the determination of the price for the transfer of goods, intangible assets and services between associated enterprises for tax purposes”.

TP is to be determined in the same way as would have been followed by entities that were not related in an economic or personnel sense. It is understood that the arm’s length principle is essentially defined identically to OECD guidelines in section 23(7) of the Income Tax Act itself, where this provision:

(a) governs and stipulates the conditions for the use of the “usual” price for the purposes of determining the income tax base; and at the same time
(b) defines related parties.

Legislation governing the obligation of arm’s length fully applies to tax residents of the Czech Republic and their mutual relations, even in cases where the parties have “established a legal relationship primarily for the purpose of reducing their tax base or increasing tax losses”. In contrast, in cases with a cross-border or foreign element in the reviewed legal relationship, it is always important to examine whether the application of the rules to foreign parties collides with international or European law for the avoidance of double taxation. The international treaties by which the Czech Republic is bound, as well as directly effective European law, will apply preferentially in the event of a collision with domestic rules (article 10 and 10a of the Constitution of the Czech Republic).

1.4. Binding ruling on the correctness of TP

In the interest of legal certainty, the taxpayer may, since 1 January 2006, request the tax administrator for a binding ruling on the manner and correctness of determined TP in transactions with related parties or who may be considered as such. Generally binding legislation is contained in the Income Tax Act as regards the taxpayer’s right to the opinion of the tax administrator, and in the Tax Code as regards the procedural aspects of issuing a binding ruling and the right to its review, if the taxpayer does not agree with result of the ruling. The objective of introducing the mechanism of a binding ruling was to achieve the international OECD standard. The mechanism is of relatively limited importance: in seven years, 121 requests for a binding ruling were submitted, with a subsequent decline.

According to Guideline D-333, the mechanism of a binding ruling has incorporated advance pricing agreements (APAs) into Czech tax law.

The guideline explicitly refers to OECD TP guidelines and stipulates that the binding ruling adopts the principles of APAs in the sense of OECD guidelines (paragraph 4.124–4.166) and other international standards. The stated objective of

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6 Constitutional Act No. 1/1993, the Constitution of the Czech Republic, as amended.
8 S. 23(7) and s. 38nc of the Income Tax Act; ss. 132 and 133 of Act No. 280/2009 Coll., the Tax Code.
9 Guideline D-333 Communication by the Ministry of Finance in respect of the binding ruling on the manner in which a price was agreed between related parties.
the binding ruling is to allow taxpayers to verify in advance whether the method of pricing agreed between related parties (associated enterprises) complies, for the purposes of determining their tax base, with the arm’s length principle as contained in article 9, associated enterprises – treaties on the avoidance of double taxation and section 23(7) of the Czech Income Tax Act. At the request of the taxpayer, the tax administrator will decide whether the taxpayer has chosen a pricing method that leads to the proper allocation of income and expenses between related parties. If, during the period for which a binding ruling was issued, the taxpayer meets all the conditions on the basis of which the tax administrator decided, and the circumstances affecting the manner of pricing do not fundamentally change, the tax administrator will consider the price to be the usual price when examining evidence for the determination of tax in a tax audit or other procedure. The decision on a binding ruling is issued either for a fixed period or for an indefinite period, not exceeding three years, and is binding for the tax administrator. The decision is not binding for the party that submitted the request.

1.5. Other rules directly affecting TP

The Czech Republic only acceded to the Convention on the Elimination of Double Taxation in Connection with the Adjustment of Profits of Associated Enterprises (Arbitration Convention) with effect from 1 October 2006. Its impact on tax practice is limited.

In terms of TP, important rules include thin capitalization, under which some of the interest paid by undercapitalized entities is not recognized as a tax deduction;\(^\text{10}\) special adjustment of the tax base of permanent establishments, according to which the proportion of profit or loss to expenses or gross revenues for comparable taxpayers or activities may be used for tax assessment;\(^\text{11}\) a stricter tax regime for recipients of investment incentives, including entities provided with the promise of investment incentives; this regime includes rules on TP (“the taxpayer shall not increase the base for calculating tax relief through business transactions with the parties referred to in section 23(7) in a manner inconsistent with the economic principles of normal business relations, or by transferring assets or part thereof to the above parties, which will result in a reduction of their tax base or an increase of their tax loss”);\(^\text{12}\) and last but not least, incorrectly set transfer prices may be considered a violation of the duty of due care (due diligence) by the taxpayer’s statutory body, regardless of whether the member of the statutory body is a partner or shareholder, even where the member of the statutory body is the taxpayer’s sole partner or sole shareholder.\(^\text{13}\)

In corporate law, it traditionally applies that if there is no control agreement, the controlling party cannot use its influence to enforce the adoption of any measures or the conclusion of an agreement under which the controlled party may incur a material loss, unless it reimburses the party for such a loss by the end of the

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\(^{10}\) S. 22(1)(g), point 3 and s. 25(1)(w) of the Income Tax Act.

\(^{11}\) S. 23(11) of the Income Tax Act.


accounting period in which the loss occurred, or an agreement is concluded at the same time on how and in what reasonable time the controlling party shall reimburse such a loss.\textsuperscript{14} The administrative courts also use corporate law when considering the tax aspects of contracts between related parties.

1.6. Supplementation of the law by the administrative courts

Given the brevity of legislation under section 23(7) of the Income Tax Act and the non-binding legal nature of administrative guidelines, Czech administrative case law significantly supplements the rules on TP.

1.6.1. Three conditions for additional taxation

It was determined (1 Afs 60/2006)\textsuperscript{15} that the tax administrator may impose additional tax on the taxpayer on the basis of a different assessment of TP only if the following three conditions are cumulatively met:

(a) The existence of a contractual relationship must be proven between parties related in an economic or personnel sense or otherwise related. The existence of a contractual relationship between related parties follows from the logic of the case and in practice, this criterion does not pose difficulties.

(b) The prices agreed between the parties must be different from the prices that would have been agreed between independent parties in normal business relations under the same or similar conditions:

"The usual price is to be understood as the normal price on an undeformed services market, i.e. the price offered to other consumers – a price unburdened by its earlier increase in the chain of companies, or other expedient conduct by the taxpayer’s suppliers. This will not be altered by the fact that additional tax is not imposed on another end-customer of the taxpayer’s supplier" (7 Afs 47/2013).

(c) The difference between these prices was not satisfactorily justified by the taxpayer.

In determining the correct amount of the transfer price, the tax administrator has an obligation to give the taxpayer a real opportunity to comment on the difference and justify the reason for the difference.

It must be clearly evident that the tax administrator informed the taxpayer of the price it determined during tax proceedings, or the price it considered as the price that would have been agreed between independent parties in normal business relations under the same or similar conditions, that it demonstrably informed the taxpayer of the resulting difference and thus gave the taxpayer a real opportunity to comment on the difference and justify the reason for it. Only then is the tax administrator entitled to assess whether the taxpayer has met the burden of proof and conclude whether or not it has adequately justified the difference, and whether there are grounds for the adjustment of its tax base in the sense of section 23(7) of the Income Tax Act.

\textsuperscript{14} Identically stipulated under repealed s. 66a(8) of Act No. 513/1991 Coll., the Commercial Code.

\textsuperscript{15} Cf. 9 Afs 87/2012.
Income Tax Act. The taxpayer must be given the time and opportunity to satisfactorily explain the difference found between prices. It is up to the taxpayer to show economically rational reasons (or special market conditions) for why the price agreed with the related party differed from the reference price. If the taxpayer does so, an adjustment of its tax base is not an option (cf. 5 Afs 48/2004 and 8 Afs 80/2007, 7 Afs 74/2010).

The tax administrator, on the other hand, does not have to prove the taxpayer’s “guilt” (cf. 9 Afs 92/2013-27, 7 Afs 48/2013-31).

The reference (usual) price is the simulated price created by considering what price would be agreed in a situation identical with that of the related parties, if such parties were not related and had conducted the transaction as part of their normal business relations (1 Afs 101/2012). If, in the context of a tax audit, the tax administrator has doubts that the prices at which the entity sold its products to related parties correspond to the usual price, it is unacceptable for the tax administrator to only inform the taxpayer of the usual price (in its opinion). In such a case, the tax administrator must give the taxpayer the opportunity to comment on the indicated price, and the taxpayer can justify (give satisfactory reasons) why the price considered as the usual price by the tax administrator (7 Afs 86/2013) was not used in the given case.

“If there is no legal standard stipulating the mechanism for determining the usual price, which is then determined by an administrative authority, it is necessary to approach the determination of the usual price with special care and to determine the amount on the basis of objective criteria, so that the conclusions of the administrative authority lead to a reliable opinion and the method of its determination and actual amount can be reviewed ... The Supreme Administrative Court does not intervene in the selection of criteria or determine which criteria the administrative authority should consider to determine the usual price, and it leaves the selection of criteria to the administrative authority, whilst repeating that these criteria must lead to a reliable and objective conclusion” [8 Afs 80/2007].

The price observing the arm’s length principle is determined by the range of most frequently realized prices by independent entities, where the tax administrator is obliged to accept any value within this interval. The tax administrator will assess the taxpayer’s tax liability based on the difference between the agreed price and the nearest range boundary (i.e. at the best value for the taxpayer)(8 Afs 80/2007, 8 Afs 51/2009).

1.6.2. Allocating the burden of proof

If the tax administrator performs a tax audit of the taxpayer and intends to contest the transfer price, it is up to the tax administrator to prove that a business relationship exists between related parties at prices that differed from the prices that would be agreed between independent parties. If the tax administrator does so, the burden of proof passes to the taxpayer, which is then required to satisfactorily justify the difference in prices agreed between related parties and prices between independent parties.

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If the taxpayer has filed a supplementary tax return, in which it reduced its tax base on the grounds that the previous tax return was based on incorrect information, it should bear the burden of proof as standard for the taxpayer’s supplementary tax return, including the obligation to prove the alleged transfer price (1 Afs 99/2012).

The court applied a different concept in the case of tax relief claimed by the taxpayer in respect of investment incentives. Compliance with market prices in transactions with related parties is a condition for the disbursement of incentives for such a taxpayer, mostly in the form of tax relief. Allocating the burden of proof in the case of investment incentives is then stricter for the taxpayer and puts it in a disadvantageous position. The taxpayer principally bears the primary burden of proof itself:

“At the moment the taxpayer applies the given tax relief, it implicitly claims that it did not increase the base for the calculation of tax relief through business transactions with the parties referred to in section 23(7) in a manner inconsistent with the economic principles of normal business relations (7 Afs 94/2012) during the relevant tax period.”

If the tax administrator proves that the recipient of investment incentives or promise of investment incentives conducted transactions with related parties, which – rationally reviewed – do not comply with the requirements of the arm’s length principle, it is up to the taxpayer to demonstrate that such transactions were not conducted and thus bears the burden of proof (7 Afs 94/2012).

An entity manufacturing and subsequently distributing complete shop fixtures and fittings, especially rack systems, supplied products to both related parties in the sense of section 23(7) of the Income Tax Act, as well as independent parties. The tax administrator proceeded on the basis of the fact that the selling price for the products supplied to a retail chain was very low and did not even cover incurred production costs. This activity thus only produced negative sales margins. The tax administrator understood that the plaintiff did not decide the selling prices to the retail chain, and that the selling prices of basic products were set centrally for the entire multinational group. High sales margins were then achieved on the supply of special products (entry systems, automatic reading devices and equipment for pharmacies) and services supplied to foreign associated enterprises, so that ultimately the entire multinational group achieved a high economic profit. According to the tax administrator, the taxpayer did not receive corresponding compensation from the multinational group, although it only achieved loss margins and lost earnings on production and the sale of products at the parent company’s instruction. Yet an independent enterprise would only perform such a service if it was adequately compensated for this service. This loss should have been compensated by payment for the service, in the same amount an independent enterprise would have received on the basis of the arm’s length principle.

The tax administrator proceeded on the basis of the legal opinion that a group operates on the principle that a company should not be forced to conduct transactions that are to its disadvantage. If the controlling party (typically the parent) uses its influence to push through a transaction, from which the company incurs a material loss, the controlling party must compensate the company for this loss by the
end of the accounting period, or at least, by the end of the same period, conclude an agreement with the company on the time and way in which it will compensate such a loss. Given that in this case the entity failed to show how the loss incurred when setting the selling prices between the entity and retail chain was compensated by the parent company, or explain why it did not show adequate compensation in its revenues for this service to the multinational group, the financial authority decided to determine the usual price and increased the tax base by the measured difference. However, in reference to previous practice, the court pointed out that although the principle generally applies that it is the taxpayer who bears the burden of persuasion in relation to its tax obligations and the burden of proof in relation to its claims in tax proceedings, in some cases the general rule regarding the burden of proof does not apply and the burden of proof and burden of proof are, on the contrary, borne by the tax administrator. This is also the case on the application of section 23(7) of the Income Tax Act. It was therefore up to the tax administrator to prove that the selling prices relating to transactions with the retail chain, from which negative sales margins were achieved, had not been set by the entity (and therefore it had no chance to influence the amount), but that these selling prices were agreed centrally by the parent company for the entire multinational group. It was then up to the tax administrator to prove that the parent company had not imposed conditions on the plaintiff that differed from those that would have been imposed between independent enterprises, resulting in a loss of profits for the plaintiff that would otherwise have achieved without these conditions, but which were not achieved due to these conditions. With respect to the conclusions of the financial authorities that the selling prices relating to transactions with the retail chain were agreed and determined centrally by the parent company and thus imposed on the entity, which had to respect these prices and had no possibility of influencing the amount, the administrative court found that the tax administrator had not borne the burden of proof (30 Af 124/2013, 67).\textsuperscript{16}

Likewise, another regional court agreed with the entity’s view that the tax administrator expressed a new legal qualification in appeal proceedings, which relied on an assessment of evidence in a different manner from that of the tax administrator during the tax audit. This meant the entity could not respond to the newly pronounced legal conclusion until the action was filed. However, the entity should have been informed of the different legal assessment so that it could raise arguments in response to the new legal conclusions and, if necessary, submit new evidence (31Af 80/2014, 55). This view, however, does not appear to be constant (contra: 5Af 54/2011, 54–69).

Although there are relatively significant differences in assessment between these individual cases in recent case law, they are not linked to a different interpretation of substantive law, but are usually the result of a different assessment of the allocation of the burden of proof between the taxpayer and tax administrator regarding the correct determination of transfer prices.

Laconic Czech legislation is continually supplemented and further elaborated by court decisions; it is developing logically and consistently on the whole and, at the level of the principle of TP, has not changed substantially as a result of BEPS.

\textsuperscript{16} The Regional Court ruled with reference to the decision-making practice of the Supreme Administrative Court (5 Afs 29/2003, 85, 1 Afs 101/2012, 31 and 7 Afs 74/2010, 81).
2. The impact of the BEPS project on TP

During the state where the current flexible legal regulations for TPsatisfied the BEPS requirements, there were no fundamental changes that would directly affect the TP mechanism as a result of the new action plan. Mandatory procurement of the documentation has yet to be introduced and remains at the discretion of taxpayers. In the opinion of the Ministry of Finance the OECD guidelines on TP in the Czech Republic are applied directly to the administrative practice of the tax administration by means of the general provision on transfer prices between related parties contained in section 23(7) of the Act on Income Tax. Substantial changes to Czech legislation on the exchange of information with foreign countries have partly taken place and are partly ongoing, i.e. will continue to take place (minutes of the 24th meeting of the Committee for EU Affairs, 1 March 2016, the Senate of the Parliament of the CR). Regarding country-by-country reporting, the Czech Republic signed the Multilateral Competent Authorities Agreement on 27 January 2016. BEPS primarily elicited one fundamental change: the obligation to report the transactions of related parties.

2.1. Reporting requirements of related parties

A significant change was at the level of the reporting requirement of subjects making transactions between related parties. Since 2014 an annex has been introduced to the tax return for the tax on corporate income entitled the overview of transactions with related parties, intended for subjects with a higher turnover or number of employees, which aids in the effective selection of subjects for tax inspection. This annex is based on the discussions which took place within the framework of preparation for the BEPS Action Plan.

The annex is completed for each related party (section 23(7)(a) and (b) of the Act), especially if a transaction was made with a related party during the tax period or during the period for which the tax return is submitted.

The overview of transactions with related parties is completed by taxpayers that meet at least one of the following criteria:
(a) total assets of more than CZK 40 million; or
(b) an annual net turnover of more than CZK 80 million; or
(c) an average number of employees greater than 50:

assuming that:
• a transaction was made with a related party based abroad. The annex is completed only in relation to these foreign related parties; or
• a tax loss was reported on line 200, and also a transaction was made with a related party, that being foreign and/or domestic. The annex is completed in relation to all related parties; or
• the taxpayer is the beneficiary of investment incentives in the form of tax relief in accordance with Act No. 72/2000 Coll., on Investment Incentives, as amended, and also made a transaction with a related party, that being foreign and/or domestic. The annex is completed in relation to all related parties.

Source: www.mfcr.cz.
The requirement to complete the annex does not apply to the permanent establishments of non-resident taxpayers. All transactions with a related party are stated in the annex.

On each row of the table it is mandatory to indicate:

- the total volume of transactions of the type concerned as they are shown in the accounts, depending on whether they concern a purchase or a sale from the tax subject;
- the total amount of proceeds from the sale of intangible fixed assets which affected profit, also indicating the sum of the amounts of the acquisition costs of intangible fixed assets purchased from the related party;
- the amount of the technical evaluation from the related party carried out on assets that have been put into use;
- the total amount of proceeds from the sale of tangible fixed assets, the amounts of the acquisition costs of tangible fixed assets, which affected profits regarding transactions with a related party;
- the total amounts of the acquisition costs and the amounts of proceeds from the sale of stocks of material, products and goods as well as services, which affected profit;
- the total amounts of revenues from granted licence rights, as well as the costs for received licence rights, which affected profit;
- the total amounts of interest income and expense from received debt financial instruments, which affected profit;
- the total amounts of all revenues and expenses, which are not indicated in the other rows of this annex and affected financial results, are indicated in relation to the related party;
- the sum of debt financial instruments received or provided, from which interest was received in the tax period (also state those debt financial instruments for which the arranged annual interest was not positive);
- the amount received from profit-sharing;
- the amount representing an increase or decrease in other components of equity;
- whether the transaction received from or provided to the related party was free of charge (advertising and promotional items are not considered to be free of charge);
- whether the taxpayer uses cash-pooling.

As can be seen from this list, the annex provides a detailed overview of transactions between related parties. Failure to complete it is penalized.

The requirement to report a transaction is very broad; essentially it concerns all transactions between related parties. It relates to goods, services, all tangible and intangible assets, and basically every conceivable transaction. No specific legislation has been adopted for fixed assets or particularly risky operations.

2.2. The relative absence of other changes to the legislation

Changes in legislation primarily concern the monitoring of transactions between related parties. However, as indicated above, they essentially involve an attempt to monitor any (all) business operations. Therefore no specific definitions for intangible assets, or other values have so far been adopted, nor, in this context, has the
need been met for a precise definition in the decision-making practice of administrative bodies and courts.

The substance-over-form principle is a general application of the principle of Czech tax law, generally valid for a tax assessment of any transactions. The principle is laid down by the provisions of section 8(3) of Act No. 280/2009 Coll., the Tax Code, according to which tax administration stems from the actual content of a legal proceeding or other facts relevant to tax administration. This provision allows tax administrations to make an assessment according to the actual content of any legal relationship or its form. The tax administrator, in contrast, bears the burden of proof for the actual content of the negotiations presented.

In this context, a special category of expert opinion is drawn up by an expert registered on a special list or by a state authority authorized to do so.

If the extra tax was set by the tax authorities on the basis of an expert opinion, which does not clearly indicate from which sources the expert gathered information, according to what aspects these resources were chosen and how accurately the scope was determined for the basis of the expert’s estimation, if it lacked the data for comparable companies and the brief content and lack of attachments, which would describe the specified criteria, testified to its incompleteness, then the report might not be conclusive proof (8 Afs 51/2009). If the tax administrator has two equal expert opinions to the same question with differing conclusions, it is not entitled to consider on its own without another’s help which of them is to be relied on and which is not. On the contrary, it is obliged to remove their mutual contradictions and inconsistencies, that being done primarily by examining the expert or experts. If these testimonies do not lead to elucidating the uncertainties that emerged, it would be appropriate to proceed to a further expert investigation or an expert assessment audit (7 Afs 50/2010). If the tax administrator did not refuse the expert opinion submitted, but assessed it in the course of the fiscal proceedings, criticized its errors, disagreed with the expert on the usual price levels while accepting them by its work when setting the usual prices, then it acted illegally (7 Afs 86/2013).

Although the Czech legal order has not yet seen significant changes in relation to the BEPS, in relation to foreign legal systems, it is appropriate to make some approximations.

2.2.1. Synergies

The administrative courts consistently look upon the sub-activities of the taxpayer as relatively independent, particularly if each activity could be materially and economically operated separately. It is possible to look upon the sub-activities of the taxpayer as a whole only if the subject has shown that the separate parts of its activities are in fact so strongly economically connected together (specifically by synergistic effects, economies of scale, using a good reputation in the market, linking trade relations) that the taxpayer from the economic point of view “could not work” without this connection. If the tax administrator demonstrates that the taxpayer could concentrate solely on any combination of two of the three activities listed, it is clear that TP and surcharges must be assessed separately for each sub-activity (Afs 94 7/2012).
2.2.2. Risk capital

According to section 25(1)(w) of the Income Tax Act, the deduction of financial expenses (which, for the purposes of this Act, means interest from debt financial instruments and related expenses (costs), including expenses (costs) for procurement, processing loans and guarantee fees if the lender is a related party to the debtor) is denied to the amount by which the total debt financial instruments from related parties during the taxable period or the period for which the tax return is filed exceeds six times the equity, if the recipient of the debt financial instruments is a bank or insurance company, or four times the equity for other recipients of debt financial instruments. If a condition for the creditor providing the debtor with the debt financial instrument is the provision of a directly related loan, lease or deposit to the lender by a related party to the debtor, it shall be considered, for the purposes of this provision and given this debt financial instrument, that the creditor is a related party in a relationship with the debtor.

Put simply, interest deduction between related parties is restricted. The amount of interest that can be deducted from the tax base is limited to four times the amount of equity, in the case of banks and insurance companies six times their equity.

2.2.3. Cross-border commodity transactions

When comparing analyses, it is necessary to take into account the characteristics of tangible assets and goods, to assess their quality, the volume of supply in the market, market availability and reliability.

2.2.4. Intra-group services

According to the Ministry of Finance changes consisting of modification to the issue of auxiliary and preparatory activities should not in any way be reflected in the text of the domestic Act No. 586/1992 Coll., on Income Taxes, as this Act does not operate in any way with the concept of auxiliary and preparatory activities.

2.2.5. TP documentation

TP documentation is not mandatory in the Czech Republic, and currently its mandatory introduction is not expected. However, it is in the interest of an entity to obtain sufficient evidence of the veracity of setting the transfer prices.

Instruction D-334 contains recommendations for the scope of the documentation for creating prices between related parties. It states that every taxpayer should endeavour to determine the transfer prices for tax purposes in accordance with the arm’s length principle, based on information reasonably available at the time of setting those prices. Its duty, in the framework of proving the stated tax, is to sufficiently demonstrate how these prices were reached and whether they would

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18 Instruction D-334 Communication from the Ministry of Finance for the scope of the documentation on the manner of creating prices between related parties.
have been reached if they had been negotiated between two independent companies. It would be in the interest of the tax administration to create the widest range of requirements on taxpayers in order to be able to obtain all the documents that must be ensured within the framework of the taxation procedure. On the other hand, the tax entities endeavour to provide the tax administrators with the most specific and narrowest enumeration of data. The purpose of setting the recommendation for the scope of the documentation is therefore to create a sort of consensus between these two tendencies in order to ensure a sufficient volume of documents for tax administration purposes and ensure that the required amount does not excessively burden the taxpayers. Instruction D-334 then contains recommended documentation corresponding to the OECD standard.

According to the Ministry’s recommendations the documentation should optimally include the following.

2.2.5.1. Information about the group

The information given should include a description of business activities, the ownership and organizational structure of the entire group, the legal status of related parties, information about related parties engaged in business relations including an overview of the financial results of individual related parties, the distribution of functions within the group, risk allocation, an overview of intangible assets (licences, patents, knowhow, etc.), and the flow of fees, an overview of the implemented TP policy, a list of the cost sharing arrangements, and an overview of the concluded APAs (issued mandatory assessments) of the participating companies. It should also include the companies’ commitment that, in the event of such information about the group having insufficient content, it will deliver further evidence, etc., within a reasonable time. If any of the above circumstances is likely to change in the near future, information about the change should also be given together with a reason.

2.2.5.2. Information about the enterprise

This should include a precise description of business activities, the complete ownership and organizational structure, financial results from previous years and corresponding financial indicators, strategies adopted, etc.

2.2.5.3. Information about business relations (transactions)

A precise description should be given of the subject of the business relationship (e.g. a precise description of the goods and services traded), the economic and business conditions, all relevant agreements concluded between the parties concerned, the volume of transactions, the functions and risks associated with this business relationship, and the like. In the case of intangibles (management and marketing services, consulting, etc.) it is necessary to sufficiently describe the characteristics of the services and identify their purpose in detail and the expected benefits arising from them.

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2.2.5.4. Information about other circumstances affecting the business relationship

This should include information concerning the company’s marketing strategy, specific economic conditions in the market, legislative specifics, etc.

2.2.5.5. Information about the TP method

This should give information on how the TP method was used, explaining why this method was chosen, information on comparable business relationships (internal within the group or outside between two comparable independent enterprises), a comparative analysis (pursuant to paragraphs 1.3–3.83 of the OECD guidelines).

2.2.5.6. Information about the documentation

This comprises information about the standards by which the documentation was created.

3. What is the future of TP?

Given the Czech system it would be an uncertain speculation to predict the development of domestic TP rules. In any case, the decision-making practice of state authorities, based on rules formulated or revised in detail, will be in conformity with OECD requirements, as it has been (proportionately) so far, for the simple reason that the administrative bodies and courts are accustomed to judging the issue according to international or European directives. There is no other sector in which after such a long time there would be such intensive and yet conflict-free contact between the Czech legal standards and the guidelines or interpretational rules of an international nature. This is most likely an upshot of the concision of the legislation and the need to quite logically and necessarily reflect the established internationally protected values while applying it.

BEPS will most definitely bring new rules during its implementation. But it is not certain that it will change the current wording of the Czech provision of section 23(7) of the Act on Income Tax.

On 2 August 2016 the Ministry of Finance sent out another draft act amending Act no. 164/2013 Coll., on International Cooperation in Tax Administration for an external consultation process. There is no doubt that this is the result of BEPS; however, the changed rules are not for determining correct TP, but are part of implementing Action 13 of the BEPS project, and Council Directive (EU) 2016/881 dated 25 May 2016 amending Directive 2011/16/EU based on this measure, as concerns the mandatory automatic exchange of information in taxation. This has to be transposed into Czech law by 5 June 2017.

According to judicial decision-making practice the tax administrator can specify the reference price, and as a rule it will do so, by comparing the prices actually obtained for the same or similar commodities between real, existing independent
entities. It can, however, specify this, especially due to the absence or unavailability of data on such prices, solely as a hypothetical estimate based on logical and rational consideration and economic experience. The reference price is essentially a simulation created on the basis of price considerations of what price would be identical with the situation of related persons if such persons agreed upon it but they were not related and had normal trade relations between themselves (1 Afs 99/2012, 52). On the other hand, from the perspective of private law (and in particular the principle of party autonomy) there is nothing preventing an entrepreneur when calculating the price from setting a de facto margin that covers a substantial part of the seller’s losses arising from unsatisfactory performance. Nonetheless – according to the Supreme Administrative Court – at the level of the tax law, this state between two related entities cannot be tolerated. It is precisely section 23(7) of the Income Tax Act that prevents related parties using contractual instruments to distort the results of their operations and thus, in violation of the law, reduce their tax liability. There is no doubt that when calculating the price, it is necessary to use the purchase price, direct and overhead sales costs as well as a reasonable profit margin. Costs can be determined not only according to the facts from the previous period, but also on the basis of a qualified estimate based on the financial plan and other analyses for the given year. The situation where a contribution to cover the seller’s losses is calculated into the price (i.e. using a “cost plus” method) certainly does not correspond to commercial relations between independent persons. With such a calculation the entity has not demonstrated that the prices are determined in accordance with the arm’s length principle (1 Afs 99/2012).

The ability to relatively very precisely formulate the principle of TP rules indicates the readiness of the Czech courts to continue in sensibly completing legislation in harmony with the requirements of modern international initiatives for the erosion of tax bases for internationally optimizing business groups.
Summary and conclusions

The Danish transfer pricing (TP) regulations are generally in line with the OECD TP guidelines. This includes explicit adherence to the arm’s length principle and the comparability factors set out in the OECD guidelines as well as OECD-accepted methods: comparable uncontrolled price (CUP), resale price, cost plus, the transactional net margin method and profit split.

As per 1 August 2016, a number of changes have been made to the Danish tax authority guidelines on TP to account for TP-related BEPS reports. These include implementation of the new OECD guidelines chapter I, section D, as well as OECD reports related to Actions 8–10, and Action 13 including the country-by-country reporting template.

Notably, the updated Danish guidelines state that the scope or meaning of the arm’s length principle as set out in the Danish Tax Assessment Act §2 has not been subject to change according to the update to specific chapters in OECD TP guidelines. Instead, the new Danish guidelines state that the Danish tax authorities consider the OECD updates and subsequent updates to the Danish tax authorities’ domestic TP guidelines a matter of outlining further details and explanations of the arm’s length principle and the way in which it is applied in practical situations. This seems to imply that the new updates to the OECD TP guidelines and domestic Danish guidelines will be applied not only for future tax years but retrospectively as well.

Specifically for intercompany services, the Danish TP rules on services are based on the OECD guidelines and hence are in line with the recommendations set forth in chapter VII of the guidelines.

Moreover, the Danish tax authorities have updated their guidelines to include the new OECD guidelines on low value-adding services. This includes that taxpayers providing intercompany services subject to the list set out in the new chapter VII of the OECD guidelines can apply the simplified cost allocation approach presented as well as the 5 per cent mark-up introduced by the OECD.

Finally, the new Danish guidelines state that some countries may have a cap for the amount of low value-adding services that will be allowed for deduc-
Denmark currently has no explicit limitation on this item, provided that the specific allocations can generally be considered in accordance with the arm’s length principle.

The Danish TP regulation on intangibles is generally in line with the updated OECD TP guidelines. More specifically, the updated Danish TP guidelines have direct references to the updated OECD TP guidelines contained in the BEPS reports, Actions 8–10.

The Danish tax authorities continue to concentrate strongly on transactions with intangibles and have a special project running focusing on avoiding the risk that intangibles that are being transferred are not taxed correctly.

In 2015 Denmark introduced a general anti-abuse rule (GAAR) in relation to treaty benefits (BEPS Action 6). The provision states that treaty benefits will not be granted if:

“it is reasonable to establish, taking into account all relevant facts and circumstances, that obtaining the benefit is one of the most significant purposes of any arrangement or transaction which directly or indirectly leads to the benefit, unless it is established that granting the benefit under such circumstances would be in accordance with the content and purpose of the tax treaty provision in question.”

Also in 2015 a provision aimed at hard-to-value (intangible) assets was introduced. According to the new rules, a binding ruling concerning the transfer of an asset (including intangibles) can be withdrawn by the tax authorities if it can subsequently be ascertained that the value of the asset deviates significantly from the value according to the binding ruling. In this respect, the term “significantly” is defined as a value that deviates by at least 30 per cent and at least DKK 1 million based on either a subsequent sale of the asset or the yield it generates.

On 4 May 2016, a new statutory order on TP documentation was issued in Denmark. This specifies that Danish TP documentation should consist of a master file and a local file, which provides for an assessment of whether the arm’s length principle has been followed in Danish intercompany transactions. The required content of the master file is fully in line with OECD’s new chapter V on TP documentation.

Also, a new Danish regulation on country-by-country reporting has been implemented by Order no. 1133 of 27 August 2016 in accordance with the OECD recommendations. The Danish tax authorities have stated that a country-by-country report will be required to be submitted in a form identical with the OECD recommendations and subject to the same definitions and guidance as applied in the OECD templates set forth in the new chapter V and Order no. 1133 from 27 August 2016.

Denmark has reacted quickly in terms of the implementation of BEPS work. The country-by-country requirements have been implemented by law and the new master file and local file concept has also been implemented by the issuance of a statutory order. Furthermore, the Danish guidelines regarding TP have also been updated to reflect the amended OECD TP guidelines as reflected in the BEPS reports.
TP remains a high focus area for the Danish tax authorities and any subsequent changes to the OECD TP guidelines as a result of the ongoing BEPS work are expected to be implemented in Denmark.

1. Current TP regulation and practice in Denmark

Danish TP regulations are generally in line with the OECD TP guidelines.

As part of the OECD’s BEPS project, the Danish Tax Ministry has explicitly stated that it is supportive of the OECD initiative and will implement the necessary adjustments to current Danish regulations and guidelines to ensure that they reflect the final BEPS reports.

The initiatives so far have focused mainly on revising the current regulation on documentation, in particular implementation of the OECD master file/local file approach and new rules for the country-by-country reporting template.

On the master file/local file, the Danish tax authorities have introduced a new statutory order (No. 401, 28 April 2016), which is in line with the informational requirement put forward by the OECD.

Hence, it includes a requirement for taxpayers to present a master file containing an overview of the multinational (MNE) group, the nature of its business and a general introduction to its TP policy, including intangibles and intercompany financial arrangements.

Similarly, the local file(s) requirements include a detailed overview of the specific intercompany transactions that the local Danish taxpayer takes part in, its functional profile, as well as choice of TP method as part of the comparability analysis set forth in OECD guidelines chapter III. Ultimately, the Danish local file should provide the documentation for why the material TP is considered in accordance with the arm’s length principle.

It should be noted that with regard to the local file, the Danish regulation entails an addition not included in the OECD’s local file structure. Specifically, the new Danish order entails the right for the tax authorities to require taxpayers to provide potential benchmark studies used in the determination of prices/margins on their controlled transactions.

The Danish regulation introduced on country-by-country reporting through Order no. 1133 of 27 August 2016 is also in line with the OECD template.

Specifically, the country-by-country report should include information on the same economic variables as listed in the OECD report. Further, a list of the local Danish entities must be included in the report as well as information on the business activities that each entity performs. Finally, the report should entail a brief description of the sources of data used in preparing the template in line with the OECD’s requirements.

Notably, while the master file/local file should only be submitted upon request from the tax authorities, the country-by-country report must be submitted within 12 months after the end of the tax year subject to the report.

In terms of the Danish tax authorities’ guidelines on TP, recent updates have been produced as well. Specifically, the latest version of 1 August 2016 comprises
the main updates to OECD guidelines with respect to Actions 8–10 of the final BEPS report, Aligning transfer pricing outcomes with value creation”. This includes the updates regarding low value-adding services and the functional analysis and TP methods for intangibles set out in the report.

With regard to fines, the Danish regulation continues to state that taxpayers failing to provide adequate documentation in order for the tax authorities to determine whether the TP applied meets the arm’s length standard can be subject to a fine of DKK 250,000 per entity per income year.

Moreover, a fine of 10 per cent of potential income adjustments can be imposed on the Danish taxpayer.

2. The impact of the BEPS project on TP

2.1. Introduction

As stated above, the main effect of the BEPS project on TP in Denmark relates to the introduction of new regulation on TP documentation and country-by-country reporting.

However, while no changes have been made to the formal wording of the Danish law governing the material TP in Denmark (Danish Tax Assessment Act §2) the Danish tax authorities have updated their TP guidelines to include the main recommendations set forth as a result of Actions 8–10 in the final BEPS reports. The most significant updates relate to:

• new guidelines for low value-adding services, including implementation of the 5 per cent mark-up introduced by the OECD (see section 2.4.2 below);
• integration of the TP revisions made to chapter VI on intangibles, including acceptance of the DEMPE-based functional analysis as well as general acceptance of the valuation methods for intangibles introduced by OECD.

2.2. Challenges of transactions with intangibles

2.2.1. Definition of intangibles

There is no specific definition of intangibles in Danish tax law. Consequently, it is not possible to provide a precise and clear definition of intangibles.

For general Danish tax purposes, an intangible is in academia seen as described simply as an asset that is neither physical nor financial.\(^1\) This definition seems to be very close to the current definition of intangibles in the updated OECD TP guidelines paragraph 6.6:

“The word ‘intangible’ is intended to address something which is not a physical asset or a financial asset, which is capable of being owned or controlled for commercial activities, and whose use or transfer would be compensated

\(^1\) See Steen Askholt, \textit{Lærebog om indkomstskat}, 1st edn, p. 603.
had it occurred in a transaction between independent parties in comparable circumstances.”

However, as the two definitions are not fully identical it cannot be ruled out that intangibles covered by the TP definition are not covered by the Danish tax definition.²

The most common examples of intangibles are listed in section 40 in the Danish Act on Amortization and Depreciation (afskrivningsloven) which forms the basis for depreciation of acquisition costs for tax purposes, such as goodwill, knowhow, patents, trademarks and patterns, rights connected to literature and art, together with other rights.

The definition of intangibles for tax purposes is, as a rule of thumb, similar to the definition in the civil intangibles law so that the civil law is the yardstick for determining an intellectual right for tax purposes together with case law as this has evolved over the years.

One particular example is the definition of goodwill which for Danish tax purposes has been defined since 1939 as the value of customers, business relations, etc.,³ and this definition has more or less remained unchanged since then. For many other purposes, goodwill is often defined as the residual after all other assets have been valued on an individual basis (e.g. in a purchase price allocation for accounting purposes). For Danish tax purposes, goodwill is the value of a business’s customers, and is not defined as a residual. Having said that, the valuation guidelines often look at the value as including a residual value.⁴

The above definitions are mostly relevant in relation to depreciation and Danish capital gains taxation in relation to the transfer of intangibles. However, the definitions have less relevance when it comes to the definition of the use of intangibles for TP purposes.

As mentioned above, Denmark does not have very detailed TP legislation when it comes to defining intangibles. However, as Denmark uses a dynamic interpretation of the arm’s length principle as it is defined in the OECD TP guidelines,⁵ any guidance here can be used as guidance for Danish TP purposes. The OECD TP guidelines are referred to in the biannual publication of the Danish tax authorities’ guidelines (Juridisk vejledning).

In the latest version of the Danish guidelines (version 2.6 as of 1 August 2016), it is stated that the changes to the OECD TP guidelines included in the BEPS report on aligning TP outcomes with value creation, Actions 8–10 are now also included in the Danish guidelines.

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² See TIS 2006.780 where the Danish National Tax Tribunal stated that group synergies could not form the basis of depreciation for tax purposes.
³ Act no. 458 of 22 December 1939; see also Ole Bjørn in “Nyere skatteretlig praksis omkring goodwill” (FSRs årsskrift 1990 – skatteret).
⁴ E.g. TS circular 2000.9 and 10.
⁵ According to the general comments to Act no. 432 of 26 June 1998 which incorporated the arm’s length principle in Danish law.
2.2.2. Transactions with intangibles

As mentioned above, Denmark’s interpretation of the arm’s length principle is generally in line with the OECD TP guidelines, and the Danish guidelines reflect the updates of the OECD TP guidelines as a result of BEPS, including the new six-step approach to intangibles. Consequently, Denmark will seek to identify transactions involving intangibles in line with the OECD TP guidelines.

Apart from the above, there are no specific rules for the recognition of transactions with intangibles for TP purposes. For capital gains tax purposes there is, as mentioned above, specific legislation for recognizing intangibles. Consequently, in order for Denmark to levy capital gains taxation on the transfer of an intangible, the specific intangible needs to be identified and qualified in accordance with the specific capital gains taxation legislation. This can be a challenge where an intangible is identified according to the OECD TP guidelines, but not recognized for capital gains purposes, and the particular intangible is used or deemed to be transferred. This potential conflict is the focus in some cases, but has so far not been brought before the Danish courts.

During recent years, Denmark has made the assessments shown in Table 1 relating to TP.

The Danish tax authorities state that the reason for the drop in the adjustment amount in 2015 compared to prior years is the several cases concerning transfers of intangibles were concluded in the period 2012–2014. Furthermore, they state that cases concerning the transfer of intangibles accounted for 40–70 per cent of the amounts in the period 2012–2014, whereas the same amount in 2015 only accounted for 18 per cent.6

Some of the cases that have been mentioned in the Danish media relate to acquisitions of Danish IT companies where intangibles owned by a Danish company were subsequently transferred abroad at a value that the Danish tax authorities disagreed with. The numbers published by the Danish tax authorities are from the original assessments, and subsequent changes thereto either from a mutual agreement procedure or from the courts are not included. The numbers can therefore not necessarily describe the tax authorities’ success in this area.

In their “activity plan”7 for 2016, the Danish tax authorities focus specifically on avoiding the risk that intangibles that are being transferred are not taxed correctly. This is a project running from 1 April 2013 to 31 December 2016. Consequently, the drop in the adjustment amount from the Danish tax authorities cannot be taken as a decrease in focus in the area of intangibles. According to the activity plan for 2016, the Danish tax authorities also have a project aimed at

<table>
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<td>Number of cases</td>
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<td>Adjustments DKK (million)</td>
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6 From the annual TP report to the Danish Parliament (Skatteudvalget 2015–16, Alm del bilag 186).
7 The Danish tax authorities publish an activity plan for each year.
BEPS-related issues – i.e. an analysis of situations where MNEs are avoiding taxes through cross-border transactions.

The Danish tax authorities have issued a valuation guideline with the purpose of providing guidance on transactions between related parties in relation to transfers of shares, businesses and intangibles. The valuation guideline is frequently used by the Danish tax authorities in TP audits, etc. The valuation methods used in relation to intangibles are the income methods (typically discounted cash flow) and market methods (multiple analysis).

The latest version of the Danish guidelines (version 2.6 as of 1 August 2016) includes references to the updated OECD TP guidelines based on BEPS Actions 8–10. However, the Danish guidelines state that the Danish valuation guideline is more specific in terms of recommendations as to valuation, but the Danish tax authorities find that the Danish valuation guideline is still in accordance with the updated OECD TP guidelines.

2.2.3. “Substance-over-form” approach towards intangibles

It has been debated for many years whether a substance-over-form doctrine exists in Denmark, and how to be more precise about how such a doctrine is applied in Denmark. The discussion has centred on whether there is a so-called doctrine of reality. The general understanding is that some form of “substance-over-form” doctrine is applied in Denmark and the courts have in general used such approaches in their rulings.

Until 2015, no GAAR or anti-avoidance legislation was incorporated into Danish law. However, in 2015 the Danish Parliament implemented a GAAR aimed at implementing the GAAR in the EU Parent–Subsidiary Directive and the GAAR in BEPS Action 6. The part of the GAAR relating to BEPS Action 6 was therefore implemented prior to the release of the final BEPS reports. The provision states that treaty benefits will not be granted if:

“it is reasonable to establish, taking into account all relevant facts and circumstances, that obtaining the benefit is one of the most significant purposes of any arrangement or transaction which directly or indirectly leads to the benefit, unless it is established that granting the benefit under such circumstances would be in accordance with the content and purpose of the tax treaty provision in question.”

The accompanying wording to Act no. 540 of 29 April 2015 implementing the GAAR into Danish legislation states the following:

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8 TP, værdiansættelse, kontrollerede transaktioner; http://www.skat.dk/SKAT.aspx?oId=1813135&chk=208529.
9 See Jan Pedersen in Cahiers de droit fiscal international, vol. 87a, p. 233 and in UfR2009B.220.
11 Act no. 540 of 29 April 2015 implemented a GAAR in s. 3 of the Danish Tax Assessment Act (ligningsloven).
“(in) Danish case law, the taxation will be made following an assessment of what has actually taken place. This means that empty and artificial dispositions subject to tax can be disregarded so that the taxation instead will be made based on the opposing reality. Thus, Danish tax law is fundamentally in line with internationally applicable principles about substance over form.”

One example to illustrate the issue, although relating to the period before section 2 of the Danish Tax Assessment Act was implemented, is the Supreme Court ruling in TfS 1999.950H regarding the transfer of a procurement function. The case related to a Danish retail company where the procurement function was transferred to a separate related Danish entity. The procurement entity functioned as a buying agent and received a commission of 5 per cent of the turnover it generated for the retail company. The ruling was a 3-2 decision where the majority of the Danish Supreme Court stated that the transfer of the procurement function should be disregarded in its entirety as the transfer lacked business reason and was just a transfer of a secure and risk-free income. It cannot be ruled out that the fact that the company acquiring the procurement function had tax losses that had nearly expired and that the company was partly owned by the shareholders’ children had some effect on the outcome of the decision.

The current Danish guidelines are now updated with the amendments to the OECD TP guidelines in line with the BEPS report. Consequently, the Danish guidelines state that when a controlled transaction is formalized in a contract, the contract will be the starting point for the TP analysis. Furthermore, if the actual conduct of the parties is not in accordance with the wording of the contract, then the actual behaviour of the parties will be guidance for the delineation of the actual transaction. This is in line with the OECD TP guidelines as amended in the BEPS report Actions 8–10.

The updated Danish guidelines also include the six-step approach for analysing risk in a controlled transaction in order to accurately delineate the actual transaction with respect to the risk in question.

The Danish tax authorities use this framework in their audits. It remains to be seen, however, whether this approach will be accepted by the Danish courts.

2.2.4. Comparability and group synergies

The Danish guidelines do not provide much guidance in terms of group synergies. They do, however, state with reference to the OECD TP guidelines paragraph 9.52 that in relation to a business restructuring, the involved parties’ functions, assets and risks before and after the restructuring, the business reasons for and the expected benefits, including the role of synergies and finally the options realistically available to the parties all need to be looked into.

The updated Danish guidelines include a brief section (C.D.11.3.3.6) on the importance of group synergies. The section is more or less a shortened reference to chapter 1, D.8 in the OECD TP guidelines in accordance with the BEPS report Actions 8–10. However, not much practical guidance is to be found there.

Apart from this, not much other guidance can be found. One court case supports the notion that group synergies are an intangible that needs to be considered. In the Danish Supreme Court decision TfS 2002.288 (Bakemark Denmark case), the
court ruled that the taxpayer had not proved that part of a payment for a business related to consolidated goodwill connected to the synergy effect. Consequently, the Supreme Court seems to have recognized that synergies could form a separate intangible.\(^{12}\) As the court found that the taxpayer did not prove that part or the whole payment constituted payment for “business synergies”, the decision in itself does not give much guidance on the more practical aspects of how to treat group synergies for tax purposes in Denmark. It should be mentioned that the Danish National Tax Tribunal has held that such business synergies that were mentioned in TfS 2002.288 could not be seen as a tax depreciable asset.\(^{13}\) So here there is a potential conflict between the general tax legislation and its definition of intangibles and the intangibles identified for TP purposes.

So far, no legislation or other measures have been implemented other than the updated OECD TP guidelines being incorporated into the Danish guidelines.

2.2.5. Hard-to-value intangibles

The guidance on hard-to-value intangibles in chapter 1, D.4 in the OECD TP guidelines in line with the BEPS report has been included in the Danish guidelines. However, no practical guidance is included as the Danish guidelines state that further guidance is expected from the OECD in 2016. According to the Danish guidelines, the supplementary guidance from the OECD will be based on concrete examples in order to avoid double taxation as a consequence of different implementations of the D.4 guidance in the individual countries.

The OECD TP guidelines paragraph 6.190 includes specific features that a hard-to-value intangible may exhibit. The Danish guidelines specifically state that it is not a requirement that a hard-to-value intangible does exhibit such feature(s).

As Denmark has a ruling institute (binding ruling) whereby a taxpayer can obtain certainty regarding the tax treatment of a transaction or the value of an asset in a transaction, the ruling institute has often been used when transferring intangibles either in or out of Denmark.

The Danish tax authorities have observed situations where an asset transferred either in or out of Denmark subsequently appears to have a significantly different value from what was included in the binding ruling. The difference in the value would then often be attributed either to events that had occurred since the ruling or insufficient information about the valuation as the basis for the ruling. The Danish tax authorities have found it difficult to ascertain which of these two alternatives is relevant due to a lack of insight into the taxpayer’s business. This information asymmetry has made it difficult for the Danish tax authorities to handle such cases effectively.

The approach for some years seems to have been to avoid issuing a binding ruling relating to a cross-border transfer of assets out of Denmark by referring to lack of sufficient information to issue the ruling, etc. This has specifically been the case in relation to hard-to-value intangibles.


\(^{13}\) See TfS 2006.280.
As a consequence, the rules on binding rulings were changed in 2015. This was part of the Danish government’s initiative on increased efforts against tax shelters as published by the Danish Minister of Taxation on 6 November 2014.

According to the new rules, a binding ruling concerning the transfer of an asset (including intangibles) can be withdrawn by the tax authorities if it can subsequently be ascertained that the value of the asset deviates significantly from the value according to the binding ruling. In this respect, the term “significantly” is defined as a value that deviates at least 30 per cent and by at least DKK 1 million based on either a subsequent sale of the asset or the yield generated by the assets. The binding ruling will not automatically be withdrawn as it is up to the tax authorities to prove that the subsequent information was also relevant at the time of granting it. If the subsequent increase in value can be attributed to subsequent events, then a withdrawal of the binding ruling is not justified.

The rules are not directly similar to the process described for hard-to-value intangibles in the BEPS report Actions 8–10 D.4, as the scope and implementation of the rules are different. However, it seems as though the Danish rules could have been inspired by the thoughts on how to address information asymmetry as described in the BEPS report. The BEPS report mentions that ex post outcomes can be a pointer to tax administrations about the arm’s length nature of ex ante pricing done by the taxpayer, and the same reasoning is the underlying foundation of the Danish rules on binding rulings.

As mentioned elsewhere, it is expected that the remaining parts of the BEPS project on TP will be implemented into the Danish guidelines when they are completed.

2.2.6. Cost contribution agreements (CCAs)

The Danish TP regulation on CCAs is in line with OECD guidelines, including the updates to OECD guidelines chapter VIII as a result of BEPS Actions 8–10.

Specifically, the new Danish TP guidelines introduce two types of CCA in accordance with the BEPS report from Actions 8–10: “development CCAs” and “services CCAs”. The Danish guidelines emphasize the importance of taxpayers ensuring that the level of risk in the specific CCA has been properly determined, implying that the expected economic return (and potential loss) should depart from this. It is implied that services CCAs entail a relatively lower risk than development CCAs, where the scope of potential economic return or loss (i.e. risk) is significantly higher.

Moreover, the updates to the Danish guidelines stress the importance of including all economic contributions (valued at arm’s length) when determining the CCA involvement of individual participants. As part of this, the updated Danish guidelines emphasize the importance of ensuring a proper balance between the economic contribution provided by specific participants and their potential economic return or loss based on the CCA. Such an assessment will provide a basis for determining whether the CCA conditions more substantially can be considered in line with the behaviour of independent parties.

In line with this, the new Danish guidelines stress the importance of ensuring that CCA participants generally exercise control with the risk they each assume as
part of the CCA. If this link is not established, for example when a CCA participant assumes an R&D risk but has no control over the decision that determine whether this specific risk materializes, the taxpayer will not be considered part of the CCA.

Also, the updated Danish guidelines emphasize the importance of establishing agreements that specifically outline the *ex ante* allocation of economic rights and responsibilities between the CCA participants. This implies that CCAs cannot follow an approach where economic returns (or losses) are negotiated after the fact; they must be determined upfront by the CCA participants and any participants that enrol subsequent to the CCA establishment.

### 2.3. Risk and capital

The formal wording of the Danish Tax Assessment Act section 2 (*Ligningslovens* §2) guiding the material pricing of related-party transactions, including MNEs’ intercompany transactions, has not been subject to change post-BEPS.

In general, Denmark has for quite some years had rules controlling the return on capital as well as clauses governing the shifting of profit based on artificial contractual allocations of risks, etc. with limited business substance.

With regard to the Actions 8–10 reports, and the additions regarding the return on capital and compensation for the assumption of risk, the new Danish guideline has adopted the revised principle set out by the OECD. This includes integration of the new extended Chapter I, section D, in the OECD TP guidelines which replaces the guidelines’ current section D.

Notably, the updated Danish guideline states that the scope or meaning of the arm’s length principle as set out in the Danish Tax Assessment Act §2 (*Ligningslovens* §2) has not been subject to change as per the update to specific chapters in the OECD TP guidelines, including chapters related to Actions 8–10. Instead, the new local guideline states that the Danish tax authorities consider the OECD updates and subsequent updates to the Danish tax authorities’ local TP guidelines a matter of outlining further details and explanations of the arm’s length principle and the way in which it is applied in practical situations. This seems to imply that the new updates to the OECD TP guidelines and local Danish guidelines will be applied not only for future tax years but retrospectively as well.

### 2.4. High-risk transactions

#### 2.4.1. CUP and quoted prices for cross-border commodity transactions

The Danish TP documentation requirements were implemented in 1998. The reason for this was that the Danish tax authorities had experienced significant difficulties in proving that Danish MNEs did not carry out their cross-border transactions at arm’s length. This was a reference to the so-called *Oil* cases, where the Danish tax authorities did not succeed in adjusting the taxable income of any of the oil companies.\(^{14}\)

\(^{14}\) *TfS* 1988.292H.
In the case for the Supreme Court, the taxpayer (BP) had used long-term contracts for its intercompany trading, which were compared with the prices on the Rotterdam oil market. The Supreme Court ruled that the Danish tax authorities had not proved that the intercompany prices used deviated from what independent companies had used. The case was more about “burden of proof” than the practical use of a commodity price.

Apart from the Oil cases there is no publicly available case law regarding the use of commodity prices in Denmark.

Having said that, the Danish tax authorities have accepted the use of commodity prices in tax audits, under the presumption that commodity pricing is sufficiently comparable under the five comparability factors. The issue is often that the intercompany trading terms differ from the commodity trading terms and the relevant question is whether it is possible to reliably adjust for those differences. Having said that, the Danish tax authorities are generally sceptical about the use of the CUP methodology and it is found that the authorities will often seek to argue that any differences in terms, etc. do have a significant impact and that therefore there is not sufficient comparability between the commodity price and the price used for intra-group purposes.

This is in line with the domestic Danish TP guidelines, which prescribe that the CUP method can be used, if differences in the comparability factors do not have a significant impact on the price and it is possible to adjust for those differences.

The so-called sixth method for commodity pricing has not been described in the Danish TP guidelines and is not seen in use in Denmark yet.

2.4.2. Intra-group services

The Danish TP rules on services are based on the OECD guidelines and hence in line with the recommendations set forth in the guidelines’ chapter VII.

Specifically, the Danish tax authorities’ TP guidelines apply the same structure as the OECD by stressing the importance of (a) assessing whether a service has been rendered, and (b) if so, what constitutes an arm’s length remuneration for the service.

As per the assessment of whether a service has been rendered, the Danish tax authorities stress the importance of performing a benefit test. In accordance with OECD guidelines, this will assist in determining whether the recipient of a service is willing to pay a third party for the service, or alternatively perform it in house, and hence whether a transfer price (at arm’s length) needs to be established.

If the benefit test is met, the Danish tax authorities state that the five TP methods recommended by the OECD apply. However, in line with OECD guidelines it is emphasized in the Danish TP guideline that the cost-plus method will often be applied to intercompany services.

The Danish guidelines furthermore divide the remuneration for services into the direct charge and indirect charge approach presented by the OECD. Hence, when a service is provided to one or only a limited number of group companies, rather than a wider pool of group companies, it might be possible to apply a direct charge approach, i.e. by invoicing the service recipient directly.

Conversely, in many cases centralized services are provided to a wider pool of group companies, where the measurement of use by each recipient can be relatively
more difficult to trace. In this case an indirect charge is accepted by the Danish tax authorities in line with OECD guidelines, whereby service costs are pooled based on the benefit test, and allocated by use of the appropriate allocation keys.

In terms of selecting allocation keys, the Danish tax authorities emphasize the potential for differentiated keys for individual services, and have generally been critical towards allocation models applying the same key (e.g. “turnover”) to all allocable services without further argumentation.

With regard to application of mark-up, the Danish guidelines explicitly mention the importance of considering whether a mark-up should in fact be allocated to costs or whether allocation of costs alone constitutes an arm’s length remuneration given the specific facts and circumstances.

Moreover, the Danish tax authorities have updated their guidelines to include the new OECD guidelines on low value-adding services. This includes that taxpayers providing intercompany services subject to the list set out in the new chapter VII of the OECD guidelines can apply the simplified cost allocation approach presented as well as the 5 per cent mark-up introduced by the OECD.

On a final note, the new Danish guidelines state that some countries may have a cap for the amount of low value-adding services that will be allowed for deduction. Denmark currently has no explicit limitation on this item, provided that the specific allocations can generally be considered in accordance with the arm’s length principle.

2.4.3. Profit splits in the context of value chains

The Danish tax authorities generally recognize the use of a profit split approach, based on either the contribution or residual analysis put forward in the OECD guidelines chapter II, as well as the recommendations set out in the new chapter VI.

However, at this point no further formal regulation or guidance from the Danish tax authorities has been presented since the BEPS reports with regard to profit splits in the context of value chains. The new Danish guidelines mention that the CUP and profit split methods are often useful for the TP of intangibles and refer to the OECD guideline section 6.146–6.152 for further insights.

That said, the reporters expect that the Danish tax authorities in specific negotiations will be more open to application of the principles set out in the new chapter VI, including the OECD’s revised position in terms of using the profit split for TP in value chains that contain more complex intercompany transactions.

2.5. TP documentation

2.5.1. Country-by-country reporting

New Danish regulation on country-by-country reporting has been implemented by Order no. 1133 of 27 August 2016 in accordance with OECD recommendations.

In line with the new OECD guidelines, the Danish regulations require MNE groups with consolidated revenues in the previous tax year exceeding DKK 5.6 billion (equivalent to the OECD’s €750 million threshold) to submit a country-by-country report for the current tax year (cf. Tax Control Act section 3B, no. 10-15).
The country-by-country report must be filed no later than 12 months after the last day of the tax year that the report applies to.

The first country-by-country report should be submitted for tax years beginning 1 January 2016 or later. The report should be filed by the ultimate parent company resident in Denmark for tax purposes, or a subsidiary resident in Denmark for tax purposes when one or more of the following conditions is met:

(a) the ultimate parent company is not required to file the country-by-country report in its country of residence for tax purposes;

(b) there is no automatic exchange of the country-by-country reports due to the lack of an agreement between the competent authorities in Denmark and the jurisdiction where the ultimate parent company is resident for tax purposes, even when a general agreement on exchange of tax information exists;

(c) there is a “systematic error” regarding the jurisdiction where the ultimate parent company is resident for tax purposes.

The Danish tax authorities have stated that the country-by-country report will be required to be submitted in a form identical with the OECD recommendations and be subject to the same definitions and guidance as those applied in the OECD templates set forth in the new chapter V and Order no. 1133 of 27 August 2016.

Specifically, this includes Tables 1–3 introduced by the OECD:

(1) an overview of the allocation of income, taxes and business activities by tax jurisdiction;

(2) a list of all the constituent entities of the MNE included in each aggregation per tax jurisdiction;

(3) additional information.

Moreover, the Danish tax authorities have explicitly stated that the country-by-country report should not be applied as a substitute for core TP analyses, including whether a Danish entity has applied the arm’s length principle on its intercompany transactions.

Hence, the Danish tax authorities are expected to follow the OECD’s recommendation to use the country-by-country report solely as a risk assessment tool, not in a formula apportionment type approach. Further, on 27 January 2016 Denmark signed the Multilateral Competent Authority Agreement on the exchange of country-by-country reports.

Finally, with regard to information exchange, Denmark signed the original Convention on Mutual Administrative Assistance in Tax Matters on 16 July 1992. The convention was implemented by Act no. 132 of 26 February 1992 (Lov om gensidig administrativ bistand i sager om direkte og indirekte skatter mellem stater, der er medlem af Europarådet eller OECD) and entered into force on 1 April 1995; however, the convention did not enter into force in the Faroe Islands until 1 January 2007. Further, the amendment was signed by Denmark, including Greenland and the Faroe Islands, on 27 May 2010 and implemented by BkJ no. 18 from 18 May 2011 (Protokol om ændring af OECD og Europarådets konvention om administrativ bistand i skattesager). The amendment entered into force on 1 June 2011.

2.5.2. Master and local files

On 4 May 2016, a new statutory order on TP documentation was issued in Denmark. The order had formal effect as of 1 July 2016, and specifies the new documentation
requirements for intercompany transactions performed in income years beginning 1 January 2016 or later. However, the order explicitly states that for income years beginning before 1 January 2017 the documentation will be considered compliant provided that it meets the requirements of the previous statutory order (no. 42 of 24 January 2006).

The new order specifies that Danish TP documentation consists of a master file and a local file, which provides for an assessment of whether the arm’s length principle has been followed in Danish intercompany transactions.

The required content of the master file is fully in line with the OECD’s new chapter V on TP documentation.

Hence, per the new Danish regulation the master file should contain the same items as listed in the OECD master file template, including:

- organizational structure (legal and ownership structure, etc.);
- description of the MNE’s business (profit drivers, description of supply chain, intercompany service arrangements, etc.);
- the MNE’s intangibles (strategy for the development, ownership and exploitation of intangibles, etc.);
- the MNE’s intercompany financial activities (intercompany financing arrangements, etc.);
- the MNE’s financial and tax positions (annual financial consolidated statements, etc.).

As per the local file, the new order requires the same items as the OECD template as well, including:

- local entity information (management structure, etc.);
- controlled transaction information (transaction types, amount, etc.);
- financial information (annual local entity financial accounts, etc.).

In addition to the OECD master file/local file template, the Danish order entails an addition not included in the OECD’s local file structure. Specifically, the Danish order has kept the right from previous local rules that the tax authorities can require taxpayers to provide the benchmark studies used in the determination of prices/margins on their controlled transactions.

The documentation should be submitted upon request from the Danish tax authorities within 60 days, and should be written in Danish, Norwegian, Swedish or English.

2.5.3. Compliance costs

The opinion of Danish-based MNEs seems to be in line with the general perception among MNEs globally.

Specifically, compliance costs in Denmark are expected to be subject to a significant one-off cost to bring current TP compliance processes and documents into line with the new chapter V in the OECD guidelines.

However, going forward many MNEs expect a more stable annual compliance burden once the new Danish order has been implemented. That said, future annual compliance costs are expected to be relatively higher than the cost of complying with the previous Danish order, especially for Danish MNEs subject to country-by-country reporting.
2.6. TP-related measures in other BEPS actions and other measures against BEPS

At the time of writing, there have been no changes in the Danish regulation of TP other than what is mentioned in the above sections. The main reason for this may be that the Danish regulation of MNEs has for quite some time included interest limitation rules, controlled foreign company taxation, exit taxation, anti-hybrid rules, etc. It should be noted that most of these rules are applicable not only to MNEs but also to most taxpayers.

2.7. Can BEPS work in favour of MNEs?

Based on feedback from MNEs, the BEPS work and in particular the country-by-country compliance work has provided a platform for some MNEs to obtain various information from other jurisdictions that was not otherwise made available e.g. a tax function within the MNE. Apart from this, no significant benefits in terms of information gathering have been identified.

3. What is the future of TP?

Denmark has reacted quickly in terms of the implementation of BEPS work. The country-by-country requirements have been implemented by law and the new master file and local file concept have also been implemented by the issuance of a statutory order. Furthermore, the Danish guidelines regarding TP have also been updated to reflect the amended OECD TP guidelines as reflected in the BEPS reports.

In the academic community, it has been discussed whether the changes to the OECD TP guidelines are so material that the changes do not conform to the arm’s length principle in OECD model article 9 and consequently, the dynamic interpretation of the arm’s length principle cannot be extended to the amendments of the OECD TP guidelines as implemented by the BEPS project. The Danish guidelines, however, clearly state that the changes are within the framework of the arm’s length principle contained in section 2 of the Danish Tax Assessment Act and consequently, also within the arm’s length principle in OECD model article 9.

TP remains a high focus area for the Danish tax authorities and any subsequent changes to the OECD TP guidelines as a result of the ongoing BEPS work must be expected to be implemented in Denmark.

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Summary and conclusions

The OECD/G20 base erosion and profit shifting (BEPS) project will have a significant impact on international tax matters. According to the OECD, the BEPS measures represent the first substantial reform of the international tax rules in almost a century. The OECD expects that once the new measures become applicable, profits will be reported where the economic activities that generate them are carried out and where value is created.

The OECD statement may be appropriate for most of the BEPS actions. However, the transfer pricing (TP) outcomes of the BEPS project will not have such far-reaching consequences. The TP outcomes will not modify the basics of TP or reform the existing TP rules. Instead, the TP outcomes merely clarify and strengthen the application of the arm’s length principle as an update to the OECD TP guidelines. Consequently, the TP outcomes have not created a new legal basis for TP purposes. The arm’s length principle as indicated in the article 9 of the OECD model tax convention has remained unchanged. The application of the arm’s length principle in future will be based on the OECD TP guidelines in a similar way to the current practice.

The impact of the TP outcomes will probably be significant in Finnish TP practice, because of the wide public discussion and the awareness they have created, but there will not be major legislative changes. The basis of the Finnish TP practice is that the arm’s length principle is applicable to both the tax treaty and the domestic TP regulation circumstances. Moreover, the OECD TP guidelines are an important interpretation reference in the application of the arm’s length principle. The TP outcomes as an update to the guidance will have a similar position.

The TP-related modifications that will be implemented in the Finnish legislation are the requirement to provide TP documentation and the requirement to file a country-by-country report (CbCR). Otherwise, the implementation of the TP outcomes will not require legislative changes. For instance, there will not be any requirement to include a definition of the term “intangible”, identification of a transaction involving intangibles or measures to improve valuation mechanisms of hard-to-value intangibles in the Finnish TP regulation. A similar approach will be applicable among other things to issues such as cross-border commodity transactions and intra-group services.

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An exception to the implementation was already in place before the TP outcomes. The non-recognition of a transaction which has replaced the current OECD TP guidelines discussion on recharacterization will probably be outside the scope of the Finnish TP regulation due to a Supreme Administrative Court decision. The TP regulation should be supplemented by the possibility of using non-recognition, if the regulation is intended to cover the complete TP analysis.

Among the most important issues of the TP outcomes for Finnish TP practice are the discussion on risk and capital. The TP outcomes provide an analytical framework to identify economically significant risks and to determine which group company assumes those risks for TP purposes. The TP outcomes also give revised guidance on funding activity and the return to a funder who is only providing capital. Finland has not adopted any specific regulatory measures to take into consideration the detailed guidance on risk or the return to the capital provider, because the guidance is specifically based on the arm’s length principle.

Another important issue of the TP outcomes is the guidance provided on an accurate delineation of the actual transaction. The TP outcomes state that in order to identify the actual transaction the analysis should not be based on contractual terms that are not in practice carried out. The terms of the contractual arrangements should be confirmed and supplemented with the evidence of the actual conduct of the parties. As well as the other issues of the TP outcomes, the guidance on accurately delineating the actual transaction is based on the arm’s length principle.

1. Current TP regulation and practice in Finland

The Finnish TP regulation was enacted in 1965. The legislation process was influenced by the then newly published 1963 OECD draft double taxation convention on income and capital, which introduced article 9 relating to associated enterprises. Therefore, the TP regulation more or less followed the wording of the new article and it contained the arm’s length principle from the very beginning. The government proposal emphasized the importance of legislating the regulation consistently with the development of international tax law. The aim was to follow internationally accepted standards, which were already included in the tax treaties. An interesting detail in the argumentation was that the law was targeted to disallow arbitrary profit shifting to foreign countries. Another detail was that the proposal stated that the tax assessment should define as accurately as possible the actual profit of the Finnish entity. Consequently, the TP regulation already included BEPS-type nuances half a century ago.

The latest update to the TP regulation has been in effect since 2007. The update was mainly related to modernizing the wording, as the substance of the TP regulation has remained essentially untouched. Simultaneously, the TP regulation was expanded to include a requirement concerning TP documentation which had by then been widely adopted in other countries. The legislation indicates that Finland is committed to the arm’s length principle and is using the OECD TP guidelines as

an interpretation reference. The position has since been confirmed by the Supreme Administrative Court.²

Although the TP regulation has been in effect for more than 50 years, TP practice has been inconsistent until recently. The Finnish Tax Administration (FTA) did not consider TP as an important issue until the late 1990s. Similarly, it seemed that most taxpayers did not pay attention to TP questions either. As evidence of this, from the 1960s to the 1990s there were only a handful of cases where the TP regulation was applied by the FTA. Some of the cases were appealed up to the Supreme Administrative Court. The court decisions illustrate that TP practice was far from sophisticated. There were basic errors in applying the arm’s length principle, among other things functional analyses were performed inadequately and tested parties were selected wrongly. For example, the TP adjustment of the FTA was upheld in one of the so called landmark Supreme Administrative Court cases, though the adjustment of the FTA was based on completely the wrong selection of a tested party in the first place.³

The lack of interest in TP resulted probably from the fact that the Finnish multinationals (MNEs) were not very globalized in those days. Another important factor was that in the early 1990s the corporate tax rate was slashed to 25 per cent, which probably brought adequate arm’s length profits and share of tax revenues to Finland at the time even without any in-depth activity by the FTA.

TP was identified as an important international corporate tax issue in the late 1990s by the FTA when the Large Taxpayers’ Office was established. It was observed that TP issues could not be tackled appropriately without specialist TP expertise. As a result, TP expertise has been developed step by step. Nowadays there are 40 experienced specialists practising TP on a full-time basis within the FTA, which is a relatively high number of specialists in respect of the size of the FTA. For the last five years all of the TP specialists have been located in a centralized office dealing with all TP-related activities. The centralized operating model has inevitably created a functional TP capability. The FTA has announced that after establishing the TP practice the focus of the current TP operations was twofold: to provide real-time guidance to taxpayers who were willing to be compliant as well as to audit TP in high-risk cases.⁴

2. The impact of the BEPS project on TP

2.1. Introduction

The overall reception of the report on Actions 8–10 of the OECD/G20 BEPS project, Aligning transfer pricing outcomes with value creation, has been diverse among stakeholders in Finland.

³ Supreme Administrative Court KHO 1986:578.
On the one hand, the report on Actions 8–10 has been well received because it emphasizes the same facts which have an essential impact on transactions between independent parties. These are among other things the functions performed and the risks assumed by the parties. In addition, according to the views presented, the actions are offering more clarity in the guidance to delineate the actual transaction, to examine the actual conduct of the parties and to identify the control over risk than the earlier guidance, although the discussion is not seen as changing the core content of the guidance in any way. The OECD TP guidelines, as well as their earlier version, already refer to the functions performed and the actual conduct of the related parties as important factors in analysing the transactions. However, it is stated that more thorough argumentation is available in the report on Actions 8–10 to consider that the transaction as drafted on paper is not the only determinative factor in TP analysis, but that all the other facts and circumstances of the case should also be taken into account.5

On the other hand, the report on Actions 8–10 has been widely criticized by some business stakeholders. There are two main arguments that have especially been mentioned. First, the status of a signed contract has met with strong criticism. Actions 8–10 state that factors other than a contract could also be determinative in pricing some transactions. This has been considered to open up too far-reaching opportunities for tax administrations to collect tax on the basis of almost anything that the tax administration claims to be arm’s length. Secondly, CbCR has met with a highly critical reception from businesses due to the heavy compliance burden, as well as the confidentiality issues, it is bound to create. Some stakeholders fear that confidential information will be leaked publicly.6 The implementation of the report on Actions 8–10 in Finland should be considered in the context of the overall framework of the report. The starting point is that the report is intended to be used as an interpretation reference when applying the arm’s length principle as indicated in article 9 of the OECD model tax convention. The report on Actions 8–10 has not created any new legal basis for TP purposes as it merely updates the current OECD TP guidelines. The status of the report on Actions 8–10 as guidance is confirmed by the fact that there was no requirement to draft modifications to article 9 of the OECD model tax convention.

The implementation of the report on Actions 8–10 is not assumed to require any legislative changes in Finland regarding the application of the arm’s length principle of the domestic TP regulation. The updated guidance is still used as an important interpretation reference in the application of the tax treaties and the domestic TP regulation in the same way as the current OECD TP guidelines. However, there is one notable exception where it is not possible to use the report on Actions 8–10 as a direct interpretation reference of the application of the arm’s length principle. According to a Supreme Administrative Court decision, recharacterization

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5 See for example a press release, Update of the application of arm’s length principle in transfer pricing (Päivitys siirtohinnoittelua ohjaavan markkinaehtoperiaatteen tulkintaan), issued by the Finnish Tax Administration, dated 16 November 2015 and a statement, Updates to the OECD Transfer Pricing Guidelines as an interpretation source (OECD:n siirtohinnoitteluhjeiden päivitykset tulkintalähteinä, A177/200/2015) issued by the Finnish Tax Administration.

6 See for example articles “Corporate taxation is driven to the eye of the storm”, Talouselämä, 35/2015, “Fortum is afraid of information leakages”, Kauppalehti, 6 October 2016 and “Experts and public companies warn about tax disputes in a category of billion euros”, Kauppalehti, 6 October 2016.
of a transaction is not possible based on the TP regulation. Consequently, it is likely that the TP regulation would need to be amended so that the non-recognition of a transaction – which has replaced recharacterization in the report on Actions 8–10 – could be used in TP analysis.

Action 13 of the BEPS project on TP documentation and CbCR will have been implemented in legislation in Finland by the end of 2016.

2.2. Challenges of transactions with intangibles

2.2.1. Definition of intangibles

Intangibles are usually considered as the most important factor in the value creation of an MNE’s business. Due to the competitive nature of present-day business there are usually only a few opportunities to make a significant profit without using any valuable intangibles in business. Consequently, identifying the valuable intangibles is a key issue in TP analysis. Identification of an intangible can be nevertheless quite difficult, as there is no clear definition of an intangible for TP purposes.

Definition of the term intangible is relatively broad in both OECD TP guidelines and the updated report on Actions 8–10. The latter addresses an intangible as something which is neither a physical asset nor a financial asset, which is capable of being owned or controlled for use in commercial activities, and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances.

This definition is unhelpful for those stakeholders who are looking for an exact definition based on, for example, accounting or legal definitions which would draw clear boundaries in all situations involving intangibles. An exact definition could also narrow down the cases where stakeholders believe that more or less fictional intangibles are being claimed to require compensation. However, Actions 8–10 ended up with a definition which is not based on any accounting or legal definitions. The selected approach could be explained by the overall framework of the BEPS guidance. The report on Actions 8–10 repeatedly emphasizes how a detailed analysis should be performed in TP. Accordingly, the key point in TP analysis involving intangibles should be the determination of the conditions that would be agreed upon between independent parties in a comparable transaction. A detailed analysis should start with identifying the relevant intangibles with specificity, but the analysis should not be realized only as a reference to an item included in some list of exactly defined intangibles. Therefore, the conclusion should not be reached solely based on some accounting or legal definitions.

In addition, the report on Actions 8–10 states that various categories of intangibles or applied labels are not important in TP analysis. There are illustrations of items often considered in TP analyses involving intangibles, but the illustrations only clarify the approach. The emphasis seems to be on a detailed case-by-case analysis. All in all, the actions state that the analysis should give a better understanding on how specific intangibles and items not treated as intangibles contribute to TP.

There is no specific definition of the term “intangible” for TP purposes in Finland. The inclusion of a definition seems irrelevant. The main reason for this is that the existing TP regulation covers the same arm’s length principle both before and
after the report on Actions 8–10. By clarifying the definition of intangibles and items not treated as intangibles the report on Actions 8–10 has not created any new legal basis for TP purposes. It is also fundamental that all countries have a similar way of interpretation when defining intangibles and that changes should be drafted in consensus. Nevertheless, the relatively broad definition of intangibles could create problems in cases where different tax administrations and taxpayers have divergent views. Disputes could, however, be avoided by focusing more on the detailed analysis in the first place.

2.2.2. Transactions involving intangibles

Identifying transactions involving intangibles is relevant in cases where there is a specific transaction involving the use or transfer of an intangible. In those cases the process to determine the intangible-related return should begin with defining an intangible and identifying a transaction. Identifying transactions involving intangibles is sometimes complicated. There could be different structures to the transaction even if the intangibles involved were similar. For instance, an intangible-related return could be received by charging a royalty fee from a user or alternatively a royalty could be embedded in product sales. On the other hand, based on the facts of the specific case, the most appropriate TP method could be different from the one applied, which could have an effect on the pricing of the transaction.

The report on Actions 8–10 explains that the principles of chapters I–III of the OECD TP guidelines apply equally to transactions involving intangibles. The analysis is therefore similar to other transactions and starts with an identification of the commercial or financial relations between associated enterprises. The analysis should aim to accurately delineate the actual transaction involving intangibles, after which it is possible to go on to make comparisons with uncontrolled transactions. It should be noted that the report on Actions 8–10 has a strong overall emphasis on an accurate delineation of the actual transaction, which is for example illustrated by the summary of revisions to section D of chapter I. According to the summary, the guidance ensures that actual business transactions undertaken by associated enterprises are identified, and TP is not based on contractual arrangements that do not reflect economic reality. In this context it is confirmed that the transaction is not simply delineated by what is set out in a contract.

The report on Actions 8–10 provides guidance on accurately delineating the actual transaction. The delineation is guided through six steps required in the framework for analysing transactions involving intangibles. The analysis should begin with identification of the intangibles and the economically significant risks as well as the full contractual arrangements. After that the functional analysis should illustrate specifically which parties perform the important functions and control the economically significant risks. The terms of the contractual arrangements should be confirmed and supplemented with the evidence of the actual conduct of the parties. The analysis should be completed when the accurately delineated transaction is priced.

There are no specific rules for identification of a transaction in Finland for similar reasons that have already been mentioned. Nevertheless, the report on Actions
8–10 has clarified the guidance which should provide a good basis for the analysis process. In particular the framework for analysing transactions involving intangibles should be made good use of in Finnish TP practice.

### 2.2.3. “Substance-over-form” approach towards intangibles

According to the report on Actions 8–10, the actual substance of the controlled transaction is the basis for the TP analysis. TP analysis focuses on the substance of the commercial or financial relations between the parties. In that sense TP is always substance based. For example, the clarifying guidance on accurately delineating the controlled transaction is an indication of the emphasis on actual substance. The focus is on what the parties actually do and the capabilities they provide. However, delineating the controlled transaction is not a “substance-over-form” type of an approach where the transaction is recharacterized, although this kind of argumentation has been frequently expressed in Finland. In delineating the controlled transaction the analysis is just on determining what has happened in the transaction taking into account not only the contract but also the economically relevant characteristics of the transaction. In other words delineation is an analysis which aims to discover the actual form of the transaction.

The “substance-over-form” approach is mentioned in the OECD TP guidelines in the context of recharacterization. According to paragraph 1.65 of the OECD TP guidelines, there are two particular circumstances in which it may, exceptionally, be both appropriate and legitimate for tax administrations to consider disregarding the structure adopted by a taxpayer in entering into a controlled transaction. The first circumstance deals with a substance-over-form approach where the tax administration may disregard the parties’ characterization of the transaction and recharacterize it in accordance with its substance. The outcome of the circumstance is that the tax administration disregards the actual transaction and replaces it with another transaction.

The guidance on recharacterization has been modified in the report on Actions 8–10 where it is now labelled as non-recognition. However, the approach itself is still similar. Non-recognition is intended to be used only in exceptional circumstances, where an accurately delineated transaction can be disregarded for TP purposes. The main reason for non-recognition is that the actual transaction does not possess the commercial rationality of arrangements that would be agreed between unrelated parties under comparable circumstances. It should be noted that non-recognition is not intended to be used in such a way that the form of the transaction is disregarded, after which the transaction is substituted with the actual transaction. According to the report on Actions 8–10, the starting point of the TP analysis is to accurately delineate the transaction. Therefore, the actual substance of the transaction is already determined before non-recognition could be considered – in exceptional circumstances.

The difference between delineating the transaction and non-recognition has already been discussed by the commentators. Andrew Hickman has admitted that there is potential for confusion over characterizing the transaction and recharacterizing it. However, he considers the issue clear. His argumentation is based on the fact that delineating the actual transaction does not change the transaction.
Moreover, he concludes that clarification about delineating the actual transaction narrows the scope of non-recognition.\footnote{Andrew Hickman, presentation “BEPS transfer pricing actions: funding and non-recognition”, International Transfer Pricing Seminar, Helsinki 2015, 10 November 2015. See also Raimo Immonen, presentation “What are the issues transfer pricing regulation covers? Mihin siirtotiedote on?” Suuri Veropäivä, 21 September 2016, pp. 137–150.}

An illustration of the difference between delineating the transaction and recharacterizing the transaction can be found in Finnish TP practice. The Finnish Supreme Administrative Court decision 2014:119 concerned the question of whether a loan agreement was considered to be a loan or an equity contribution for tax purposes. The court analysed the structure of the controlled transaction in two separate steps. First, the court defined the nature of the agreement for tax purposes. Based on the characteristics of the loan agreement the court stated that the agreement was to be deemed as a loan for tax purposes. Secondly, the court decided whether the loan agreement could be recharacterized according to the domestic TP regulation. The court decided that recharacterization as formulated in the OECD TP guidelines was not covered by the wording of the domestic TP regulation, so recharacterization was not possible.

The court decision is following a similar kind of reasoning that is included in the report on Actions 8–10 published later on. The conclusion of the court decision, as premised on the language of the report on Actions 8–10, is that a TP analysis should include an analysis to accurately delineate the transaction before an analysis of disregarding the actual transaction could be performed. Thus, the TP analysis of a transaction involving intangibles should always be based on a substance-oriented analysis and the approach should not be mixed up with a recharacterization type of substance-over-form approach.

A substance-oriented analysis has in fact a strict legal basis in Finland, because an analysis made in accordance with the TP regulation should seek an outcome similar to that which independent parties would have undertaken in a comparable transaction under comparable circumstances. The TP regulation does not state that the analysis should only look at the legal form of the transaction. The approach has not changed because of the BEPS project.

The report on Actions 8–10 summarizes the approach so that the legal ownership of intangibles by an associated enterprise alone does not determine the entitlement to returns from the exploitation of the intangibles. Instead, analysing transactions involving intangibles requires a six-step framework where identifying the full contractual arrangement including legal ownership of intangibles is just one of the steps. The return to the legal owner depends upon the functions it performs, the assets it uses, and the risks it assumes, and upon the contributions made by other MNE group members.\footnote{Implications of the approach were raised in an article on Stack Reassures Economists on Changes to chapters 1 and 6 of the OECD guidelines in Bloomberg BNA Tax Management Transfer Pricing Report, 6 August 2015, p. 354. According to the article Robert Stack, US deputy assistant Treasury secretary for international policy, told the economists that “your work should be more of the same in the vein that you are aware of it in terms of concepts. I think that is because we were able to pull back on a lot of the concepts that would have led to more subjective and problematic interpretations from a technical point of view.”}
2.2.4. Comparability and group synergies

Actions 8–10 do not make any attempt to determine with precision various classes or categories of intangibles, although there are some illustrations of items often considered in TP involving intangibles, as already mentioned. The illustrations include, among other things, patents, knowhow and brands. Goodwill and ongoing concern value is also explained to be taken into account in an analysis, although there is no definition of when goodwill or ongoing concern value may or may not constitute an intangible. On the other hand, group synergies, such as streamlined management and purchasing power, are not considered to be intangibles. The report on Actions 8–10 illustrates them as comparability factors, which may have an effect on the determination of arm’s length conditions for controlled transactions, but are not owned or controlled by any party.

The category of group synergies is in any case not that relevant. Actions 8–10 could be interpreted in such a way that the categories are not determinative in TP. The most important guidance involving intangibles is that contributions to value creation should always be considered and evaluated in a detailed TP analysis regardless of whether the contributions involve intangibles or other items such as group synergies not treated as intangibles. The analysis should conclude what conditions independent parties would have made in a comparable transaction under comparable circumstances regardless of categories.

However, the effects of group synergies cannot be compared to independent parties because of their nature. Therefore, the overall guidance on group synergies in chapter I of the report on Actions 8–10 indicates that the benefits of group synergies should generally be shared by members of the group in proportion to their contribution to the creation of the synergy, if group synergies can be attributed to deliberate concerted group actions. The outcome is different if synergistic benefits or burdens arise purely as a result of membership in an MNE group. In such circumstances the synergistic benefits of group membership need not be separately compensated and the synergistic burdens of group membership need not be specifically allocated among members of the MNE group.

Incidental benefits have already been taken into consideration in Finnish TP practice. There are lower court cases where a Finnish entity was not required to make any payment to a foreign associated enterprise when it received incidental benefits attributable solely to its being part of an MNE group and being able to use a group name.9 The Finnish TP practice is mainly based on chapter VII of the OECD TP guidelines. The fundamental view of group synergies within the report on Actions 8–10 seems to be similar to the earlier guidance on intra-group services, so the discussion of group synergies could be considered as additional guidance to the existing practice. Therefore, Finnish TP practice could be followed without any changes when related to the synergistic benefits or burdens resulting from group membership. Similarly, the new guidance on proportional share of the benefits, if there are deliberate concerted group actions, does not create any new approach. The guidance seems to be clearly in line with the application of the arm’s length principle.

9 See for example Helsinki Administrative Court 06/1258/4.
2.2.5. Hard-to-value intangibles

The report on Actions 8–10 concerning hard-to-value intangibles turned out to be narrower than requested under Action 8 of the BEPS project. Action 8 requested the development of TP rules or special measures for transfers of hard-to-value intangibles when the valuation was highly uncertain at the time of the transaction. Based on the action plan it was considered a strong possibility that hard-to-value intangibles could be tackled by special measures falling outside the scope of the arm’s length principle. Special measures were even envisaged as anti-abuse rules that could override the arm’s length principle. However, the report on Actions 8–10 adopted an approach that follows the overall TP basis. The report requires that transfers of hard-to-value intangibles are priced at arm’s length.

Finland has not adopted any measures to improve the valuation mechanisms of hard-to-value intangibles. Although the approach could be considered as using hindsight when making adjustments based on ex post profit levels, the report on Actions 8–10 explains that the approach is just taking into account information asymmetry between taxpayer and tax administration. The ex post outcomes are considered as evidence to assess the reliability of the information on ex ante pricing. Following this, there seems to be no need to change the Finnish TP regulation.

2.2.6. Cost contribution arrangements (CCAs)

CCAs are in summary agreements among related parties to share the contributions and risks involved in the joint arrangement with the expectation of creating benefits for the participants. The report on Actions 8–10 aims to ensure that the guidance on CCAs follows the same approach as the overall analytical framework of the report. By labelling the arrangement as a CCA, the outcome should not be different from other contractual arrangements. The analysis should, among other things, delineate the actual transaction and value intangibles at arm’s length.

In some countries CCAs have created significant BEPS issues in cases where intangibles were contractually moved between group members without arm’s length compensation. CCAs have sometimes included elements where the compensation for contributing existing intangibles that were part of the arrangement has been more or less nominal compared to the pricing of the comparable intangible in a transaction between unrelated parties. It seems likely that the updated guidance should sort out the inconsistencies related to CCAs.

In Finland there have been no similar cases, at least not to a large extent. A more frequent scenario relating to transfer of intangibles in Finland is a business restructuring, which is usually targeted at more fundamental changes in the business than a CCA. The TP practice related to CCAs in Finland has mainly dealt with allocation of service costs where, for instance, management service costs are contractually allocated to group companies. Therefore, the updated guidance on CCAs is not likely to have much relevant effect on Finnish TP practice.

2.3. Risk and capital

Risk can be considered as a key issue in TP analysis. The importance of risk has been taken into account in the BEPS project, because tax planning strategies based
on contractual reallocation of risks were identified as one of the main reasons for BEPS. Especially the contractual allocation of risk without any corresponding activity being actually carried out by the risk taking entity was highlighted. The report on Actions 8–10 stated that allocating risks on paper does not in itself shift profits. In this context it is understandable that there is a more detailed discussion about risk than that which was included in the current OECD TP guidelines. It should be noted, however, that the report on Actions 8–10 does not indicate that risks are more important than functions or assets. According to the report the expanded guidance on risks reflects the practical difficulties presented by risks. Risk may also be harder to identify than functions or assets.

A significant outcome of the risk discussion is that the updated guidance is based on the arm’s length principle. Even so it could be argued that the extensive risk discussion of the report fundamentally revises the TP analysis and introduces new rules. However, that is not the case because the updated guidance merely clarifies how the unrelated parties are taking into account risks in their transactions. Confusion related to this could be explained by the starting point of the BEPS Action Plan. The working hypothesis was initially that in addition to the arm’s length approach, the BEPS project provided the possibility of fixing profit shifting issues with measures beyond the arm’s length principle. However, according to the executive summary of the report on Actions 8–10, the goals set by the BEPS project were achieved without the need to develop special measures in addition to the arm’s length principle.

The conclusion of the report on Actions 8–10 is that risks contractually assumed by a party that cannot in fact exercise meaningful and specifically defined control over risks, or does not have the financial capacity to assume the risks, will be allocated to the party that does exercise such control and does have the financial capacity to assume the risks. In summary, control over risk requires the capability to make decisions on taking on the risk and the capability to make decisions on how to respond to it together with the actual performance of that decision-making function. The notion of control over risk is essential. As indicated above, the analysis on control is also a measure fully in line with the arm’s length principle.

Similarly, capital can have an important impact on TP analysis. The report gives revised guidance on funding activity and the return to the funder who is only providing capital. The guidance deals with so-called cash-box structures, where a capital-rich entity provides funding to other group entities without performing actual functions or where the entity has low functionality. The conclusion of the report is that the funder is entitled to no more than a risk-free return, if the funder does not control the financial risks associated with its funding. Following the lines of the overall risk guidance the risk of the funding activity, and the premium profits, will be allocated to the entity which has control and the financial capacity to assume the risk associated with the funding.10 The outcome is different, if the funder exercises

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10 See Bloomberg BNA Tax Management Transfer Pricing Report, 6 August 2015, pp. 354–355, Stack Reassures Economists on Changes to Chapter 1 and 6 of the OECD guidelines. The article mentioned that Robert Stack, US deputy assistant Treasury secretary for international policy, explained the guidance on risk-free return: “That may be a little controversial for you guys but the fact is that we had a political imperative – and I think it’s the right one – to really kill off the funding entity in the zero jurisdiction that has a billion dollars in cash and can’t do anything”, he said.
control and has the financial capacity to assume the financial risk. In such a situation the funder is entitled to a risk-adjusted rate of return on funding.

Finland has not adopted any specific regulatory measures to take into consideration the detailed guidance of the report on Actions 8–10 on risk or the return to the capital provider. New measures would have been required only if the report had included some special measures beyond the arm’s length principle. As the report related to the guidance on risk and capital is specifically based on the arm’s length principle, exceptions are not required. A similar approach would also be preferable in other countries, because it would be easier to resolve possible double taxation if the treaty partners used the report on Actions 8–10 as a reference without any country-specific exceptions.

At the same time it could be observed that especially the guidance on risk and the return to the capital provider could be among the most difficult sections of the report to comprehend by both the tax administrations and the taxpayers. The guidance is undoubtedly challenging, even though it merely illustrates the circumstances that have an impact on transactions between unrelated parties. There is definitely a demand to increase awareness of how to use the guidance as a standard practice in TP analysis.

2.4. High-risk transactions

2.4.1. Comparable uncontrolled prices (CUP) and quoted prices for cross-border commodity transactions

The report on Actions 8–10 includes an addition to chapter II of the OECD TP guidelines. The new guidance deals with the analysis of commodity transactions which have been identified as being of critical importance for developing countries, along with low value-adding intra-group services.

Finland has a long history of mining activity. This is the most important commodity sector in Finland, on the assumption that raw wood supply is considered as part of the large paper industry supply chain. According to the Ministry of Employment and the Economy, mining activity is concentrated on gold, platinum group metals, base metals, diamonds and industrial minerals. A good example is that Finland has become the largest producer of gold in the European Union. Another example illustrating the importance of the mining industry in Finland is that according to the Fraser Institute’s Annual Survey of Mining Companies, Finland is the world’s most attractive jurisdiction for mining investments. However, the value added by the mining industry to the overall Finnish economy is not substantial.

Considering the relatively large mining activity and the large-scale raw wood trade, it is surprising that Finnish TP practice related to commodity transactions is scarce. There have been some cases where the FTA has examined the financial transactions of the mining companies, but it seems to be that the transactions of minerals and other commodities have not been the focus of the FTA to a large extent.

“Whatever the arguments and theory that that (kind of) entity could really still get some whacking return is going to be a thing of the past.”

extent. Consequently, there seems to be a lack of information about the pricing of commodity transactions in the first place, let alone information on whether aggressive tax planning schemes have been used as base eroding arrangements. In any case, the CUP method should be an appropriate TP method applicable to commodity transactions in Finland, if reliable comparable transactions are available or quoted commodity prices reflect comparable uncontrolled agreements as illustrated in the new guidance.

2.4.2. Intra-group services

Intra-group service transactions were the most common transactions that the FTA used to examine within the area of TP in the 1990s. Similarly, intra-group services seem to be commonly examined transactions by present-day tax administrations worldwide. The interest of the tax administrations probably follows from the high frequency of service transactions in any MNE group, but also from the widespread assumption that service payments should be scrutinized properly by the tax administrations, because of the possibility that the payer is not receiving any benefit in return or that the service is being overpriced.

In earlier Finnish TP practice the focus on intra-group services was explained because of the benefit test, but it was additionally explained by an opposite circumstance. There were many cases in the 1990s where the costs of a Finnish entity were not charged out to the other MNE group members even though they were benefiting from the contributions. This kind of TP practice illustrates perfectly the two-sided outlook for intra-group services. There should be a compensation for service contributions, but on the other hand protective measures against base eroding payments should be available. The practical experiences gained when examining intra-group transactions were a good lesson for the FTA. Since the 1990s, the focus of the FTA has shifted towards other transactions, because the TP risk management of the FTA has identified fiscally more substantial issues than the service transactions.

The adjustments in relation to the intra-group services are inevitably generating various disputes. The disputes are ranging from whether a service has been provided at all to what is an exact cost for a service provider. In fact, the cost base may have considerably more importance to both tax administrations and taxpayers than a customary disagreement on level of a mark-up on service costs. It could be added that shareholder costs are also causing many disputes. All in all, the above-mentioned issues are good examples of the complexities related to intra-group services regardless of whether intra-group service payments are considered as artificial base eroding payments or actual business expenses.

At least from the Finnish perspective the simplified approach to low value-adding intra-group services as introduced by the report on Actions 8–10 could provide some relief to the disputes. The guidance is aiming to provide balance between appropriately allocating the charges for intra-group services to MNE group members and the need to protect the tax base of payer countries. Because of

According to an unpublished internal study by the FTA there were 189 TP adjustments made by the Large Taxpayers’ Office covering tax years 1993–2000, of which 154 adjustments were related to intra-group services.
the conflicting interests between countries the balance of the guidance as well as the rationality of the tax administrations in selecting the cases will be important issues to mitigate the number of disputes in future.

2.4.3. Profit splits in the context of value chains

Action 10 of the BEPS Action Plan required clarification of the application of the transactional profit split method in the context of global value chains. However, the OECD was not able to finalize the guidance on time in order to publish it simultaneously with the report on Actions 8–10 in 2015. Because of this the report included only a proposed scope of work to continue the development of the guidance on profit splits. The guidance is expected to be finalized in the first half of 2017.

There seems to be wide approval by the stakeholders that the guidance should be updated to clarify the application as such, but especially regarding the issues referred to in updated chapters I and VI. The current guidance on OECD TP guidelines points out that the application of the transactional profit split method could be used in two specific situations. Profit split could be the most appropriate method for highly integrated business operations and in situations where both parties to the transaction make unique and valuable contributions. In these situations the application of a one-sided method is inappropriate, if there are no reliable comparable transactions available. Such scenarios deal with some of the most difficult issues in TP and it is therefore not surprising that the current guidance is somewhat incomplete.

There are some cases where the transactional profit split method has been applied in Finnish TP practice, but there is no published case law on profit splits. However, the reporter is aware of the recent developments relating to the APA applications in Finland which indicate that the taxpayers are applying the transactional profit split method far more frequently than in the past. An APA is probably a good tool for handling in advance the complicated issues of the application of the profit split method, although one should bear in mind that a detailed functional analysis will always be helpful in circumstances where the selection and the application of the most appropriate method turns out to be the profit split method. In any case, the expected OECD guidance should provide more clarity on the issue.

2.5. TP documentation

2.5.1. CbCR

CbCR is considered as a main element of BEPS to enhance transparency and provide useful information for tax administrations. CbCR will give tax administrations a clearer picture of the tax position of the whole MNE group, instead of just the limited view on the local entity. MNEs are required to file an annual report which will provide essential information for each jurisdiction about where they earn their revenues, where they book their profits and the amount of their taxes paid as well as certain other annual information.

Finland will implement the requirement for CbCR by following closely the recommendation of the report on Actions 8–10 and the EU directive. In this
way Finland is ensuring the harmonized implementation of the requirement for its part. The government proposal of the legislation was issued in September 2016 and the legislation process is supposed to be finalized by the end of 2016. The requirement should not be confused with the initiative to publicly disclose certain tax information. CbCR is intended to be disclosed only to tax administrations.

According to the proposal, the parent company of a large MNE group with a consolidated group revenue exceeding €750 million will have to provide annual CbCR on the whole MNE group directly to the tax administration where it is resident. There is also a secondary reporting mechanism. The MNE group could under certain conditions appoint a subsidiary to provide the report instead of the parent company or under certain conditions a subsidiary or permanent establishment will be required to file the report for the entire group.

Further, according to the proposal, the reporting entity will be required to file the report within 12 months from the end of the fiscal year to which it relates. The first report will be required for fiscal year beginning on or after 1 January 2016. After that the tax administration will be sent the report with automatic exchange of information within six months from the deadline of the filing to the tax administrations in every jurisdiction where the MNE is resident, if the jurisdiction meets certain conditions. All in all, the deadline for the first filing will be 31 December 2017 and the first exchange of information transmission to other jurisdictions for the year 2016 report will be 30 June 2018.

Finland has signed the Multilateral Competent Authority Agreement on the exchange of CbCR in January 2016. The steps that are required to bring the agreement fully into force are still in progress.

### 2.5.2. Master and local files

The report on Actions 8–10 recommends a three-tiered approach to TP documentation. The approach should provide tax administrations with relevant information to perform a TP risk analysis and to select appropriate issues for further examination. The approach should also ensure that taxpayers evaluate their TP compliance with the arm’s length principle. The recommended approach is well received by the FTA, because the standard of the TP studies has been inconsistent in Finland. There have been too many documentation studies, which have been inadequate. Therefore, the expectation of the FTA is that the new three-tiered approach will improve the documentation standard.

The three-tiered approach requires MNEs to provide a master file and a local file in addition to the above-mentioned CbCR. The master file should provide tax administrations with a high-level overview regarding the MNE’s global business operations and TP policies. The purpose of the master file is to provide tax administrations with a broad overall picture of the whole MNE group’s TP without any detailed information. On the other hand, the local file should provide more detailed information relating to the specific transactions of the local taxpayer. The three-

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13 EU Directive 2016/881/EU.
The current TP documentation requirement in Finland covers the local file of the recommendation. In order to implement the whole package, the requirement to provide the master file and the CbCR should be included in the regulation. As already mentioned, the government proposal was issued in September 2016. Parliament will enact the requirement by the end of 2016. According to the proposal, the first master file and the local file should be produced for fiscal years beginning on or after 1 January 2017. The documentation should be submitted to the tax administration only on request – as is the current procedure – which means that the submitting procedure of the master file and the local file will differ from the mandatory annual filing of the CbCR.

2.5.3. Compliance costs

The report on Actions 8–10 attempts to balance the information requirements of tax administrations with the compliance costs and burdens imposed on business. According to the report there was a discussion on the issue, as there were countries which would have required more information than that which was included in the finalized report. As a conclusion, the balance will be reviewed by the participating countries no later than the end of 2020.15

The issue of compliance costs and burdens has already been raised in Finland. During the public consultation of the legislation process there were many statements from the stakeholders in Finland. Some of the business stakeholders considered that the three-tiered approach to TP documentation required disclosing too much information, especially on significant business secrets, so the future claims by some of the countries participating in the BEPS project to expand the content of the reports will definitely be objected to by Finnish businesses. Altogether, most of the statements by business stakeholders criticized the heavy compliance burden on taxpayers. For instance, it was stated that the amount of new information required was substantial and that collecting information would require demanding exercises.16

2.6. TP-related measures in other BEPS actions and other measures against BEPS

The report on Actions 8–10 points out that the TP guidance is linked in a holistic way with other BEPS actions. As an example the report mentions the guidance on capital-rich entities without any actual functions where the conclusion is that the capital provider is entitled to little compensation. The same compensation is targeted by the interest deductibility rules of BEPS Action 4, the treaty abuse guidance of BEPS Action 6 and possible controlled foreign company (CFC) rules of BEPS Action 3. All the approaches are likely to have an impact on the conduct of the taxpayers. The holistic approach is aiming to discourage BEPS planning strategies.

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16 See the published statements http://www.valtioneuvosto.fi/hanke?selectedProjectId=17012.
Finland already has in force other legislation than the TP regulation that is intended to protect the tax base. Since the early 1990s the focus of the corporate tax policy in Finland has mostly been to legislate a low corporate tax rate with a broad tax base. An example of the policy is the CFC regulation, which was legislated in the 1990s. The CFC regulation has been fairly effective in tackling tax planning strategies which exploit controlled entities located in low-tax jurisdictions. Another example of the policy is the interest deductibility rule which has reduced the tax deductible interest expenses at least partially. In addition, there have been several recent cases where the FTA has successfully applied the general anti-abuse rule to tackle abusive tax arrangements. As a result, BEPS opportunities for aggressive tax planners have not been as widely used as in some other countries.

The Finnish government has not published any plans to introduce the BEPS actions other than the TP documentation requirement and the filing requirement of the ChCR at the time of the writing. However, the EU has already initiated the process. Finland should, as a Member State of the EU, apply the Anti-Tax Avoidance Directive, which provides anti-avoidance measures to tackle aggressive tax planning. In this respect, it should be noted that the measures are not directly related to TP. It seems to be that TP will not have an effect on any of the non-TP BEPS actions in Finland.

2.7. Can BEPS work in favour of MNEs?

The report on Actions 8–10 recommends transparency requirements. The three-tiered documentation approach will particularly improve tax administrations’ access to relevant TP information. There are also other initiatives like the EU directive aimed at improving transparency on tax rulings. The directive will require Member States to exchange information automatically on cross-border tax rulings and advance pricing arrangements, which will also improve significantly the tax administrations’ access to information.

On the other hand, could there be situations where the exchange of information could work in favour of taxpayers? The platform of the BEPS information gathering could be used, for example, by the local group company as a way to obtain information from other countries for its domestic compliance. However, at least in Finland this kind of approach seems to be peculiar. The BEPS initiatives are supposed to give a transparent view of the MNE. Therefore, the final responsibility of disclosing transparent information is with the parent company of the MNE group. Leaving the local group company on its own is not good practice in any parent company.

There are other issues working in favour of the MNEs. For instance, there could be an enhanced possibility of avoiding a time-consuming tax audit by disclosing adequate information in the first place. It could be reasonable to assume that in most cases transparent information could give a tax administration enough information to compile an understanding of the business and the tax positions of the local group company already in an early risk assessment phase without starting a lengthy audit process. By using these means the resources of the parties could be directed to more important activities. Moreover, for those cases where
TP adjustments have nonetheless been made the BEPS initiatives regarding dispute resolution mechanisms could provide an efficient way to eliminate double taxation.

3. What is the future of TP?

The BEPS project is considered likely to have a significant impact on international tax matters. The implications could be concluded at least from the public presentations of the project. The OECD announced a far-reaching statement in the foreword to the BEPS package. According to the OECD, the BEPS package of measures represents the first substantial reform of the international tax rules in almost a century. The OECD expects that once the new measures become applicable, the profits will be reported where the economic activities that generate them are carried out and where value is created.

However, the OECD statement is not in place regarding the report on Actions 8–10, even though it may be appropriate for most of the other BEPS actions. The report will not reform the existing TP rules. Instead, it merely clarifies and strengthens the application of the arm’s length principle and as a result updates the current OECD TP guidelines. Consequently, the report has not created a new legal basis for TP purposes. The arm’s length principle as indicated in article 9 of the OECD model tax convention has remained unchanged. The application of the arm’s length principle in future will be based on the OECD TP guidelines in a similar way to the current practice.

In Finland, the implementation of the report requires a legislative change to the filing of TP documentation and the CbCR. The legislation process will be finalized by the end of 2016. Otherwise, the report *per se* does not require any legislative changes to the domestic TP regulation in Finland. The report on Actions 8–10 as an update to the OECD TP guidelines will be used as an important interpretation reference in applying the arm’s length principle embedded in the tax treaties and the TP regulation. The approach will be same as the current one, although there is an exception. The non-recognition of a transaction which has replaced the current discussion on recharacterization will probably be outside the scope of the TP regulation in the future. The TP regulation should be supplemented with the possibility of using non-recognition.

Altogether, the impact of the report will probably be significant in Finland, even though the guidance will only update the application of the arm’s length principle. The importance of TP seems to have increased, because of public discussion on the BEPS issues. With respect to this, there are also widespread anxieties among business stakeholders regarding the implementation of the BEPS actions and the practice of tax administrations. The discussion has spread out to extreme views where almost all kinds of cross-border activities are supposed to be scrutinized. Following this, the public discussion could also generate a positive reaction. It could be possible to seek common solutions to the BEPS-related issues by all the stakeholders involved in Finland.
Another aspect to the future of TP is the global implications of the BEPS project. The project has increased the awareness of possible misallocation of the profits to the MNE group companies in different countries. This will probably add substantially to the volume of TP audits and subsequent TP adjustments by the tax administrations as countries are protecting or expanding their tax bases. As an inevitable consequence, tax disputes will also increase. Under these circumstances it will be necessary to have an effective dispute resolution mechanism in place. It should be noted that all the countries involved will be responsible for resolving the disputes. To ensure an appropriate outcome, countries should allocate sufficient resources to deal with the mutual agreement procedure as well as being willing to eliminate double taxation based on the international standard of the arm’s length principle.
Summary and conclusions

Transfer pricing (TP) has been a real matter of interest in France since the beginning of the 1990s, for both taxpayers and the tax administration. In this context, the OECD works on base erosion and profit shifting (BEPS) have been seen in France as a really important contribution. In fact France has been one of the countries most involved in those BEPS works and the public reports were welcomed at the end of 2015 by the government and tax administration. Taxpayers are generally speaking more suspicious about the real consequences of the implementation of the BEPS recommendations.

A TP regulation has been in place for a long time in France, even though no detailed explanations have been provided, unlike in some Anglo-Saxon countries. This explains why both taxpayers and the tax administration directly refer to OECD principles and commentaries. Broadly speaking, the French tax administration (FTA) pays specific attention to TP as it is one of the main interests of the tax audit department.

However, France has always been keen to enforce the arm’s length principle and to respect the choices of multinational companies (MNEs) in their organization, in order to allow international groups to establish themselves in France and to carry out their activities there. Nevertheless, the FTA is ready to contest abusive schemes and fight tax fraud. That is the reason why it broadly favours the BEPS recommendations. On the other hand, taxpayers have expressed concerns about the way those recommendations may be enforced by the FTA and are waiting for clarifications and explanations, in order to be able to comply and have legal security.

One of the specific challenges in France is connected to transactions with intangibles. As there is no detailed definition of an intangible in the French law, either in accounting law or tax law, both tax administration and taxpayers are doing their best to align with OECD principles; but it is not certain that the latest BEPS explanations will be sufficient to clarify the matter, even though a large number of the BEPS recommendations have already been implemented by French tax auditors.

The FTA has been fighting against business restructuring for some years now and it does not hesitate to use its abuse of law procedure to challenge some con-
tracts or organizational schemes of MNEs if the legal structure of the group and the contracts provided do not match with reality. The French approach is in line with the “substance-over-form” position of the BEPS reports, even though it is based on an exclusive purpose test, and not a principal purpose test.

French tax auditors have sound experience with comparability and group synergies. Even though there is no specific regulation or domestic guidance, they apply consistent argumentation. In fact Actions 8–10 of the BEPS report are in line with recent tax cases.

Looking at “hard-to-value intangibles”, the BEPS recommendations may lead to a change in the tax auditors’ position. The ex post evidence as described in the OECD report may be seen as a possibility for tax auditors to adjust past profits or losses on the basis of the real situation as currently known, even if that real situation could not possibly have been anticipated at the time of the entry into force of agreements or operations.

The FTA has always been concerned by financial interests and still is. However, tax auditors’ practices are in line with BEPS recommendations and they have for a long time been using some of the criteria suggested by the OECD, even though the latter are more detailed. However, there is no indication that the French tax law will soon be modified to include them.

The French approach to intra-group services is connected to reality, looking at the contract, at evidence that the services are really provided and that the evaluation method for the fees is appropriate and correctly implemented. There is no general refusal of those intra-group services and France could easily endorse the OECD simplified mechanism; however, no move can be anticipated for now from the FTA.

The French position on profit split is gradually evolving, as one can see that tax auditors generally accept the use of that method more easily, even though this is more as a double check method than an initial one. However, they will accept its use as a first rank method, if it is implemented by a group; tax auditors would then be really thorough during audit investigations.

The country-by-country reporting (CbCR) requirement is now part of French tax law and France has mentioned that it will soon be part of the process of exchanging information with treaty partners. The debate is actually focusing on a possible public CbCR now and the situation may evolve very quickly in the coming months. As the BEPS recommendations are adding some specificity to the master file which are not included in domestic tax law, one could anticipate an addition of these specifics at some point; however, nothing is planned for now.

From a French perspective, one could consider that the BEPS recommendations might provide more security to MNEs, by detailing rules and bringing guidance to taxpayers. This benefit may also come from OECD proposals regarding limits to intangible comparisons, the optional approach of limited value-added services and an improvement in advance pricing agreement (APA) and mutual agreement (MAP) procedures.

Looking to the future, a generally accepted approach is to anticipate a shake-up in the area of TP, as the BEPS recommendations will probably lead to more pressure on business, starting with a requirement for more transparency, including public information, more severe penalties and less amicable discussions with tax audit services. Beyond this technical evolution, three major changes may be foreseen in
France, with (a) the profit split being accepted as a more common method, (b) a possible change in the field of TP coming from the introduction of the CCTB in Europe and (c) TP aspects entering into the public sphere of concern, outside the usual tax specialist fora.

1. Introduction

TP has been a real matter of concern in France, for both the tax administration and taxpayers, since the beginning of the 1990s. At that time, tax auditors started to delve deeply into the details of the TP policy of MNEs, the amounts at stake started to increase and international groups started to develop their international organizations to better fit their markets and their operational needs.

Since then, interest in TP has been constantly growing. This has led to an increase in the resources devoted to it by the FTA, both in the number of tax auditors able to manage this specific kind of audit and in the quality of these tax auditors, increasing the number of specialists in this area and also the training of general tax auditors able to deal with this specific aspect of international tax. Taxpayers also have considerably increased their knowledge of this matter, developing sophisticated TP policies, increasing their skills and expanding the number of TP specialists embedded in their tax teams.

Moreover, after a period during the mid-2000s when TP was considered as “under control”, or at least manageable, the FTA and taxpayers were conscious of the specific aspects of this sensitive part of taxation, but aware of the technicalities of working with and managing them, a new era came when, in the mid-2010s, TP was suddenly seen as a specific tool used by MNEs to drive their profitability in France (a high corporate tax rate country compared to some other OECD countries). A common feeling started to develop of seeing TP policy as fraudulent behaviour used by taxpayers to pilot the location of their profits, in the wake of (a) various leaks, (b) concerns about the business restructuring of several international groups, and (c) several attacks against various GAFA. This was obvious when, at the end of 2013, Parliament voted for the end of tax collection suspension during an MAP (Finance Law for 2014) and the expression “tax fraud” was explicitly mentioned during the parliamentary debates on this specific aspect of TP.

In this context, the OECD works on BEPS have been seen in France as a really important issue, specifically in the TP area, and particular attention has been paid to the expected outcomes. These were seen as possible solutions to limit abuses and provide help to deal with specific and difficult situations.

Before reading the following report, it should be recalled that France has been one of the leading countries in those BEPS works and that the French tax community (whether the FTA or the private sector) has been willing to be very much involved in the process, and saw itself as one of the major contributors. This partly explains the favourable perception in France of the BEPS recommendations, the commentaries expressed to welcome them and reactions to the future of TP in France.

It should also be noted that, at the time this report was written, France had implemented the CbCR and the provision for an exchange of information with its
treaty partners. Works have been completed during summer 2016 at the European Union (EU) level to finalize the Anti-Tax Avoidance Directive, and France will in fact implement its own set of measures and take into account the EU rules.

2. Current TP regulation and practice in France

The TP concept was introduced in France by article 57 of the Tax Law in 1933. The words “transfer pricing” are not used but this article explicitly refers to “direct or indirect transfer of profits” by a company under the dependence of a foreign company or controlling a foreign company. This single article of the French tax law is actually the only one to be used by tax auditors to adjust the price of international transactions between companies of the same group.

The wording of this article is largely in line with article 9(1) of the OECD model and is fully aligned with the principles underlying this article. Knowing that French tax conventions are broadly in line with the OECD model, there is usually no conflict between treaties and the domestic rule.

To challenge the TP policy in place in a group or the price of a specific transaction, the FTA should be able to gather facts showing that two cumulative conditions are met: (a) a real dependence between the French company and the foreign entity concerned in the transactions at stake; (b) a real advantage (the transfer of profits) provided by the French company to the foreign entity.

The FTA has provided general guidance to help taxpayers and tax auditors to implement this article (BOI-BIC-BASE-80-10-10-20140218 and 80-10-20-20160203). This is much less developed than what can be found in some other countries. It is often seen as a matter of concern by taxpayers, mostly by foreign groups, that no specific and detailed directions or advice are provided. However, it can also be seen as positive, as the FTA may not challenge the group implementation of its TP policy as long as the group is able to detail it and provide solid consistent explanations.

Interestingly, specific developed guidance has been provided (in 2006) by the FTA to help small and medium-sized groups to expand their international development. A summary of the main OECD principles and basic landmarks are highlighted to facilitate the understanding of TP by this group of taxpayers and guide them (TP methods, use of comparable companies, the possibility of asking for an APA and a specific procedure dedicated to small and medium-sized enterprises).

In this context, it is quite logical that the FTA and taxpayers directly refer to OECD principles and commentaries to substantiate their positions.

If this article of the French tax law has been stable, various tools have been developed over time to help tax auditors to really challenge the TP policy of a group. These articles of the French tax law have provided them with more time to ask the French treaty partners for information, to access more information and figures after the beginning of the tax audit, and even before the tax audit starts.

To focus on the main possibilities offered to tax auditors, it is interesting to make a distinction between (a) the initial move, which is intended to help the FTA during the audit procedure, and (b) a recent second step, which leads to facilitating
risk assessment and the work on the file, from the office, in order to target international tax audits.

The initial move was made in 1996, when article L.188A allowed for an extended period of possible tax reassessment (two further years) when information was requested from a treaty partner. It was complemented more recently by article L.13AA of the French Tax Procedure Law, which in 2009 introduced the European Union Joint Transfer Pricing Forum (JTPF) recommendations regarding the master file and the entity file, to be mandatorily provided to the tax auditors from the very beginning of the tax audit.

The second step was initiated in 2015 with the introduction of article 223 quinquies B of the French Tax Law, creating a mandatory report of the main information relating to the intra-group transactions, to be electronically filed with the FTA.

Broadly speaking, the FTA pays specific attention to international tax aspects, and specifically to TP as this is one of the main matters of interest of the Tax Audit Department and one of the key drivers of FTA audit activity. At the same time, the double taxation which arises from these TP audits is a major source of concern for international groups as the duration of an MAP is slowly decreasing but there is no longer any tax collection suspension during the course of this procedure.

3. The impact of the BEPS project on TP in France

3.1. Introduction

As mentioned above, the BEPS TP recommendations were seen as an important outcome of the BEPS works. France has been one of the active contributors and the French private sector has been vigorous during the public consultation process.

The authorities in France warmly welcomed the BEPS reports at the end of 2015. The French Minister of Finance strongly supported the BEPS recommendations, seeing in the reports a major effort in the fight against MNE tax erosion. He also encouraged a European common action to implement part of these recommendations on a coordinated basis.

This evident French support for the BEPS recommendations has peaked with the early introduction of CbCR into French tax law at the end of 2015, under article 223 quinquies C of the French Tax Law, a few weeks after the BEPS reports were made public, with wide support from the French Parliament (CbCR is mandatory for fiscal years starting on and after 1 January 2016). Moreover, France has been one of the first countries to sign the Multilateral Competent Authority Agreement on the exchange of CbCR (France signed on 27 January 2016). Another example of this active support has arisen from the question of public CbCR, which was taken up at the end of 2015 and has been constant since then.

The FTA has not publicly commented in detail on the BEPS reports. There is no doubt that it broadly favours the implementation of the recommendations. However, one could assume that some recommendations may not be totally in line with the initial and ideal wishes of the FTA. For example, France was keen in a specific action dedicated to internet activity (works are still to come on this aspect under Action 1). Another is related to business restructuring, where France has been
actively promoting stringent measures to help contest this type of MNE reorganization, even though BEPS provides some useful tools.

The private sector approach consisted, in a nutshell, in a fear of an unfair implementation of the BEPS recommendations by tax auditors, knowing that changes brought by the OECD reports were major and that groups would have to adapt in the context of limited guidance. Moreover, it was clear that anticipation of the domestic implementation of these new rules would be difficult (and still is), despite the fact that the OECD was providing a relatively weak insurance by improving and strengthening the elimination of double taxation. Representatives of the financial sector and insurance companies were worried about the fact that those recommendations did not provide guidance specifically applicable to these two particular sectors. One of their concerns was that examples are irrelevant for companies in those industries and that, in dealing with risks, the specificities of these activities are not addressed. They also highlighted that some OECD suggestions have already been implemented, and that concepts and proposals have already been taken into account.

### 3.2. Challenges of transactions with intangibles

#### 3.2.1. Definition of intangibles

The qualification of an intangible has always been a question of specific interest in France, as intangibles are commonly recognized as the main driver of the value creation and, consequently, of the remuneration level to be allocated to their owner.

Quite recently, starting in the mid-2000s, it has also been a major question for tax administrations in general and the FTA in particular, as groups have started to reorganize their activities, opening some interrogations about so-called “business restructuring”, which usually leads to relocating not only some intangibles, recognized as such, but also part of the activities, functions and risks, which may, alone in combination, be considered at some point as intangibles.

As long as France only had a limited specific domestic set of regulations, particularly looking at intangibles, there was no definitive clear public guidance provided by the FTA. Intensive domestic works were carried out during the OECD works leading to the July 2013 report on intangibles. In line with the OECD works at that time, the main question was to consider whether or not the definition of intangibles should stick to the legal definition (mainly, assets that can be accounted in an entity’s books). As a Latin law country, this was the most obvious answer for France. However, that answer could not capture specific circumstances such as business restructuring, where no accounting asset may be moved from one entity to another.

This situation has led the FTA to try to amend article 57 of the Tax Law (see above): in the case of business restructuring, meaning the transfer of intangibles, functions and risks, the article would have created a presumption of transfer of profits, and the French entity would have faced the burden of proving that no benefit had been transferred (and not the tax administration, as provided under the article 57 provisions). However, the *Conseil Constitutionnel* (the High Administrative Court responsible for ensuring that the law conforms to the Constitution) rejected
the draft article as the intangibles, functions and risks supposed to be transferred are not defined in tax law.

Of course, like other tax administrations, French tax auditors have also faced problems in dealing with specific situations where “marketing intangibles” may be developed by an entity, or when unique intangibles and high-value intangibles were at stake (such as intra-group synergies, specific economies arising from a single procurement for the whole group, unique management of the logistic chain, etc.).

In fact, there is no specific tax definition in France. Article 38 quater of Annex III of the Tax Law refers to the French general accounting rules. The FTA regulations detail the criteria of the accounting rules, which mention in their article 211-5 that an intangible is a “non-monetary asset without any physical substance”. This asset should meet one of the following alternative conditions:

- be separable from the activity of the owning entity, meaning that it can be sold, transferred, leased; or
- be protected by a legal or contractual right (like a patent or a commercial property).

According to the FTA regulations (BOI-BIC-CHG-20-10-10-20141013), an intangible should also be the source of future profits and be usable for a long time (at least more than one fiscal year). This definition is applicable to all kinds of intangible types, whether bought from another entity or internally created.

Those criteria are commonly used by the judge and consistent jurisprudence has drawn a clear line to identify intangibles.

However, the BEPS Actions 8–10 report has changed the OECD TP guidelines under chapter VI, introducing clarifications, particularly on the fact that intangibles are not always recognized as intangible assets for accounting purposes. Similarly, the report states that whether an item should be considered to be an intangible for TP purposes, under article 9 of the OECD model, can be informed by its characterization for accounting purposes, but will not be determined by this characterization alone.

Despite this attempt at clarification, it is not certain that this new OECD guidance will be sufficient to provide an easy recognition of intangibles. Nevertheless, this OECD clarification may need a particular French tax rules modification to include these specificities in the body of French law and regulations. However, tax auditor practices have already tried to include such an approach in some of their tax adjustments.

3.2.2. Transactions with intangibles

As mentioned above, the FTA has been active on this aspect of intangibles. More generally speaking, French tax audits have been driven by a concern for international operations and the fight against tax avoidance. To work in that direction, specific attention has been paid to operations with high amounts at stake, specifically in transactions regarding high-value intangibles, and audit services have tried to challenge MNE organization and intangible transactions with tentative new approaches.

In some ways, even though the OECD has provided clarification with more details and explanations, it could be considered that the FTA was already implementing
some of the BEPS recommendations in this area. That is the situation regarding the way in which groups use an intangible.

French tax auditors are usually very careful about the way several entities of the same group deal with an intangible. They would typically ask questions about investment in the maintenance of the intangible, the actions performed by the supposed intangible owner to defend its legal right to this intangible and to fight against counterfeiting, etc. This information will then drive the allocation of the remuneration, depending on the level of an entity’s involvement in these various functions.

Even though the so-called DEMPE functions (development, enhancement, maintenance, protection and exploitation of intangibles) are not mentioned by tax auditors and are clearly not mentioned in the FTA regulations, the approach is identical to that now suggested by the OECD in the new chapter VI of the guidelines. These DEMPE criteria will certainly now be used by tax auditors, who may set a specific list of questions to taxpayers when looking at transactions on intangibles. However, this may not lead to a revolution in the general approach of the FTA.

Even though there is no need in France for an introduction of these new criteria to identify the functions and value the remuneration, it will be interesting to see whether the FTA will take the opportunity of this specific BEPS recommendation to develop and give details of its TP regulation on this matter.

What may be considered in France as a brand new approach in the BEPS recommendation in this area is the new place allocated to the \textit{ex post} outcomes as presumptive evidence about the appropriateness of \textit{ex ante} pricing arrangements. French tax auditors were already looking to the actual results of the transactions, to gather a sense of what had been done by MNEs and to see whether what was originally planned was genuine. However, until now, this has been more of an indicator or an initial step of a risk analysis, but it has not been used as the main element of a tax reassessment.

The new wording of the chapter VI principles will probably lead the French tax audit services to adopt this approach, which is expressly presented as a way to provide comfort to tax administrations, given information asymmetries. Even though the BEPS report on Actions 8–10 states that further guidance will be drafted during 2016, it may be anticipated that this \textit{ex post} check will be implemented in audits, even before this guidance is provided. The FTA may also want to include some specific comments or details in the domestic regulations.

3.2.3. “Substance-over-form” approach towards intangibles

This method of taking an \textit{ex post} look at transactions could be seen as similar to the substance-over-form approach included by the OECD within the new chapter VI of the OECD TP guidelines. It offers a possibility for tax administrations to challenge the organization and the prices presented by MNEs, based on contracts and what is often described as their internal operational organization.

This possibility exists in France and is used by the FTA. It allows tax auditors not to stick with the presentation provided by taxpayers or in contracts, but to try to demonstrate that the reality, whether operational or economic, is different. This demonstration is subject to judicial validation.
The *abus de droit* (abuse of law) allows tax auditors to contest the outcome of a contract or any other legal agreement between parties when they are able to demonstrate that this contract was only designed to bypass a law for the sole purpose of avoiding tax.

Article L.64 of the Tax Procedure Code mentions that, when determining taxable income, the tax administration can reject any contracts, organizations or transactions, whether they are (a) fictive or (b) only seeking an incorrect implementation of the law, to take into account the reality of the activity.

The FTA regulation (BOI-CF-IOR-30-20140124) details the difference between these two branches of this procedure. Looking at fictive operations, it specifically mentions that this is designed to contest situations where there is a discrepancy between the contract or/and the transaction on the one hand, and the economic reality on the other. Examples include a situation where a taxpayer is setting up an artificial legal and economic organization.

This procedure is dedicated to fighting against severe tax evasion schemes and is complemented by penalties, depending on the taxpayer activity and its implication in the design of the scheme. Article 792 bis of the French Tax Code states that those penalties could be 40 per cent or 80 per cent of the tax adjustment.

Tax auditors have to perform in-depth investigations, and collect information and facts to substantiate their position. They will have to detail the rationale of this abuse of law to a tax judge in charge of the validation of the tax administration position.

This procedure is commonly used by tax auditors (even though the number of abuse of law cases is commonly quite low). It provides the FTA with a real possibility to contest the alleged operations and organizations of taxpayers.

The OECD has provided clarifications in the recommendations on Actions 8–10 of the BEPS report regarding intangibles. However, OECD TP guidelines have already included the possibility for tax administrations to contest the initial presentation of transactions by MNEs. Paragraph 1.64 of section D.2, Recognition of the actual transactions undertaken, states that a tax administration’s examination of a controlled transaction may, in exceptional cases, disregard the actual transactions or substitute other transactions. This was part of chapter I dedicated to the arm’s length principle and so is of general application, including transactions on intangibles.

The BEPS report provides a new version of chapter VI dedicated to intangibles. Paragraph B.1 explicitly states that contracts are a starting point of the analysis of a transaction but should be completed by a careful examination of facts and the parties’ behaviour. It also refers to paragraph D.1.1 of the new chapter I, which explains the way to better apprehend the real functions performed by each of the parties.

The French legal approach is commonly based on contracts and official documents settled between the parties. However, as described above, the FTA benefits from specific tools designed to allow for a detailed scrutiny of real transactions, in order to depart from the contract and eventually work on the basis of the substance of the transactions.

Moreover, this approach has been strengthened by the validation in July 2016 of the EU directive dedicated to measures against tax avoidance, which will enter into force on 1 January 2019. This directive, partly worded to organize a consistent implementation of the BEPS recommendations within EU Member States, includes
a general anti-abuse rule leading Member States to ignore arrangements when they are not genuine and defeat the object or purpose of the applicable tax law.

Although the French approach is already in line with such provisions, it will differ, as the directive targets arrangements when they are in place “for the main purpose or one of the main purposes of obtaining a tax advantage”. Article L.64 of the Tax Procedure Code explicitly mentions that an abuse of law is constituted when arrangements are exclusively devoted to gaining a tax advantage. Of course, it will be much more difficult for MNEs to explain that their arrangements did not include a tax advantage as one of their main purposes than to explain that this was not the exclusive goal of entering into those arrangements.

While the new chapter VI will provide room for more discussion and work for French tax auditors, one could anticipate that it will not dramatically change the way they perform their investigations, even though they may pay more attention to specific transactions. No change in the French law may be anticipated on this aspect. However, from a general point of view, it will be interesting to see how French tax law will be adapted to take into account the EU implementation of such a general anti-abuse rule.

3.2.4. Comparability and group synergies

French tax auditors have been active in the analysis of the integration of entities within a group, and the benefit the whole group may be able to gain from such integration. Once again, there is no specific law or tax administration regulation connected to this approach. However, tax auditors have developed a common understanding and are able to apply consistent argumentation.

One of the main examples provided by Actions 8–10 of the BEPS report is well known by the French tax auditors, whether it is within chapter VI, dedicated to intangibles, or within chapter I, devoted to arm’s length principles (and examples 3 to 5 under section D.8, MNE group synergies). The actions of a shared services company involved in purchases for the entire group is one of the most obvious examples of group synergy.

The FTA has for several years been developing a position leading to an attempt to evaluate the share of the benefit coming from this group action to be allocated to the single French entity as one which allows the group to be able to use its size in the negotiation with its suppliers.

On this specific matter, the French tax audit services will probably not have to adapt to new rules or new principles. In fact, the BEPS recommended approach has already been designated in France for several years now. Roughly speaking, tax audit services share the group synergies arising from the combined purchasing power between entities mostly using the turnover of each of them.

The new BEPS recommendations may lead the FTA to issue new regulations to develop its approach towards this specific type of synergy, in order to detail it and provide tax auditors and taxpayers with precise directions. It may also take the opportunity of this new regulation to expand the scope of its consideration for this specific group benefit.

The financial side of the BEPS recommendations (see examples 1 and 2 under section D.8 of the new chapter I) has been a difficult aspect for tax auditors to take into account. The issue has been seen and explored for a long time now, but ways
of dealing with it may have changed over time, depending on an MNE’s organization and financial operations. In fact, the guidance provided by Actions 8–10 of the BEPS report is in line with recent case law: the judge is ready to take into account the benefit provided by the group, by the decrease in the rate of a loan for example, as long as there is a positive action of the mother company of that group, i.e. when it agrees to guarantee the loan.

Once again, one may anticipate that the FTA may want to internally adapt some of the OECD recommendations, in order to provide guidance to tax auditors and taxpayers. However, this would not lead to a change in the French tax law.

Paragraph 6.30 of the new chapter VI explicitly mentions that such group synergies cannot lead to an intangible creation, as they are not owned or controlled by an enterprise. The FTA has never followed that route and would contest such a demonstration if it was tentatively developed by a group.

### 3.2.5. Hard-to-value intangibles

The new chapter VI on intangibles provides a definition of hard-to-value intangibles. It uses two criteria: (a) that no reliable comparable exists and (b) that projections at the time of the transactions were highly uncertain, making it difficult to predict the level of success of the intangible. The FTA has not provided such a definition for these specific types of intangible and nothing in its regulations is specifically designed to deal with them.

However, transactions on these hard-to-value intangibles have been a matter of concern to tax audit services for a long time. They are trying to take into account references helping them to find comparability with other intangibles or similar situations and functions. Valuation often leads to long discussions with taxpayers on the criteria to take into account and figures to be used.

The *ex post* approach is much appreciated by auditors, even if it is not always used as the only way to correct revenues allocated to the French entity but as a clue among others to come closer to what may be the real substance of the transaction and the intangible at stake.

In fact the main part of discussions between tax auditors and MNEs will be focused on the nature of the hard-to-value intangible. It will include a description of the development procedure of the intangible, in the life-science sector for example, in order to better see what this procedure is and identify the different phases of development, to weigh the potential risks to come and see whether the procedure can already be considered as an intangible and, if the answer is yes, what revenues may already be anticipated from it, knowing that the group is still bearing a high level of risk as the development may not lead to the expected outcome, due to unsuccessful fundamental research. Similar situations may arise in the development of software or brands.

This part of the work is mainly of a technical/scientific/operational nature and not directly connected to tax matters. It relies on the experience of tax auditors and the capacity of MNEs to describe their activities and provides a rationale to detail the common habits of their industry community. It clearly highlights the need for stable and experienced resources within the tax administration and the MNE’s capacity to gather, keep and detail contemporaneous information to sustain its position later during possible tax audits and MAPs.
These kinds of specific transactions have sometimes been scrutinized by the FTA, on the occasion of APA requests. In such cases, the precision and the reliability of the information provided by MNEs can be decisive for the success of the request. For instance, some APA requests have been modified or could not be accepted because of uncertainties connected to the transactions, to the future activity to be developed with the intangible, or because of the nature of the intangible itself (i.e. partly developed, or still in the process of obtaining public agreement before its introduction on to the market).

As explained above, details provided by the FTA in the area of TP are quite limited. However, due to the development of the OECD guidance under the BEPS recommendations, specific advice would be helpful for taxpayers involved in some industry sectors (pharmaceutical, IT, industries relying on highly technical intangibles with a long period of development) and may be provided by the FTA, based on its experience in specific cases.

Moreover, knowing that the general French technical position regarding BEPS reports is in line with the conclusions and recommendations, there may be a specific move and public regulations provided to embed the two most important exceptions mentioned by the new chapter VI: (a) the avoidance of the *ex post* evidence approach when detailed information on the *ex ante* domestic projections is provided and when unforeseeable events explain discrepancies between financial projections and actual outcomes; and (b) the absence of adjustment when the difference between projections and outcomes leads to an increase or a decrease of the intangible compensation limited to a maximum of 20 per cent.

### 3.2.6. Cost contribution agreements (CCAs)

As indicated above, not much detail is provided by the FTA to provide national guidance to economic operators. CCAs are only mentioned in the FTA regulation as a way to split the costs to develop an intangible (BOI-BIC-BASE-80-10-10-20140218) but no further explanation is provided.

French tax audit services and MNEs can refer to the EU report on CCAs on services not creating intangible property. This report of the JTPF of the European Commission (finalization of works performed from July 2010 to June 2012) provides explanations to both European tax administrations and international groups with advice to reviewers about this type of CCA. The report details a list of criteria to check, in order to ensure a common understanding among EU Member States with factual recommendations.

Even though this JTPF report does not provide information connected to intangibles, as long as there is no specific information, the FTA currently relies on those principles and, knowing that CCAs are not often used by MNEs and so are not so commonly scrutinized during tax audits, one could anticipate that France will not provide further domestic guidance regarding this specific type of intra-group contract.

### 3.3. Risk and capital

For a long time French tax auditors have been paying a lot of attention to the questions of risk and capital attribution as revenue allocation drivers. This started when
international groups implemented specific policies designed to structure their organizations differently from the way independent operators would do. By carefully attributing risk and capital to dedicated companies, they were deconstructing normal transactions, including a whole range of services, risks and capital ownership, and were creating new types of transactions which did not exist as such between third parties.

The FTA soon saw those transactions as dangerous from a tax collection perspective and it has targeted them in tax audits. However, although they were described as risks to be assessed, no specific or detailed commentaries and guidance were provided. Nevertheless, tax audit services have identified what has become the usual way of analysing the reality of those transactions and valuing them.

In fact, one can recognize in Actions 8–10 of the BEPS recommendations some of the criteria that French tax auditors are currently using, aiming either to demonstrate that such a risk/capital allocation is not real or that the pricing is inappropriate.

Tax auditors are paying attention to (a) the control of the risk (whether it is acceptable to bear it or to mitigate that risk), (b) the capacity of the risk-taker to financially face that risk, and (c) whether that risk really exists. That focus is leading to a list of questions connected to the group operational organization, the situation of the key people able to take the appropriate decisions, the careful description of the nature of the risk, the last time that risk was borne by the group, the possibility of asking for insurance coverage from a third party, etc.

However, the BEPS recommendations have either (a) detailed the steps of the process to analyse risks in a controlled transaction or (b) clearly offered the possibility of ignoring the contract and organizational description provided by groups and sticking to what is assumed to be the intention of the parties (see new section D.1.2.1 of chapter I of OECD TP guidelines, Analysis of risk in commercial or financial relations, especially paragraphs 1.60 and 1.86, the latter providing explanations on step 5 of the process).

There is no indication for now of any move from the FTA to internally introduce those comments or provide for any specific detail within the French regulations. It may be anticipated that it will not do so, as a direct reference to the OECD TP principles is possible, but tax auditors will certainly now use these precise indications during their investigations.

### 3.4. High-risk transactions

#### 3.4.1. Comparable uncontrolled price (CUP) and quoted prices for cross-border commodity transactions

In this area, France does not have a specific position that deviates from the OECD TP principles. As already described above, as TP comments from the FTA are rather limited in comparison to those from some of its treaty partners, nothing specific has been published. However, those new principles introduced in the OECD TP guidelines are already enforced by the French tax audit services and will probably not lead to additional comments from the FTA.
3.4.2. Intra-group services

The FTA has always held a moderate position regarding intra-group services, in line with OECD TP principles and the EU JTPF recommendations.

In fact this position is in line with principles designated for many years by well-established domestic jurisprudence. The French judiciary has designated a clear process in three steps, leading to a validation of the deduction of those expenses: (a) are they real? (b) Are these expenses correctly priced? (c) Are these expenses useful for the paying company?

On the basis of these criteria, taxpayers can be confident that the management fees/low value-added services will be accepted by tax auditors during an audit. Moreover, and unlike some of its treaty partners, French tax auditors have adopted a reasonable standpoint when investigating under the first step of the process. Some years ago, they followed the temptation to dig into too much detail to assess the reality of the services provided and the way in which they were allocated to subsidiaries. They were asking for lots of explanations on the type of services and people involved in the activities, challenging allocation keys and asking for detailed timesheets.

This approach belongs to the past and, in the vast majority of cases, tax auditors are today more focused on the needs of the French entity and the rigorous enforcement of the policy set by the group. This pragmatic approach can be linked to the progressive implementation by the French tax audit services of the EU recommendations in that matter.

On 25 January 2011, the EU JTPF adopted a report based on the works performed by the forum between April 2009 and June 2010, including guidelines on low value-added intra-group services. In line with the OECD TP guidelines, it was in particular suggested that a 5 per cent mark-up was usually a remuneration commensurate with the effort provided by the entity in charge of regular central services and management fees.

This 5 per cent rate is mentioned in Actions 8–10 of the BEPS recommendations. However, those recommendations go a step further, providing for a simplified mechanism. Such a mechanism is expected to be in place once sufficient countries have recognized this new simplified approach. This OECD BEPS suggestion includes the possibility for tax administrations to adopt a threshold, to enable them to review the simplified approach in cases where the threshold is exceeded.

This threshold may recall the habits of some French treaty partners of not allowing the deduction of those central low value-added services for an amount exceeding some kind of arbitrary threshold (not deriving from domestic law or tax administration regulations). The FTA has never enforced such a cap, even though tax audit services of course look at the weight of such services in the audited company, paying more attention when they exceed a commonly accepted percentage.

For now, the FTA has not made any specific announcement on that OECD suggestion. However, it may be anticipated that France will accept this new initiative and endorse the domestic implementation of this simplified approach before 2018. The French Parliament or the tax administration may not take the opportunity of this endorsement to introduce a threshold, as suggested by the Actions 8–10 OECD BEPS report.
3.4.3. Profit splits in the context of value chains

The FTA regulation includes the description of the TP method recommended by the OECD (BOI-BIC-BASE-80-10-10-20140218). The profit split method is of course one of them. Although the methods were originally differentiated into preferred and subsidiary, as initially recommended by the OECD, this distinction has now disappeared and the regulation states that the most appropriate method should be selected by the group to properly remunerate the French entity, once again fully in line with recommendations provided in chapter I of the OECD TP guidelines.

However, experience shows that tax auditors may not always be keen to use the profit split method, as the way some groups implement that method may be complicated, with no detailed information about the keys they use and no clear explanation of the link between these keys and the activities performed or the profit to share.

Interestingly, even though the profit split is usually used by larger international groups, as long as this method is supposed to be connected to the use of the more integrated transactions and the highest value-added intangibles, the FTA has detailed some more explanations regarding the profit split method in a specific TP guide dedicated to small and medium-sized companies.

Published in 2006 to help small groups to better understand TP matters and to provide further clarification, including on a specific APA procedure dedicated to small entities, this guide details an example and a calculation to illustrate the way the method works. As the guide was drafted in 2006, and nothing further has been added since then, it clearly mentions that the profit split is a last resort method (see above on this aspect) and suggests that this method could be used as a corroborative one, to validate the consistency of the outcomes of a traditional method.

When used by tax auditors, the profit split method is of course linked to a strong functional analysis and a detailed scrutiny of the intangibles used by the group as well as the risks borne by the group entities. This means that if there is no specific rule or mechanism concerning the application of TP rules to MNE value chains, the way the analysis is performed during a tax audit is actually in line with Actions 8–10 OECD BEPS recommendations.

It is obvious during tax audit works that tax auditors carefully examine the transactions detailed by the group and take time to achieve a good understanding of the contracts. When possible, they also embed in the audit team people with an economic profile, in order to better understand the business activity of the group.

The last subject included in the scope of revision on the transactional profit split method mentioned by the BEPS report is the use of the profit split to determine the transactional net margin method (TNMM) range, royalty rates and other payment forms. Experience shows that the French tax audit services may accept this approach to a profit split to substantiate the rate of some kind of royalty (auditors of the national tax audit services in charge of the largest groups rather than other auditors).

When accepting such an approach, they also make a cautious examination of the functions and risks of the various entities of the group, in order to identify the value-added activities performed and the appropriate key remuneration drivers of
the profits. This allows them to then better understand the value chain of the group at stake and to be able to challenge the profit splitting factors.

The FTA has not specifically reacted on this matter and it may be anticipated that it will not provide details on the use of this specific method before the end of 2017, when it is expected that the draft working party 6 guidance will be finalized.

3.5. TP documentation

3.5.1. CbCR

Soon after the BEPS report was published, France indicated that CbCR will be implemented and information will be provided to its partners. It is interesting to recall that the government was initially considering including a dedicated article in the Finance Law for 2016, at the very end of 2015, but Parliament has requested its introduction earlier, in another law connected to several aspects, including tax matters, leading to a validation of this article a few weeks earlier.

CbCR is mandatory for fiscal years beginning on or after 1 January 2016, under article 223 quinquies C of the French Tax Law. It is fully in line with the BEPS recommendations: the first report will be filed with the FTA before the end of 2017 and the information will then be shared with France’s treaty partners. France actually signed the Multilateral Competent Authority Agreement on the exchange of CbCR on 27 January 2016, and was one of the first countries to sign it.

A decree is expected to detail this new mandatory reporting procedure, and the FTA has circulated several drafts. However, no specific explanations or formal guidance for its implementation has been provided by the FTA to date.

Early during the parliamentary discussions on the implementation in France of this CbCR, voices were raised to ask for an implementation of public CbCR. The Minister of Finance has explained that the French government was looking for the full implementation of the BEPS recommendations, but only the BEPS recommendations, explaining that public reporting could be a goal, as long as it was implemented at the same time by other partners.

This debate on public reporting is still alive in France: public CbCR is included in (a) two draft EU directives (one on accounting and one on shareholder rights) that still need work and (b) a draft French law related to transparency and the fight against corruption (article to be added to the commercial law). This French draft law will be discussed in Parliament before the end of 2016.

Moreover, this last draft law has also included a progressive decrease in the BEPS recommended threshold of €750 million. The current wording of that draft law provides for an initial decrease to €500 million in 2018 and to €250 million in 2020. At the same time, the FTA is also requesting the introduction in this law of an amendment to the Tax Law (article 223 quinquies C) to substitute a €50 million threshold instead of the €750 million from the BEPS recommendation.

3.5.2. Master and local files

Article L.13AA of the French Tax Procedure Law has introduced, starting on 1 January 2010, mandatory documentation to be provided to the tax auditor from
the beginning of the tax audit. This article explicitly mentions the distinction between a set of general information connected to the group and a set of specific information connected to the French entity and the TP method.

The JTPF code of conduct on TP, validated in June 2006, has been the main reference of this article of the French law, as well as initiatives of other European Member States. This clarified the documentation and the information to provide to French tax auditors, but also increased the pressure on MNEs to present this information on TP very near the beginning of the audit procedure. Before the introduction of the article, it was difficult for tax auditors to access a clear set of documents to detail and prove the internal organization of the group and to have detailed and reliable information, in order to assess the MNE TP.

If this information is not available at the beginning of the tax audit, the French entity may face specific penalties, if this information is not provided in the 30 days following a formal request of the tax auditor.

As French tax law already includes this distinction between master file and local file, the Action 13 recommendations in this area will not lead to a major change in France. However, some information to be included in the master file following the BEPS Action 13 report is not currently mentioned by the French Tax Law, mainly:

- a description of the supply chain for the group’s five largest products and/or services offering;
- a list and brief description of important service arrangements between members of the group (other than R&D);
- significant financing arrangements with unrelated lenders;
- the group annual consolidated financial statement for the fiscal year and a list and brief description of existing unilateral APAs and rulings.

However, for now, the FTA does not anticipate a change in domestic tax law.

### 3.5.3. Compliance costs

There is no specific domestic requirement and no discrepancy with OECD recommendations. Experience shows that mandatory TP documentation is not easy to prepare and to file with tax administrations. Even though the information may be somewhere in the accounts or in the IT systems of the groups, it is not always computed as such and may not usually be documented by the tax directorate of the groups or the local entities.

For example, one piece of CbCR information to mention on the form is the number of employees. This information, which may lead to a specific calculation when people outside a company will be included in the total number of employees (see the Action 13 BEPS report on the possibility of including employees of independent contractors, in specific situations), may be difficult to collect. Figures may also be difficult to sum up, due to the use of different reporting systems in a single group (when groups were built by several acquisitions for example).

The fact that this mandatory reporting and information has to be provided has led MNEs to invest in new tools and time to design the appropriate internal procedure to ensure useful information collection and ensure the quality of the figures provided. Groups have also been careful in drafting comprehensive reports and
making sure that all useful information has been provided to the tax administra-
tions/tax auditors.

These are direct costs connected to the implementation of the new CbCR
requirement. MNEs are also anticipating indirect costs, arising from the possible
reactions of tax auditors, who will investigate these international transactions in
depth, using these new detailed information flows to ask more, very specific ques-
tions, probably aiming at reconciling the figures provided in the CbCR with figures
included in other tax returns or mandatory reports, or even provided by other tax
administrations under the exchange of information. This will be time consuming
and expensive to manage.

The only specific requirement (effective in the French tax law at the end of 2013)
arises from the mandatory TP report (article 223 quinquies B of the Tax Law) to be
filed with the FTA, to provide an electronic report including general information
about the group and its activities, and specific figures and elements on transactions
and the TP method. However, no specific costs to be borne by MNEs are expected
in France other than those connected with the implementation of CbCR.

3.6. TP-related measures in other BEPS actions and other measures
against BEPS

As already mentioned, France is in a specific situation where most of the BEPS
recommendations are already included in French tax law or implemented under tax
audit procedure practices. This means that no specific action is anticipated in most
of the other BEPS actions areas. If necessary, France will of course include in its
domestic law specific measures arising from EU directives to align EU legislation
with the BEPS recommendations.

In fact, what can be expected is the very dynamic participation of the French
representatives in the coming works on the IT sector. France was one of the co-
chairs of the BEPS group dedicated to Action 1. The interest of France in this area
is obvious and it is certain that it will provide new ideas and will contribute to an
evolution of the principles in that matter, if possible.

No information has been provided for now on the possible reaction of the FTA
regarding the Action 5 recommendations. Knowing that France has an R&D
regime which may be considered as not BEPS compliant, it may be expected that a
careful examination of this regime will have been carried out. However, this
regime has already been scrutinized in the EU context of the code of conduct (the
Primarolo Group) and it has been validated.

Under Action 4, specific recommendations connected to financial expenses and
financial transactions have been provided by the OECD. Most of them are already
covered by French tax law, but the FTA may want to take this opportunity to clar-
ify some of the existing legal provisions or to strengthen the French anti-abuse law.
For example, interest limitation rules (also included in the Anti-Tax Avoidance
Directive) may be adjusted, but they would certainly have an impact in the more
general TP area as such a limitation may have an impact on the TNMM TP method
for example, when the TNMM is designed to take into account the bulk of several
intra-group transactions, including financial transactions.

Looking to Action 13, France has made it very clear that it is ready to include an
arbitration clause in its tax treaties. It has indicated that it will systematically sug-
gest doing so to its partners whenever a convention is to be negotiated or amended. France has said that it is willing to be one of the countries to sign the OECD multilateral instrument to ensure the effective introduction of the arbitration procedure.

3.7. Can BEPS work in favour of MNEs?

From a general point of view, the BEPS recommendations have been seen as a strong global strengthening of rules which will favour the position of tax administrations, especially when it is connected to a “substance-over-form” analysis and to the ex post approach. This is not a surprise as the BEPS works were intended to facilitate the fight against BEPS.

However, MNEs may be in a position to benefit from some of the BEPS recommendations, either from the limits to intangibles comparisons, from the optional approach of limited value-added services, from the improvement in the APA/MAP procedures or from the clarifications about cross-border commodity transactions.

Moreover, the focus of the BEPS recommendations on transparency may also be an opportunity for MNEs. For now, no specific initiative has been taken by the business or the FTA to specifically use the information which will be shared with the tax authorities in a way to favour taxpayers. But it is certain that groups may benefit from this move to gather and centralize all the information, not only in France but in other countries of course.

This move towards transparency and exchange of information would lead groups to collect, more systematically and on a larger scale, information that may have been somewhere in the accounts or in a specific subsidiary but has not been used to date. It may also lead to the setting in place of specific procedures or methodologies to find and keep information which was not collected before, or to collect much more detailed figures and indicators.

Having this information easily available may help MNEs to explain in more detail their position, their organization, their TP method and their profit allocation. It may also lead tax administrations to avoid challenging groups on some transactions or levels of remuneration, due to the fact that they may have a better understanding of the group activities and the transactions’ organization.

4. The future of TP in France

It is certain that France will continue what has been its traditional approach for years, to enforce international TP principles and guidance, whether they come from the OECD (specifically the arm’s length principle) or the EU, as well as taking into account genuine MNE international and operational organizations. In this context, the FTA is ready to deal with international transactions and explains that it is not specifically targeting MNEs when preparing its tax audit programme.

Bearing this context in mind, and from a general point of view, one would easily agree that the BEPS recommendations will probably lead to increasing pressure on businesses from tax administrations. This will be evidenced by a rise in tax audit numbers, by a more focused attention on TP from tax auditors, by higher amounts of TP tax reassessments, by a more common use of penalties in the area of TP tax
reassessments, and probably by some countries investigating TP when they did not, or not so much, in the past.

Most of this will probably also happen in France, in the medium to long term, and actually seems to have already started with the momentum of the BEPS works. MNEs have seen (a) the amount of TP tax assessments increased and (b) penalties more often used in the TP area (either because a full set of information has not been provided or because the TP policy detailed by the group has not been fully implemented or was leading to what is called a “significant discrepancy”), where it was not in the past.

In France, a rapid growth in the amount of double taxation may be anticipated, arising either from French audit activity or from the tax reassessments of economic partners. This will naturally lead to an increase in MAPs, because this focus on TP matters may also be accompanied by a reluctance of most of the tax audit services to enter into an amicable discussion with groups (partly because of the use of penalties, as described above). At the same time, some of the treaty partners of France appear to have a less open APA approach, considering that they do not want/cannot work (a) on requests that are too difficult or (b) when the transactions at stake are said to be too challenging. France has not followed this avenue to date but may be tempted by a similar approach.

To face that situation, treaty partners may ask France to be part of joint TP audits or simultaneous TP audits, to work together and choose a consistent position on both sides of the border. Up until now, France has not been keen on this kind of joint tax audit procedure but may change its approach, to ease TP audit procedures and decrease the flow of MAPs.

Looking to the future from a more theoretical point of view, three main changes may be foreseen.

(a) The profit split may become a more common method. Knowing that it is difficult to find agreeable comparables (more difficult access to useful information, specificities in the rules of several countries to build a comparables study, less useful comparables in some industry sectors such as IT, tech-economy, collaborative economy development, etc.), this method may become more acceptable and less challenged, becoming the last reliable TP method in some situations. France seems not to be reluctant to use the profit method on a larger scale.

(b) The common consolidated corporate tax base (CCCTB) may be introduced soon in the EU and would lead to fewer concerns regarding some European transactions. The CCCTB implementation is one of the main goals of the European Commission, in the momentum of Brexit, in its attempt to invigorate European action and end current corporate tax competition. After the introduction of such a common corporate tax rule, and depending on the design of the CCCTB, some tax administrations, including the FTA, would then focus on other transactions than those performed within the CCCTB zone. This may decrease the overall number and amount of TP reassessments, but may increase the pressure on transactions with some countries and so may lead to specific technical problems with these countries, as well as a rise in the opening of MAPs.

(c) TP aspects may become a matter of concern for people outside of the traditional tax area. If more information is made public, this will become of spe-
cific interest for non-tax partners of MNEs, whether employees, NGOs, customers, shareholders or managers of the group. This has already started, in France as in other European countries, due to recent leaks and following the recent public actions of Mrs Vestager, the European Commissioner for Competition. Specific technical attention may then be needed to design a TP policy, which would have to be simple enough to be explained to the public, and to carefully ensure the full implementation of that policy, to avoid an adverse impact on the group brand and image.
Summary and conclusions

In 2008 and 2013 the “adjustment of income” requirement in the case of business connections abroad (section 1 German Foreign Tax Code (FTC)), translating the arm’s length principle into German law obtained additional subsections:

• determining the order and the prerequisites for applying the internationally accepted transfer pricing (TP) methods in accordance with German law;
• specifying more closely the “hypothetical arm’s length approach” as well as its application in cases of transfer of functions, and the possibilities of retrospective price adjustments;
• revising the definition of the term “business relationship” with foreign countries; and
• extending the application of the arm’s length principle to the allocation of profits to permanent establishments.

In their interpretation of this principle, for a wide range of issues the German tax authorities still refer to their administrative guidelines of 1983. This holds true in particular for the TP of goods and products, the question of whether transactions with intangibles are subject to tax, whether group synergies resulting from concerted group actions have to be taken into account, and how to account for intragroup finance and administrative group services. As far as the definition of intangibles is concerned, TP rules make general use of the term “business asset”.

In the course of revising and adjusting these principles in line with developments at the level of the OECD, the Federal Ministry of Finance has issued regulations governing the area of cost sharing arrangements and the posting of workers in a separate communication. The former communication deals with details concerning the application of the arm’s length principle as far as they affect the general prerequisites for its application, the allocable amount, the allocation mechanism, special cases, documentation and the provision of evidence. For the purposes of determining each participant’s proportionate share of the overall contributions to a cost contribution agreement (CCA) in Germany, the communication requires that the value of each participant is measured at cost.

In the aftermath of a Federal Tax Court case in 2001, section 1 FTC has been supplemented with documentation and penalty provisions. Additional detail to the latter provisions was laid down in a legal ordinance and explained in the context of
administrative principles (binding for subordinate authorities). The ordinance governs the type, content, and scope of records in the case of ordinary, specific and exceptional business transactions. Besides a duty to document the facts and circumstances on which the transactions between related parties are based, the ordinance also explicitly demands evidence on the appropriateness of the transfer prices applied.

The focus of the changes to the arm’s length principle in German tax law (section 1 FTC) is on the determination of a hierarchy and the terms of application for individual TP methods. Consequently, for intra-group cross-border business transactions, the German FTC requires the transfer price to be determined primarily according to the comparable uncontrolled price (CUP) method, the resale price method, or the cost plus method. Use of the transactional profit split method has the explicit acceptance of the tax authorities, but due to a statutorily determined order of application, it can only be employed where the standard methods cannot or cannot reliably be used in the absence of unequivocally comparable arm’s length prices (section 1(3) FTC). From the perspective of the German tax authorities, this may be possible where more than one group company performing an entrepreneur function participates jointly in the initiation, processing, and completion of a cross-border business transaction in which the individual contributions cannot be separately identified.

In order to prevent base erosion and profit shifting (BEPS) in line with the OECD/G20 recommendations, the German legislator is now interested in assessing and evaluating the integrated processes of multinational companies (MNEs) in their entirety, and ensuring that the resulting profits are taxed where added value is generated. A closer look at these recommendations makes it evident that the potential of the BEPS project to reshape TP rules and practices around the globe should lie in the fact that the OECD is dealing with the allocation of integration benefits to a far greater extent than in the past, thus bringing the arm’s length principle closer to the realities of an MNE. Moreover, the relevance of legal ownership rights and the contractual allocation of operating risks is now to be given less significance in the TP context, in favour of the actual conditions of a transaction. Finally, the tax authorities will obtain two supplementary instruments, country-by-country reporting (CbCR) and the master file, which will contribute to the transparency of TP and provide an evidential basis for the audit process. These measures also counter the susceptibility of existing TP rules to tax planning.

In light of the latter, it is to be expected that Germany will for the most part take up the OECD/G20 recommendations. Germany is already meeting its international obligation to introduce the minimum standard for CbCR and is modifying the documentation duties in terms of the OECD master and local file approach. Whereas in terms of intangible assets there is no major deviation of the German approach from what the OECD/G20 understands as an intangible and no need for action is seen with a view to the OECD/G20 recommendations concerning CUP and quoted prices for cross-border commodities, in addition to implementing CbCR and modifying the documentation duties, further measures are to be expected with regard to intangible transactions, the substance-over-form approach, hard-to-value intangibles, CCAs, taking proper account of risk and capital, and intra-group services.
However, reservations exist in Germany as far as the OECD/G20 recommendations for use of the profit split method are concerned. There are doubts as to whether the across-the-board application of the profit split method will be helpful with regard to its lacking practicability and difficulty of justification. Furthermore, it is believed that the profit splits could result in a formula allocation mechanism, which while simpler to apply, is not expected to result in an appropriate allocation of profits.

1. Current TP regulations and practice in Germany

To prevent affiliated companies from shifting taxable profits or deductible expenses out of or into Germany by way of inappropriate TP arrangements or business conditions, the German tax legislator has created four basic defence mechanisms with respect to the adjustment of income. The following instruments have to be taken into account:

- general provisions on the determination of the tax base applying to all areas of tax law and prohibiting all manner of abusive arrangements;
- hidden profit distributions disallowing the deductibility for tax purposes of business or financial disadvantages in favour of one or more of its shareholders or their related parties;
- hidden capital contributions which do not increase the profit of the recipient, but are also not deductible expenses for the (domestic) contributor;
- the “adjustment of income” requirement in the case of business connections abroad translating the arm’s length principle into German law.

To guarantee the uniform application of the law, the executive authorities can be empowered to set details of application for these legal provisions. For transfer prices, the legislator has made use of this possibility in the determination of type, context, and scope of the documentation required and in connection with the cross-border transfer of functions. The tax administration has no other powers to issue legally binding regulations. Nevertheless, the authorities are able to issue administrative regulations in the interests of achieving equal application of the laws. Such administrative regulations consist of the federal government’s guidelines, Ministry of Finance communications, state finance ministries’ decrees, and the orders of the higher tax offices. Although not legally binding for the individual taxpayer, these exert a de facto binding effect.

Of central importance here are the administrative principles. These principles specifically interpret the legal provisions regarding international attribution of income and include positions on various types of intercompany transactions. The communication on CCAs deals with the application of the arm’s length principle in terms of general prerequisites, the allocable amount, the allocation mechanism, special cases, documentation and provision of evidence in this context. The administrative principles regarding the posting of workers regulate in particular the attribution of expenses associated with the posting of staff, relevant qualification criteria, special arrangements, questions of treatment for tax purposes, and the procedure and duties concerning provision of evidence and cooperation.
The “adjustment of income” requirement has been supplemented with documentation and penalty provisions. They are:

- documentation requirements for cross-border transactions with related parties including permanent establishments;
- the consequences of inadequate or missing documentation; and
- penalties in the case of non-compliance with documentation requirements by the taxpayer.

Additional details to these provisions were laid down in a legal ordinance and explained in the context of administrative principles (binding for subordinate authorities):

- the ordinance regarding the documentation of profit attributions governs the type, content, and scope of records in the case of ordinary, specific and exceptional business transactions;
- administrative principles regarding procedure deal with questions on the duties of the tax authorities, participants’ duties to cooperate, the legal consequences of failure to cooperate, the implementation of adjustments and the process of TP corrections, and mutual agreement or arbitration procedures.

The “adjustment of income” rule covers provisions determining the order and the prerequisites for applying the internationally accepted TP methods in accordance with German law. If no third-party values of at least limited comparability can be found and, especially, where a function including the related opportunities and risks is transferred, accompanied by assets and other advantages transferred or lent, in principle the taxpayer is to base income determination on a “hypothetical arm’s length comparison”, i.e. some form of “profit split of anticipated profit” using valuation techniques as proposed by the OECD/G20 in their revised guidance on profit splits.

This latter element of the arm’s length principle has also been supplemented by a legal ordinance dealing with taxation of transfer of functions, and has been explained in corresponding administrative principles. Here, i.e. in the:

- ordinance regarding the transfer of functions; and
- administrative principles regarding the transfer of functions,

the spotlight is on provisions regarding the determination of value associated with assets and other advantages (such as goodwill forming an integrated part of a business) bundled in a “transfer package”, and on the conclusion resulting in the determination of respective transfer prices.

2. The impact of the BEPS project on TP

2.1. Introduction

At their Antalya meeting, with a view to tackling issues where no action by some countries would have created negative spill-overs, the OECD/G20 agreed on four minimum standards, including two – CbCR and dispute resolution – with relevance for TP. Whereas the latter is dealt with in the context of developing a “multilateral instrument”, in Germany the obligation to file CbCR requires enforcement via domestic law. To this end, in September 2016 the German federal
government presented a bill to implement the changes required by the EU Mutual Assistance Directive and other measures to tackle BEPS, by way of which the OECD/G20 recommendations regarding the local file and master file approach are to be implemented.¹

With a view to the further OECD/G20 recommendations that have not as yet been officially approved under international law, the question is how the new OECD guidelines are to be taken into account when interpreting section 1 FTA. In Germany, application of the OECD/G20 recommendations needs a legal basis in domestic law, in particular if their application would lead to a higher tax burden for the taxpayer. This legal basis will require an amendment of laws (section 1 FTC), legal ordinances or other means insofar as recommendations change the current interpretation of the arm’s length principle. This is clearly apparent, for example, with respect to CCAs. However, we may anticipate that most of the changes seen as necessary by the German legislator – in order to implement the new OECD guidelines supplementing the recommendations on application of the arm’s length principle as presented in the OECD/G20 Action items 8–10 – will be taken into account in the long-awaited ordinance on the application of the arm’s length principle.

In response to German Federal Tax Court decisions ruling on the “blocking effect” of double taxation convention (DTA) provisions, the government bill requires that the interpretation of the arm’s length principle is based solely on the provisions of section 1 FTA regarding “adjustment of income”. Whereas some critics believe this requirement to be an “anticipated treaty override”, the legislator intends to “clarify” the government’s position that the arm’s length principle is to be interpreted uniformly, domestically as well as internationally.

German company representatives believe the proposed OECD/G20 actions to be right and proper.² They also accept the main target of ensuring effective taxation where profits are generated. The usefulness of the new reporting requirements, however, is a less widespread perception. Moreover, most company representatives do not believe the OECD/G20 actions to be helpful in determining individual corporate entities’ fair share in an MNE’s total profit. As a consequence, doubts arise about whether the expected benefits of a broader basis of information may justify the additional effort concerning information and documentation. This applies all the more so since in light of the more rigorous reporting duties the potential for TP disputes is expected to increase, thus leading to a higher risk of double taxation. Therefore, companies’ acceptance of the OECD/G20 TP outcomes also depends on whether it proves possible to increase the effectiveness of dispute settlement procedures.³

German economists note that increased reporting requirements can effectively target profit shifting.⁴ On the other hand, however, it is made clear that the proposed

² Cf. the presentation in section 2.5.3 of a questionnaire submitted online to company representatives in order to receive feedback on the expected impact of the OECD/G20 recommendations for TP and documentation on the compliance cost of companies and the overall reception of these recommendations in 2016; for similar findings see, for example, Geberth and Heggmair, DB 8/2014, M8; Bärsch, Engelen and Färber, DB 2016, 972.
2.2. Challenges of transactions with intangibles

2.2.1. Definition of intangibles

In Germany, there is no specific definition of intangibles for TP purposes. TP rules do, however, make use of the general term *Wirtschaftsgut* (business asset), which has been defined in the tax accounting context.\(^5\)

For tax accounting purposes, the German Federal Tax Court defines assets in general as items, rights and other economic advantages that came into being by way of effort, can be valued independently, and are useable beyond the accounting period. Assets include actual positions of economic value which are conceived as separate items. The German Federal Tax Court regards this condition as being met where a third party would give this item separate consideration. It must promise the taxpayer a specific advantage and may be neither part of another item nor so lacking in clear demarcation that it “evaporates into general advantages”. As a consequence, assets must have a specific value for the taxpayer (basically meaning that they are “capable to be owned and controlled”), but may not form part of the firm’s goodwill. There is no requirement that they can be individually transferred. The latter preconditions serve in particular to identify intangible values that do not merit the status of intangible property or are registered in other forms.

Assets are said to be intangible if they are neither material nor form part of the financial assets.\(^7\) Obvious examples are patent rights, trademarks or brand names. But this group also includes such items as knowhow, trade secrets, underlying rights of use (contractual rights or rights *in rem* granting a secure legal position), concessions and goodwill-type assets. It is irrelevant whether, and if so to what extent, the intangible asset is protected legally, contractually or in any other way. Such items as advantages of simple use or synergy advantages, however, are not deemed to be intangible assets. This means that there is no major deviation from what the OECD understands as an intangible.

From the German perspective, however, goodwill is not an intangible asset. It is the added value over and above the overall value of the individual business assets minus debt that is inherent to an enterprise, business or activity.\(^8\) Of its very nature, goodwill is the equivalent of the business opportunities provided these are not embodied in the individual assets, but appear to be guaranteed by way of the operation of the business as an ongoing concern.\(^9\) Integral business elements forming part of goodwill, such as the company reputation, customer base, favourable purchasing possibilities, ongoing employment contracts, and the (internal and

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\(^6\) An example is the ordinance on the determination of transfer prices in the event of a transfer of functions.

\(^7\) Cf. Schmidt, *Einkommensteuergesetz* (ITA), s. 5 ITC, marg. no. 171.

\(^8\) Cf. German Federal Tax Court (FTC), 27 March 1996, I R 60/95, German FTC, 14 January 1998, X R 57/93.

\(^9\) Cf. German FTC, 28 March 1966, VI 320/64, German FTC, 25 January 1979, IV R 21/75, German FTC, 26 July 1989, I R 49/85, German FTC, 26 November 2009, III R 40/07.
external) organization of the company or assembled workforce, are not intangible assets.\textsuperscript{10} Apart from special cases, the goodwill is attached to the enterprise, business or activity and may only be transferred as part of them.\textsuperscript{11} The distinction between individual assets and goodwill is also relevant for TP purposes.\textsuperscript{12}

2.2.2. Transactions with intangibles

Here, it is necessary to distinguish between transactions based on the use of intangible assets by the contracting parties in carrying out their business, and those concerning sale or lease of intangible assets as such. Except for the transfer of functions, the identification of transactions with intangibles is not governed by statutory provisions. Transfer of function is given where assets and other economic benefits (possibly including goodwill) accompanied by the associated opportunities and risks (“transfer package”) are transferred or lent, in order for the receiving entity to carry out this function, even temporarily, so that exercising this function by the transferring entity carrying it out prior to the transfer is limited. Where no underlying contract exists or the underlying contract fails to make it clear whether the transfer package has been transferred or lent, upon application by the taxpayer the tax authorities presume that the transfer package has been lent.

In the leasing context, goodwill is not transferred if its value depends solely on the retained (i.e. not transferred) business assets. However, if the assets constituting goodwill are transferred or lent on a lasting basis such that the licensor has no legal right to claim return of these assets by the licensee,\textsuperscript{13} goodwill is transferred even if both parties assume or have contracted otherwise.\textsuperscript{14}

The German administrative principles rule that the taxpayer has to:

- price the licensing of an intangible at arm’s length even where the receiving enterprise does not actually make use of the intangible but gains a business advantage from it (e.g. blocking patent or patent for future use);
- price the intangibles actually licensed individually and may only determine a global value if they constitute a technical and economic unit;\textsuperscript{15}
- refrain from charging a licence fee where the value of the intangible asset is incorporated in the price of the good or service;\textsuperscript{16}

\textsuperscript{10} Cf. Schmidt, ITA, para. 5 ITC, marg. no. 223; where these advantages (for example a customer base) are conceived as separate items and can be valued independently, a separate transfer as an intangible is possible. But it is also conceivable that with reference to the customer base there could be a link binding customers to the entrepreneur himself, cf. German FTC 26 November 2009, III R 40/07.

\textsuperscript{11} Cf. German FTC, 26 November 2009, III R 40/07.

\textsuperscript{12} S. 1(2)(1) Ordinance on Transfer of Functions.

\textsuperscript{13} Cf. German FTC, 27 March 2001, I R 42/00, German FTC, 16 June 2004X R 34/03, 378, German FTC, 2 September 2008, X R 42/05.

\textsuperscript{14} Cf. German FTC, 5 June 2008, IV R 79/05.

\textsuperscript{15} By the same token, where a function including the related opportunities and risks is transferred accompanied by assets and other advantages transferred or lent, for which no arm’s length value of even limited comparability can be found, the taxpayer should determine the scope for agreement on the basis of the transfer of the function as a whole (s.1(3)(9) FTC).

\textsuperscript{16} Cf. German Federal Ministry of Finance (MoF), 23 February 1983, IV C 5 -S 1341 – 4/83, marg. nos. 5.1.1, 5.1.2, 5.2.1; on the latter see also Tax Court Munich of 28 November 2006, 6 K 578/06, no appeal by the German FTC granted, see German FTC, 6 November 2007, I B 7/07.
take into account when pricing a licence the fact that the licensee concedes an unprotected technically enhancing or similar service (knowhow) accruing in the course of using the intangible.\(^{17}\)

The general precondition for user charges is the existence of a business relationship (section 1(4) FTC). The term “business relationship” covers “any contractual relationship affecting income, other than an agreement between a company and its shareholders”.\(^{18}\) Accordingly, it is essential that apart from the shareholding there is an exchange of goods or services.

On this note, for the German tax authorities the right to use the company name is granted on the basis of the underlying shareholder relationship. Consequently, a parent company may not charge for “passive association” including the right to make use of the company name.\(^{19}\) It is different if a link is established between the firm name and a brand name or trademark, for instance by way of a trademark licence agreement granting the right to use the firm name and the firm logo as a trademark for products sold. Where in such cases the trademark is recognized as a separate value carrying more weight than the firm name, it is possible to charge a uniform price for the trademark that is made up of a logo and the firm name.\(^{20}\)

Where goods or products were produced using intangible assets, the acquisition and subsequent use or consumption of these goods or products by the acquirer does not, in principle, constitute use of the underlying intangible; in such cases, the acquirer owes no licence fee to the seller since the value of the intangible is considered to be part of the acquisition price.\(^{21}\) With such transactions that are based on the use of intangible assets, this is to be taken into account in the context of the comparability analysis.\(^{22}\) In this way, the manufacturer or distributor should be granted prices for goods supplied or acquired that enable them to cover their costs of exploiting the market in a reasonable period of time.\(^{23}\) More generally, a company holding the significant tangible and intangible assets needed to carry out a business, exercising the functions decisive for the success of this business and assuming its most important risks, should reap (together with other principal companies, as the case may be) the profit resulting after the other associated companies have been remunerated for complementary services.\(^{24}\)

In contrast to the German approach, the OECD/G20 recommendations distinguish between the transfer of intangible values, the transfer of their use, and the transfer of the right to their use. Since the latter is not regarded as a separate avenue towards exploiting an intangible value under German law, the legislator needs to scrutinize the question of whether further regulation is required. As yet, no fresh information is available on the status of this process.

\(^{17}\) Cf. marg. no. 5.1.3


\(^{19}\) German MoF, 23 February 1983, IV C 5 -S 1341 – 4/83, marg. no. 6.3.2.


\(^{21}\) Cf. German MoF, 23 February 1983 FTG I 1983, 218, marg. no. 3.1.2.3.

\(^{22}\) Cf. German MoF, 12 April 2005, FTG I 2005, 570, marg. nos. 3.4.12.7 and 3.4.11.4 (a).

\(^{23}\) Cf. German MoF, 23 February 1983 FTG I 1983, 218, marg. no. 3.4.

\(^{24}\) Cf. German MoF 12 April 2005, FTG I 2005, 570, marg. no. 3.4.10.2(b).
2.2.3. “Substance-over-form” approach towards intangibles

In the “substance-over-form” context two sets of issues are to be distinguished. The first group of questions concerns the attribution of assets to taxpayers, and the second the attribution of earnings and expenses.

As a matter of principle, assets are to be attributed to the legal owner. Such ownership results essentially from legal rights or contractual agreements including possible registration. Competition law and labour law can also give rise to legal ownership. However, assets may not be attributed to the legal owner if someone other than the legal owner (“the economic owner”) in fact exercises control over the asset in such a way that he can exclude the legal owner from having influence over the asset (section 39(1) FC). It is also irrelevant in the taxation context whether legal transactions are, or become, invalid. A comparable situation applies in connection with paper transactions. If a paper transaction is to cover up another transaction the latter is relevant for tax purposes (section 41 FC). But in principle it is most relevant that tax laws may not be circumvented by using legal planning possibilities in abusive ways. Abuse is deemed to exist where an inappropriate legal planning option is chosen leading to a tax advantage for the taxpayer or a third party compared to the result of an appropriate arrangement, in a manner not intended by the law. In cases such as these, the tax authorities are entitled to levy tax corresponding to that arising from business transactions with appropriate legal arrangements (section 42 FC).

However, this general anti-abuse clause has not proved to be fully effective in the past, and from the perspective of the German tax authorities, implementation of the OECD/G20 recommendations requires an explicit “substance-over-form” provision providing a clear statutory definition for a specific legal consequence. In the business community, however, there are serious reservations about introducing a provision of this kind since doubts exist about whether this is consistent with the arm’s length principle. Moreover, agreement between the Federal Ministry of Finance and the Länder (federal state governments) has yet to be reached. The former regards the introduction of a specific substance-over-form provision as being necessary, in order for it to enable Germany to withstand or enforce claims vis-à-vis treaty partners. No decision has been made as yet in this area.

Among the rights that an owner holds are the right to dispose of the asset in his ownership or to which he is entitled, the right to use this asset, and the right to lease or sell it. He carries the costs associated with the use or other utilization, but also has a claim on the returns resulting from its exploitation. Here, the legal agreement on which exploitation is based is, as a matter of principle, authoritative.

Legal ownership does not, however, constitute an exclusive right to the return on the exploitation of intangible assets. Rather, the legal owner’s claim is determined on the basis of the functions he is exercising, the assets employed and the risks assumed. Where development, enhancement, maintenance or protection of the intangible lies with another group company, the claim on returns to which the owner is entitled is reduced accordingly.

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25 Examples of this are trust relationships, ownership reservation, and particular leasing arrangements.

26 Cf. German FTC, 8 May 2003, IV R 54/01; German FTG, 28 January 1992, VIII R 7/88; German FTG, 29 October 1981, I R 89/90.
legal owner is entitled is reduced by the arm’s length remuneration of this group company for its contribution.27

This also applies if the legal owner does not assume all the risks associated with the exploitation of the intangible. Risks relevant in this context are in particular the case of R&D not culminating in success, products becoming obsolete, infringement of legally protected rights, or an action triggering liability. To resolve the issue concerning attribution of returns on intangible assets, it is therefore decisive which company bears the costs if a risk actually materializes. But besides this, it is no less significant which entity carries the cost of development, enhancement, maintenance, and legal protection.

The German approach as presented here is in line with the OECD recommendations. A change in the German TP regulations is not to be anticipated.

2.2.4. Comparability and group synergies

Group synergies have not been generally addressed up to now. When applying the CUP method, they are only taken into account to the extent that synergies are reflected in the arm’s length price. Although where profit split methods are applied, the allocation of profit has to include integration benefits, no details are provided on this application either. Regarding calculation methods, again, considering synergies is neither foreseen nor common practice. Participation in synergies results, if at all, where the arm’s length mark-up actually includes such advantages. The pertinent ruling by the tax court of Muenster 28 cannot be interpreted in any other way. According to this judgment the court holds that with the transfer price considered appropriate, the contracting parties “share the advantage resulting from producing abroad equally”. When assessing the appropriateness of this price, however, the court deemed it decisive “whether the mark-up … was determined in line with economic principles” and did not rule on the allocation of synergies.

In the context of the “hypothetical arm’s length test”, however, German rules require the taxpayer to estimate the lowest price for the seller and the highest price for the buyer on the basis of a functional analysis and internal planning calculations. As a consequence, integration benefits in either case are factored into the marginal prices for the participants of the transaction, the scope of agreement, and the relevant transfer price.29

Besides, differentiating between “passive association” and integration benefits resulting from concerted group actions is likewise relevant. In this context, administrative principles dating from 1983 make it clear that a parent company may not charge a fee for passive association, including the right to trade under its

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27 The legislator highlighted this relevance of the functions performed and risks assumed when substantiating its position on the appropriate remuneration for an intra-group finance company passing on its equity capital to other group companies in the form of loans. According to this position, the activities of such a subsidiary are limited to the redirection of funds and corresponding administration, for which it is entitled to a remuneration for services, but no finance margin, cf. German Bundestag, Drs 16/6290 of 4 September 2007, justification, special section, regarding s. 8(2)(5) FTA.

28 Tax Court of Muenster, 16 March 2006 – 8 K 2348/02 E; different conclusions drawn by Wellens and Hanken, WTS Tax Journal 1 2007, 11.

name and the advantages resulting from legal, financial, and organizational integration. Accordingly, therefore, brand and trademarks are to be distinguished from the firm name. In the context of intra-group loans, however, the implications of such “passive association” remain as yet ill defined in Germany. The German Federal Tax Court rules that for intra-group loans no collateral is required due to the possibilities of a controlling shareholder supporting its group company. This ruling does not, however, take sufficient account of the role of the controlling shareholder as the possible provider of collateral on the one hand and the passive association having effect on the terms of the loan and the collateral arrangement on the other. Moreover, the German Ministry of Finance acts in line with the Federal Tax Court in ruling that within a group no collateral needs to be agreed because the shareholder relationship per se grants sufficient security (“passive association”). Here, in contrast to the general understanding of this term, the Federal Ministry of Finance holds that such “passive association” exists as long as the controlling shareholder (actively) guarantees the subsidiary’s ability to settle outstanding liabilities.

As far as possible changes in the light of BEPS are concerned, from the perspective of the German legislator, synergies are already taken into account when applying the hypothetical arm’s length approach. They also play a role in the context of “passive association”. For the standard TP methods, synergies are considered only to the extent they are reflected in the market price. No changes are expected here, or in the light of the Muenster decision. As far as profit split methods are concerned, no detailed provisions exist in Germany. In order to take the OECD/G20 profit split recommendations into account, the law would have to be amended accordingly. In the light of the risk that more general provisions are hard to deal with, and with a view to making the application of the profit split method as efficient as possible, few but clear-cut new provisions determining how to take account of integration benefits on the basis of statutory definitions when using the profit split method are to be expected.

2.2.5. Hard-to-value intangibles

In the course of reviewing its provisions governing the application of TP methods, Germany introduced additional rules regarding hard-to-value intangibles (HTVI) as long ago as 2008. Under German law, HTVI are deemed to exist if no transfer prices of limited or unlimited comparability can be determined for intangible assets using the CUP method, the cost plus method, the resale price method, or, after proper adjustments, any other appropriate TP method, having the consequence that transfer price determination has to be carried out on the basis of the expected future profit and using valuation techniques (“hypothetical arm’s length approach”). Where a business transaction involves significant intangibles and advantages and

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31 See above, s. 2.2.2.
33 Cf. German MoF, 29 March 2011, IV B 5 – S1341/09/1004, marg. no. 11.
34 Cf. German MoF, 23 March 1983, IV C 5 – S1341 – 4/83, marg. no. 6.3.2.
35 In the case of a transfer of functions, intangible assets and advantages are deemed significant if they are essential for the function transferred and their transfer price amounts to more than 25
the future profitability varies significantly from the assumption on which the transfer price was based, there is to be a rebuttable presumption that, at the time of the contract, there was uncertainty as to future profits, and independent third parties would have agreed on a suitable price adjustment provision. If no such provision was agreed and there is a significant variance during the first ten years from the date of the contract, the adjustment is to be made in an appropriate lump sum amount as a correction to the original transfer price with tax effect for the business year following that in which the variance occurred. A significant deviation is deemed to exist if the transfer price determined on the basis of the actual subsequent profit development lies outside the original scope for agreement. A significant deviation also exists if the new marginal price of the acquirer falls below the original marginal price of the seller.

In the light of the fact that the adjustment mechanism put forward by the OECD/G20 recommendations operates on a different basis from the German concept for adjusting the transfer price in the case of HTVI, it is likely that the German provisions will be amended in line with the OECD approach. Recall that the OECD requires a thorough TP analysis regarding HTVI, and calls on the authorities to generally take the true value of such an intangible using hindsight as their point of departure, accepting deviations only under exceptional circumstances, whereas in the German case it is sufficient in the case where the future profitability of the intangible varies significantly from the assumption on which the transfer price was based that the taxpayer agreed a suitable price adjustment provision with the contracting partner. These amendments should not imply any material change to the TP of intangible values; it is more the technical implementation that will change.

2.2.6. CCAs

According to the German TP guidelines, CCAs are restricted to services that internationally associated companies “render or receive in mutual interest over a longer period of time through cooperative pooling”. Such services in the contracting parties’ mutual interest distinguish between CCAs and group services that a service provider renders on behalf, and in the interests, of a (specific) recipient or several recipients simultaneously, irrespective of whether “the transfer price is determined by way of a direct or an indirect method”.

In order to define the scope of application of a CCA, the German tax authorities list various criteria in their administrative principles designed to distinguish CCAs from services rendered under the terms of a service contract. The corresponding rules essentially reflect the OECD guidelines on CCAs. In part, however, in comparison to the international principles, they are more limited in terms of the scope of application.

36 An adjustment rule is also deemed to exist if licence agreements have been concluded for intangible assets and advantages that make the payable licence fee dependent on the turnover or the profit of the licensee (cf. s. 9 FVerlV).

of their scope of application. For example, the contributions of pool members are restricted to auxiliary functions. Moreover, in the case of R&D pools, holding and patent exploitation companies are excluded.

Using a CCA, the deductible expenses have to be allocated among the contracting partners. The actual direct and indirect expenses arising in the context of the contributions made provide the basis for the calculation of the allocable amount. For reasons of space, it is not possible to show the details of this calculation here. Where the pool members provide business assets, however, this constitutes a transfer of exploitation, the value of which is to be assessed using their acquisition or production costs. If intangible values are transferred, it is acceptable if the business expense on the part of the pool (the return for the licensor) is assessed using the arm’s length licence fee minus the arm’s length profit. Where tangible assets are concerned, the business expense is to be assessed using its market value at the point of transfer taking into consideration the residual period of use. Regarding intangibles, this approach means charging deemed rental or licence fees in a manner that differs here from the OECD/G20 recommendations. The way of considering business expenses and, in particular, also expenses of employing equity capital goes in the same direction, since due to the deemed absence of entrepreneurial risk on the part of the contributing entity, imputed interest and a profit mark-up on business expenses are not acceptable for tax purposes. The German tax authorities, however, do allow as an option consideration of imputed interest. Where such interest is imputed, in line with the arm’s length principle the pool members making contributions realize a corresponding profit, whereas the pool may deduct business expense for the equity capital involved.

The allocation of business expenses is to be carried out in view of the use that every pool member can expect for itself. Here, the number of produced or sold items, material expenses, operational machine hours, staff, total wages, capital invested, and turnover may serve in particular as a basis.38

Where pool members join or leave at a later point in time entry payments or exit fees are to be charged if an orderly and prudent business manager would have paid or charged such remuneration. The same applies where a new member contributes assets to the pool or a member withdraws assets upon leaving the pool.

As far as possible changes in the light of BEPS are concerned, from a German perspective, there is a need to adjust the regulations currently in force in order to bring them into line with the new OECD concept. This also requires that a clear legal basis for this different approach is put forward, which is to be expected with high probability. Regarding the resulting tax consequences for intra-group cooperation in MNEs – which will be quite considerable – we may expect generous transitional adjustments and no applicability until the end of a transitional period. In this context, it is also highly likely that a comparable adjustment will be carried out by the Federal Ministry of Finance with respect to the provisions governing posting of workers. To date, corresponding services are to be charged at cost.

38 Cf. ibid., marg. no. 3.2.
2.3. Risk and capital

Germany has not yet adopted any TP measures aligned with the Actions 8–10 report to control the return on capital or the compensation for the assumption of risk. However, as mentioned in the “substance over form” section earlier in this report, it is the understanding of the German legislator that contractual provisions or articles of association are not decisive where the deemed status of a company is not substantiated by its functional and risk profile.

It is to be expected, however, that the German legislator will continue to recognize the legal independence of corporations for tax purposes and maintain the principle that TP is to be based on the terms and conditions agreed between the separate legal entities in the group. Application of the permanent establishment authorized OECD approach to separate legal entities does not find any political support at this time in Germany. In order to implement in German law the OECD/G20 recommendations, which Germany has approved, it is to be expected that clear legal provisions allowing for deviations from contractual agreements only under narrowly defined conditions limited to exceptions (for example no taxation without substance) will be brought into force. In terms of content, correspondence with the OECD/G20 recommendations is envisaged. It is not to be expected that acceptance of contractual agreements will be made subject to a general condition concerning abuse, which would be hard to enforce. From a methodological perspective, it can be ruled out that possible adjustments will be carried out in the course of a recharacterization of the transaction involved. Rather, it may be expected that with respect to the allocation of risk and capital Germany will follow the OECD/G20 recommendations. To date, however, no decision has been made on this issue by the German government. But no clear cut change (that would not be enforceable) is envisaged.

2.4. High-risk transactions

2.4.1. CUP and quoted prices for cross-border commodity transactions

For the TP of goods and products, the CUP method is also the preferred method in Germany. Where no CUP can be identified, in general the resale price method and the cost plus method are the methods of choice. In applying the CUP method, reference is possible to market prices derived from stock market quotations, customary prices or transactions between parties acting at arm’s length. In this context, reference is required to the price for similar goods and products which independent third parties would charge for goods and products in comparable quantities, on the sales market, at the same trade level and on the basis of comparable terms of trade and under the conditions of economically comparable markets. Upon audit of transfer prices, all conditions of the individual case are to be taken into account.

Pricing is based on the conditions existing on the contract date; where the contracts are to be fulfilled in the long term, it is to be scrutinized whether independent third parties would charge for goods and products in comparable quantities, on the sales market, at the same trade level and on the basis of comparable terms of trade and under the conditions of economically comparable markets. Upon audit of transfer prices, all conditions of the individual case are to be taken into account.

39 Cf. German MoF, 12 April 2005, IV B 4 – S 1341 – 1/05, marg. no. 3.1.3.
40 Cf. ibid., marg. no. 2.2.2.
third parties would consider the associated risks using corresponding arrangements (for example price adjustment clauses).

In the light of these provisions, in Germany no need for action is seen with a view to the OECD/G20 recommendations.

2.4.2. *Intra-group services*

Regarding administrative group services, separate charging is only possible if in a third party context compensation would have been made. Such examples include book-keeping services, specific consulting services or short-term posting of staff, but not group management or management of shareholdings. Therefore, it is required that these services are:
- clearly identifiable and assessable; and
- provided in the interests of the recipient (i.e. promise an advantage and/or save own costs).

The charging has to have been contractually agreed in advance and documentation of the service has to be provided. Charging is not possible if compensation for the services provided takes a different form, for example, through TP of intra-group goods or other services at market prices that already take into account the administrative services provided.

In addition, the services must actually be rendered. The mere offer within the group does not suffice, since among third parties only services actually received are generally compensated. However, it is acceptable if in the case of fluctuating service provision, average compensation is charged in accordance with the actual provision over a several-year period.

Market prices can be employed here, provided the services for which markets exist are comparable to intra-group services in kind and scope. Here, it is to be taken into account that the parties involved are in a long-term contractual relationship. Where no market prices are identifiable, the third-party price is generally to be determined according to the cost plus method. Moreover, it is to be noted that an orderly business manager would pay no amount exceeding the costs that would be incurred if he were to carry out comparable tasks in their own business to commission local external service providers. In deriving the compensation according to the cost plus method, the:
- individual services; and
- corresponding costs;
are to be taken as a basis. The taxpayer is required to submit documentary evidence (section 90(2) FTC).

Where charging for services on an individual basis is difficult or not possible, the only remaining possibility is to charge these services on an indirect basis. Such indirect charging is the preferred way to account for an intra-group administrative service, as is done in many German groups. Indirect charging has to comply with the arm’s length principle. Where evidence for individual pricing cannot be procured effectively or is impossible to procure, the only remaining option is to

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42 Cf. *ibid.*, marg. nos. 6.2.1, 6.2.2
43 Cf. *ibid.*, marg. no. 6.2.3
44 Cf. *ibid.*, marg. nos. 6.4.1, 6.4.2
distribute the costs plus a mark-up using appropriate allocation keys. German administrative principles do not provide explicit guidelines for this. In contrast to cost contributions, the German administrative guidelines implicitly make it clear that charging for services is permissible using both direct and indirect methods.\textsuperscript{45}

From the German government’s perspective, it is disputed whether applying fixed margins to a broad range of services corresponds to the arm’s length principle. Such a regime would be conceivable in the eyes of the German government where this took the form of a rebuttable presumption which would not be applicable if the taxpayer provided evidence of other margins. The German government sees the need for flexibility in order to do justice to the circumstances of specific cases, as well as the need for regulations that are straightforward to administer. However, since the German government has approved the OECD/G20 recommendations changes to the existing guidelines are likely. But it is unclear how these recommendations will be implemented. Recall that in Germany legislation is a political process in which the Länder and also other stakeholders, such as companies, must be involved or consulted. Changes in that area may well extend to the cost basis, which is currently very openly defined.

2.4.3. Profit splits in the context of value chains

The German TP provisions refer to value chains only in the context of documentation.\textsuperscript{46} It is made clear that value chain analyses are helpful in order to gain an indication on the appropriate pricing, cost mark-ups, margins, etc., for determining the share of each company in the group’s total value added. This is relevant in connection with the profit split method, and in applying value-added analyses to internal planning calculations where the taxpayers base their transfer prices on internal planning data. In compliance with documentation duties, the taxpayer is required to describe the whole chain of value added, including its own contribution thereto. In this context, it is first necessary to identify the individual business processes relevant to the value added by the group. The relevant importance to one another and to the whole must then be established, so that the contribution of each to the group result is apparent. Finally, the value added by each process is to be analysed across the companies producing it. The contribution of each one is to be set in relationship to the contribution of all related parties.

In principle, the application of the transactional profit split method is possible in Germany only with limitations. Use of the transaction profit split method has the explicit acceptance of the tax authorities, but due to a statutorily determined order of application, it can only be employed where the standard methods cannot or cannot reliably be used in the absence of unequivocally comparable arm’s length prices (section 1(3) FTC). From the perspective of the German tax authorities, this may be possible where more than one group company performing an entrepreneurial function participates jointly in the initiation, processing, and completion of a


\textsuperscript{46} Cf. German MoF, 12 April 2005, IV B – 4S 1341 – 1/05, marg. no. 3.4.11.5.
cross-border business transaction, in which the individual contributions cannot be separately identified.\textsuperscript{47}

The German government will discuss the recommendations of the OECD/G20 with reference to the application of the profit split method. There are, however, doubts as to whether the across-the-board application of the profit split method will be helpful with regard to its lacking practicability and difficulty of justification. Among other things these concern the danger of simplified application in the form of formula apportionment. It may be that a small number of typical cases will be defined in which application of the profit split method is considered to be right and proper.

\textbf{2.5. TP documentation}

\textbf{2.5.1. CbCR}

In early September 2016, the German government presented a bill concerning implementation of changes to the EU Mutual Assistance Directive and further measures to counter BEPS.\textsuperscript{48} The bill includes a new provision to implement both reporting requirements arising from the amended EU Mutual Assistance Directive concerning automatic exchange of tax information,\textsuperscript{49} and minimum standards for CbCR resulting from the further change to this directive.\textsuperscript{50}

The amended EU directive provides a legal basis for the automatic exchange of information among the EU Member States on cross-border tax rulings and APAs involving internationally associated enterprises. By the same token, the amended directive creates the legal foundation for automatic exchange of CbCR among the EU Member States.

With the automatic exchange of tax relevant information, Germany fulfils the political obligation which it entered into in the context of the BEPS project as far as the exchange of information within the EU is concerned. Information exchange with further (non-EU) countries participating in the BEPS project is possible on the basis of the existing legal provisions; administrative regulations are sufficient here.

The provisions of the EU directive concerning the obligation to prepare CbCR, and their automatic exchange, largely correspond with the arrangements proposed in the framework of the BEPS project. The international exchange of information regarding CbCR with non-EU countries is possible on the basis of existing treaties in connection with international agreements of the competent authorities. On 27 January 2016, Germany signed a corresponding administrative agreement\textsuperscript{51} which now (status 21 October 2016) includes a total of 49 states.

Domestic parent companies will have to file CbCR for the group if, in the previous year, the consolidated return as reported in the group accounts amounted to at least €750 million. Such CbCR is to be filed with the Federal Tax Office within 12

\textsuperscript{47} Cf. \textit{ibid.}, marg. no. 3.4.10.3(c), German MoF, 23 February 1983, IV C 5 -S 1341 - 4/83, marg. no. 2.4.6.


months of completion of the business year concerned. To assess TP risks, in line with the international minimum standards and the requirements of the EU Mutual Assistance Directive, the CbCR must contain in particular information regarding two areas:

- per country aggregate information on all companies and permanent establishments included in a consolidated statement;
- information on the individual group entities containing a list of all group companies and permanent establishments showing their major business operations. Foreign parent companies may delegate preparation and submission of CbCR to domestic group companies (parent surrogate filing). Moreover, domestic group companies may be obliged to file such CbCR if the Federal Tax Office receives no corresponding report from the parent company (secondary mechanism).

In any case, each domestic group company is required to declare whether this company is a domestic parent company, a company commissioned to carry out parent surrogate filing or a secondary reporting domestic group company. The latter company is not obliged to provide a full CbCR, but only the information that is available or can be procured. If this information does not fulfil the requirement of a CbCR, no automatic exchange according to the CbC MCAA is due.

2.5.2. Master and local files

In order to implement the international recommendations, the bill concerning implementation of changes to the EU Mutual Assistance Directive and further measures to counter BEPS modifies the documentation duties in Germany. The existing reporting duties already contain most of the information required for the country-specific business documentation (local file) and the master file, so that only the supplementation of existing duties is required.

The government bill proposes to implement the recommendations in annex II of the final report of Action 13 regarding the local file. Supplementary information duties concerning choice and application of TP method and time of transfer price determination are added.

Moreover, as proposed in the OECD/G20 recommendation, with respect to the master file it is made clear that for companies constituting an MNE, an overview of the nature of its global operations and of the TP principles applied form part of the documentation duties in Germany. With that, the recommendation of the OECD/G20 will become a mandatory element of the documentation duties in Germany.

In Germany, creation of a master file is to be mandatory only for companies:

- receiving income from trade or business;
- having at least one business relationship with foreign countries;
- realizing a turnover of €100 million or more in the previous business year.

The content and scope of the master file will be set out in detail by way of decree in accordance with the OECD/G20 recommendations following annex I of the final report concerning Action 13. In drawing up the master file, the taxpayer should use reasonable business sense to achieve the aims of the master file using appropriate time and effort. In case of doubt, reference to other documents to be submitted with the tax declaration is sufficient.

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2.5.3. Compliance costs

In Germany, the bill concerning implementation of changes to the EU Mutual Assistance Directive and further measures to counter BEPS put forward by the government works on the assumption that the CbCR will raise the annual compliance effort of companies by 104 minutes per company or a total of €536,000. Discussions with representatives, however, lead us to assume that the actual increase of costs will in many cases be considerably higher. In order to substantiate this assessment, the reporter with the support of the Chamber of Industry and Commerce has carried out a survey among their member companies. A total of 94 persons, most of them active in leading positions in industrial, commerce and service companies, took part in this survey, which does not claim to be representative. The response rate concerning fully completed questionnaires amounted to 50 per cent and covered in particular large manufacturing companies with a turnover exceeding €100 million and a workforce of more than 50. Tax advising firms made up 17 per cent of the participants.

Although it is not possible to determine a reliable result for the increase of time and cost on the basis of the responses, they do allow a qualitative assessment of the expected consequences of BEPS on the compliance costs of the companies involved as well as showing to what extent the OECD/G20 measures are considered useful.

In terms of the revised TP guidelines businesses expect higher burdens especially with respect to the identification of intangibles, business transactions involving intangibles (use and transfer) and the attribution of risk.

As to documentation, there is large consensus that the effort connected with the introduction of an additional master file will rise or rise steeply; this concerns both description of the supply and service chain, the list and overall strategy concerning intangibles, and documentation of financing activities.

Most companies also expect additional effort with respect to reporting in the local file; this expectation concerns in particular the linking of transfer price determination with annual financial statement information.

In the framework of the CbCR companies anticipate considerable additional time needed to prepare information in connection with income tax paid and accrued. In addition, describing operation areas of the group entities per source state is seen to be time consuming.

3. What is the future of TP?

The German TP guidelines of 1983 have been reviewed and adjusted taking into account international developments several times in recent years. These changes were not made for their own sake, but reflect the globally changing conditions to which tax authorities and MNEs are subject in determining and auditing transfer prices. Whereas in the past companies pursued domestic strategies, today numerous MNEs are in a situation where they have to coordinate their activities on a worldwide basis in order to maintain their high performance and efficient competitiveness. This situation required the arm’s length principle in the CCA and
profit-split context to be amended to include elements of an indirect method, as a market comparison in terms of benefits accruing to the group as a result of integration can provide no reliable basis.\(^{53}\) Moreover, the ICT developments have brought with them the possibility of coordinating integrated processes from a central office. The associated rise of principal structures was also supported by the fact that TP has been largely oriented to the contractual allocation of ownership (of intangibles) and operating risks.

However:

- whereas under a contribution analysis, the division of combined profits is based on the relative value of the functions performed by each of the associated enterprises participating in the controlled transactions, in practice, this division of profits is generally achieved using one or more allocation keys, so that in this regard the differences between the profit split method and formula apportionment become obscured;
- whereas the use of residual analyses in connection with the profit split method was intended to implement the assumption that in principal structures, market comparable services (contract R&D, contract manufacturing, and contract distribution) can be remunerated on the basis of standard TP methods also in global structures, TP of market comparable services ignores the fact that intra-group arrangements have no coordinating function and hence do not have to govern all the details of the contractual relationship (e.g., the risk associated with the transaction); therefore, the contractual allocation of assets and risks does not guarantee an arm’s length outcome;\(^{54}\)
- whereas for the purposes of determining whether each participant’s proportionate share of the overall contributions to a CCA is consistent with the participant’s proportionate share of the overall expected benefits it is necessary to measure the value of each participant’s contributions to the arrangement, valuing these contributions “at cost”, constitutes the risk of a profit shift if the proportion of costs and the proportion of the contributions at market values do not match. This is the case in particular where one party to the agreement provides valuable intangible assets.

In order to prevent BEPS in line with the OECD/G20, the German legislator is now interested in assessing and evaluating integrated processes in their entirety, and ensuring that the resulting profits are taxed where added value is generated. Against the background of the above-mentioned issues, the real potential of the BEPS project to reshape TP rules and practices around the globe should lie in the fact that the OECD is dealing with the allocation of integration benefits to a far greater extent than in the past, thus bringing the arm’s length principle closer to the realities of an MNE. Moreover, the relevance of legal ownership rights and the contractual allocation of operating risks is now to be given less significance in

\(^{53}\) In fact, using the cost plus or resale price method results in marginal prices only for the purchaser or vendor with the consequence that the allocation of profits from intra-group transactions depends on the perspective taken when determining transfer prices (“continuum price problem”), cf. S.I. Langbein, TN 1986, 625; TN 1989 1391; Treasury Department and Internal Revenue Service, 1988, 81.

\(^{54}\) Furthermore, it needs to be noted that initiation, execution, completion, and adaptation of transactions within a company give rise to different costs as compared to market transactions, see O.E. Williamson, JoLE 1979, 233, AJS 1981, 1537, JITE 1984, 195.
the TP context, in favour of the actual conditions of a transaction. Finally, the tax authorities will obtain two supplementary instruments, the CbCR and the master file, which will contribute to the transparency of TP and provide an evidential basis for the audit process. These measures also counter the susceptibility of existing TP rules to tax planning. Central elements of this policy include:

- more significance of an accurate delineation of the actual transaction, including the assumption of economically significant risks, where the contractual conditions form a kind of point of departure, but are not primarily or solely decisive. Rather, what is decisive is the determination of whether a transaction is in line with reasonable business practice, and the question of whether associated risks can be controlled and financially covered by the party to which they are assigned;
- acknowledgement of the fact that business relationships between associated companies are in many cases part of an integrated business operation or are arranged in another manner “that may create opportunities to capture profits in excess of what market would otherwise allow”;
- development of more specific guidelines on the best way to apply or not to apply the profit split method depending on the kind of transaction (“anticipated versus actual profit”), its form (“parallel or sequential integration”), and the level of integration or risk sharing (“non-/existence of a specific commercial relationship”);
- clarification of the fact that a CCA is an arrangement to share the “contributions” (as opposed to costs) and risks involved in a joint project. Hence, in order for the conditions of a CCA to satisfy the arm’s length principle, the value of participants’ contributions must be consistent with what independent enterprises would have agreed to contribute under comparable circumstances, given their proportionate share of the total anticipated benefits they reasonably expect to derive from the arrangement.

It is to be expected that Germany will adopt these recommendations for the most part. Germany is already meeting its international obligation to introduce the minimum standard for CbCR and is modifying the documentation duties in terms of the OECD master and local file approach. In addition, further measures are to be expected with regard to intangible transactions, the substance-over-form approach, hard-to-value intangibles, CCAs, taking proper account of risk and capital, and intra-group services. With respect to the substance-over-form and risk and capital recommendations, there will be no general abuse proviso in Germany. Possible adjustments are foreseen here only in narrowly defined exceptional cases. But reservations still exist in Germany regarding the OECD/G20 recommendations for use of the profit split method, both in terms of their practicability and their justification. Furthermore, it is believed that the profit splits could result in a formula allocation mechanism, that while simpler to apply, is not expected to result in an appropriate allocation of profits.

Such lack of trust in formula-based profit allocation, featuring the allocation of a consolidated tax base using a fixed formula allocation mechanism, currently renders it not very likely that the draft proposal for a CCCTB put forward in October 2016 by the EU Commission will find support in Germany.
Summary and conclusions

Hungary applies a comparatively low corporate income tax (CIT) rate of 10 per cent/19 per cent and further offers a wide variety of tax advantages both in the form of tax holidays and tax base adjusting items that may easily result in a relatively low effective tax rate. The widely applied withholding tax exemption on Hungarian source interest, royalties, dividend distributions and service charges also make the country attractive.

For the protection of the tax base, however, Hungary therefore applies strict thin capitalization rules, controlled foreign company (CFC) legislation, transfer pricing (TP) obligations and also general anti-avoidance rules.

Considering that the TP rules are two decades old in Hungary, CIT taxpayers have learned to develop TP documentation on a professional level. Hungary endeavours to comply with the OECD TP guidelines and therefore the Hungarian domestic TP regulations are rather brief and most topics are not covered at all at a Hungarian domestic level.

The number of TP audits has increased significantly in previous years, and this trend is expected to continue in Hungary in the future. During these audits, the Hungarian tax administration increasingly focuses on substance requirements, as compared to the earlier approach which focused on legislative implementation by concentrating primarily on administrative and formal requirements. Revealing the true and valid contents of the transactions, i.e. their economic substance, focusing on functional and risk analyses, and investigating the complete value chains of multinational (MNE) groups has gradually been becoming part of the day-to-day practice of the Hungarian tax authority.

The number of tax authority challenges has decreased, while their significance has increased in terms of tax shortages and connected tax penalties. Due to the relatively high annual threshold below which TP documentation is not compulsory on given transaction types (HUF 50 million, approximately €161,000), increased
attention may be paid by the Hungarian tax authority to the TP documentation which is subject to a preparation requirement.

As far as the TP base erosion and profit shifting (BEPS) related Hungarian legislative changes are concerned, currently no rules have been implemented in Hungarian domestic law. By having definite regulations pertaining to low value-adding services and TP documentation requirements Hungary will amend its domestic law in the near future in order to comply with the BEPS standards.

Hungary is preparing to extend the master file–local file content of the documentation and is also preparing for the introduction of country-by-country reporting (CbCR). The Convention on Mutual Administrative Assistance in Tax Matters has been in effect from 1 March 2015 in Hungary. Further, Hungary is also a signatory to the competent authority agreement with a target date of September 2017 for the first information exchange. Hungary is thus among the first countries to participate in the automatic information exchange system. The country is therefore well prepared to participate in the automatic exchange system that is necessary to give life to the CbCR system. No corresponding amendments have been taken into the Hungarian domestic law as yet, but this is not likely to hinder the process at all.

As far as the other TP-related BEPS topics are concerned, their implementation is still uncertain due to the fact that the Hungarian legislative body might decide to take relevant alternative steps in the light of international practical experience.

1. Current TP regulation and practice in Hungary

Hungary is an open economy benefiting from foreign direct investment. Considering the fact that profits generated locally are usually subject to international repatriation and that Hungary does not apply a system of withholding taxes (i.e. all capital income such as dividends, interest, royalties and also service fees distributed to a foreign corporate recipient are exempt from withholding taxation in Hungary), TP rules play a determining role in the protection of the tax base for direct taxation purposes.

The TP rules date back decades in Hungary. The arm’s length principle appeared from 1 January 1997, while the TP documentation requirements came into force later as of 1 September 2003 and became generally applicable on all kinds of related-party transactions from 2005. Hungary has been applying the OECD TP guidelines ever since the appearance of the arm’s length principle in Hungary, also reflected by a clear reference thereto in the relevant Hungarian domestic law. However, Hungary applies a stricter approach mainly in respect of documentation requirements and verifiability of connected database researches than the OECD systems.

In Hungary not only cross-border but also domestic related-party transactions fall under the TP requirements. Parties are considered related provided that one person exercises direct or indirect majority influence (i.e. ownership or voting rights of over 50 per cent) over the other, or if the influence is exercised by a third party in both entities. The percentage of influence exercised by close relatives should be cumulated; further, entities with similar management may also be regarded as related parties since 1 January 2015. The scope of related parties is a
little narrower in Hungary than usual, as in most cases an influence of 25 per cent may be sufficient to constitute a related party relationship.

By applying transfer prices not in compliance with the arm’s length principle, both increase and decrease of the tax base are available based on the respective double tax convention (DTC) and/or domestic tax law. A tax base increase is obligatory, and is due irrespective of any other tax base increasing items; thus double tax base correction may also be required. A tax base decrease is linked to meeting certain preconditions; in particular, beginning from January 2017, the other party must declare that the amount of the difference is taken into consideration for taxation purposes in his country of residence. Further, the CFC status of the other party is also not permitted in order to qualify for a tax base decrease.

A tax shortage deriving from transfer price differences revealed by the authorities may be penalized by a 50 per cent tax penalty plus late payment interest at double the Hungarian prime rate.

TP documentation is not required to be filed with the Hungarian tax authority; however, submission is compulsory within three working days upon request. Failure to submit proper TP documentation prepared by the taxpayer within the statutory deadline incurs a default penalty of up to HUF 2 million (approximately €6,500) per transaction per annum. Repeated non-compliance may result in a penalty four times higher.

Transactions below a threshold of HUF 50 million (approximately €161,000) per tax year, cost recharges without a mark-up, transactions covered by advance pricing agreements (APAs) and free cash transfers are not subject to TP documentation requirements. Small enterprises are also exempt from the TP documentation requirements; however, the size of companies is judged on a consolidated level for group companies.

If the traditional transaction methods (comparable uncontrolled price (CUP), cost plus, resale) cannot be used for a TP analysis, the new transactional methods (TNMM, profit split) or even other methods may also be applied according to the Hungarian legislation. There is only one safe harbour rule in Hungary which aims at accepting a cost plus mark-up of 3–10 per cent on certain low value-adding services without any research for independent comparable data (i.e. without performing any benchmarking). Consequently, benchmarking is quite commonly used and may be required by the tax authorities in Hungary.

The preferred database that is suitable for benchmarking purposes is the Amadeus database, which is also available to the Hungarian tax authority. In addition to performing quantitative searches, there is also an exceptional emphasis on qualitative searches, the steps of which must strictly be documented with print screens of the entities remaining in the final sample or excluded upon a website review. Considering controlled transactions, there is an increasing preference for performing a transaction based analysis instead of benchmarking the overall profitability of the tested party. Each step of the database researches must be duly documented, especially if a given database is not accessible to the Hungarian tax authority. As far as the comparable entities are concerned, pan-European comparable companies are preferred.

Tax authority audits focus on both the substance and formal requirements of the TP documentation. In a tax authority audit that is either comprehensive or focusing on direct taxes, the submission of TP documentation is virtually always requested.
There is a specialist team in the central office of the Hungarian tax authority engaged solely in auditing TP issues. A separate department is responsible for APA applications. These have been available from 2007.

2. The impact of the BEPS project on TP

2.1. Introduction

Concerning TP-related BEPS projects, from the side of the Hungarian finance authorities, representatives have actively participated in international meetings and fora and have provided their respective contributions to facilitate the development of the various TP-related BEPS action plans.

In addition to the finance authorities, understandably also in Hungary first tax advisers and then MNE entities belonging to larger groups have started to deal with the potential impacts of BEPS developments and to seek the answers to be provided to certain challenges.

Out of the TP-related BEPS action plans, it is clearly BEPS Action 13 and the CbCR obligation that have received the most attention in practice in spite of the fact that the outcome of the TP-related BEPS actions affects a much wider scope of businesses.

BEPS Action 13 is the one which created the so-called CbCR obligation that is sufficient to provide an overview of the activity of a company group focusing on the circumstances that could provide an answer to whether the place of value creation is aligned with the place where the income generated is taxed. BEPS Action 13, being a risk assessment tool itself, will encourage the largest MNEs to perform their own risk assessments as well.

Although Hungary is home to only a few ultimate parents of the largest MNEs, it is clear that CbCR will be implemented in Hungarian domestic legislation, together with the introduction of penalties for cases of non-compliance. The majority of the TP-related BEPS actions will, however, probably be not implemented directly in Hungarian domestic law, as they have become part of the OECD TP guidelines which have always been used as a kind of background legislation for Hungarian TP-related matters whenever an issue has not been regulated at the domestic level.

In addition to giving a detailed regulation on TP documentation requirements, Hungary has relevant domestic regulation pertaining to low value-adding services, which will be amended in order to become aligned with the expectations of the respective BEPS action plan.

Summarizing briefly the expected legislative changes in Hungary, BEPS Action 13 and the regulation on low value-adding services are the areas that may trigger deliberate steps from the Hungarian legislative body; in other areas of TP, Hungary will probably follow the recommendations of the OECD TP guidelines as amended by the TP-related BEPS action plans, and no Hungarian tax law amendments are expected.
2.2. Challenges of transactions with intangibles

2.2.1. Definition of intangibles

The BEPS reports handle the definition of intangibles rather broadly, mainly giving the specifics to be considered, thus ensuring a wide interpretation and ignoring situations where valuable items would fall outside the scope by adhering to a strictly worded definition.

The BEPS reports define intangibles based on the following specifics. Intangibles are neither physical nor financial assets; they are capable of being owned and controlled for use in a commercial activity; their use would be compensated if it occurred between independent parties under comparable circumstances. According to the revised OECD TP guidelines, “no attempt is made in these Guidelines to delineate with precision various classes or categories of intangibles or to prescribe outcomes that turn on such categories”.

The OECD definition regards intangibles as independent of their accounting or legal characterization; the availability of legal protection is not required. Separate transferability is also not required.

The Hungarian domestic rules also define intangibles, but basically not for TP purposes. The Act on Corporate Income Tax and Dividend Tax specifying the TP rules defines certain intangibles such as patents and rights protected by law. Further the Act on the Rules of Taxation, serving as the background law for procedural issues for all types of Hungarian tax, defines R&D activities, the result of which may be a certain kind of intangible. Nevertheless this definition was primarily created for the purposes of tax allowances concerning R&D activities.

Consequently, the present domestic Hungarian regulation is not sufficiently in line with the OECD TP guidelines in defining intangibles as it applies a more formalized and passive approach than the OECD approach described, especially regarding legal protection and separate transferability. Nevertheless, the Hungarian rules regarding TP also refer to the OECD TP guidelines as a background regulation, thus providing the Hungarian tax authorities with a second line approach to interpreting the broader definition introduced by the OECD under the BEPS reports.

The need to amend Hungarian regulations has already been expressed by the tax authorities; nevertheless, it is uncertain whether such changes may be incorporated in the domestic regulation in the near future. The Hungarian Ministry of National Economy as a legislative body may be cautious about the implementation of the new BEPS related changes in the domestic regulation. This approach is due to the desire to provide an ongoing investment friendly climate in the economy and the desire to avoid issuing further complicated domestic regulations until the BEPS-related OECD actions are interpreted at EU level and the changes have produced sufficient practical experience. This approach may leave the Hungarian tax administration with the OECD reports to apply as background legislation, developing the applicable practice gradually.

2.2.2. Transactions with intangibles

Defining intangibles may prove to be a challenge; further complications will arise in connection with identifying transactions with intangibles. Transactions with
Intangibles may be divided into two specific types according to the OECD reports: the transfer of the intangibles themselves or transfer of rights to intangibles where a wide variety of possibilities exist in the possible limitations of the rights transferred. In certain cases the categorization of a transfer can become borderline, if, for example, the transfer of all rights for the full useful life of an intangible occurs under a transaction which may be temporary in nature according to its legal classification as a “rental”.

Further difficulties may surface if the transfer of intangibles occurs in combination with other intangibles or with goods or services. In this case it has to be decided whether the intangible is to be priced separately from the other intangibles or goods/services or whether it should be viewed as one item.

As per the transfer of intangibles, the OECD TP guidelines define the legal owner based on the given contractual terms if a written contract exists. Further help is provided in the definition by public records such as patent or trademark registrations. If no legal owner can be defined under applicable law or governing contracts, then the member of the MNE group that, based on the facts and circumstances of the transaction, controls decisions concerning the exploitation of the intangible and has the practical capacity to restrict others from using the intangible qualifies as legal owner. Further, the legal owner of the intangible and the person exercising any right to the intangible may be different entities.

In the Hungarian legislation no separate definition exists for the transfer of intangibles for TP purposes. In practice intangibles are tested to ascertain whether they should be viewed as separate items from a TP perspective; if they can be sold separately, meaning that independent parties would initiate the transfer of the given intangible separately from other intangibles or goods/services, then the given intangible is to be priced autonomously.

The legal owner is defined by other background legislation (in particular by civil law regulations) based on the contractual terms be they written or only verbal. If no written or verbal contract exists, or in case of the latter the terms cannot be sufficiently specified, the legal owner will be defined based on the facts and circumstances according to the revealed facts of the transaction.

2.2.3. “Substance-over-form” approach towards intangibles

The revised OECD TP guidelines put emphasis on the fact that a transaction including intangibles should not be viewed in the conventional way as if existing simply between contractual parties. The whole value creation process of the transaction should be revealed, in order to reach the goal of the BEPS revisions – namely aligning TP with value creation – thus mapping all the affected parties and dividing profits according to the assets used, risks assumed and functions performed.

The revised OECD TP guidelines give a five-step method for accurately delineating a transaction, where only the first step includes the analysis of the contractual terms. Further steps should be taken to map the actual circumstances of the transaction by an analysis of risks, assets and functions; to review the characteristics of the property transferred (in the case of intangibles especially the form of transaction, the type of property, the duration and degree of protection, the anticipated benefits) as well as the economic circumstances and business strategies.
Based on this analysis the tax authorities may reclassify the transaction if the contractual terms are not in line with the factual substance of the commercial and financial conduct of the parties.

Special attention is focused on the analysis of risks given the fact that contractual shifting of risk is often used to reallocate profits. The OECD TP guidelines provide a six-step process to analyse risks. In this process the two decisive key features are financial capacity to control and the actual performance of the control over the risks. The first criterion indicates the party’s financial ability to tackle negative effects arising from the risk or to finance the mitigation of the risk. The second means the actual performance of the control over risk by decision-making to take on or lay off, responding to or mitigating risk. The decision-making is closely related to the competent person and to the location of that person; mere formalizing of the decision (for example by the minutes of the board meeting) is insufficient. In the case of outsourcing a function control over the function according to the two key features as described above has to be kept in order to be able to claim part of the profit for the specific function.

Based on the analysis, risk might be reallocated by the tax authorities to reflect accurately the conduct of the parties and the factual circumstances. If the legal owner only assumes financial risks, he will have to compensate the other parties for assuming operational risks; thus he will only be entitled to a risk-adjusted return. Should he exercise only minor control regarding the financing function it is possible that only a risk-free return may be allocated to this party as a maximum. If no functions are performed, no risks assumed and no assets used by the legal owner in the transaction, he will not be entitled to any share in the profit at all.

In the Hungarian legislation a decree of the Finance Minister contains the particulars of the compulsory elements of the TP documentation, among other things providing for a definition of the functional analysis. According to the definition of the decree in the functional analysis the functions conducted by the related parties as well as the independent parties in the given transaction have to be described (e.g. R&D, planning, production, marketing, transportation); the assets used (e.g. costs, expenditure, investments) and the risks borne have to be analysed (e.g. exchange rate risks, guarantees, financial risks). This definition is rather brief. To adapt the evolved BEPS criteria for functional analysis the Hungarian tax authorities will have to turn directly to the OECD TP guidelines as background rules and require the taxpayer to map the whole value creation chain while documenting a transaction based on the methodology outlined there. In practice it is anticipated that the completion of such extensive functional analysis is likely to prove to be a challenge for Hungarian related party companies. This is because they are usually subsidiaries of foreign parent companies and the high level decision-making and relevant background documentation is not always available to them for TP purposes or not in a properly detailed form.

In practice the delineation of the transaction must also be considered based on a general substance-over-form clause defined in the Act on the Rules of Taxation. Although this is a general clause it has increasingly been applied in TP audits from the beginning of 2010. According to this clause a contract, transaction or other similar action is to be judged based on its valid content. Valid contracts or other legal transactions are only to be considered from the taxation point of view if their economic result is evidenced. Based on this clause it is already the practice of the Hun-
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garian tax authorities during TP audits to reclassify certain transactions. This happens mainly in the case of hidden capital contributions, where the transfer was described according to the contractual terms as a long-term loan.

Concluding from the above, further action is expected in Hungary resulting not only from the BEPS results but also continuing actual TP audit trends, with the Hungarian tax authorities further increasing their attention to functional and risk analysis. Even an amendment to the Hungarian TP documentation rules cannot be excluded. Nevertheless, due to the introduction of the CbCR obligation, the tax authorities will have an extensive information base to also reclassify other transactions that are not as easily detectable as the above-mentioned hidden capital transfer, based on the principle of aligning TP with value creation.

The above general clause can also be viewed in connection with the OECD TP guidelines non-recognition rule, where the guidelines state that the key factor in an analysis is whether the actual transaction possesses the commercial rationality of agreements that would be agreed between unrelated parties under comparable economic circumstances. Should this key factor not be satisfied the tax authorities are entitled to disregard the transaction for TP purposes. This commercial rationality criterion is translated into the Hungarian domestic rules in the form that a transaction’s economic result should be evidenced. Based on these regulations in the present practice of the tax audits the authorities already question the commercial rationality of certain services, for example management services between related companies, where the fee for the service is disproportionately high compared to the turnover of the company and no valid reason exists for the rendering of such services. Nevertheless non-recognition cases are rare in Hungary.

2.2.4. Comparability and group synergies

One of the reasons for the existence of MNEs is the creation of group synergies. It is inevitable that a group benefits from the interactions of its members in combined purchasing power, integrated management and IT systems and joint marketing efforts. Negative effects can also arise, such as increased bureaucracy or ineffective IT systems. Group synergies are not intangibles according to the definition of the OECD TP guidelines as they cannot be owned or controlled. In essence this segment of the OECD TP guidelines takes into consideration that independent parties would also consider a company not only as a standalone party but also as a part of a group and it should be considered as such from a TP perspective. Nevertheless since this consideration is only voluntary and incidental and not a result of a deliberate action on the part of the group the guidelines do not consider that synergies should be rewarded according to the arm’s length principle. Consequently the OECD provides a definition of group synergies – be they positive or negative – as result of deliberate, concentrated actions. Although the key criterion is clearly set out, finding the decisive factor – the deliberate action – may be difficult in practice due to the fact that such transactions are not always documented in writing or any other tangible form. It may also prove a challenge to determine the amount by which an adjustment should be made. Further, dividing the effect of implicit and incidental conduct of the parties and only pricing the implicit part might cause further difficulties.
In Hungarian legislation group synergies are not defined. Any such adjustment would have to be based on the OECD TP guidelines. In practice only minor negative synergies have been detected, mainly in the form of excess bureaucracy or duplicated functions. The increased information base from CbCR and more detailed and thorough functional analysis required in the future may offer the Hungarian tax authorities more insight into the matter of group synergies during tax audits.

2.2.5. Hard-to-value intangibles

In the case of lack of reliable comparables, when the future outcome (future cash-flow income) of a transaction is highly unpredictable, the OECD TP guidelines provide the tax authorities with the possibility of using ex post outcomes as pointers about the arm’s length nature of the ex ante pricing arrangement and the existence of uncertainties at the time of the transaction. The guidelines define six key features where, if one or more of them applies to an intangible, it can be defined as a hard-to-value intangible (HTVI), thus creating quite a broad definition. All intangibles are to be regarded as HTVIs if they were only partially developed at the time of the transfer, if they are not expected to be exploited commercially until several years following the transaction, if they are integral to the development of other HTVIs, if the manner of their exploitation is new, if they have been transferred for a lump sum payment, or if they were used in or developed under a cost contribution agreement (CCA). Taking into account that the former guidelines avoided the use of ex post results altogether, the present revision took a considerable step in order to – according to the OECD TP guidelines – balance information asymmetries between MNEs and tax administrations. Nevertheless it is stated that the consideration of the ex post evidence should be based on the determination that such evidence needs to be taken into account to evaluate the correctness of the ex ante pricing. Where the tax administration is able to determine the reliability of the information the ex ante valuation is based on, adjustments should not be made based on the ex post results. Further the guidelines define exceptions to the application of ex post results. An exception mainly applies if the taxpayer provides sufficient details regarding the ex ante projections and reliable evidence that any significant differences between the ex ante and ex post outcomes are due to unforeseeable developments or the playing out of anticipated negative possibilities. The existence of a bilateral or multilateral APA is also an exceptional case. A 20 per cent divergence in the compensation or projection compared to commercialization to unrelated parties within five years is also accepted.

In the Hungarian legislation the usage of ex post results is not regulated. The use of this method is presently deemed highly debatable and uncertain. For the pricing of HTVIs among the traditional methods the OECD guidelines refer to the CUP method and the profit split method as the most appropriate. The Hungarian tax authorities handle the CUP method strictly as they require a high level of comparability; thus this method is usually not preferred for documentation. The profit spilt method is rarely applied; thus in this case valuation technics are preferred for the documentation of transactions with HTVIs or rights concerning HTVIs. Also the use of more than one method is preferred to ensure a proper and reliable arm’s length price.
A further acceptable method for related parties might be to revise their agreement and consequently their TP if *ex ante* expectations are not fulfilled or over-achieved, just as unrelated parties would do in similar transactions regarding transactions with hard-to-predict outcomes. Even more preferable in the mitigation of TP tax risks would be to include such future adjustments in the written agreement between the parties such as limitation of the time frame of the agreement or application of a price adjustment clause or milestone payments (for HTVI under development).

### 2.2.6. CCAs

The BEPS actions regarding CCAs largely follows previously issued CCA-related OECD TP guidelines; however, the new changes are likely to pose significant challenges to CCA participants even in Hungary.

As per Hungarian legislative practice, it is worth mentioning that Hungary has endeavoured to comply with OECD TP guidelines; consequently CCAs have been handled and scrutinized accordingly. Furthermore, Hungary generally follows and implements the BEPS initiatives in a dynamic way; Hungary will more than likely apply the BEPS-related approach in handling CCAs in practice.

However, it is still uncertain whether the Hungarian legislative body plans to implement new BEPS-related changes regarding CCAs in the domestic regulation; nevertheless OECD TP guidelines continue to be considered as background regulation in Hungary, thus providing the tax administration with the opportunity of interpreting and handling CCAs in accordance with the BEPS approach.

The timing of implementation of the BEPS-related approach concerning CCAs in Hungary is still uncertain due to the fact that the Hungarian legislative body plans to determine and take relevant alternative steps in the light of international practical experiences.

According to the BEPS approach, CCAs continue to be evaluated based on the substance of the arrangement rather than the contractual form. The requirement that all CCA participants must have a clearly defined interest in the CCA output remain unchanged as well; however, under the BEPS project all CCA parties must also have the ability to exercise control over the risks and must also have the financial capacity to assume those risks.

As a consequence of these new substance and control requirements, the need to perform more detailed function and risk analyses regarding CCAs may arise on the part of the Hungarian tax administration. An additional requirement may also be the regular revision of CCAs in order to reflect an evolution of the arrangement based on changing business needs and opportunities.

Concerning valuation under BEPS, all contributions should be measured at value; however, cost is generally not permitted as an approximation of value. Restrictions are introduced for using cost as a basis for valuing pre-existing and current contributions. As a consequence, the Hungarian tax administration may require CCA parties, in many cases, to change their method of valuing CCA contributions.

Overall, MNEs in Hungary may easily find that the BEPS approach mandates an extensive monitoring of CCAs and an increased administrative commitment to these arrangements.
2.3. Risk and capital

The BEPS approach concerning delineation of the transaction and the allocation of risk provides important new guidance on the application of the arm’s length principle that will more than likely have a significant impact on many MNEs in Hungary.

The BEPS project provides a revised interpretation of the arm’s length principle by placing particular emphasis on accurately delineating the actual transactions. Accordingly, an expanded view and analysis of the economic substance of controlled transactions is required in the form of performing significantly more granular and detailed functional and risk analyses.

The Hungarian domestic regulation also includes the requirement to perform a functional analysis as a compulsory element in the local file; however, the Hungarian information request seems to be inadequately defined or rather general. While BEPS proposes a five-step process to accurately delineate the actual transactions together with a six-step risk process, only the requirement to perform functional analysis is determined in the Hungarian regulation without providing exact and detailed guidance regarding its appropriate content.

The Hungarian tax administration’s emphasis on conducting detailed examination of functional and risk analyses in its auditing practice is already increasing. Moreover, as Hungary has the intention of implementing the BEPS approach concerning the accurate delineation of actual intercompany transactions, Hungarian MNEs may face the requirement of preparing more detailed functional and risk analyses. Furthermore, Hungarian legislation may also change in this respect to ensure better compliance.

As per Hungarian legislative practice, it is worth mentioning that Hungary has endeavoured to comply with OECD TP guidelines; consequently the arm’s length principle has been considered. Furthermore, Hungary generally follows the BEPS initiatives in a dynamic way; thus the existing BEPS approach is expected to be implemented in Hungary.

2.4. High-risk transactions

2.4.1. CUP and quoted prices for cross-border commodity transactions

The BEPS approach proposes an improved framework for the analysis of cross-border commodity transactions. Accordingly, the new guidance states that the CUP method would generally be an appropriate TP method and that quoted prices may be used under this method to determine the arm’s length prices for controlled commodity transactions.

In respect of the above, it is worth mentioning that Hungarian TP rules do not apply solely to cross-border intercompany commodity transactions, but are also applicable to domestic commodity transactions between related parties.

The Hungarian domestic regulation has not included specific requirements concerning the treatment of commodity transactions. Nevertheless, Hungary has been engaged in complying with the OECD TP guidelines which establish the priority
of TP methods. In spite of the fact that generally the CUP method is considered as being the most preferred method according to the OECD TP guidelines, transactional profit methods, in particular TNMM, are currently used to determine the arm’s length price for controlled commodity transactions in Hungary.

As per the present auditing practice of the Hungarian tax administration concerning commodity transactions documented by transactional profit methods, it is worth stressing that profit-based valuation on a transactional basis is preferred vis-à-vis profit-based valuation on a company-wide basis.

The Hungarian tax administration has not placed particular emphasis on conducting a detailed examination as to whether appropriate comparable data or quoted prices are available for MNEs performing controlled commodity transactions. Nevertheless, as Hungary has the intention of implementing the BEPS approach, Hungarian MNEs may be faced with the requirement of putting greater emphasis on finding appropriate comparable data and applying the CUP method as far as possible, or giving a more detailed explanation of the reasons why the CUP method is not applicable.

According to BEPS developments, for the CUP method to be reliably applied to commodity transactions, the economically relevant characteristics of the controlled transactions and uncontrolled transactions or uncontrolled arrangements need to be comparable. The pricing date is highlighted as a particularly relevant factor for commodity transactions.

As a consequence of the above, the Hungarian tax administration may require MNEs to perform more sophisticated comparable analyses, by paying strict attention to economically relevant characteristics of commodities when applying the CUP method for establishing the arm’s length price or range for the transfer of commodities. However, it may pose challenges for Hungarian MNEs to determine how deep and detailed an analysis needs to be to be sufficient.

In addition to the above, the Hungarian domestic regulations establish cases in which the interquartile range of comparable data is applicable when determining the arm’s length price range (for example preparation of a database-based benchmark analysis, or application of a profit-based method for determining the arm’s length price range). It is also worth noting that the application of interquartile ranges may also be required from Hungarian MNEs when quoted prices can be used under the CUP method in documenting a controlled commodity transaction.

However, even without direct implementation of the new BEPS-related changes regarding commodity transactions, the OECD TP guidelines continue to be considered as background regulation in Hungary, thus providing tax administrations with the opportunity of treating controlled commodity transactions in accordance with the BEPS approach.

2.4.2. Intra-group services

BEPS proposes an elective, simplified approach to document low value-adding intra-group services, that is determining whether the service charge is due (the benefit test) and calculating the arm’s length charge in the case of low value-adding services.

The countries participating in the BEPS project have agreed a two-step approach for implementation. The first step consists of a significant majority of
countries enabling this elective mechanism by endorsing its applicability in their countries before 2018. As a second step, countries that have indicated that intra-group head office charges and management services constitute a major concern will be entitled to determine and apply a threshold that, if exceeded, would permit tax administrations to require a full TP analysis, including a benefit test.

As per Hungarian legislative practice, it is worth underlining that Hungary has already included a simplified approach concerning low value-adding intra-group services in its domestic regulation. However, the Hungarian simplified approach rather differs from that proposed in the BEPS action plans.

The BEPS action plans provide a general definition of low value-adding intra-group services together with a list of services that may qualify for application of the simplified method and examples of activities that would not qualify for the simplified approach. The Hungarian domestic rules also define low value-adding intra-group services by providing a list of services (with NACE Rev. 2 codes) that may be considered as low value-adding intra-group services. However, by comparing the BEPS definition with the definition applied in the Hungarian regulation, it may be concluded that the BEPS project handles the definition of low value-adding intra-group services rather broadly, especially in the specifics to be considered, thus ensuring a broader interpretation of the definition than the Hungarian one.

Furthermore, concerning the possibility of introducing a threshold as indicated in BEPS, it is worth mentioning that the application of the existing Hungarian simplified approach to document low value-adding intra-group services is already subject to a threshold, that is that the value of the transactions referred to in the contract should not exceed HUF 150 million (approximately €500,000) without VAT calculated at an arm’s length price level in the tax year under review, and should not be higher than 5 per cent of the net revenue of the service provider in the tax year or 10 per cent of the operating costs and expenses of the beneficiary of the services (the latter two conditions shall be evaluated from the point of view of the entity preparing the TP documentation for Hungarian purposes).

In accordance with the BEPS approach, the mark-up under the simplified methodology should be equal to 5 per cent; however, a profit mark-up range of between 3 per cent and 10 per cent is applied in Hungary regarding low value-adding intra-group services.

In addition, the BEPS approach provides guidance on information and documentation required from an MNE group electing for the application of the simplified methodology to document low value-adding intra-group services. The Hungarian domestic regulation also includes provisions for information required in the case of applying a simplified approach. However, the Hungarian information requirement seems to be narrower than that proposed in the BEPS approach.

Overall, the present Hungarian domestic regulation is not sufficiently in line with the proposals regarding BEPS in determining and handling low value-adding intra-group services; nevertheless Hungary more than likely has the intention of implementing and applying the BEPS approach even in legislation in the near future.

2.4.3. Profit splits in the context of value chains

The Hungarian domestic legislation has not included any requirements to perform value chain analysis to identify the features of the commercial or financial relations
between related parties, or to provide information in accordance with where and how value is created in business operations. That is, Hungary has no special rules concerning the application of TP rules to MNEs’ value chains.

However, Hungary has engaged to comply with OECD TP guidelines and generally follows and implements the BEPS initiatives in a dynamic way, that is Hungary will more than likely apply the BEPS related approach in putting greater emphasis on the potential application of the profit split method in the context of value chains.

Hungary has engaged in participating in the CbCR initiatives as well. CbCR, as a result of information gathering BEPS initiatives and as a risk assessment, is expected to be a useful tool for the Hungarian tax administration in auditing MNEs. Nevertheless, considering the fact that there are only a few ultimate parent companies in Hungary\(^1\) that would belong to an MNE group exceeding the consolidated annual turnover of €750 million set for compulsory CbCR, Hungarian MNEs will probably be connected to the reporting system from the side of data provision primarily. Consequently, only a few Hungarian MNEs will be obliged to provide information regarding value creating processes. Therefore, the Hungarian tax authorities will take advantage of the information exchanged by other tax authorities through the CbCR system, as subsidiaries of the above huge MNEs are frequently located in Hungary.

The timing of implementation of the BEPS-related approach, placing greater emphasis on the application of profit splits in the context of value chains, is still uncertain due to the fact that the Hungarian legislative body plans to consider and take relevant alternative steps in the light of international practical experiences.

2.5. TP documentation

2.5.1. CbCR

Hungary applies a comparatively low CIT rate of 10 per cent/19 per cent and further offers a wide variety of tax advantages both in the form of tax holidays and tax base adjusting items that may result easily in a relatively low effective tax rate. The widely applied withholding tax exemption towards Hungarian source interest, royalties, dividend distributions and services charges also makes the country attractive.

Regardless of the above, being an EU Member State Hungary strictly follows the tax related guidance and requirements deriving from EU legislation; the same applies to OECD tax related matters. Hungary therefore applies strict thin capitalization rules, CFC legislation, TP obligations and also general anti-avoidance rules. Consequently, even though the regulations pertaining to CbCR have not been implemented in Hungary yet, this is scheduled already for early 2017. The starting date of the first reporting period is planned to be 1 January 2016.

The necessity of implementing the CbCR rules is strongly supported by the fact that Council Directive 2011/16/EU of 15 February 2011 on administrative cooperation in the field of taxation wholly took over the key regulations pertaining to CbCR from BEPS Action 13, including also the reporting template. The directive

\(^{1}\) The estimated number of ultimate parent entities likely be compelled to file CbCR is around ten.
requires EU Member States, including Hungary, to implement the regulations of the directive in their domestic law on a compulsory basis.

The proper utilization of the results of CbCR presumes that data assembled on the level of individual countries should be exchanged or distributed to the relevant tax authorities where the respective MNE groups operate. In this regard, the Convention on Mutual Administrative Assistance in Tax Matters has been in effect from 1 March 2015 in Hungary. Further, Hungary is also a signatory of the competent authority agreement with a target date of September 2017 for the first information exchange. With the latter mentioned date Hungary is among the first countries to participate in the automatic information exchange system. With regard to the facts as described herein, Hungary is well prepared to participate in the automatic exchange system that is necessary to bring the CbCR system to life. No corresponding amendments have been made in Hungarian domestic law yet, which may, however, probably not hinder the process at all.

From the point of view of Hungarian practice – as already mentioned above – considering the fact that there are only a few ultimate parent companies in Hungary\(^2\) that would belong to an MNE group exceeding the consolidated annual turnover of €750 million set for compulsory CbCR, Hungarian taxpayers will probably be connected to the reporting system from the side of data provision primarily.

A practical issue may be that the Hungarian domestic definition of “related parties” is narrower than that used in international practice. In Hungary a direct or indirect participation of 50 per cent is required, while the generally applied level is a much lower 25 per cent. Therefore, a Hungarian entity may quite easily find itself in a situation where it records no related parties for Hungarian taxation purposes, while it may still be obliged to participate in CbCR. A unified definition of “related parties” for direct taxation purposes on an international level may help in tackling this issue and could also ensure consistent CbCR in all countries concerned with this requirement.

2.5.2. Master and local files

Hungary has not implemented the rules of BEPS Action 13 pertaining to master files and local files yet. However, on the basis of the code of conduct on TP documentation for associated enterprises in the European Union (2006/C 176/01) Hungary implemented the EU TP documentation rules beginning from 2010. These regulate the compulsory elements of local files and master files, the use of which is linked to the decision of the Hungarian taxpayers to be indicated in their CIT returns.

Hungary will probably amend its already available domestic TP regulation in order to comply with the BEPS Action 13 requirements. As far as the compulsory information included in the master files and local files is concerned in Hungary, the following data are not yet included in the current domestic TP rules following on from the relevant BEPS Action 13 requirements.

Regarding an MNE’s intangibles in the master file:

- a description of the MNE’s overall strategy for the development, ownership and exploitation of intangibles, including the introduction of:
  - the location of the principal R&D facilities;

\(^2\) See note 1.
– the location of its management;
– a list of significant intangibles from a TP perspective and their legal owners within the group;
– a list of significant agreements related to intangibles (CCAs, research service agreements, licence agreements);
– a general description of the group’s TP policies related to R&D and intangibles;
– a general description of any significant transfers of interests in intangibles among associated enterprises during the fiscal year concerned.

Regarding local files:
• the management structure of the local entity;
• the local organization chart;
• individuals to whom local management reports and the countries in which such individuals maintain their principal offices;
• information on business restructuring/transfer of intangibles and an explanation how this affects the local entity;
• a detailed description of the business and business strategy;
• key competitors;
• information on APA claims connected to any of the group members.

Concluding from the above, Hungary should adopt numerous data requirements pertaining to intangibles in the master files, as well as certain general information connected to the group in the local files.

Hungary also plans to introduce a new requirement according to which the most important elements of related party transactions should be included in the CIT return; however, no relevant draft legislation has been published yet.

2.5.3. Compliance costs

MNE group entities subject to CIT in Hungary will probably only be involved in the CbCR requirement from the side of data supplied to ultimate parent entities.

In Hungary there are numerous MNE entities which are considered small in terms of revenue, headcount and balance sheet total; however, they will still be expected to participate in CbCR if the MNE group becomes obliged to do so. From a Hungarian perspective CbCR would create a disproportionately high compliance burden for the smallest entities. Therefore, it would be beneficial to seek for a solution that would still exempt such entities from reporting; however, the probability of this change is rather low, as BEPS Action 13 provides sufficient argumentation that once an MNE group becomes obliged to perform CbCR, in no event can any of its constituent entities become exempted from the reporting obligation.

2.6. TP-related measures in other BEPS actions and other measures against BEPS

Steps that have been taken in Hungary aiming to counterattack BEPS derive primarily from Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, also referred to as an EU BEPS.
According to the amendment of the Hungarian Act on CIT, taxpayers are obliged to report on their associated enterprises in their CIT return and the real economic reasons underlying the transaction if their receivables from them turn into bad debts. This amendment helps to prevent the phenomenon of tax base erosion.

Another amendment aiming at protecting tax base erosion is that TP differences between associated enterprises may be used as deductions only if the respective enterprise declares that the difference between the applied price and the arm’s length price has been taken into account when calculating the CIT base at the other entity.

In order to ease administrative burdens, Hungarian permanent establishments will not be obliged to prepare TP documentation should their income be exempt from CIT payment liability based on an international tax convention in force.

Although the Hungarian intellectual property box regime has no direct connection to the TP rules, it is worth mentioning that the regime has already been amended to follow the OECD–EU requirements; however, Hungary also took advantage of the grandfathering provisions to keep alive the old rules until 2021.

### 2.7. Can BEPS work in favour of MNEs?

The information gathering initiatives concerning CbCR may work especially in favour of MNEs which are ultimate parent companies. Accordingly, CbCR as a risk assessment tool may be useful for such companies to consider the value creating processes within the group from a TP perspective and thus minimize risks arise from profits that are not taxed where economic activities take place and value is created.

From the point of view of the Hungarian practice, considering the fact that there are only a few ultimate parent companies in Hungary that would belong to an MNE group exceeding the consolidated annual turnover of €750 million set for compulsory CbCR, Hungarian MNEs will probably be connected to the reporting system from the side of data provision primarily. Consequently, only a few MNEs will benefit from the information gathering initiatives regarding CbCR in Hungary.

As a consequence of the increased information requirements included in BEPS Action 13 pertaining to the content of master files and local files, MNEs may benefit from such information as well even in Hungary.

The present Hungarian domestic regulation also includes provisions for information required concerning the content of master files and local files; however, the current Hungarian information requirement is narrower than that proposed in the BEPS action plans. The changes are likely be implemented, although the timing is not known at the moment.

Overall, the rules of BEPS Action 13 may work in favour of the Hungarian tax authorities by providing them with more detailed information through master files and local files. On the other hand, the information collection and documentation work will definitely increase the compliance burden of MNEs.

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3 See note 1.
3. What is the future of TP?

CIT revenues have increased recently in Hungary, mainly for the reason that it has a favourable tax environment for R&D activities, as well as certain large MNEs having established significant subsidiaries in Hungary. However, the Hungarian tax system with its various tax advantages schemes and the scarcity of withholding taxes introduced may only be able to protect the tax base through TP and other anti-avoidance practice rules.

Considering the fact that the TP rules are two decades old in Hungary, CIT payers have learned to develop TP documentation on a professional level already by 2010. The number of TP audits has increased significantly in recent years, and this trend is expected to continue in Hungary in the future. During these audits, the Hungarian tax administration increasingly focuses on substance requirements compared to the earlier approach of concentrating on administrative and formal requirements primarily. Revealing the true and valid contents of the transactions, i.e. their economic substance, detailed functional and risk analyses, and investigating the whole value chains of MNE groups has gradually been becoming part of the day-to-day practice of the Hungarian tax authority.

The number of tax authority challenges has decreased, while their significance has increased in terms of tax shortage and connected tax penalties. Due to the relatively high annual threshold under which TP documentation is not compulsory on given transaction types (HUF 50 million, approximately €161,000), increased attention may be paid by the Hungarian tax authority to the TP documentation compulsorily prepared.

Hungarian MNEs will more than likely be faced with the requirement of preparing more and more detailed function and risk analyses in the future as well. In addition to the above, Hungarian MNEs may face the requirement to put greater emphasis on finding appropriate comparable data and applying the CUP method as far as possible, or giving a more detailed explanation for the reasons why the CUP method is not inapplicable. The Hungarian tax administration may require MNEs to perform more sophisticated comparable analyses in the future, by paying strict attention to the economically relevant characteristics of comparables when applying the CUP method for establishing the arm’s length price or range especially for the transfer of commodities.

Hungary has participated in CbCR initiatives, which may therefore trigger an excessive administrative burden for MNEs and their Hungarian subsidiaries exceeding the threshold of €750 million per annum on a consolidated level.

The Hungarian implementation of the BEPS-related approach to increase emphasis on the application of profit splits in the context of value chains is still uncertain.
Summary and conclusions

Indian transfer pricing (TP) regulations are specific anti-avoidance provisions, applicable to international transactions between associated enterprises (AEs). AEs are widely defined, being connected by reason of capital, control or management.

There is considerable jurisprudence on the subject, and in particular TP is not applicable if income is not chargeable to tax (High Court judgments in Vodafone/Shell).

Recent rules provide for use of multi-year data and range, thereby aligning with international practice.

Advance pricing agreements (APAs) and safe harbour provisions also exist, although APAs have attracted more applicants due to the high safe harbour rates.

India has signified its decision to adopt the BEPS actions (updated India chapter in the UN TP manual).

The impact of BEPS is felt on marketing intangibles and contract R&D activities, where conduct is being given a weight relative to contract. India has not subscribed to the guidance on low value services, and AEs of MNEs have made deviations from group policy for India. Risk-based audits have been introduced. India has maintained that the BEPS approach is a codification of India’s stated position that profits are earned and taxes should be paid where value is created. Adoption of Action 14 would bolster dispute resolution by a peer review of a mutual agreement procedure (MAP).

Intangible property has been widely and inclusively defined in the Act right from the start.

The service of brand building (advertisement marketing and promotion (AMP)) is regarded as an international transaction, requiring compensation, although the transaction has to be established as an international transaction in the first place. The intensity of functions is denoted by the quantum of AMP spend relative to comparables. Marketing functions should be benchmarked if the Indian entity is performing market development (DEMPE) functions, adding value to intangibles owned by AEs.

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Location savings are considered as one of the comparability factors, and functional analysis of the parties and relative bargaining power is to be taken into account if a profit split method (PSM) is adopted in the absence of comparables. However, there is no further allocation of location savings if they are already embedded in the profit margins of appropriate comparables.

The economic ownership of intangibles is recognized; however, AMP expenses incurred will be regarded as a transaction and require compensation, as distributors do not become economic owners of the brand. Further, the examination of a controlled transaction should be based on how it is structured and undertaken by AEs, except in cases where the economic substance differs from its form, or arrangements made in relation to the transaction, when viewed in total, differ from those that would have been adopted by independent enterprises.

The impact of group synergies is normally experienced in the case of financial transactions. No payment is required to the parent for implicit support, in the absence of a guarantee. Further, a guarantee extended for financing to a special purpose vehicle (SPV) subsidiary is regarded as a shareholder function.

For cases involving hard-to-value intangibles (HTVI), a tribunal has adjudicated that financial projections drawn up at the time of the transaction should prevail over actual results. What is important is the value available and its basis at the time of making the business decision.

Cost contribution agreements (CCAs) to which an Indian AE is a party typically take the form of allocations of charges for services. Judicial precedents have emphasized the demonstration of services provided through documentation and allowance of the allocation on a reasonable and consistent basis.

With respect to risk, India is of the view that it is unfair to give undue importance to it relative to functions performed and assets employed. The conduct of the parties is key to determining whether the actual allocation of risks conforms to contractual risk allocation. Allocation of risks depends upon the ability of parties to the transaction to exercise control over such risks. Indian jurisprudence takes into consideration the level of risk assumed by comparables while adjudicating on comparability vis-à-vis the tested party.

For comparable uncontrolled prices (CUP) and quoted cross-border commodity transactions, the sixth method notified in financial year 2011–12 supports the adoption of quotations that reflect the price that would have been charged or paid for the same or a similar uncontrolled transaction. The courts have also held that price publications that are authentic and reliable will be relevant material for the purpose of documentation.

The Indian Revenue views services from the standpoint of high value and low value, and whether they are used or provided. It is held that the decision to use services is a business judgment of the taxpayer, but evidence of receipt of services has to be maintained. Where the details of rendering services are furnished and the benefits to the taxpayer’s business can be ascertained, a TP adjustment is without any justification. For the rendering of services by taxpayers to their AEs, the judicial authorities have taken a strict comparability approach and recommended the stratification of services for benchmarking. Value chain analysis is also given due importance, especially in the case of APAs.

Profit splits are seldom used in India.
India has adopted Action 13 on country-by-country reporting (CbCR) and three-tier documentation and has signed the CbC MCAA. India already has detailed guidance on maintenance of contemporaneous local file documentation and this would be augmented by the master file. Indian compliance costs are occasioned for TP documentation and audits and are expected to increase for outbound Indian multinational companies (MNEs) that will have to maintain CbCR and three-tier documentation. The risk-based audits could trigger more APAs as companies seek to gain certainty on their structures and transactions such as AMP. India has introduced the equalization levy in response to the action point (AP) on the digital economy and the patent box regime in response to the AP on countering harmful tax practices.

On balance, MNEs could benefit from the BEPS project on account of exchange of information on matters such as policies for intra-group services and facilitation and expediency of dispute resolution via MAPs and bilateral APAs.

Recent trends point to a decline in audit adjustments, and with the amendments in TP regulations, the days of routine adjustments are numbered. The levels of sophistication and scrutiny of complex transactions are likely to increase, fuelled by the premise of conduct over contract.

1. Current TP regulation and practice in India

Though India has a federal structure of governance; however, the levy and collection of income tax comes under the domain of central government although it is shared with the state governments based on recommendations of the Finance Commission. The Income Tax Act, 1961 is a central Act through which the levy and collection of income tax is regulated and it applies to the whole of India. Under the Act, every person has to pay income tax, if his income exceeds the specified limit. The general principle of taxation is that only real income is taxable and notional or hypothetical income is not taxable unless there are specific provisions to the contrary.

1.1. Substantive law

As envisaged in article 9 of the OECD model convention, commercial transactions between AEs, particularly between different constituents of a multinational group, may not be subject to the same market forces that shape relations between two independent firms. Hence, specific provisions have been made in the Act to tackle the problem of transfer mispricing. These provisions fall into two broad categories. Certain provisions are made to deal with specific transactions where the chances of tax evasion or avoidance are higher and are applicable to all taxpayers. On the other hand, certain provisions are applicable only when the transactions are between close relatives and associated concerns, e.g. TP provisions.

1 UN TP Manual 2013.
Before the amendment of the Act with effect from 1 April 2002, section 92 was the only section dealing specifically with cross-border transactions. However, this provision was of a general nature and limited in scope. Therefore, in the Finance Act, 2001, detailed provisions based on 1979 OECD TP guidelines (as amended) were introduced. These provisions lay down that income arising from an international transaction between AEs should be computed having regard to the arm’s length price (ALP). These provisions are applicable to “international transactions” as defined under the Act, if the following conditions are fulfilled:

- there is a transaction;
- the transaction is between two or more AEs;
- at least one of the enterprises is non-resident; and
- the transaction should have a bearing on the profits, income, losses or assets of the enterprise.

Based on the recommendation of the Supreme Court in the case of CIT v. Glaxo Smithkline Asia (P.) Ltd (TS-47-SC-2010-TP) (2010) 195 Taxman 35 (SC), TP provisions have also been made applicable for specified domestic transactions with effect from 1 April 2013.

Except for a few deviations, some of which have also been amended recently, the Indian provisions are in line with the international consensus provided under OECD TP guidelines. Some of the provisions are briefly discussed here.

Section 92B provides the meaning of the expression “international transaction” with reference to which income is to be computed under section 92. All types of transaction, actual and deemed, tangible and intangible, written or oral are covered within the scope of a “transaction”. The scope of intangible property has recently been defined in broad terms (discussed in the following sections).

Section 92A defines the expression AE. While subsection (1) of section 92A gives a general definition, based on the concept of participation in management, control or capital (substantially based on article 9 of the OECD model convention), subsection (2) specifies the circumstances under which the two enterprises shall be deemed to be AEs (it gives 12 specific conditions based on percentage of share capital holding, control, loan, guarantee, use of knowhow and patents, etc.). The specific conditions are very broad in coverage. For example, a shareholding (26 per cent or above), loan (51 per cent or more of the book value of the total assets of the other enterprise) or guarantee (10 per cent of borrowing) is sufficient to trigger the AE provision.

Section 92C of the Act provides that the ALP in relation to an international transaction shall be determined by the most appropriate method (MAM). The MAM can be any of the six methods. India also follows the same five specified methods which are prescribed under the OECD TP guidelines, though the method of computation in the case of the PSM is slightly different. The sixth method is a residual method which was prescribed very recently. India follows the approach of MAM and there is no hierarchy of methods.

The Indian TP regime is the subject of much litigation and jurisprudence as disputes are brought before the courts. The Bombay High Court in the case of Vodafone India Services (P.) Ltd v. UOI (TS-308-HC-2014(BOM)-TP) has held that TP provisions are not applicable unless the transaction has a bearing on the profits, income, losses or assets of the enterprise and this decision is followed in almost all the later decisions.
Indian TP regulations are anti-avoidance provisions. To this end, the Indian TP rules under section 92(3) provide that a decrease in income or increase in expenses so as to conform with arm’s length standards is not permitted. Further, Indian TP rules do not provide for correlative relief to the counterparty in case of a TP adjustment (section 92C(4)), thus preventing the Indian company from taking a corresponding deduction upon such adjustment. Hence a foreign AE is independently subject to the application of the TP regulations. The Kolkata Special Bench\(^2\) held that if an interest-free loan was extended by a foreign AE to its Indian subsidiary, then even if the Indian company did not pay any interest and, therefore, had no expenditure to claim as a tax deduction, an upward adjustment for deemed arm’s length interest could be made in the hands of the non-resident AE, based on which withholding tax under the treaty would be applicable. The tribunal rejected the argument of base erosion (tax rate on shield obtained on deduction of interest being higher than the rate of withholding), observing that the Indian company had a loss in the given year.

1.2. Relevant rules

Initially, the rules\(^3\) provided that single-year data relating to the financial year in which the international transaction had been entered into must be used in analysing the comparability of an uncontrolled transaction with an international transaction. However, data relating to a period within two years preceding the financial year in question may also be considered, if such data reveal facts which could have an influence on the determination of transfer prices in relation to the transactions being compared. However, the Indian judiciary\(^4\) has only allowed relevant year data for comparison in almost all the cases decided.

The proviso to subsection (2) of section 92C of the Act provides that if the application of the MAM leads to determination of more than one price, the arithmetical mean of such prices shall be taken to be the ALP in relation to the international transaction.\(^5\)

Recently, the provisions of the Act were amended through the Finance (No. 2) Act, 2014 to facilitate the alignment of the Indian TP regime with international best practice. The amended rules allow the “range concept” for determination of ALP and the “use of multiple year data” for undertaking comparability analysis. The range concept is applicable in certain cases\(^6\) for determining the price and begins with the 35th percentile and end with the 65th percentile of the comparable prices. A transaction price shown by the taxpayers falling within that range is accepted.

\(^2\) Instrumentarium Corporation, Finland (TS-467-ITAT-2016(Kol)-TP).
\(^3\) Sub-rule (4) of rule 10B of the Income Tax Rules, 1962.
\(^6\) The arithmetic mean with a tolerance band would be the ALP where there are fewer than six comparables in the case of the CUP method, RPM, CPM and TNMM method. The 35th percentile to the 65th percentile would be the arm’s length range if there were six or more comparables under the previous methods.
1.3. Recent developments

As a part of the Finance Act 2012, the government legislated an APA scheme and during 2013–14, the government introduced rules relating to safe harbours. Safe harbours are defined\(^7\) to mean “circumstances under which the income tax authorities will accept the transfer price declared by the assessee”. Safe harbours have not particularly found favour with taxpayers, due to the high mark-ups sought to be returned as income, especially in sectors such as information technology and information technology enabled services (between 20 per cent and 22 per cent), knowledge process outsourcing (25 per cent), and contract R&D in pharmaceuticals (29 per cent) and software development (30 per cent). On the other hand, taxpayers have overwhelmingly responded to APAs, with over 700 applications filed to date and over 100\(^8\) APAs actually executed between taxpayers and the Central Board of Direct Taxes. The APAs and outcomes from MAPs are expected to reduce the widespread litigation on TP.

1.4. India and the OECD

India is not a member of the OECD; therefore, legally, the OECD TP guidelines have only persuasive value. However, where the matter is not covered by any specific statutory provision, the India Courts, including the Supreme Court,\(^9\) High Courts\(^10\) and Income Tax Appellate Tribunals\(^11\) (ITAT), have, from time to time, relied on the UN or OECD TP guidelines to decide various issues.

2. The impact of the BEPS project on TP

2.1. Introduction

India is an active member of the G20 and actively contributed to the OECD BEPS project and is a votary for the alignment of substance with value creation. To this end, India has implemented certain BEPS actions, including the institution of three-tier documentation as part of the Finance Act 2016. Common minimum standards are Actions 13 and 14. In the latest edition of the UN TP manual, India has expressed its commitment to implementing all the recommendations contained in the BEPS reports, including those relating to TP.\(^12\) Apart from the statutory enactment of the BEPS actions, the active Indian judiciary has had recourse

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\(^7\) S. 92CB of the Act.
\(^8\) Including four bilateral APAs.
to the BEPS actions\textsuperscript{13} and is likely to continue to do so with more force than the extant OECD guidelines. Therefore, the impact of BEPS will not only be experienced through legislation, but also through circulars issued by the Revenue and jurisprudence. India is a major consumer market and many investments are, therefore, market seeking investments. Accordingly, the Indian Revenue has been emphasizing matters such as marketing intangibles (refer to the Special Bench ruling in the case of \textit{LG Electronics})\textsuperscript{14} and contract R&D activities and, hence, the BEPS guidance is a refined version of the existing process and will take it forward. The Indian Revenue has already instituted a programme of risk-based selection of cases for scrutiny\textsuperscript{15} and CbCR will further aid this approach. The specific guidance on delineation of transactions and transactional profit splits is likely to raise considerable audit questions as the one-sided profit methods are augmented by the findings of the CbCR analysis, in particular, the determination of profits that may be found to be parked in low-tax jurisdictions without apparent corresponding substance. The safe harbour mark-up advocated for low value services under BEPS Actions 8–10 is not intended to be adopted by India as several shared service centres are set up by MNEs in India and high double-digit mark-ups have been asserted by the Indian Revenue and eventually partly upheld based on comparability analysis. MNEs have, therefore, adopted higher mark-ups in India for services as a deviation from their group TP policy. Aside from the TP actions, the BEPS Action 7, which pertains to permanent establishments (PEs) that amplify the scope of PE, could give rise to more attribution situations, in particular, those pertaining to connected preparatory and auxiliary activities that taken together could constitute a business activity under the anti-fragmentation rule.\textsuperscript{16} The exchange of rulings under BEPS Action 5 could allow more transparency and consistency in the framing of assessments. And finally, Action 14 pertaining to dispute resolution and Action 15 pertaining to the multilateral instrument could provide the impetus for a speedy resolution of MAP and APA proceedings that are hindered by lack of bandwidth and the absence of correlative relief under article 9(2) in certain treaties.

\textbf{2.2. Challenges of transactions with intangibles}

\textbf{2.2.1. Definition of intangibles}

Section 92B of the Act, as originally applicable from assessment year 2002–3, gives an exclusive definition of “international transaction” with reference to which the income is to be computed under section 92. An explanation was inserted under section 92B by the Finance Act 2012 with retrospective effect from 1 April 2002 to clarify the meaning of international transaction and intangible property. The expression “intangible property” includes:

(a) marketing related intangible assets, such as, trademarks, trade names, brand names, logos;

\textsuperscript{13} Watson Pharma Pvt. Ltd v. DCIT (TS-3-ITAT-2015(Mum)-TP).
\textsuperscript{14} LG Electronics India Pvt. Ltd v. ACIT (TS-11-ITAT-2013(DEL)-TP).
\textsuperscript{15} Instruction No. 3/2016.
\textsuperscript{16} As an example, treaties that India has with the UK, for instance, already embody the anti-fragmentation rule and the India–US treaty has the force of attraction rule for attribution of profits.
(b) technology related intangible assets, such as, process patents, patent applications, technical documentation such as laboratory notebooks, technical knowhow;
(c) artistic related intangible assets, such as, literary works and copyrights, musical compositions, copyrights, maps, engravings;
(d) data processing related intangible assets, such as, proprietary computer software, software copyrights, automated databases, and integrated circuit masks and masters;
(e) engineering related intangible assets, such as industrial designs, product patents, trade secrets, engineering drawing and schematics, blueprints, proprietary documentation;
(f) customer related intangible assets, such as customer lists, customer contracts, customer relationship, open purchase orders;
(g) contract related intangible assets, such as favourable suppliers, contracts, licence agreements, franchise agreements, non-compete agreements;
(h) human capital related intangible assets, such as a trained and organized work force, employment agreements, union contracts;
(i) location related intangible assets, such as, leasehold interest, mineral exploitation rights, easements, air rights, water rights;
(j) goodwill related intangible assets, such as institutional goodwill, professional practice goodwill, personal goodwill of professionals, celebrity goodwill, general business going concern value;
(k) methods, programmes, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, or technical data;
(l) any other similar item that derives its value from its intellectual content rather than its physical attributes.

Therefore, India had adopted a very broad definition of “intangible property” even before the start of the BEPS project.

2.2.2. Transactions with intangibles

Aside from the specific definition of intangibles, India has not passed any legislation or issued any circulars in relation to transactions involving intangibles. Most of the debates arise in respect of the existence of international transactions with respect to marketing intangibles. In the Sony Ericsson ruling, the Delhi High Court held that the service of brand building was an international transaction and analysed the compensation for such a function under various methods. In the case of Maruti Suzuki India Limited, which was followed by several other decisions, the Delhi High Court held that the existence of an international transaction was not established in the first place because the agreement between the parties did not provide an option for the Indian company to build any brand for the overseas AE and the Revenue was unable to prove an arrangement absent such an agreement. While many of these cases are currently decided on the basis of contracts, the courts and the Revenue authorities had looked into the material on record to establish

17 Sony Ericsson Mobile Communications India Pvt. Ltd & Ors v. CIT (TS-96-HC-2015(DEL)-TP).
18 Maruti Suzuki India Ltd v. CIT (TS-360-ITAT-2016(DEL)-TP).
whether, in fact, any service had been rendered that went beyond the contract. The existence of an international transaction is a sine qua non for the determination of the ALP. To this end, the department has started to issue questionnaires to taxpayers to establish whether, in the absence of a written agreement, there is evidence of sufficient conduct that implies the performance of functions by a taxpayer for the benefit of the AE. The questionnaires also seek to ascertain whether there is evidence to show who bears the risk in relation to the marketing function, e.g. devising marketing strategy, controlling and supervising marketing function, explicitly stipulating the manner and quantum of compensation in the event of termination or restructuring. Finally, the queries seek to understand whether connected transactions on account of royalties relating to marketing intangibles or intra-group services relating to marketing functions are involved in such cases and the treatment accorded to such transactions.

Once the department is able to establish the international transaction in respect of marketing activities, the TP adjustment for AMP functions would be determined by ascertaining the difference in the intensity of functions by way of the AMP spend. It remains to be seen how the refinement in the Revenue approach will stand the test of judicial scrutiny, but the Revenue is of the view that DEMPE functions that are carried out by an Indian distributor have to be remunerated at arm’s length. Judicial precedents such as Sony Ericsson (above) provides that marketing functions should be benchmarked if the Indian entity is performing market development functions, thereby adding value to the marketing intangibles owned by the AE.

With respect to location savings, the Indian tax administration is of the view that the concept of “location savings” – which refer to cost savings in a low-cost jurisdiction such as India – should be one of the major aspects to be considered while carrying out a comparability analysis during TP audits. The Indian TP administration believes that it is possible to use the PSM to determine the arm’s length allocation of location savings and rents in cases where comparable uncontrolled transactions are not available.

In these circumstances, the functional analysis of the parties to the transaction (functions performed, assets owned and risks assumed), and the bargaining power of the parties (which at arm’s length would be determined by the competitiveness in the market) should both be considered as appropriate factors. The BEPS actions take a more measured view, providing that if the location savings are already embedded in the profit margins of comparables, no further allocation of location savings is required. This view is also endorsed by the judiciary.

In many cases, Indian subsidiaries using the technical knowhow of their parent company have incurred significant expenditure to customize such knowhow and also to enhance its value by their R&D efforts. Costs of activities, such as R&D activities which have contributed in enhancing the value of the knowhow owned by the parent company, are generally considered by the Indian TP officer while determining the ALP of royalties for the use of technical knowhow.

19 In the case of Watson Pharma (above).
20 Para 10.4.8.6 of the UN TP manual.
2.2.3. “Substance-over-form” approach towards intangibles

The concept of economic ownership of a brand, albeit relevant in a commercial sense, is not recognized under the Indian statutory provisions. In view of the landmark ruling in the case of Vodafone International Holdings BV v. UOI (TS-23-SC-2012), where the Supreme Court held that the situs of shares is situated at the place where the company is incorporated and/or the place where the share can be dealt with by way of transfer, it is now clarified by amending section 9(1)(i) of the Act that the situs of the share will be situated in India if the share derives its value substantially (50 per cent or more) from assets located in India. However, there is no express provision to determine the situs of intangible assets. At one point of time, even the government issued a guideline to the field authorities to explore the possibilities of using PSM in cases of R&D centres of MNEs which were working out the value mostly on a cost plus basis. However, due to industry representation, the guideline was later amended. It is the general view of the tax authorities that where the Indian entity is performing valuable functions in creating/enhancing value of brands legally owned by foreign entities, it should be remunerated adequately.

The Special Bench of the Tribunal in case of L.G. Electronics India (P.) Ltd v. Asstt. CIT (TS-280-ITAT-2013(DEL) – TP), by a majority decision, had held that when AMP expenses are incurred towards the promotion of a brand legally owned by the foreign AE, this will constitute a “transaction” and that retailers or dealers of electronic products, etc., who sell branded products will not become the economic owners of the branded products they sell. However, this decision was partially reversed by the Delhi High Court vide Sony Ericsson Mobile Communications India (P.) Ltd v. CIT (TS-543-HC-2016(DEL) – TP). The Delhi High Court observed that the economic ownership of a brand was an intangible asset just like legal ownership. Undifferentiated, economic ownership brand valuation was not done from moment to moment but was mandated and required if the assessed was deprived of or denied economic ownership or the assessed transferred it. This could happen upon termination of the distribution-cum-marketing agreement or when economic ownership was transferred to a third party. TP valuation, therefore, would be mandated at that time. The international transaction could then be made a subject matter of TP and subjected to tax. However, this approach has no legal backing under the statutory provisions. The same High Court in the case of CUB Pty Ltd (Formerly known as Foster’s Australia Ltd) v. UOI (TS-401-HC-2016(DEL)) held that the situs of an intangible capital asset would be the situs of the owner of that asset; therefore, a capital gain on a transfer would not be taxable in India, if its owner was not located in India at the time of the transaction.

The statutory form of the general anti-avoidance rule (GAAR) has been deferred three times since its insertion in the Indian Budget 2012–13 and will now be applicable from 1 April 2017. Though on some occasions the substance-over-form approach is accepted by the Indian judiciary, in most cases, it does not find favour with the judiciary, especially in matters relating to recharacterization of transactions. For example, it is the general contention of tax authorities that procurement agents providing sourcing services to AEs situated abroad have created...
human assets and supply chain intangibles in India and, therefore, should be bench-
marked under a PSM. Therefore, in some cases even these procurement agents are
benchmarking by treating them as distributors/traders and determination of arm’s
length margin on value of goods sourced, which is not appreciated by the
judiciary.\(^{23}\) Recharacterization of investment in equity share capital as a loan is
also not appreciated by the judiciary.\(^{24}\)

From the above it follows that the examination of a controlled transaction
should ordinarily be based on the transaction as it has been actually undertaken and
structured by the associated enterprises. Two exceptions which have been recog-
nized by the Delhi High Court\(^ {25}\) based on the OECD TP guidelines, are as follows:
(a) cases where the economic substance differs from its form; and
(b) where the form and substance of the transaction are the same but arrange-
ments made in relation to the transaction, viewed in its totality, differ from
those which would have been adopted by independent enterprises behaving
in a commercially rational manner.

This decision of the Delhi High Court has since been followed in most cases.\(^ {26}\) In
other cases also substance over form was not appreciated even by the Supreme
Court\(^ {27}\) and various High Courts.\(^ {28}\) Statutory provisions\(^ {29}\) also lay down that the
comparability of an international transaction with an uncontrolled transaction shall
be judged with reference to the contractual terms (whether or not such terms are
formal or in writing) of the transactions which explicitly or implicitly provide for
how the responsibilities, risks and benefits are to be divided between the respective
parties to the transactions.

2.2.4. Comparability and group synergies

So far as mechanisms to identify group synergies in the application of TP rules are
concerned, there is no specific statutory guidance under the Act. However, in a few
cases, this issue has cropped up before the judiciary, who have followed the inter-
national guidance available at the relevant time.

\(^{23}\) GAP International Sourcing (India) (P.) Ltd v. Assist. CIT (TS-667-ITAT-2012(DEL)-TP), Li &
Fung India (P.) Ltd v. CIT (TS-346-HC-2013(DEL)-TP), and CIT v. Haworth (India) (P.) Ltd (TS-
534-HC-2016(BOM)-TP). Against the decision of Delhi High Court, Supreme Court vide CIT v.
Li & Fung India (P.) Ltd (2014) 52 taxmann.com 249 (SC), has accepted the special leave petition
of the Revenue Department.

\(^{24}\) Vodafone India Services (P.) Ltd v. UOI (TS-308-HC-2014(BOM)-TP). This decision is followed
in the later decisions including, Shell India Markets (P.) Ltd v. Asst CIT (TS-380-HC-
2014(BOM)-TP) and Topsgrup Electronic Systems Ltd v. ITO (TS-61-ITAT-2016(Mum)-TP).

\(^{25}\) CIT v. EKL Appliances Ltd (TS-206-HC-2012(DEL)-TP).

\(^{26}\) Denso India Ltd v. CIT (TS-77-HC-2016(DEL)-TP), Sony Ericsson Mobile Corporation Pvt.
Ltd v. ACIT (TS-96-HC-2015(DEL)-TP), SC Enviro Agro India Ltd v. Dy. CIT (TS-704-ITAT-
2012(Mum)-TP) and Honda Motorcycle & Scooter India (P.) Ltd v. Dy. CIT (TS-181-ITAT-
2015(DEL)-TP).

\(^{27}\) Vodafone International Holdings BV v. UOI (TS-23-SC-2012) and CIT v. B.M. Kharwar (TS-1-
SC-1968).

\(^{28}\) CIT v. EKL Appliances Ltd (TS-206-HC-2012(DEL)-TP), Denso India Ltd v. CIT (TS-77-HC-
2016(DEL)-TP) and Sony Ericsson Mobile Corporation Pvt. Ltd v. ACIT (TS-96-HC-2015(DEL)-
TP).

\(^{29}\) Sub-rule (2) of rule 10B of the Income Tax Rules, 1962.
It is a view of the judiciary that the financial position and credit rating of the subsidiaries will broadly be the same as that of the holding company. Therefore, even if there is certain saving in interest rates, without any specific guarantee from parent, no payments to the AE are required. However, where the AE of the taxpayer provided a corporate guarantee specifically on a loan taken out by the taxpayer, the taxpayer accepted before ITAT that under internationally accepted norms, savings are to be shared equally between the parties. Hence, where an enterprise, being a part of an MNE group, obtains some benefit without any deliberate concerted action of any member of the group, no payment is required to be made to any member of the group. Therefore, where the particular business model gives rise to an edge for the assessee, as a result of group synergy and intangibles, it cannot be assigned to the assessee alone. In any event, the impact of group synergy is taken into account only for deliberate concerted action benefits and not when it merely consists of passive association benefits. It has also been held that no payment is warranted for a shareholder function of providing guarantees, where the beneficiary is an SPV established for the purpose of holding investments of downstream subsidiaries.

It is also a fact that an enterprise, which is part of an MNE group, obtains the benefit of group synergies and brand value even without explicit support from the group. Therefore, it is accepted for comparability purposes that big and complex companies cannot be treated as comparable to small captive service providers. Similarly an enterprise, even a small one, which is part of a big group, could not be compared with an independent enterprise of the same size.

2.2.5. Hard-to-value intangibles

So far as the valuation aspects of “hard-to-value intangibles” are concerned, there is no definite guidance under the statutory provisions. Although quoted price at stock exchange, book value method, earnings multiple method, discounted cash flow method (DCF) method etc., are some of the recognized methods which are used in case of transfer of movable properties, including shares and stock, for domestic transactions. However, there is no guidance for valuation of intangibles for international transactions. While the judiciary has approved the use of internationally recognized methods, such as the DCF method, the modalities of computation and assumptions made for the computation are open to challenge. In some of the cases, the DCF method is used to value the sale of intellectual property rights (IPR). In practice, the excess earnings method and the capitalized cost method are

31 DSM Anti-Infectives India Ltd v. Addl. CIT (TS-241-ITAT-2014(CHANDI)-TP).
32 Bharti Airtel Ltd v. Addl. CIT (TS-76-ITAT-2014(DEL)-TP).
33 Mitsubishi Corp. India (P.) Ltd (TS-200-HC-2014(DEL)-TP) and Marubeni Itochu Steel India (P.) Ltd v. Dy. CIT (TS-339-ITAT-2015(DEL)-TP).
34 M/s Tega Industries Ltd v. DCIT (2016) (TS-780-ITAT-2016(Kol)-TP).
36 Equant Solutions India (P.) Ltd v. Dy. CIT (TS-28-ITAT-2016(DEL)-TP).
also adopted under the sixth method. There is no dispute on the use of the DCF method for valuation, which is now supported by the BEPS reports; however, considerations such as the manner of computation (projections), period of projection, ascertainment of routine returns, terminal value and the use of a discounting factor (including risk premium) remain open to differences of opinion for the taxpayer as well for the judiciary.

In the case of Tally Solutions (P.) Ltd v. Dy. CIT (TS-620-ITAT-2016(Bang) – TP), the assessee company sold IPR held by it to its AE situated in Dubai on 31 January 2006 for a total consideration of INR38.50 crores and it was repurchased on 30 September 2008 for a sum of INR53.68 crores. The tax authorities determined the ALP at INR 501.46 crores with respect to sale. The ITAT did not find any infirmity in the adoption of the excess earning method by tax authorities for the simple reason that the relevant data were available with reasonable accuracy. The ITAT also rejected the assessee’s contention that the ALP should be computed based on actual sales and not on a projection adopted by the tax authorities. On the contention of the assessee with regard to the calculation of IPR as on 31 January 2006 as compared to repurchase of IPR by the assessee on 30 September 2008, the ITAT agreed with the Revenue’s contention and held that the value paid by the assessee to the AE for subsequent purchase of the same software product could not be considered as an uncontrolled transaction as the transaction was between two AEs.

More recently, in the case of DQ (International) Ltd v. Asstt CIT (TS-367-ITAT-2016(HYD)-TP), the assessee sold IPRs to its AE and after considering the independent valuation from two valuers arrived at the sale consideration. The Revenue did not find fault with the valuation, but replaced the projected values with actual values. However, the ITAT observed that the valuation method adopted could not be replaced with the actual down the line, as the valuation could go either way. When it increases, the Revenue may adopt it, and on the other hand, if the actual decreases, the assessee may adopt it, and there will not be any consistency. What is important is the value available at the time of making the business decision.

Therefore, the Indian experience is that while there may be differences of opinion between the taxpayer and the Revenue on the use of ex post data as opposed to ex ante data, the judiciary are keen to adopt a DCF method based on projected cash flows at the time of the transaction and there are no decisions to the contrary. On a slightly different note, the judiciary has also taken cognizance of the DCF method in the context of share transfer, even though it is at variance with the erstwhile exchange control regulations.

2.2.6. CCAs

CCAs in India are regarded as international transactions. Specifically, section 92B(1) of the Act defines that international transactions include a mutual agreement or arrangement between two or more AEs for the allocation or apportionment of, or any contribution to, any cost or expense incurred or to be incurred in connection with a benefit, service or facility provided or to be provided to any one or more

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39 Ascendas (India) Pvt. Ltd v. DCIT (TS-1-ITAT-2013(CHNY)-TP).
40 VIHI LLC v. ADIT (TS-319-ITAT-2013(CHNY)-TP).
of such enterprises. They apply to both intangibles and services, although in practice, they are more prevalent in services.

The precedents on CCAs are typically in the nature of disputes on management charges, where costs are allocated to jurisdictions for services rendered. The Indian tax authorities in the field routinely disallow the charges for CCAs in cases where the Indian subsidiary is making a remittance to the overseas associated enterprise, on the premise that either an arm’s length comparable transaction is not demonstrated for the stand-alone transaction of CCAs, or that the services are not adequately established to have been provided, or that the benefits of the services are not adequately demonstrated. However, at the level of the tribunal, the view adopted is more reasonable and judicial precedents have called for the demonstration of the services being provided through documentation41 and the allowance of the allocation of the charges (including an arm’s length mark-up) on a reasonable and consistent basis.

The Indian TP regulations have not been specifically modified in the light of BEPS to deal with CCAs, but the Circular No. 6/2013 that deals with contract R&D centres contemplates centres which are based on cost sharing arrangements. The circular states that there are three categories: (a) centres that are entrepreneurial in nature, (b) centres which are based on cost sharing arrangements and (c) centres which undertake contract R&D. The circular acknowledges that, while the three categories are not watertight, it is possible to distinguish them based on functions, assets and risk. It will be obvious that in the first case the development centre performs significantly important functions and assumes substantial risks. In the third case, it will be obvious that the functions, assets and risk of the centre are minimal. The second case falls between the first and the third cases. To this end, the Revenue has laid out tests that would assist in identifying R&D centres that assume little risk. Most significantly, one of the guidelines for identifying a centre as a contract R&D service provider assuming insignificant risk is that the Indian development centre has no ownership right (legal or economic) of the outcome of the research which vests with the foreign principal and that this is evident from the contract as well as from the conduct of the parties.

2.3. Risk and capital

Rule 10B(2), which deals with judging the comparability of an international transaction with an uncontrolled transaction for determination of the ALP, provides that the risk assumed and assets employed should, in conjunction with functions performed, by the respective parties to the transactions, be taken into account. India believes that it is unfair to give undue importance to risks in determination of the ALP in comparison to functions performed and assets employed.42 India believes that the conduct of the parties is key to determining whether the actual allocation of risks conforms to contractual risk allocation. Allocation of risks depends upon the ability of parties to

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41 Dresser-Rand India Pvt. Ltd v. ACIT (TS-545-ITAT-2011(Mum)-TP) (Mum), Ericsson India (P) Ltd v. DCIT (TS-319-ITAT-2012(DEL)-TP) and AWB India Pvt. Ltd v. ACIT (TS-67-ITAT-2013(DEL)-TP).

the transaction to exercise control over such risks. The Indian chapter in the UN TP manual provides, “Core functions, key responsibilities, key decision making and levels of individual responsibility for the key decisions are important factors to identify the party which has control over the risks”. Vide Circular 6/2013 (above), the Revenue gave further guidance on this matter to identify contract R&D centres assuming insignificant risk. Specifically, the following points are relevant:

(a) the foreign principal performs most of the economically significant functions involved in research or product development cycle either through its own employees or through its AEs while the Indian development centre carries out the work assigned to it by the foreign principal. Economically significant functions would include critical functions such as conceptualization and design of the product and providing the strategic direction and framework;

(b) the foreign principal or its AE(s) provides funds/capital and other economically significant assets including intangibles for research or product development. The foreign principal or its AE(s) also provides remuneration to the Indian development centre for the work carried out by the latter;

(c) the Indian development centre does not assume or has no economically significant realized risks. If a contract shows that the foreign principal is obligated to control the risk but the conduct shows that the Indian development centre is doing so, then the contractual terms are not the final determinant of actual activities.

The Indian safe harbour rules also apply only where Indian R&D centres assume little risk. Although no specific guidance has been additionally issued consequent to the BEPS actions, Indian jurisprudence takes into consideration the level of risk assumed by comparables while adjudicating on comparability vis-à-vis the tested party. This is particularly evident in the case of captive software companies (CIT v. Agnity India Technologies (P.) Ltd (TS-189-HC-2013(DEL) - TP) and investment advisers (CIT v. Carlyle India Advisors (P.) Ltd (TS-219-ITAT-2012(Mum)). The Indian TP administration finds it difficult to make risk adjustments in the absence of any reliable, robust and internationally agreed methodology to provide risk adjustment. That said, capacity adjustment is still granted by the courts depending upon the characterization of the entity and the risk actually assumed.

2.4. High-risk transactions

2.4.1. CUP and quoted prices for cross-border commodity transactions

A substantial part of world business comprises trading in commodities. Though the CUP method is the best for benchmarking commodity trading, lack of actual data restricts the use of this method.

Section 92C of the Act provides that the ALP in relation to an international transaction shall be determined by the MAM. MAM can be any of the six methods including the sixth “other method”. However, the sixth method is notified recently with effect from assessment year 2012–13. This “other” method specifically allows comparison with the price which has been charged or paid, or would have been charged or paid, for the same or similar uncontrolled transaction. Therefore, quota-
tions are now held to be valid under the “other method”\textsuperscript{43} though there were some apprehensions earlier in respect of the CUP method.

Before notification was issued in respect of the sixth method, in some decisions\textsuperscript{44} it was held that the comparison was required to be done with the actual uncontrolled transactions and not with quotations, etc. While in other decisions\textsuperscript{45} it was held that data published by independent organizations, which reflect the prevailing market rates, would be relevant material for purposes of carrying out comparability analysis in the course of application of the CUP method. The Gujarat High Court has held\textsuperscript{46} that the price publication, as long as it was authentic and reliable, would be relevant material for the purpose of rule 10D(3)(c). This decision was followed by Delhi ITAT in the case of Dy. CIT v. Noble Resources & Trading India (P.) Ltd (TS-268-ITAT-2016(DEL)-TP). It is important to note that Delhi ITAT drew support for use of quoted prices from the OECD BEPS action plan.

\subsection*{2.4.2. Intra-group services}

Intra-group services (IGS) can be viewed from the prism of high-value services and low-value services. IGS are closely reviewed by the Revenue authorities, as Indian MNEs are actively engaged in rendering IGS as well as receiving them. Based on judicial precedents, key considerations for IGS include:

- the existence of a service;
- a benefit for the recipient – this is a prerogative of the business;
- a willingness to pay for services received in a third party situation; and
- the arm’s length nature of the charge.

Whereas the courts have specifically ruled that duplicating services cannot be charged, on-call services can be paid for, even if certain services as part of the retainer are not used.\textsuperscript{47} The decision to receive and pay for the services is left to the business judgment of the taxpayer.\textsuperscript{48} What is required to be evidenced is the receipt of services. Where the details of rendering services are furnished and benefits for the taxpayer’s business can be ascertained, a TP adjustment is without any justification.\textsuperscript{49} In view of several disputes concerning the allowability of cost allocations towards IGS, taxpayers are resorting to APAs. Such APAs normally set out the template documentation required to be maintained for IGS. Further, even if an arm’s length result is achieved in respect of such payments from India, an additional protection in the form of an overall ceiling on the amount of such payments may be required.\textsuperscript{50}

\textsuperscript{43} KTC Ferro Alloys (P.) Ltd v. Addl. CIT (TS-20-ITAT-2014(VIZ)-TP), Ambo Agro Products Ltd v. Dy. CIT (TS-136-ITAT-2014(Kol)-TP) and Gulf Energy Maritime Services (P.) Ltd v. ITO (TS-74-ITAT-2016(Mum)-TP).

\textsuperscript{44} Sinosteel India (P.) Ltd v. Dy. CIT (TS-341-ITAT-2013(DEL)-TP) and Noble Resources & Trading India (P.) Ltd v. Asstt. CIT (TS-73-ITAT-2014(DEL)-TP).

\textsuperscript{45} CIT v. Adani Wilmar Ltd (TS-171-ITAT-2013(Ahd)-TP) and Cargill Foods India Ltd v. Dy. CIT (TS-548-HC-2016(DEL)-TP).

\textsuperscript{46} CIT v. Adani Wilmar Ltd (TS-171-ITAT-2013(Ahd)-TP).

\textsuperscript{47} Merck Limited (TS-608-HC-2016(BOM)).

\textsuperscript{48} CIT v. Cushman & Wakefield India Pvt. Ltd (TS-150-HC-2014(DEL)-TP).

\textsuperscript{49} Gillette India Ltd v. ACIT (ITAT Jaipur) (TS-372-ITAT-2015(JPR)-TP).

\textsuperscript{50} Para. D.4.11.6 of the India Chapter of the UN TP Manual, 7 October 2016.
In relation to the rendering of services by Indian companies to their AEs, the judicial authorities have taken a strict comparability approach while dealing with comparables. Stratification of services is recommended (BPO v. KPO),\(^{51}\) in order that the nature of services rendered can be benchmarked accurately having regard to comparability factors.

The Indian courts have drawn reference to value chain analysis (cf. *Sony Ericsson & Ors*), especially while dealing with the aspect of AMP expenses that are regarded as an IGS performed by the Indian company for the AE.

The Indian Revenue does not appear to agree with up to 5 per cent mark-up assigned to low-value services in BEPS,\(^{52}\) and believes that they should be benchmarked with functionally comparable companies. Per information in the public domain, the Indian Revenue authorities have agreed to mark-ups ranging between 16 per cent and 19 per cent for IT and ITES services in APAs and MAPs. Several APAs in the service domain are being agreed between the Revenue and the taxpayer. These APAs involve a site visit that seeks to understand the positioning of the service in the value chain of the group, the level of skills employed in the rendering of the services and the characterization of the entity providing services.

### 2.4.3. Profit splits in the context of value chains

As per OECD TP guidelines, the PSM may be used in cases where transactions involve the transfer of a unique intangible or any multiple interrelated international transactions, which cannot be evaluated separately for determining the ALP of any one transaction. The PSM can be applied in two ways, either as a residual PSM or as a transactional PSM. In India, so far, this method is applied only in a few cases.\(^{53}\) The procedure prescribed under the Indian PSM is slightly at variance with the international standard.\(^{54}\)

There are no recent data on use of PSM in India. An earlier study\(^{55}\) on the most preferred method for determination of arm’s length price has revealed that the status of most preferred method in financial year 2006–07 was the TNMM (72 per cent), CUP (19 per cent), CPM (6 per cent), RPM (3 per cent) and PSM (0.1 per cent). The Indian APA programme\(^{56}\) received 704 unilateral and bilateral applications in the first four years of the programme (financial year 2012–13 to financial year 2015–16). Out of over a hundred agreements finalized so far, the PSM has


\(^{52}\) India Chapter of UN TP Manual, October 2016.

\(^{53}\) Global One India Ltd v. Asstt. CIT (TS-115-ITAT-2014(DEL)-TP) (taxpayer was engaged in providing internet and related network services to the group’s customers in India), Satellite Television Asian Region Ltd v. Dy. DIT (TS-34-ITAT-2016(Mum)-TP) (taxpayer derived revenue from distribution of television channels and sale of advertisement time) and Orange Business Services India Networks (P.) Ltd v. Dy. CIT (TS-197-ITAT-2015(DEL)-TP) (taxpayer was engaged in providing data services and related network services to customers in India).

\(^{54}\) Global One India Ltd v. Asstt. CIT (TS-115-ITAT-2014(DEL)-TP).

\(^{55}\) Source: Mr Prakash Chandra’s presentation during FIT Mumbai Conference 2008. Mr Prakash Chandra was Director General, International Taxation, India at that time.

\(^{56}\) “Advance Pricing Agreements: An Indian Perspective” written by Mr. Sanjeev Sharma in *Global Taxation*, July 2016 issue. Mr Sanjeev Sharma is an officer of the Indian Revenue Service and is presently working as an APA Commissioner.
been used in just one case. Therefore, the PSM is used very rarely in India. This may be due to the fact that most MNEs have set up a captive service provider which works on the CPM having no intangible assets.

2.5. TP documentation

2.5.1. CbCR

India being one of the active members of the OECD/G20 BEPS Project has recently introduced revised standards for TP documentation in line with BEPS Action Plan 13. It includes preparing and filing CbCR and preparing and maintaining a master file. While the essential elements have been provided in the Act by the Finance Act 2016, detailed aspects will be provided in the Rules. The amendments shall apply from the Assessment year 2017–18. The CbCR provision will apply in respect of an international group having consolidated revenue above a threshold of €750 million equivalent in local currency (INR 5,395 crores (at current rates)). The report would contain aggregated information in respect of revenue, profit and loss before payment of income tax, amount of income tax paid and accrued, details of capital, accumulated earnings, number of employees, tangible assets other than cash or cash equivalent in respect of each country or territory along with details of each constituent’s residential status, nature and details of the main business activity and any other information as may be prescribed. This should be based on the template provided in the OECD BEPS report on Action Plan 13. An entity in India belonging to an international group shall be required to furnish CbCR to the prescribed authority if the parent entity of the group is resident:

• in a country with which India does not have an arrangement for exchange of the CbCR; or

• such country is not exchanging information with India even though there is an agreement; and

• this fact has been intimated to the entity by the prescribed authority.

On 27 February 2012, India also ratified the Convention on Mutual Administrative Assistance in Tax Matters which was opened for signature to all countries in June 2011. India has become the first non-member associate of the OECD and the Council of Europe to become a party to the convention.

The convention, by virtue of its article 6, requires the competent authorities of the parties to the convention to mutually agree on the scope of the automatic exchange of information and the procedure to be complied with. Against this background, the MCAA CbC for the automatic exchange of CbCR, and the MCAA on automatic exchange of financial accounting information (CRS MCAA) pursuant to the common reporting standard, have been developed. As part of continuing efforts to boost transparency by MNEs, India has also signed the CbC MCAA bringing the total number of signatories, as of 30 June 2016, to 44 countries.

India has also signed more than 90 double taxation avoidance agreements and 17 tax information exchange agreements (TIEAs) with other countries for exchange of information and assistance in respect of collection of taxes including TP matters.
2.5.2. Master and local files

Section 92D of the Act provides for the maintenance of prescribed information and documents relating to international transactions. The maintenance of local file as contemporaneous documentation has, therefore, been in place since the time the TP regulations were instituted in 2001. In order to implement the international consensus, the Act has been amended through the Finance Act 2016 to provide a specific reporting regime with respect to CbCR and the master file. The amendment in the Act in respect of maintenance of a master file provides that the entities being constituent of an international group shall, in addition to the information related to the international transactions, also maintain such information and documents as prescribed in the rules. The information and documents should also be furnished to the prescribed authority within such period as may be prescribed and the manner of furnishing may also be prescribed in the rules. A penalty of INR 5 lakh may be imposed for non-furnishing of the information and documents to the prescribed authority. Though the facilitating provisions have been made, the prescribed rules are yet to be formulated. It is believed that the rules will prescribe the information and documents as mandated for the master file under the OECD BEPS Action 13 report. It is not known if the threshold of the monetary limit to be specified for the maintenance of the master file will be lower than that specified for maintenance of CbCR.

2.5.3. Compliance costs

Existing compliance costs pertain to expenses for maintenance of contemporaneous TP documentation, obtaining an accountant’s report of international transactions and wide-ranging TP audits. Compliance costs are bound to increase in view of the three-tier documentation, particularly in India which has so far mandated only local file maintenance. Therefore, master file and CbCR maintenance will call for incremental investment in systems and processes, in particular for Indian outbound multinationals. That would be in the nature of a one-off cost, and thereafter constitute a recurring annual compliance cost. Further, in view of the risk-based audit process introduced recently, it is expected that smaller groups of companies will be taken up for audit, but these are likely to be the outcome of CbCR review, for which the department is expected to deploy analytical tools. More detailed scrutiny will, therefore, be adopted for such companies. The Indian experience has been that several cases are normally taken up for audit and even then, the intensity of audit is considerable. This is expected to be increased due to the smaller number of cases and the focus on BEPS-related issues. Therefore, it is presumed that in addition to compliance costs, there will be more spending to defend the audit and possible litigation for AEs whose parent companies meet the CbCR threshold. The risk-based audit parameters introduced recently provide for a computerized selection of cases for audit based on certain internally determined parameters or compulsory manual selection system in accordance with the departmental instructions. They also contemplate cases where the TP adjustment of prior year is in excess of INR 100 million. Certain other conditions are also provided for cases

57 Instruction No. 3/2016.
where international transactions or specified domestic transactions are not disclosed in the accountant’s report or a disclaimer is provided while reporting international transactions in a given situation.

India is already witnessing widespread litigation on the issue of AMP expenses, which has reached the apex court. Such litigation, that has its eventual resolution in the BEPS actions, will lead to an increase in the cost of litigation and, eventually, in the cost of compliance. Companies are also likely to go in for APAs for their proposed transactions to become BEPS-proof, which will add to costs of APAs, although subsequent compliance costs will decrease. This trend is evident from the rush for APAs on account of widespread adjustments made in the course of audits in the first six to seven cycles.

2.6. TP-related measures in other BEPS actions and other measures against BEPS

India has instituted three measures against BEPS in the Finance Act 2016: the equalization levy, the patent box and three-tier documentation.

The equalization levy, which is in response to BEPS Action 1 (digital economy), is a unilateral action in the form of a transaction-related withholding tax at the rate of 6 per cent in respect of specified services provided from a foreign country and the non-resident does not have a PE in India. Such income is not liable to tax in India in the hands of the foreign company but the equalization levy is not creditable under the treaty as it is not a covered tax.

The patent box is an incentive provided to enable the creation of IP based on the nexus approach advocated under Action 5 (countering harmful tax practices). The incentive provides for a reduced rate of tax of 10 per cent in respect of licence income if the IP is developed and legally owned in India. The outlicensing of the IP to an AE overseas would be regarded as an international transaction subjected to TP.

India has also introduced indirect transfer rules that seek to tax gains arising on transfer of shares of an offshore company where the substantial value of underlying assets (over 50 per cent) are situated in India.

Finally, India has recently renegotiated its treaties with Mauritius, Cyprus and is in the process of doing so with Singapore. The earlier treaties provide that gains arising from sale of shares of an Indian company would be liable to tax in the contracting state of which the alienator was a resident. Due to the fact that Mauritius or Singapore or Cyprus do not levy tax on capital gains arising from sale of securities, these transactions of disposal of securities have in effect led to a situation of double non-taxation. The revised protocol protects benefits extended to investments made prior to 1 April 2017, and any future gains will be sheltered from tax. Fresh investments made in shares of an Indian company after this date will be subject to capital gains tax upon disposal in India. India has also introduced a “limitation of benefit” clause in these treaties and had put riders on the concessional treatment of capital gains during the transitional period by way of the primary purpose test and the business purpose test. The GAAR will be effective in India from 1 April 2017.

58 Chapter VIII of the Finance Act, 2016.
These mechanisms are intended to prevent treaty shopping in the field of investments and, in effect, prevent BEPS. India has also made commitments towards Action 14, and to this end, expeditious resolution of MAP cases and recent treaty activity providing for correlative relief through article 9(2) are of significance.

2.7. Can BEPS work in favour of MNEs?

Previously the tax authorities were facing the problem of lack of information from MNEs, but henceforth the tax authorities will face the problem of excess information received from various fora. Some of the information, which was previously not provided by MNEs, will be automatically available to tax authorities. However, it will be very difficult to say, at this moment, in how many cases, it will work in favour of MNEs. This may work favourably, if the constituents of MNEs are not situated in tax havens or low-tax jurisdictions and the effective tax paid in other jurisdictions is not considerably lower than domestic tax rates. However, so far as India is concerned, it will still be a challenge to satisfy the tax authorities in view of India’s claim to locational advantages. MNEs should not face difficulty if the margin earned in India is much higher than that earned in other jurisdictions; otherwise, there could be a challenge for taxpayers to convince the tax officers. Taxpayers may have to justify not only the level of Indian profitability arising from international transactions by providing a great deal of information about the MNE group to the department, but also the margin earned in other jurisdictions, particularly if that margin is equivalent to or on the higher side. Positively speaking, the admissibility of cost allocations, even if subject to a ceiling, based on consistent policy, could provide MNEs with some relief. So measures to improve dispute resolution by means of the adoption of Action 14 would also be well received.

3. What is the future of TP?

The future of TP in India seems to be on the right track after some years of aggressive adjustments. In recent audit cycles, adjustments have decreased. The recent amendments made in the statutory provisions along with landmark rulings from the judiciary and the success of Indian APA programme has provided the necessary relief to taxpayers.

On the statutory front, a risk-based TP audit process has been introduced in place of the quantum-based audit process adopted earlier. The range concept has also been introduced along with the simple arithmetic mean concept used earlier. Multiple year benchmarking has also been introduced in the Rules in place of single year benchmarking used earlier. The CbCR requirement has also been introduced based on the OECD BEPS report. The government has also accepted the

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60 India–Korea DTAA notified in October 2016.
61 In 2012–13, with a jump of 54 per cent, TP adjustments were at INR 700 billion which recently came down to INR 465 billion in audit cycle 2014–15.
decision of the Bombay High Court\(^\text{64}\) where the court has held that the alleged shortfall in receipt of a share premium on the issue of shares by Indian subsidiaries to foreign parents could not be charged to tax as TP provisions are not charging provisions but merely machinery provisions.

As noted earlier, the APA scheme has attracted tremendous interest from MNEs, with several applications filed and some APAs concluded.

The judiciary is also not far behind in providing necessary relief to taxpayers. Under TP, AMP expenses is one of the most controversial issues. The Indian courts have preferred an aggregated approach\(^\text{65}\) for the benchmarking of AMP transactions along with other similar transactions instead of separately benchmarking AMP transactions only. Even in recent cases, the courts have ruled that in the absence of agreement between the Indian entity and foreign AE whereby the Indian entity was obliged to incur AMP expenditure to an extent for the foreign entity for the purpose of promoting the brand value of the products of the foreign entity, no international transaction can be presumed.\(^\text{66}\) However, we are likely to witness more nuanced jurisprudence on the categorization of distributors (low-risk, routine, full-fledged) and the treatment of AMP expenditure based on facts of each case and the methodology to be applied for benchmarking. It is also the consensus view of the Indian judiciary that government cannot question the commercial expediency of the taxpayer or the quantum of benefit the taxpayer derived while making the royalty payment for use of intangibles, etc.\(^\text{67}\)

Therefore, from several points of view, as taxpayers are getting required relief after some aggressive years of adjustments on the aspects of comparability and questions of income chargeable to tax arising out of TP adjustments. However, more complex questions, such as delineation of transactions, conduct or arrangement, risk and capital are likely to come up before the APA or the judicial authorities in the course of time.

Addendum

The Finance Bill was presented in the Indian Parliament on 1 February 2017. The following is an update to the India branch report, setting out new proposals on TP. It is important to note that these will be effective only when the Finance Bill is passed by the Indian Parliament.

\(^{64}\) Vodafone India Services (P.) Ltd v. UOI (TS-308-HC-2014(BOM)-TP).

\(^{65}\) Sony Ericsson Mobile Communications India (P.) Ltd v. CIT (TS-96-HC-2015(DEL)-TP).


\(^{67}\) CIT v. EKL Appliances Ltd (TS-206-HC-2012(DEL)-TP).
Secondary adjustments introduced (section 92CE)

- The Finance Bill 2017 proposes to introduce the concept of making secondary adjustments in certain cases where the primary adjustment to the transfer price has been made under the Indian TP legislation.
- Though the existing TP legislation reverses the tax effect of a non-arm’s length intra-group transaction by making primary adjustments, it still leaves outstanding the actual cash benefit from those arrangements with AEs.
- In essence, the cash benefit received by an AE benefiting from the non-arm’s length arrangement would be deemed to be an advance from the Indian AE and would be subject to imputed interest if not repatriated to India within a timeframe to be prescribed.
- The memorandum to the Finance Bill 2017 defines a secondary adjustment as an adjustment in the books of accounts of the Indian taxpayer and requires its AE to reflect consistency between actual allocation of profits between the taxpayer and the AE and the transfer price determined under primary adjustment, thus removing the imbalance between the eventual determination of transfer price and the actual transactions.
- The newly inserted section provides that a taxpayer is required to make a secondary adjustment in the following cases where a primary adjustment has been made:
  - *suo motu* by taxpayer;
  - by the assessing officer and accepted by the taxpayer;
  - pursuant to an APA;
  - pursuant to safe harbour rules; and
  - pursuant to an MAP.
- To note that a secondary adjustment is required to be made only when the taxpayer accepts the primary adjustment made by the TP ordinance. Therefore, secondary adjustments are not required to be made until the matter reaches conclusion.
- Further, where a primary adjustment made to the transfer price results in an increase in the total income or reduction in the loss of taxpayer, the differential amount should be repatriated to India within the prescribed time. If not repatriated timely, the excess money would be treated as a deemed advance by the taxpayer to the AE and interest on the advance be computed as per the computation mechanism to be prescribed.
- The provisions relating to secondary adjustment will be applicable from assessment year 2018–19 onwards and no secondary adjustment can be made in the following cases:
  - for primary adjustments made for assessment year 2016–17, pertaining to financial year 2015–16 or prior years; and
  - for primary adjustments where the amount of adjustment does not exceed INR 10 million.
- Guidelines relating to time limit for repatriation of excess money to India and for imputing interest on deemed advance are to be prescribed.
Limitation of interest deduction introduced (section 94B)

- The Finance Bill 2017 proposes to insert a new section 94B, in line with the recommendations of the OECD BEPS Action 4 (limiting base erosion involving interest deduction and other payments).
- These provisions will be applicable to an Indian company or a PE of a foreign company, being the borrower, which pays an interest (exceeding INR 10 million) for any debt issued by an AE being a non-resident or PE of a non-resident.
- This section will restrict the deduction of the interest expense to the extent of 30 per cent of the earnings before interest, taxes, depreciation and amortization (EBITDA) or interest paid/payable to an AE, whichever is less.
- Further, if the lender of debt is not an AE of the borrower, but an AE provides an implicit or explicit guarantee to the lender or deposits a corresponding and matching amount of funds with the lender, this debt transaction will be deemed to be entered into between two AEs. This implies that while calculating the amount of interest deductible, any interest paid on the debt would also be considered while computing the 30 per cent limit of interest allowable as per this section.
- The disallowed interest expense shall be allowed to be carried forward for eight assessment years immediately succeeding the assessment year for which the disallowance was first made and would be allowable in the succeeding assessment years to the extent of maximum allowable interest, i.e. 30 per cent of EBITDA.
- The amendment excludes the borrowers engaged in banking and insurance business, and companies with an interest expense of less than INR 10 million. This amendment is applicable with effect from 1 April 2018, i.e. assessment year 2018–19 onwards, pertaining to financial year 2017–18.

The budget proposal on secondary adjustments is intended to secure repatriation of the primary adjustment as a default option, failing which interest would be imputed as an anti-avoidance measure. The budget proposal on interest limitation seeks to further assert India’s commitment to implementing the BEPS actions.
Summary and conclusions

It is agreed by scholars, the Italian tax authorities (ITA) and the Italian courts that the Italian transfer pricing (TP) rules should be interpreted by reference to the OECD TP guidelines. Considering that on 23 May 2016 the OECD Council approved the amendments to the OECD TP guidelines, as set out, *inter alia*, in the base erosion and profit shifting project (BEPS) Actions 8–10, Aligning transfer pricing outcomes with value creation, there should be no doubt that the update process will take effect in Italian tax law.

This should be true e.g. with respect to the definition of intangibles, comparability and group synergies, risk and capital, cost contribution agreements (CCAs), commodity transactions, the use of the profit split method and, according to the ITA, the possibility of disregarding actual transactions in exceptional circumstances.

That said, some deviations exist both in some interpretations made by the ITA – to which some rulings from the Italian jurisprudence still refer – and a recent tax law provision according to which companies operating in the field of on-line advertising and connected services should avoid determining the arm’s length profitability by reference to their cost, unless an agreement is reached with the ITA under the international ruling procedure.

As far as Action 13, Transfer pricing documentation and country-by-country reporting, is concerned, Italy had already implemented non-mandatory documentation requirements including master and local files. Following the approval of this action, Italy has also introduced the country-by-country reporting (CbCR) obligation in its 2016 budget law.

Apart from the CbCR, Italy implemented other measures against BEPS, e.g. following the inputs contained in BEPS Action 2, Neutralizing the effects of hybrid mismatch arrangements (update of the already existing linking rules and a proposal for new ones), BEPS Action 3, Designing effective controlled foreign company rules (update of the Italian controlled foreign company (CFC) rules), BEPS Action 5, Countering harmful tax practices more effectively, taking into account transparency and substance (the patent box regime), BEPS Action 6, Preventing the granting of treaty benefits in inappropriate circumstances (anti-abuse of law concept), and BEPS Action 14, Making dispute resolution mechanisms more effec-

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tive (improvement of the functioning of the Mutual Assistance Procedure/Arbitration Convention).

The work on TP of the BEPS actions has been carried out without the need to develop special measures outside the arm’s length principle. Thus, Italy being a country in which reference is made to the arm’s length principle, the OECD TP guidelines will continue to guide the attribution of profits in intercompany transactions.

1. Current TP regulation and practice in Italy

In the Italian tax legislation reference to the arm’s length principle is contained in the notion of “normal value”. Relevant provisions are included in the Italian consolidated income tax legislation (Testo Unico delle Imposte sui Redditi (TUIR), ITC) article 9(3) and 9(4) and article 110(7), ITC. Regulations on TP were issued in the early 1980s (circular letter of 22 September 1980 no. 32/9/2267 and circular letter of 12 December 1981, no. 42/12/1587).

Pursuant to article 110(7), ITC, income arising from intra-group transactions between a resident enterprise and non-resident enterprises which directly or indirectly control the resident enterprise, are controlled by the resident enterprise or are controlled by the same enterprise that controls the resident enterprise is to be evaluated according to the “normal” value of the goods sold and the services rendered or that of the goods and services received in the case of upward adjustment. The same principle applies also in cases of downward adjustment, but only when the transaction falls within a mutual agreement procedure provided by a tax treaty.

As stated by the ITA in the 1980 circular letter, chapter 1, paragraphs 2 and 4, the definition of control has to be extended to the notion of “enterprise” in general (including permanent establishments, partnerships, etc.) and should cover all the hypotheses of “economic influence”, actual or even potential control (on the definition of control see also the resolution of 15 February 2005, no. 18/E and the ruling of the Italian Supreme Court of 22 April 2016, no. 8130).

Under article 9(3) ITC, the “normal value” is defined as the average price or consideration paid for goods and services of the same or a similar type, in free market conditions and at the same level of commercialization, at the time and place at which the goods and services were purchased or performed, or, if no such criteria are available, at the nearest time and place. In determining the normal value, reference must be made – to the extent possible – to price lists or tariffs of the party which has supplied the goods and services or, if necessary, to the price lists of the chamber of commerce and professional tariffs, taking normal discounts into account. For goods and services subject to price control, reference must be made to the regulation in force.

Finally, pursuant to article 9(4), ITC, the “normal value” is determined:
(a) for shares, bonds and other securities traded in Italian and foreign regulated markets, on the base of the average prices of the previous month;
(b) for other shares, quotas and securities, in proportion to the value of the net equity of the company or of the entity, or, for newly incorporated companies or entities, with reference to the amount of contributions;
for other bonds and securities different from those indicated under letters (a) and (b), with reference to the “normal value” of securities with similar characteristics traded in Italian and foreign regulated markets, or, in their absence, based on other objective criteria.

According to the Italian Supreme Court (see e.g. ruling of 23 October 2013, no. 24005) the “normal value” contained in article 9 ITC is a “general principle” of tax assessment.¹

That said, it is agreed by scholars, the ITA (see e.g. the circular letter of 15 December 2010, no. 58/E) and the Italian courts (see e.g. the ruling of the Italian Supreme Court of 22 April 2016, no. 8130)² that the Italian TP rules should be interpreted by reference to the OECD TP guidelines.

Thus, as a rule, Italy follows the OECD TP standards and all potential deviations from the OECD TP guidelines contained in the 1980 circular letter should take account of its non-binding nature (the non-binding nature has been explicitly stated, e.g. in the ruling of the Italian Supreme Court of 22 April 2016, no. 8130).

That said, the reporter will comment on some “potential” deviations from the OECD TP guidelines contained in the 1980 circular letter, especially considering that the Italian courts sometimes still make reference to them (see e.g. the ruling – concerning royalties – released by the Provincial Tax Court of Como of 24 October 2012, no. 96).³

First of all, in the 1980 circular letter, chapter 5, paragraph 6, the ITA made reference to certain safe harbour provisions as far as intangible property (IP) is concerned. Pursuant to the ITA, considering the difficulties in establishing the arm’s length value for transactions concerning IP:

(a) royalties up to 2 per cent of sales should be allowed (i) when the transaction is governed by a written contract entering into force before the first payment and (ii) where sufficient documentary evidence can be given about the effective use of the licence;

(b) royalties ranging from 2 per cent to 5 per cent should be considered fair by reference to the (i) technical and (ii) legal factors and (iii) where sufficient documentary evidence can be given about the effective use of the licence; and

(c) royalties exceeding 5 per cent of the sales (or, with some exceptions, royalties of any sort paid to a low-tax jurisdiction) should be allowed only in exceptional cases which are justified by the high technological level of the industry or by other circumstances.

With specific reference to royalties, in the ruling of 27 February 2013, no. 4,927, the Supreme Court stated that a tax audit made consistently with the 1980 circular letter was legitimate as “grounded on a valid and efficient investigation made by

¹ See also rulings of: 19 October 2012, no. 17,953; 13 July 2012, no. 11,949.

² See also rulings of the Italian Supreme Court of: 15 April 2016, no. 7,493; 1 April 2016, no. 6,331; 18 September 2015, no. 18,392; 5 August 2015, nos. 16,397, 16,398 and 16,399; 21 July 2015, no. 15,298; 21 July 2015, no. 15,282; 17 July 2015, no. 15,005; 13 May 2015, no. 9,709; 19 December 2014, no. 27,087; 1 October 2014, no. 20,710; 23 October 2013, no. 24,005; 25 September 2013, no. 22,010; 8 May 2013, nos. 10,742 and 10,739; 27 February 2013, no. 4,927; 19 October 2012, no. 17,953; 13 July 2012, no. 11,949; 31 March 2011, no. 7,343; 16 May 2007, no. 11,226; 13 October 2006, no. 22,023; 23 April 2004, no. 7,851; 26 January 2001, no. 1,133.

³ See also rulings – still concerning royalties – of the Provincial Tax Court of Treviso of 4 September 2001, no. 64; the Provincial Tax Court of Ravenna of 19 June 1998, no. 387.
the ITA”, thus (it is hoped) implying that a mere reference to the mentioned safe harbour would not be sufficient.4

Another “potential” deviation from the OECD TP guidelines contained in the 1980 circular letter concerns the provision of services and the application of the mark-up. Paragraph 5, of chapter 6 of the 1980 circular letter highlights that the mark-up should be added to the costs, “as a rule” only for services that constitute the main business of the service provider. This assumption appears not to be fully consistent with the OECD TP guidelines, according to which there are circumstances in which an independent enterprise may not realize a profit from the performance of services alone, for example where a supplier’s costs exceed market price but the supplier agrees to provide the service to increase its profitability, perhaps by complementing its range of activities. In the OECD TP guidelines, reference to the business activity of the supplier is made only incidentally. For further comments, see section 2.4.2 below.

Apart from the 1980 circular letter, it is worth highlighting that article 1(177) of the financial bill for 2014 (Law of 27 December 2013, no. 147) states that companies operating in the field of on-line advertising and connected services should avoid determining the arm’s length profitability with reference to their costs, unless an agreement is reached with the ITA under the international ruling procedure (article 31 bis of the presidential decree of 29 September 1973, no. 600). This vague provision appears to be in contrast to the OECD TP guidelines; as a matter of fact it seems to deny, in principle, the validity of the cost-plus or transactional net margin (TNMM) (with profit level indicator based on costs) methods.

Finally, it is also worth mentioning that article 1(281–284) of the law of 27 December 2013, no. 147 (financial bill for 2014) also extended the TP rules to IRAP (Imposta regionale sulle attività produttive – regional tax on productive activities), a tax levied in most cases on the company’s gross margin, but with special rules for certain industries. As a consequence, due to the interpretative nature of the law, the adjustments operating under TP rules are retroactively applicable also to the IRAP tax base. Nevertheless, penalties are not applied for the taxable years between 2008 and 2012. In practice, this means that, despite the rules for the computation of the tax base being different, the TP rules used for corporate taxation also have to be applied to the calculation of the company’s gross margin for IRAP purposes.

2. The impact of the BEPS project on TP

2.1. Introduction

TP outcomes of the BEPS include Actions 8–10, Aligning transfer pricing outcomes with value creation, and Action 13, Transfer pricing documentation and country-by-country reporting.

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4 See also e.g. rulings of the Regional Tax Court of Milan of 17 May 2016, no. 2,931; the Regional Tax Court of Turin of 16 March 2009, no. 11; the Provincial Tax Court of Turin of 16 March 2009, no. 11.
On 23 May 2016, the OECD Council approved the amendments to the OECD TP guidelines, as set out in Actions 8–10 and Action 13.

The amendments approved by the Council translate these BEPS TP measures into the OECD TP guidelines, as well as into the recommendation of the Council on the determination of transfer pricing between associated enterprises (C(95)126/FINAL), which now contains a reference in the preamble to these BEPS reports.

As already indicated in the previous section, it is agreed by scholars, the ITA and the Italian courts that the Italian TP rules should be interpreted by reference to the OECD TP guidelines. Thus, with respect to most of the contents of Actions 8–10, there should be no doubt that the update process takes immediate effect in Italian tax law.

Differently, as far as Action 13 is concerned, the OECD work in this area has suggested a three-tiered approach, where a master file, a local file and CbCR will be the essential elements of TP documentation.

Italy had already implemented non-mandatory documentation requirements including the master and local files by means of article 26 of the decree of 31 May 2010, no. 78, the benefit of which is penalty protection for the taxpayer. See below section 2.5.2 for details.

Following the approval of Action 13, Italy also introduced the CbCR obligation in its 2016 budget law: see section 2.5.1 for details.

Having said that, the main concern expressed by the business community is on the possible misuse of the data contained in the CbCR by the tax authorities. Another concern of the business community is about the “public” CbCR, due to the sensitive data such reporting may contain. See, again, section 2.5.1 below for details and also section 3.

2.2. Challenges of transactions with intangibles

2.2.1. Definition of intangibles

The draft Italian accounting principle no. 24 (intended, when approved, to replace the older one) defines intangible assets as those assets that are not tangible, being those costs that have a value over more than one accounting period.

Paragraph 4 of the draft accounting principle no. 24 states that intangibles include charges to be spread over several accounting periods (start-up and development costs), intangible goods (industrial patent rights, rights of use of intellectual property, concessions, licences, trademarks and similar rights), goodwill, immaterial assets in progress and advance payments.

Apart from accounting, there is no single definition of intangibles under Italian tax law. As a matter of fact, different definitions can be found for different tax purposes, e.g. the patent box or the step-up regimes.

In its 2015 budget law Italy introduced its patent box regime. Pursuant to article 1(37–45) of the law of 23 December 2014, no. 190, the patent box regime is an elective tax regime granting a 50 per cent exemption (reduced to 30 per cent for 2015 and 40 per cent for 2016) from corporate income tax and local tax (i.e. IRES and IRAP generally levied at 27.5 per cent – 24 per cent from 2017 – and 3.9 per
cent respectively) on income derived from the licensing or the direct exploitation of qualifying intellectual property. The regime is eligible for taxpayers who perform R&D activities and is characterized by a five-year lock-in period. The election is renewable.

Under article 6 of the ministerial decree of 30 July 2015, Italian taxpayers can claim the Italian patent box regime, limited to the following intangibles:

(a) copyrighted software;
(b) industrial patents, already granted or in the process of being granted, including invention patents – encompassing biotechnological inventions and relevant complementary protection certificates – patents for utility models as well as patents and certificates for vegetable varieties and topographies of semiconductor products;
(c) trademarks (including collective brands) already registered or in the process of being registered;
(d) models and designs capable of being legally protected;
(e) business and technical-industrial knowhow, including commercial or scientific, capable of being protected as confidential information and capable of being legally protected.

For the purpose of defining the list of eligible intangibles and the requirements for their existence and protection, reference should be made to the Italian, European Union and international provisions (thus, including BEPS Actions 8–10) as well as to those contained in EU regulations, treaties and international agreements on intellectual property, as applicable in the relevant jurisdictions.

As far as the ordinary step-up regimes are concerned, Italy has periodically introduced the possibility of stepping up the values of tangible and intangible assets recorded in the financial statements.5

Other step-up regimes apply in the case of extraordinary transactions. Mergers of two or more companies, and demergers and contributions of going concerns in exchange for shares are, in principle, tax-neutral transactions. Pursuant to Italian tax law, companies undertaking mergers, demergers and contributions of going concerns in exchange for shares may step up the tax basis of the assets by applying a substitute tax ranging from 12 per cent to 16 per cent. Different types of step-up elections are available for tax purposes (see article 176 ITC, and the ministerial decree of 25 July 2008; article 15(10–12) of the law decree of 29 November 2008 no. 185). In these contexts, all intangibles could be stepped up.

With respect to TP, chapter 7 of the master file (see section 2.5.2 below) should contain a description of the intangibles of the group. According to paragraph 4 of the 2010 circular letter, intangibles include those not recorded in the financial statement, e.g. process knowhow, group synergies, networking.6

As already indicated above, it is agreed by scholars, the ITA and the Italian courts that the Italian TP rules should be interpreted by reference to the OECD TP guidelines. Thus, with respect to the definition of intangibles contained in Actions 8–10, there should be no doubt that the update process takes effect in Italian tax

6 For confirmation that non-recorded assets should also be considered see ministerial resolution of 7 November 2006 no. 124/E.
law for TP purposes. It goes without saying that the definition of intangibles for TP purposes is one thing, but the possibility of taxing the transfer of an IP absent a specific Italian tax provision is another, as pointed out in paragraph 6.14 of the OECD TP guidelines.

2.2.2. Transactions with intangibles

Considering that the Italian TP rules should be interpreted by referring to the OECD TP guidelines, there was no need for any change in Italian tax law. The identification of the transactions with intangibles should start from the signed contracts and then the criteria referred to in the BEPS Actions 8–10 should be followed. For further consideration see the following section.

2.2.3. “Substance-over-form” approach towards intangibles

The identification of transactions concerning intangibles should start from the signed contracts, if any. However, considering that Italy follows the OECD TP guidelines, as amended consistently in BEPS Actions 8–10, the latter should be taken into consideration when determining the appropriate levels of profit to be attributed to associated companies.

That said, it is worth highlighting that Italian tax law incorporates different remedies to counteract abusive transactions. The most recent one is contained in article 10 bis (introduced by the legislative decree of 5 August 2015, no. 128) of the law of 27 July 2000, no. 212.

According to this article, an abuse of tax law exists when a transaction lacks any “economic substance” and, while formally consistent with tax law, is intended to obtain “undue tax advantages”.

Transactions are regarded as lacking any “economic substance” when they consist of facts, contracts and deeds, even those that are interconnected, that are unsuitable for generating any significant effects other than tax saving.

“Undue tax advantages” consist of tax benefits, including those incurred in the long run, that are not consistent with the purpose of the tax rules or with the principles of the tax legal system.

A transaction is not considered to be abusive when it is justified by sound non-marginal non-tax reasons, whether managerial or organizational, aimed at improving the structure or the functionality of the business of the taxpayer.

A taxpayer is always free to choose between different optional tax regimes provided by the law or between different transactions leading to different tax burdens.

Abuse of law can be challenged only if the tax benefits cannot be accessed through other specific tax provisions.

The definition of abuse of law outlined in article 10 bis is explicitly drawn from the one used in the recommendation on aggressive tax planning issued by the European Commission on 6 December 2012.

It is worth noting that the non-recognition of transactions could, in principle, lead to cases of criminal law proceedings under article 3 of the legislative decree of 10 March 2000, no. 74 (fraudulent tax return by means of other artificial arrangements).
One of the consequences of such a challenge would be the impossibility of claiming the Arbitration Convention under article 8 of a convention on the elimination of double taxation in connection with the adjustment of profits of associated enterprises of 23 July 1990, no. 90/436/EEC.

More precisely, pursuant to article 8 of the convention, the competent authority of a contracting state is not obliged to initiate the mutual agreement procedure or to set up the advisory commission where legal or administrative proceedings have resulted in a final ruling where, as a result of actions giving rise to an adjustment of transfers of profit, one of the enterprises concerned is liable to a serious penalty. According to unilateral declarations, Italy takes the view that the term “serious penalties” means penalties laid down for illicit acts, within the meaning of the domestic law, constituting a tax offence (see also circular letter of 5 June 2012, no. 21/E, paragraph 5.3).

That being stated, from an EU perspective, on 12 July 2016, the Council adopted a directive (2016/1164) laying down rules against tax avoidance practices that directly affect the functioning of the internal market. The directive is part of a January 2016 package of Commission proposals to strengthen rules against corporate tax avoidance. The package builds on BEPS. The directive covers all taxpayers that are subject to corporate tax in a Member State, including subsidiaries of companies based in third countries. Member States will have, subject to exceptions, until 31 December 2018 to transpose it into their domestic law with effect starting from 1 January 2019.

Pursuant to article 6 of the directive, Member States should ignore an arrangement or a series of arrangements which, having been put in place for the main purpose or one of the main purposes of obtaining a tax advantage that defeats the object or purpose of the applicable tax law, are not genuine having regard to all the relevant facts and circumstances. An arrangement or a series thereof should be regarded as non-genuine if it is not put in place for valid commercial reasons which reflect economic reality.


Coming back to the OECD TP guidelines, paragraphs 1.119–1.128, as redrafted based on BEPS Actions 8–10, provide for the possibility of the tax administration disregarding actual transactions in exceptional circumstances (previously, such a possibility was contained in paragraphs 1.64–1.69). According to paragraph 1.122, a transaction may be disregarded and, if appropriate, replaced by an alternative transaction where the arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a “commercially rational manner” in comparable circumstances, thereby preventing determination of a price that would be acceptable to both of the parties taking into account their respective perspectives and the options realistically available to each of them at the time of entering into the transaction.

The ITA has made reference to the OECD TP guidelines and the possibility of recharacterizing a transaction based on the OECD TP guidelines in different circular letters, e.g. in the 2010 circular letter, paragraph 4 and, recently, in the circular letter of 30 March 2016, no. 6/E. In particular, in the latter circular letter, the ITA stated that recharacterization should be carried out only in “particular and exceptional circumstances”.
Finally, for the sake of completeness, it is worth noting that the Italian TP legislation has been mainly qualified by the Italian Supreme Court as of an anti-avoidance nature (see e.g. the ruling of the Italian Supreme Court of: 30 June 2016, no. 13,387), even though there is no need for the ITA to provide evidence that the transaction has been implemented with an arbitrage purpose. The qualification of the Italian TP legislation as such raises some doubts considering that TP rules are aimed, as indicated by the European Court of Justice (see ruling of 21 January 2010, C-311/08, *SGI*), at the correct allocation of taxing rights between states. Equally, according to the OECD TP guidelines, paragraph 1.2, “the consideration of transfer pricing should not be confused with the consideration of problems of tax fraud or tax avoidance, even though transfer pricing policies may be used for such purposes”.

2.2.4. Comparability and group synergies

In the Italian TP context, chapter 7 of the master file (see the section below) should contain a description of the intangibles of the group. According to paragraph 4 of the 2010 circular letter, chapter 7 is aimed at providing a description of the intangibles of the group, including group synergies. There is no mechanism for identifying group synergies in the application of the Italian TP rules.

However, no specific changes are expected in the Italian tax law on comparability and group synergies as any development made in the OECD context is, once approved and incorporated in the OECD TP guidelines, referred to in the interpretation of the Italian TP rules as indicated above.

2.2.5. Hard-to-value intangibles

Italy has not adopted any specific measure to improve the valuation of hard-to-value assets following BEPS Actions 8–10.

2.2.6. CCAs

Chapter 6, paragraph 6, of the 1980 circular letter deals with CCAs. According to the 1980 circular letter, CCAs are agreements whereby costs are allocated within a multinational (MNE) group based on the benefit that each member is expected to receive. CCAs may cover a wide range of topics, e.g. IP, R&D activities and services.

The 1980 circular letter provides very few indications on the subject matter; namely:

- the costs charged to the Italian recipient should be deductible if they relate to its business activity;

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7 See also e.g. rulings of the Italian Supreme Court of 1 April 2016, no. 6,331; 5 August 2015, nos. 16,397, 16,398 and 16,399; 24 July 2015, no. 15,642; 21 July 2015, no. 15,298; 21 July 2015, no. 15,282; 17 July 2015, no. 15,005; 13 May 2015, no. 9,709; 19 December 2014, no. 27,087; 23 October 2013, no. 24,005; 25 September 2013, no. 22,010; 27 February 2013, no. 4,927; 19 October 2012, no. 17,953; 13 July 2012, no. 11,949; 20 April 2012, no. 6,221; 27 September 2011, no. 19,696; 31 March 2011, no. 7,343; 16 May 2007, no. 11,226; 13 October 2006, no. 22,023.
In the Italian TP context, the master file (see below) should contain the list of CCAs in the group, with an indication, for each arrangement, of the scope, duration, members, areas of activity and projects covered.

Still in the Italian TP context, the local file (see below) should contain an indication, for each CCA, of the:

- participants, scope and terms;
- activities’ framework and projects covered;
- method used for the determination of the expected benefits for each participant, including expected results, partial outcomes and divergences;
- form and amount of each participant’s contribution to the arrangement, including the methods and criteria for determining them;
- formalities, procedures and consequences arising from the entry and withdrawal from the CCA by associated enterprises participating in it, including the termination thereof;
- contractual arrangements concerning balancing payments or amendments to the CCA stemming from a change of circumstances;
- changes that have occurred during the validity period of the CCA.

No specific changes have affected CCAs considering that, as indicated, the OECD TP guidelines, as updated by BEPS Actions 8–10, are referred to in the Italian TP context.

Having said that, in the EU scenario, it is worth remembering the report of the EU Joint Transfer Pricing Forum on CCAs on services not creating IP (see communication from the Commission to the European Parliament, the Council and the European Economic and Social Committee of 19 September 2012, COM (2012) 516 final).

2.3. Risk and capital

As already indicated, the Italian TP rules should be interpreted based on the OECD TP guidelines. Thus, there is no need to adapt Italian tax law with respect to risk and capital.

As far as the allocation of the capital to a permanent establishment is concerned, ancillary reference to the OECD TP guidelines has been made in a number of cases, e.g. in the ruling of 17 June 2014, no. 63/E; circular letter of 28 September 2012, no. 37/E; ruling of 30 March 2006, no. 44 (see also the government report to the ACE/NID tax allowance).

2.4. High-risk transactions

2.4.1. Comparable uncontrolled prices (CUP) and quoted prices for cross-border commodity transactions

As already said, Italy makes reference to the OECD TP guidelines. Thus, with the approval of the amendments to the OECD TP guidelines from the OECD Council,
reference should be made to the new paragraphs 2.16A–2.16E with respect to cross-border commodity transactions.

Under paragraph 2.16A, “commodities” should be understood to encompass physical products for which a quoted price is used as a benchmark by independent parties in the industry to set prices in uncontrolled transactions.

Pursuant to paragraph 2.16C, for the CUP method to be reliably applied to commodity transactions, the economically relevant characteristics of the controlled transaction and the uncontrolled transactions or the uncontrolled arrangements represented by the quoted price need to be comparable. For commodities, the economically relevant characteristics include, among others, the physical features and quality of the commodity, the contractual terms of the controlled transaction, such as volumes traded, period of the arrangements, the timing and terms of delivery, transportation, insurance and foreign currency terms.

According to paragraph 2.16E, a particularly relevant factor for commodity transactions determined by reference to the quoted price is the pricing date, which refers to the specific time, date or time period (e.g. a specified range of dates over which an average price is determined) selected by the parties to determine the price for commodity transactions.

Under the 1980 circular letter, chapter 2, paragraph 2, the CUP method is the preferred one; and internal comparables are preferred vis-à-vis external ones. Consistently with the quoted paragraphs, in the 1980 circular letter, chapter 3, paragraph 1, the ITA had already pointed out that in order for the CUP to be reliably applied, the economically relevant characteristics of the controlled and uncontrolled transactions need to be comparable; the economically relevant characteristics mentioned in the 1980 circular letter include the quality of the product and the contractual terms (e.g. transportation, packaging, advertising, trading, insurance, exchange risks, terms of delivery, etc.).

2.4.2. Intra-group services

Chapter 6 of the 1980 circular letter concerns intra-group services.

According to paragraph 4 of this chapter, consistently with the OECD TP guidelines, the question of whether an intra-group service has been rendered depends on whether the activity provides the recipient with an economic or commercial value. This can be determined by considering whether an independent enterprise in comparable circumstances would have been willing to pay for the activity if it were performed by an independent enterprise or whether it would have performed the activity in house for itself. If the activity is not one for which the independent enterprise would have been willing to pay or perform for itself, the activity ordinarily should not be considered as an intra-group service under the arm’s length principle. No intra-group service should be found for activities undertaken by one group member that merely duplicate a service that another group member is performing.

See also e.g. rulings of the Italian Supreme Court of 13 May 2015, no. 9,709; 25 September 2013, no. 22,010; 23 October 2013, no. 24,005; 19 October 2012, no. 17,953.
As to the arm’s length value of the intra-group services, it has already been pointed out that the 1980 circular letter states that the CUP method is the preferred one. However, if the CUP method cannot be reliably applied, reference can be made to the costs borne to provide the services; evidence of the costs can be given using e.g. the certification of an audit company (circular letter of 21 October 1997, no. 271/E, paragraph 1).9

Paragraph 5 of chapter 6 of the 1980 circular letter highlights that the mark-up should be added to the costs, as a rule, only for the services that constitute the main business of the service provider. This assumption appears not to be fully consistent with the OECD TP guidelines according to which there are circumstances in which an independent enterprise may not realize a profit from the performance of services alone, for example where a supplier’s costs exceed market price but the supplier agrees to provide the service to increase its profitability, perhaps by complementing its range of activities. In the OECD TP guidelines, reference to the business activity of the supplier is made only incidentally.

Finally, pursuant to paragraph 5 of chapter 6 of the 1980 circular letter, no mark-up should be added for pass-through costs.

This being stated, as a matter of practice, during tax audits in which Italian recipients are involved, the ITA normally investigates whether:

• the services have actually been provided (benefit/shareholder/duplicative tests);
• the services have been charged at the fair market value.

On the first point, the ITA normally makes reference to the OECD TP guidelines.

With respect to the second point, the ITA has historically accepted a 5/10 per cent mark-up for low value-adding intra-group non-pass-through services, thus recognizing that a mark-up is generally levied by the service provider.

As a further remark, it is worth pointing out that the Italian Supreme Court has allocated the burden of proof in TP matters between the ITA and the taxpayer differently. Pursuant to the latest rulings, bearing in mind that the jurisprudence is not fully consistent, it should be for the ITA to prove that the TP rules apply from a subjective standpoint because of non-consistency with the arm’s length principle, while it should be for the taxpayer to prove that the costs are related to its activity and do not exceed the normal value (see e.g. ruling of the Italian Supreme Court of 15 April 2016, no. 7,493).10

Based on such rules, it has to be checked whether the ITA (and the courts) will accept the newly introduced simplified approach as per BEPS Actions 8–10 for low value-adding intra-group services, should a taxpayer rely on it. It is worth recalling that the matter of low value-adding intra-group services has also been investigated by the EU Joint Transfer Pricing Forum. In particular, according to the latter (see communication from the Commission to the European Parliament, the Council and the European Economic and Social Committee of 25 January 2011, COM (2011) 16 final) low value-adding intra-group services should, if any, have a mark-up from 3 to 10 per cent, often around 5 per cent.

9 On the value of such certifications see also e.g. rulings of the: Provincial Tax Court of Milan of 24 June 2016, no. 5,590; Provincial Tax Court of Milan of 29 July 2005, no. 158.

10 See also e.g. rulings of the Italian Supreme Court of 1 April 2016, no. 6,331; 18 September 2015, no. 18,392; 5 August 2015, nos. 16,397, 16,398 and 16,399; 17 July 2015, no. 15,005; 25 September 2013, no. 22,010; 19 October 2012, no. 17,953; 13 July 2012, no. 11,949.
As far as the management fees (spese di regia) are concerned, the position of the ITA has changed over time. In fact, at the beginning, management fees were considered non-deductible. Then, in the circular letter of 21 October 1997, no. 271/E, the ITA recognized that some services can be centralized in MNEs and that the deduction should no longer be challenged a priori (see also paragraph 5.1.1 of the circular letter of 17 May 2000, no. 98/E and, more recently, the circular letter of 30 March 2016, no. 6/E). In the circular letter, the ITA also invited tax inspectors to rely on collaboration with the tax authorities of other countries or, absent this, on the certification of the audit companies to check whether the costs were actually incurred and related to the business activity of the recipient; in addition, the ITA indicated the revenues as a possible allocation key.

Finally, the Italian Supreme Court (see e.g. rulings: 14 March 2008, no. 6939; 1 August 2000, no. 10,062) has clearly allowed the deductibility of such expenses subject to the general principles mentioned above.

To conclude on services, it is worth pointing out that sometimes the ITA denies the deduction of intercompany charges not relying on TP rules but, differently, claiming that they not relate to the business of the recipient (see again e.g. the circular letter of 30 March 2016, no. 6/E). The adverse consequence, in the opinion of the ITA, is that the mutual agreement procedure/Arbitration Convention cannot be claimed by the taxpayer as the latter applies only to TP matters (see paragraph 5.2 of the circular letter of 5 June 2012, no. 21/E).

2.4.3. Profit splits in the context of value chains

In the 1980 circular letter, chapter 4, the ITA expressed its opinion mainly against the use of the profit split method. Then, in the 1981 circular letter, the ITA agreed with the use of the method where the attribution of profits would be consistent with the functions of the parties, e.g. in the case of a fully fledged manufacturer being granted two-thirds of the profits while the distributor kept the remaining one-third.

The profit split method has finally been recognized as a valid method by paragraph 5 of the 2010 circular letter. As a matter of fact, according to the last official bulletin on international tax rulings released on 19 March 2013, 23 per cent of advance pricing agreement (APA) procedures have been concluded using the profit split method in the period 2004–2012.

Having said that, Italy has no special rules concerning the application of TP rules to MNEs’ value chains. In addition, there has not been any specific reaction to the OECD’s work on profit splits.

The fact that Italy refers to the OECD TP guidelines implies that there is no need to adopt any sort of profit split mechanism in the application of the TP rules; the OECD’s work on profit splits will become relevant once the OECD Council has approved the amendments to the OECD TP guidelines.

2.5. TP documentation

2.5.1. CbCR

Italy introduced the CbCR obligation in its 2016 budget law. Article 1(145–146), of the law of 28 December 2015 no. 208, introduced an obligation to submit an
annual report indicating the amounts of revenues, gross profit, taxes paid and accrued, and other indicators of effective economic activities. Further rules regulating the detailed procedural aspects will be issued by the Ministry of Economy and Finance.

Taxpayers obliged to file CbCR are:

- Italian parent companies of groups which are required to submit group consolidated financial statements, have realized a consolidated annual turnover in the year prior to the CbCR of at least €750 million and are not controlled by any other entity;
- Italian resident companies, controlled by a foreign company, which are required to submit group consolidated financial statements in a country where the CbCR does not apply, or in a country which does not grant an actual exchange of information on CbCR.

In the case of omission or incomplete submission of CbCR, penalties apply from €10,000 to €50,000.

With respect to the Convention on Mutual Administrative Assistance in Tax Matters, this has been signed and ratified by Italy. In addition, Italy is among the countries signing the multilateral competent authority agreement on the exchange of CbCR.

In the EU context, it is worth mentioning that the directive of 25 May 2016, no. 2016/881/EU, has adopted the practical arrangements necessary for the upgrading of the common communication network contained in the directive of 15 February 2011, no. 2011/16/EU, consistently with BEPS Action 13. More precisely, on 25 May 2016, the Council adopted rules on the reporting by MNEs of tax-related information and exchange of that information among Member States. The directive covers groups of companies with a total consolidated group revenue of at least €750 million and requires MNEs to report information e.g. on revenues, profits, taxes paid and accrued, capital, earnings, number of employees and tangible assets.

This information must be reported already for the 2016 fiscal year to the tax authorities of the Member State where the group’s parent company is tax resident. If the parent company is not EU tax resident and does not file a report, it must do so through its EU subsidiaries. Such secondary reporting will be optional for the 2016 fiscal year, but mandatory from the 2017 fiscal year.

The directive requires the tax authorities to exchange these reports automatically. For this purpose, it builds on the existing EU framework for automatic exchange between tax authorities, established by Directive 2011/16/EU.

The directive sets a 12-month deadline after the end of the fiscal year for companies to file the information. A further three months is allowed for tax administrations to automatically exchange the information. The directive also requires Member States to lay down rules on the penalties applicable to infringements.

Member States should adopt the directive by 4 June 2017 with effect from 5 June 2017. Italy has not implemented the directive as yet.

However, as far as the EU is concerned, it is important to highlight the Commission proposal of 12 April 2016 (Com (2016) 198 final – the so-called “public” CbCR for a directive aimed at requiring MNEs operating in the EU with global revenues exceeding €750 million per year to publish key information on where they make their profits and where they pay their tax in the EU on a CbC basis. The same rules would apply to non-European MNEs doing business in Europe. In
addition, companies would have to publish an aggregate figure for total taxes paid outside the EU.

The proposal would amend the accounting directive of 26 June 2013, no. 2013/34/EU to ensure that large groups published annually a report disclosing the profit and the tax accrued and paid in each Member State on a CbC basis. This information should remain available for five years.

Once adopted, the new directive would have to be transposed into the domestic legislation of all EU Member States, within one year after its entry in force.

### 2.5.2. Master and local files

Article 26 of the Decree of 31 May 2010, no. 78 provides that, in the case of a TP assessment, no penalties (normally ranging between 90 per cent and 180 per cent of the additional income tax) are levied if the taxpayer both complies with specific documentation requirements (TPDR) and a specific communication is filed with the ITA. The Italian TPDR and the content and terms of the communication have been set forth by the ITA on 29 September 2010. Clarifications on the Italian TPDR are contained in the 2010 circular letter.

In order for penalty protection to apply all the following conditions should be met. Similar to the recommendations contained in the EU Code of Conduct on TP documentation for associated enterprises in the EU (see communication from the Commission to the European Parliament, the Council and the European Economic and Social Committee of 7 November 2005, COM (2005) 543 final), the taxpayer should draft, on an annual basis, a master file and a local file, as requested:

- Italian “holding companies” are requested to have both a master file and a local file. A “holding company” is an Italian resident company that: (a) is not controlled by any other (resident or non-resident) person other than individuals and (b) controls, even by means of a sub-holding company, one or more non-Italian resident companies;
- Italian “sub-holdings” are requested to have both a master file (for the sub-group) and a local file. A master file containing information about the entire group could also be maintained, even if prepared by another EU resident company, provided that the document was compliant with the standards set forth by the EU code of conduct (in such a case, if the information on the sub-holding’s sub-group contained in the master file is less extensive than that required by the Italian TPDR, the sub-holding entity is required to supplement such information). A master file prepared by a non-EU resident company could also be maintained under certain conditions. A “sub-holding company” is an Italian resident company that: (a) is controlled by another (resident or non-resident) person other than individuals; and (b) controls one or more non-Italian resident companies;\(^{11}\)
- Italian subsidiaries of foreign MNEs are required to maintain only a local file. A “subsidiary” is an Italian resident company that: (a) is controlled by another (resident or non-resident) person other than individuals; and (b) does not control any non-Italian resident company.

Permanent establishments of foreign enterprises are requested to maintain either a master file and a local file or a local file only, depending on the foreign enterprise’s qualification either as a holding or a sub-holding or as a subsidiary.

Both the local file and, if any, the master file must be prepared following the scheme indicated except for minor changes or integrations aiming at a better understanding of the documents.

The master file should contain information as follows: (a) a general description of the MNE group; (b) its group structure; (c) business strategies including changes from the previous year; (d) transaction flows by rationale; (e) intra-group transactions by type; (f) functions performed, assets used and risks assumed including changes from the previous year; (g) intangible assets; (h) the TP policy of the MNE group; (i) APAs and TP rulings. The submission of more than one master file is allowed if the MNE group carries out several industrial and commercial activities different from each other and regulated by specific TP policies.

The local file should contain information as follows: (a) a general description of the enterprise; (b) its business sectors; (c) an organizational chart; (d) business strategies including changes from the previous year; (e) controlled transactions; (f) CCAs; annex 1: a flowchart describing the transaction flows; annex 2: a copy of written contracts.

Small and medium-sized enterprises (taxpayers with an annual turnover not exceeding €50 million) are not obliged to update TP data with respect to the two taxable periods following the one which the documentation relates to, if the comparability analysis is based on publicly available information sources, and as long as the analysis does not undergo substantial changes during the above-mentioned taxable periods.

No penalty protection is granted when:

- notwithstanding compliance with the formal structure, the documentation delivered in the course of the tax audit is not complete and consistent with the Italian TPDR;
- the information provided in the documentation is only partially true or completely untrue.

Omissions or partial inaccuracies and other missing elements that do not undermine the analysis of the ITA and the correctness of the results should not be an obstacle to penalty protection. Equally, the omission of the annexes to the local file should have no effect on penalty protection.

In a nutshell, as indicated by the 2010 circular letter, paragraphs 3 and 10, in order for penalty protection to apply, the local file and – if any – the master file must provide all the information which allows it to be verified that intercompany transactions comply with the arm’s length principle.

In addition, the following apply:

- both the local file and – if any – the master file must be drafted, as a rule, in the Italian language. The English language is permitted as far as annexes are concerned. Additionally, the master file can be drafted in the English language subject to certain conditions;
- each page of the local file and – if any – the master file must be initialled by the legal representative of the taxpayer (or by any person designated as his delegate) and signed on the last page;
• the local file and – if any – the master file must be made available to the tax auditors in electronic format;
• the master file and the local file must be made available to the tax auditors, within 10 days of a request. Further information requested by the tax auditors should be made available, as a rule, within seven days;
• the existence of the TP documentation must be communicated to the ITA upon filing the annual tax return (currently expiring nine months after the end of the tax period).

2.5.3. Compliance costs

No information is available on this matter.

2.6. TP-related measures in other BEPS actions and other measures against BEPS

As to TP developments driven by any of the non-TP BEPS actions, as indicated in section 1 above, article 1(177) of the financial bill for 2014 (Law of 27 December 2013, no. 147) states that companies operating in the field of on-line advertising and connected services should avoid determining the arm’s length profitability with reference to their costs, unless an agreement is reached with the ITA under the international ruling procedure (article 31 bis of the Presidential Decree of 29 September 1973, no. 600). This vague provision appears driven by BEPS Action 1, Addressing the tax challenges of the digital economy, and could be seen as contrasting with the OECD TP guidelines should it be interpreted as a denial of the validity of a cost-plus or TNMM (with profit level indicator based on costs) methods.

Still driven by BEPS Action 1, even though not a legislative action, it is worth mentioning the number of tax assessments raised by the ITA on some important MNEs operating (mainly, but not only) in the high-tech and internet sectors grounded on either/both on the permanent establishment or/and TP concepts as developed in the BEPS context. That said, Italy has also implemented other measures against non-TP related BEPS.

As to BEPS Action 2, Neutralizing the effects of hybrid mismatch arrangements, Italian tax law already contains a linking rule similar to the ones suggested. This rule was introduced, well before the BEPS actions were considered, in 2004. This is the case of article 44(2)(a) ITC. Pursuant to the mentioned provision:

“participation in the capital or equity, as well as securities and financial instruments … issued by companies and institutions mentioned in article 73, paragraph 1, letter d (i.e. non-resident persons) are considered similar to shares on the condition that the related remuneration is fully not deductible for the non-resident issuer in determining the taxable income in the foreign country of residence; for this purpose the non-deductibility must result from a statement by the issuer itself or by other certain and reliable elements of proof…”

Therefore, a payment made under one of these instruments is not treated as a dividend at the level of the receiving resident taxpayer if the distributing company
can fully or partially deduct its amount in its state of residence. The rule has been recently supplemented to implement the Directive of 8 July 2014 no. 2014/86/EU, amending the Parent–Subsidiary Directive (of 30 November 2011, no. 2011/96/EU).

Another measure is also driven by BEPS Action 2. Article 14 of the legislative decree of 14 September 2015, no. 147, introduced the so-called branch exemption regime into Italian tax law. As a matter of fact, Italy followed the capital export neutrality approach in taxing the permanent establishments of Italian taxpayers. Article 14 introduces an optional branch income exemption regime (article 168 ter ITC) alternative to the ordinary imputation regime. The optional regime is granted on an “all in, all out” basis and is irrevocable. Implementing regulations are to be enacted by the tax authorities: to date only a draft has been published. Article 11 of the draft contains switch-over clauses to avoid double non-taxation.

With respect to BEPS Action 3, Designing effective controlled foreign company rules, Italian tax law already contains provisions substantially aligned with those suggested. As a matter of fact, article 167 ITC, on the Italian CFC rules, has been amended (mainly by both article 8 of the Legislative Decree of 14 September 2015, no. 147 and by article 1(142) of the law of 28 December 2015, no. 208 – financial bill for 2016) consistently with the BEPS suggestion to ensure, inter alia, less compliance work and to reduce cases of double taxation.

As far as BEPS Action 5, Countering harmful tax practices more effectively, taking into account transparency and substance, is concerned, Italy has implemented its patent box regime: see section 2.2.1 above.

With respect to BEPS Action 6, Preventing the granting of treaty benefits in inappropriate circumstances, Italy recently codified an anti-abuse rule under article 10 bis of the Law of 27 July 2000, no. 212: see section 2.2.3 above.

Driven (also) by BEPS Action 7, Preventing the artificial avoidance of permanent establishment status, it is worth mentioning, again, the tax assessments (thus, not a legislative action) raised by the ITA on some important MNEs operating (mainly, but not only) in the high-tech and internet sectors.

On the indicated measures, it is also worth remembering where we are from an EU perspective. As indicated in section 2.2.3, on 12 July 2016, the Council adopted a directive (2016/1164) laying down rules against tax avoidance practices that directly affect the functioning of the internal market. The directive is part of a January 2016 package of Commission proposals to strengthen rules against corporate tax avoidance and builds on the BEPS proposals. The directive covers all taxpayers that are subject to corporate tax in a Member State, including subsidiaries of companies based in third countries and concerns a number of topics, e.g. interest limitation (article 4), anti-abuse (article 6), CFCs (article 7) and hybrid mismatches (article 9).

Italian tax law, as already mentioned, contains provisions on each of the topics, even though it is not wholly consistent with those contained in Directive no. 2016/1164. Thus, some amendments to the currently applicable provisions may be expected. In this respect, Member States have until 31 December 2018 to transpose the directive into their domestic laws with effect starting from 1 January 2019. By way of derogation, Member States have until 31 December 2019 to implement the provisions on the exit taxation, with effect starting from 1 January 2020. By way of further derogation, Member States which have targeted domes-
tic rules for preventing BEPS risks at 8 August 2016, which are equally as effective as the interest limitation rule set out in the directive, may apply these targeted rules until the end of the first full fiscal year following the date of publication of the agreement between the OECD members on the official website on a minimum standard with regard to BEPS Action 4, but at the latest until 1 January 2024.

Coming back to the BEPS topic from an OECD perspective, as far as the BEPS Action 14, Making dispute resolution mechanisms more effective, is concerned, Italy recently introduced, by means of article 9 of the Legislative Decree of 24 September 2015, no. 156, the possibility of suspending the tax litigation process in the case of an MAP/Arbitration Convention proceeding (article 39, paragraph 1 ter, of the Legislative Decree 31 December 1992, no. 546).

2.7. Can BEPS work in favour of MNEs?

In Italy, there has not been any initiative to use the BEPS platform to benefit MNEs with information that is in the possession of other countries.

3. What is the future of TP?

The work on TP of the BEPS actions has been carried on without the need to develop special measures outside the arm’s length principle. Italy being a country in which reference is made to the arm’s length principle, the OECD TP guidelines will continue to guide the attribution of profits in intercompany transactions.

That said, TP BEPS Actions 8–10 are not necessarily to be seen as innovative. For MNEs in which form and substance are already aligned there will probably be very little to change. Conversely, for MNEs that, in the past, allocated the profits relying on a more formalistic approach, i.e. mainly, if not only, on contracts, BEPS Actions 8–10 will oblige them to reshape their structure in a more consistent way. This can only be evaluated positively.

TP BEPS Action 13 has also been thought to have a potential positive impact being aimed, through the sharing of information, at putting the tax administrations and the taxpayers on the same footing during tax audits. However, there is some concern in the Italian business community that the positive impact might reverse into a negative one depending on the attitude of the ITA in interpreting the information.

As a matter of fact, the information contained in the CbCR appears to be very general and have a meaning only read in conjunction with the master and the local files and, even more importantly, with the cooperation of the taxpayer. Thus, the actual outcome of BEPS Action 13 has to be tested against the attitude of the ITA during tax audits.

It goes without saying that the Italian business community is also concerned by the use that the foreign tax administration could make of the data contained in CbCR. The concern is about the possibility that the foreign tax authorities, especially in developing countries, might use some of the data in order to move, de facto, towards a formulary approach during tax audits.
To address these concerns, the outcome of Action 14, Making dispute resolution mechanisms more effective, is often indicated as being very important by the Italian business community.

With respect, specifically, to the future of TP in Italy, it is broader than the BEPS project’s outcome. Already before the BEPS actions were released, in order to have certainty during TP tax audits, the Italian business community had asked the ITA, *inter alia*, that the tax audits on TP should be done by a specialized team; that an official procedure should be developed (e.g. on the benchmark analysis, the criteria for comparability, the database to be used); that the TP documentation should be simplified; that fines should be reduced if not repealed; that the functioning of the MAP/Arbitration Convention should be improved, etc. No official answer has been obtained yet from the ITA, but some concerns have been addressed directly by the Italian law-maker, e.g. by introducing the possibility to suspend the tax litigation process (see section 2.6) and by providing for the substantial non-applicability of criminal fines, the latter being an aspect that created a great deal of concern in recent years.

In this context, it can also be recalled that starting from the ruling of the Italian Supreme Court of 8 May 2013, no. 10,739, the general perception of TP is changing slightly. In fact, together with the more “traditional” essence of an anti-avoidance body of rules, TP is starting to be intended also as a standard for the fair allocation of taxing rights among states. This links the TP’s rationale to the principle of territoriality, and transforms it into a means for the correct computation of profits effectively arising in each jurisdiction.

In the long term this “more neutral” approach to TP is expected to have some influence on the way in which it is used by the tax administration in its daily practice. Therefore, it can be expected that this will result in a more thoughtful usage of this tool.

It is hoped that further changes will be introduced either in terms of legislative actions or official interpretation by the ITA on the indicated aspects.

**Addendum**

With respect to section 2.2.1, the Italian accounting principle no. 24 was released on 22 December 2016.

As far as sections 2.2.3 and 2.6 are concerned, the Commission presented a proposal on 25 October 2016, to complement the existing rule on hybrid mismatches (Com (2016) 687 – proposal for a Council directive amending Directive 2016/1164 as regards hybrid mismatches with third countries).

With respect to section 2.3, reference was made to some rulings concerning the allocation of capital to a permanent establishment. For the sake of completeness, it is worth remembering that article 152 ITC, paragraph 2, following the changes made by article 7 of the legislative decree of 14 September 2015, no. 147, provides that the endowment fund is determined reference being made to OECD criteria. Article 7, paragraph 3 of the same legislative decree states that it should be for the Italian revenue to set the criteria for specific sectors. As far as the banks are concerned, the criteria have been set forth on 5 April 2016. To date no criteria have been set for other sectors.
Summary and conclusions

In general, the current Japanese transfer pricing (TP) rules follow the OECD TP guidelines. The preferred TP methods used in Japan were until 2012 the comparable uncontrolled price (CUP), CUM and CPM. Recently, taxpayers have been given more options from which to choose their TP methods, i.e. the profit split (PS) method and the transactional net margin method (TNMM) method. Those are prescribed as “other methods” in the Japanese TP regulation (STMA) and there are no priority rules for choosing between the first three methods (CUP, CUM, CPM) and the latter (i.e. the so-called other) methods. In addition, it should be noted that there is a quasi-TP taxation in Japan (so-called international Kifu-kin taxation, which is taxation on a contribution to a foreign affiliate). Where the Japanese tax authority (NTA) cannot apply the normal TP taxation to taxpayers, it may apply the Japanese corporate tax rule to excessive profit shifting between a Japanese parent company and a foreign affiliate. The NTA levies this alternative TP taxation quite frequently.

Apart from the TP rules in Japan (prescribed in the STMA and its ordinance/directive) the NTA has published several examples of TP transactions among multinational companies (MNEs) in an official guide as a supplement of the Japanese TP guidelines which assists taxpayers to avoid potential TP disputes in Japan. Furthermore, Japan introduced the so-called unilateral advance pricing agreement (APA) from the very beginning of TP taxation, which worked quite efficiently (although it takes a long time) and was later extended to the bilateral level (bilateral APA). Thus, the number of TP disputes in Japan is relatively small in comparison with those in other jurisdictions.

In contrast with other jurisdictions, it should also be noted that the NTA prefers to opt for the mutual agreement procedure (MAP) with a competent authority on behalf of domestic corporate taxpayers to resolve TP disputes. The reasons may be as follows: first, the Japanese judiciary (Japan has not established a special tax court and the only tax tribunals exist at first instance). Consequently, Japanese professional judges are not always familiar with (international) tax law, especially in TP cases. Secondly, most Japanese taxpayers’ compliance behaviour is not traditionally aggressive. Thus, TP disputes are generally resolved before they reach court.

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The most important aspect of the base erosion and profit shifting (BEPS) project in relation to Japanese TP taxation is BEPS Action 13, the filing/lodging requirement of the new comprehensive TP documentation (the country-by country report (CbCR) and the master and local file) rule. As the headquarters of traditional Japanese MNE groups do not control their foreign affiliates, TP policy is not centrally determined within the whole group. The new documentation rule will force changes not only to their tax compliance approach, but also their corporate decision-making process. As a result, the local file rule is to be deferred for one year (for MNEs with fiscal year starting 1 April 2017), while CbCR and the master file already have to be prepared by taxpayers (MNEs with fiscal year starting 1 April 2016). However, this rule will not be applied to MNEs whose annual consolidated income is less than JPY 100 billion.

Regarding transactions with intangibles, the Japanese Ministry of Finance has tried to amend the definitions of “intangible” and “transaction with intangibles” in the Japanese TP guidelines in accordance with the new definition in the OECD guidelines. Nevertheless, the original definition of “intangible” in the Japanese Corporate Income Tax Act (CITA) is not directly relevant to the TP rules. It is still open whether the Japanese legislator will prescribe those notions contained in the BEPS action plans in the Japanese TP guidelines or more generally in the CITA.

Japan has always been reluctant to introduce the notion of group synergies into the TP guidelines. From the Japanese perspective, the notion “intangibles” is restricted and it should be “posed or controlled”. Thus, there has been no reaction from either the Japanese legislator or the NTA. On the other hand, the Japanese Ministry of Finance is considering introducing the so-called super-royalty clause (“commensurate with income standard”) to evaluate hard-to-value intangibles in the future. On this point, Japan will follow the USA and Germany.

The Japanese TP guidelines already prescribe their cost contribution agreement (CCA) rule very precisely. There has been no official announcement to amend the current TP rule to adjust it in response to the BEPS Action Plan at the moment.

Regarding commodity transactions, Japanese tax experts prefer not to argue in support of the CUP method but use a method similar to the CUP.

There is no change to the tax treatment of intra-group services in the Japanese TP guidelines.

The next step of the BEPS Action Plan process in Japan must be to establish exchange of information systems between competent tax authorities. Otherwise the requirement to create CbCR and master and local files is pointless. Japanese corporate taxpayers already suffer considerable compliance costs.

Secondly, the impact of the super-royalty rule in Japan may be limited where (bona fide) Japanese MNEs do not drastically change their behaviour. The rule will be more applicable to foreign MNEs which have affiliates or permanent establishments (PEs) within the Japanese jurisdiction.

Finally, the ongoing global discussion between the formulary approach (e.g. PS method) and the arm’s length approach (e.g. TNMM) will affect the future Japanese TP rules. Notwithstanding that Japan has had relatively few TP cases/court decisions in the past, corporate taxpayers in Japan prefer to use the TNMM method, while the NTA tends to apply the PS method seeing merit in its cross-referencing.
1. Current TP methods in Japan

The current Japanese TP rule is basically oriented to the OECD approach. However, it originally followed the US arm’s length price provision (IRC 482). The Japanese TP regulation was introduced in 1987 in the STMA but it was seldom applied. Indeed, the Japanese legislator at that time intended to refund Japanese MNEs as they were seen as subject to too much foreign tax from the Japanese perspective. This generous attitude of the Japanese tax authority changed in the mid-1990s. Since then the Japanese TP rule has been more aggressively applied. There is no difference between domestic and foreign corporations in the application of the Japanese TP rule.

According to §66-4 (2) of the STMA the CUP, CUM and CPM (so-called “the traditional transaction methods”) are applicable. In addition, “other most appropriate methods (e.g. PS method, TNMM, other methods)” which were referred to in §39-12 (6)-(8) of the order of the STMA were prescribed in 2012. Until 2011, in Japan the three traditional transaction methods always took priority. The other methods were only applied where taxpayers could explain their use on reasonable grounds. Nevertheless, due to the adoption of the best method in the OECD guideline, the Japanese TP rule was also amended. In addition, the Berry ratio has also been used under the TNMM since April 2013.

In practice, a very important guideline that should be taken into account is the Japanese TP guideline (Iten kakaku Jumu Unei Yôryô) (TPGL) which was last updated in June 2016. The TPGL also contains the rules on APAs. Basically, it follows the OECD TP guidelines. Although this Japanese TPGL is not statute law which has been passed by the Japanese legislative body, it is usually considered as a quasi-law, or a government circular (i.e. having informal binding power).

In relation to tax treaties, Japan follows the OECD model agreement (MA). Thus, article 9 is applied between Japan and other contracting states where Japan has concluded a double taxation treaty (DTC) on a bilateral basis. At present (as of 1 November 2017) Japan has concluded 66 DTCs applicable to 102 jurisdictions. Additionally, Japan has entered into multilateral tax information exchange agreements (TIEAs) since 2009 under which CbCR and master files are provided to/by foreign tax authorities.

Furthermore, it should also be noted that sometimes the NTA applies the so-called Kifu-kin (taxation for profit shifting between group companies or affiliations, i.e. contribution to foreign affiliate) rule in accordance with §37 of the

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2. §39-12(8)-4-5 of the STMA Ordinance.
3. It was announced to the public by the NTA in August 2001.
5. The first Japanese APA rule has been introduced since 1987.
6. https://www.mof.go.jp/english/tax_policy/tax_conventions/international_182.htm. (in English). Please note that Japan concluded the tax treaty with the former Soviet Union, so that currently the number of Japanese tax treaties does not match that of jurisdictions.
Japanese CIT and §66-4(1) of the STMA, which is considered as an alternative method of TP taxation in Japan. This alternative TP rule applies to cross-border intra-group transactions, especially between a domestic parent company and its foreign subsidiaries, where the above-mentioned current Japanese TP regulation is out of scope. Thus, the alternative rule is applied where the parent company either does not have more than 50 per cent of the shares in the foreign subsidiary (and affiliates) or it fails a substantial (affiliate-inclusive) ownership rule.\(^7\)

Usually, cross-border intra-group transaction fees (e.g. for assets, loans, services) at extraordinarily low prices and debt waivers between intra-group companies are subject to Kifu-kin taxation.\(^8\) There is no difference in the taxable amount between normal TP taxation and Kifu-kin taxation; no expenses are deductible. However, the statute of limitation rule (the date up to which the NTA is able to investigate and amend the taxable amount which the taxpayers initially declared) is different. Under TP taxation it is six years, while it is shortened to five years under Kifu-kin taxation. In addition, intangible transactions tend not to be subject to Kifu-kin taxation but TP taxation in practice. Besides, where the Japanese NTA has applied Kifu-kin taxation in accordance with §37 of the CITA (instead of applying TP taxation), taxpayers are not able to ask the NTA for the MAP procedure. The most targeted companies are middle-sized companies.\(^9\)

One example: in 2014 NTA Osaka announced an administrative action to levy Kifu-kin taxation on one of Japan’s leading manufacturing companies, Panasonic. During the seven prior years up to the fiscal year 2011 Panasonic made several cross-border intra-group transactions at extraordinarily low prices. The NTA estimated the total amount of its corporate income tax omission at approximately JPY 340 billion. According to a Nikkei article on 6 April 2015, the percentage of Kifu-kin taxation in relation to cross-border corporate tax omission was 60 per cent while that of TP taxation is roughly 20 per cent.

### 2. Impact of the BEPS project on TP

#### 2.1. Introduction

In comparison with the amendment to chapter V of the OECD guidelines in 2010, the BEPS project made a huge impact on Japanese tax practitioners as soon as the draft was released in January 2014. The BEPS project required Japanese taxpayers to file their consolidated tax returns with an enormous volume of documentation, imposing a heavy technical and compliance burden.

The most important influence from the BEPS project on Japan is the strict obligation to file the TP documentation, i.e. CbCR (BEPS Action 13). The new Japanese TP documentation regulation regarding CbCR passed the Japanese Parliament in 2015 and will be effective from fiscal year April 2017 (master file) and from fiscal

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\(^7\) §3-19 of the TPGL and §66-4(3) STMA.


\(^9\) Tajima, “Kaigai Kifu-kin to iten kakaku zeisei no jitsumu (The practice of cross-border Kifu-kin taxation and that of transfer pricing taxation)”, p. 4.
year April 2018 (local file). Japan had already introduced its APA rule in 2002 and also the TP documentation rule in 2008. However, that former TP documentation rule was not on a worldwide basis. Indeed, most Japanese corporate taxpayers reacted nervously, as usually they are not concerned about the accounting departments of their foreign subsidiaries. Upon the request of the Japan Business Federation Keidanren, the requirement to file CbCR in Japan is applicable only to companies whose annual amount of sales (on a consolidated basis) exceeds JPY 100 billion.

Previously Japan had introduced another documentation rule for cross-border intra-company transactions in 2010. The defects of this former Japanese documentation requirement were as follows: parent companies need not produce their documents on a worldwide basis comprehensively, i.e. their foreign subsidiaries/affiliates (global change) each made a report for their TP analysis and their policies individually (on a local basis). In addition, there is no consistency in TP policies and realized income/losses among group companies.

Consequently, the new documentation requirements (especially to produce a master file and CbCR) for most Japanese MNEs threaten not only to increase administrative costs, but also to increase the risk of being subject to tax on the overseas basis recorded deficits or lower profit margins, and to increase the possibility that foreign tax authorities will make inquiries to Japanese headquarters about their internal documents.

2.2. Challenges of transactions with intangibles

2.2.1. Definition of intangibles

The term “intangibles” is not defined comprehensively in the formal tax legislation in Japan. It has been partially prescribed, such as in the definitions of “intellectual property etc.”, “copyright”, “royalty” in the CITA. Further, the CITA directive defines the term as “patent, utility model patent, copyright, trademark” while the STMA directive defines it much more broadly as follows: “In addition (to the definition in §20-1-21 of the CITA Directive), a list of customers and supply chain are also included.”

Traditionally, the NTA tended to interpret the term “intangibles” with reference to the OECD TP guidelines or the US arm’s length principle regulation. Such abstract and broad interpretations have caused numerous TP disputes in Japan.
In 2007, upon the request of Japanese industry, the relevant parts of “intangibles” in the STMA directive\(^{19}\) and the Japanese TPGL were amended. The notions “intangible assets” and that of “services are provided” were prescribed in the TPGL separately, while the former SMTA defined simply “intangibles for human resources” and “intangibles for organization”. Consequently, the following sentences were added as a postscript to the Japanese TPGL in 2007:

“(Note) Where intangible property used for providing services is being examined, the provision of services and the use of intangible property shall be noted as being conceptually distinct. Examinations shall be conducted regarding such matters as whether the service provider uses the intangible property listed in the SMTA Directive 66-4(2)-3(4) when providing services, and what impact the provision of services has on the activities and functions of the service recipient.”\(^{20}\)

Furthermore, the NTA issued a separate volume on their website regarding the application of TP rules.\(^{21}\) From the NTA’s perspective, there was no longer any difference between the OECD rules and no discrepancy with the IRS regulation. According to the website, in the event that the NTA, after investigation, applies a different method from that which the taxpayer originally chose the NTA must provide the taxpayer with reasons.

Today, §1(19) of the Japanese TPGL states that “intangible property” should be as prescribed in the STMA directive 66-4 (2)-3-(18). For more information see the Japanese TPGL.\(^{22}\) From an examination of the NTA, the following factors are considered as “intangible”: patent rights and trade secrets derived from technical innovation; knowhow derived from the experience of employees and other human resources through business activities such as management, trade operations, production, R&D, and sales promotion; production processes, negotiation procedures, and development, distribution and financing networks. However, in the part on provision of services in the Japanese TPGL,\(^{23}\) some “intangibles” are excluded as follows: (a) in some cases, the consideration for use of intangible property is not included in the price for the provision of services, even though the intangible property is used for providing services.

As at the date of this report there have been no changes to the Japanese rules following the release of the BEPS Actions 8–10 report. However, it may be expected that the STMA directive will be amended again, i.e. §66-4(3)-3 of the STMA directive note 1 and §3-11 of the Japanese TPGL (intangible property to consider in examination). There has been no discussion about prescribing the definition of “intangibles” comprehensively within the CITA.

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\(^{19}\) SMTA directive means special measures concerning the Taxation Act, especially the Corporate Taxation directive (Sozei Tokubetsu Sochi hô Tsutatsu (Hôjin Zei Kankei)).

\(^{20}\) §3-8 (1) of the Japanese TPGL.


\(^{22}\) See §3-11 of the TPGL (last updated in June 2015). For an English translation (however, not of the latest version, but that of 2002), see https://www.nta.go.jp/foreign_language/07.pdf.

\(^{23}\) §3-8(1) of the TPGL.
2.2.2. Transactions with intangibles

In Japan, the term “licensing transaction of intangible property” exists in the TPGL. According to §3-13 of the Japanese TPGL the licensing transaction of intangible property is described as follows:

“Where either a corporation or a foreign affiliate is using the intangible property owned by the other party without an agreement concerning its use, it shall be noted that the arm’s length price relating to this transaction is to be determined, assuming that there is a licensing transaction in respect of the intangible property, except when it is deemed that there has been a transfer transaction.”

It continues as follows:

“The commencement date of the licensing transaction shall be determined from among the dates when the intangible property was provided, the use thereof started or any profit was recorded through the use thereof, by considering examples of transactions between non-affiliates.”

From this paragraph the scope of the tax definition of intangible transaction is not strictly equal to that of the legal definition.

There is also a specific rule relating to examinations by the NTA in relation to licensing transactions of intangible property. §3-12 of the Japanese TPGL governs the contribution on the creation, maintenance or development of intangible property. That paragraph states:

“when examining licensing transactions of intangible property, it shall be noted that not only the legal ownership of the intangible property but also the degree of contribution of a corporation or a foreign affiliate to the activities for the creation, maintenance or development of the intangible property (hereafter referred to as the ‘creation, etc.’) needs to be taken into account.”

Furthermore, the following two sentences in the same paragraph of the Japanese TPGL define the scope of the limitation.

“When assessing the degree of the contribution to the creation, etc. of intangible property, the functions that the corporation or the foreign affiliate performed, in such processes as decision making, provision of services, bearing of costs, and risk management, shall be taken into account comprehensively. In this case, it shall be noted that the degree of contribution is to be assessed as low when the corporation or the foreign affiliate merely bears the cost of the creation, etc. of the intangible property that is highly expected to be a source of income.”

Finally, there are also the special provisions in relation to CCAs. According to §3-6 and 3-7 of the Japanese TPGL the existing intangible property is treated differently from that acquired/developed through CCAs.

See for details section 2.2.6.
As at the date of this report, there is neither an amendment to the aforementioned regulation nor an attempt to introduce the notion of “transactions with intangibles” into the Japanese TP rules to follow up the BEPS Actions 8–10. However, there should be an amendment in the near future, as the Ministry of Economy, Trade and Industry of Japan (METI) has already started discussing the documents needed in relation to BEPS Actions 8–10. (A comparative survey by EY Japan will be uploaded at the website of METI in Japanese in March 2017.)

2.2.3. “Substance-over-form” approach towards intangibles

First, it should be noted that the NTA traditionally tended to apply the so-called “substance over form” TP taxation on MNE groups which also covered cross-border intangible transactions within a MNE group. Sometimes taxpayers are subject to Kifu-kin taxation, when TP taxation cannot be applied. As a result, upon the request of industry, the Japanese APA rule was introduced to assist domestic MNEs (i.e. a unilateral APA) and was later extended on a bilateral basis. Although the Japanese APA is solely administrative guidance (Gyôsei Shidô), a sort of a pre-confirmation system, it works relatively well as there seem to be fewer opportunities for unexpected TP taxation to arise in comparison to other countries.

Secondly, in relation to the definition of “intangibles”, as with the new OECD TPGL, the current Japanese TPGL has not yet imposed the notion “economic ownership” as overriding “legal ownership”. Nevertheless, in Japanese TP taxation practice in assessing whether intangibles are held by MNEs not only are legal definitions/perspectives taken into account but also several economic factors.

Indeed, judgments of the recent Japanese Tax Tribunal (it is not a court formally, but it considers tax disputes at first instance in Japan) stated as follows:

“in relation to factors to evaluate the value of intangibles which are owned by the both (parent company and affiliate) companies, not only the legal aspects of the intangible property are taken into account but also the degree of contribution of related parties to the activities for the creation etc. of intangible properties should also be taken into account. Consequently, in such a process it is necessary to consider the following factors comprehensively; decision making, provision of services, bearing of costs, and risk management.”

The judgments cited the text of the first and second paragraphs of §3-12 of the Japanese TPGL.

As mentioned above, there was no official announcement to amend the STMA in relation to intangible transactions after the release of the BEPS Actions 8–10. However, the discounted cash flow (DCF) method is to be allowed in Japan in the near future. There is a precedent for this method; however, it was not a TP

25 See for details §6 of the TPGL.
26 Tsunoda and Fujieda, op. cit., p. 89; §3-12 of the TPGL. See above section 2.2.2.
27 Decision of Tribunal (Saiketsu) on 27 January 2010; Decision of Tribunal on 18 March 2013. Both cases were disputes on residual profit methods.
28 Tsunoda and Fujieda, op. cit., p. 95.
related dispute but rather a tax case on corporate reorganization and the applicability of the DCF method to evaluate the purchase price of treasury stock was partially approved.\textsuperscript{29}

2.2.4. \textit{Comparability and group synergies}

Japan still has a negative attitude to the introduction of the notion of “group synergies” into the TP guidelines. The Japanese perspective is that the notion “intangibles” is restricted to only that which can be held or controlled. Thus, group synergies of MNEs do not fall within the scope of the TP rules. Consequently, there is nothing special to refer to on that subject in this report.

2.2.5. \textit{Hard-to-value intangibles}

There is no specific rule relating to hard-to-value intangible assets in the Japanese TP rules. Nevertheless, it should be noted that recently the tax bureau of the Japanese Ministry of Finance (MOF, the upper division of the NTA) considered the introduction of the so-called super-royalty clause, i.e. “commensurate with income standard” to evaluate hard-to-value intangibles in the Japanese TP tax regulation (as of 1 November 2015).

2.2.6. \textit{CCAs}

There is no amendment in respect to BEPS Actions 8–10 at this moment. However, CCAs have been already prescribed in the Japanese TPGL very precisely. According to §3-14 of the Japanese TPGL:

“CCA means a contract to share the cost required for the activities necessary for the achievement of a common purpose, such as the development of specific intangible property (hereinafter referred to as ‘activities such as research and development’), between contracting parties (hereinafter referred to as ‘participant(s)’, and to obtain the share of the outcome yielded from the activities such as research and development in accordance with the proportion of the total amount of expected benefit (hereinafter referred to as the ‘expected proportion of benefit’) of the profit that is expected to increase or the cost that is expected to decrease (hereinafter referred to as the ‘expected benefit’) for each participant by the new outcome yielded from the activities such as research and development. For instance, the following falls under a CCA: a contract to share the cost required for the development of the manufacturing technology for new products between the corporation and a foreign affiliate, using the expected proportion of benefit calculated on the basis of the expected benefit that would be enjoyed by the corporation and the foreign affiliate through the sale of the new products to be manufactured by using the manufacturing technology, and to obtain the share of the new intangible property yielded from the development of the manufacturing technology in accordance with the cost to be shared by each of them.”

\textsuperscript{29} Tokyo High Court Decision on 25 March 2015 (\textit{IBM Japan v. NTA}).
Regarding the treatment of CCAs, it should be noted that the total cost is not deductible. §3-15 of the TPGL stated as follows:

“Cost contributions (including adjustment of the amount of cost contributions) and acquisition of shares based on a CCA concluded between a corporation and a foreign affiliate shall be based on a CCA concluded between a corporation and a foreign affiliate fall under transactions with a foreign affiliate, and in cases where the corporation’s expected proportion of benefit under the CCA is recognized as excessive compared with the proper expected proportion of benefit for the corporation (meaning the proportion calculated based on examinations as prescribed in 2-16 and 2-18), it shall be noted that from out of total cost borne by the corporation, the amount borne for the part of the proportion that is excessive shall not be included in the amount of deductible expenses as it exceeds the arm’s length price.”

More precisely, a note is added in the subsequent paragraph:

“(Note) The cost shared by a corporation shall be treated in accordance with the provisions of the laws and regulations concerning corporation tax. Therefore, for instance, in case where there are entertainment expenses, etc. prescribed in Article 61-4, paragraph (3) of the STMA in the cost required for the activities such as research and development, the amount of entertainment expenses, etc. shared by the corporation based on the proper expected proportion of benefit shall be treated in accordance with the provisions of STMA Directive 61-4(1)-23-(1) (‘Method of Expenditure of Entertainment Expenses, etc.’). Therefore, it shall be noted that the amount of non-deductible expenses under paragraph (1) of the same Article is to be calculated based on the amount of entertainment expenses, etc. shared by the corporation.”

If a domestic corporation concluded a CCA with a foreign affiliate, the following allocation rule would be applied:30

“Where a corporation concluded a CCA with a foreign affiliate, whether or not the amount of cost contribution of the corporation is appropriate shall be examined, taking the following points into account: (a) Whether the range of the activities such as research and development is clearly defined and the content is provided for specifically and in detail; (b) Whether all participants are expected to enjoy the benefit directly by using the outcome yielded from the activities such as research and development for themselves; (c) Whether the amount of cost to be shared by each participant has been determined by allocating the total amount of cost required for the activities such as research and development, based on the expected proportion of benefit, which has been properly estimated; (d) In case where it is difficult to estimate the expected benefit directly, whether the standard (sales amount, gross profit, operating income, volume of production or sales, etc.) used for the calculation of the expected benefit is reasonable enough for assuming the degree of benefit obtained by each parti-

30 §3-16 of the TPGL.
Participant from the outcome yielded from the activities such as research and development; (e) Whether the expected proportion of benefit is reviewed in accordance with the fluctuation of the standard used to calculate it; (f) Whether it has been examined if each participant’s expected benefit was estimated properly, when there are significant deviations between the expected proportion of increased benefit and the realized proportion of benefit (meaning the proportion of increased profit or decreased costs for each participant (hereinafter referred to as the ‘realized benefit’) based on the outcome yielded from the activities such as research and development, to the total of the realized benefit for each participant); (g) In case where there is a new entry in an active CCA or a withdrawal and there is intangible property, etc. created through the past activities such as research and development, whether the intangible property, etc. is evaluated at the time of the new entry or the withdrawal, and whether the proper consideration for the intangible property, etc. is paid or received among the participants in proportion to the share of the intangible property, etc.”

The use of intangible property under a CCA is described in the subsequent paragraph:

“Well existing intangible property owned by a participant (meaning any assets other than the intangible property acquired/developed through the CCA; the same shall be apply hereafter) is used for the activities such as research and development under the CCA, it shall be noted that it is required to examine whether the participant who owns the existing intangible property has received the arm’s length royalty or that the cost shared has been calculated assuming that such an amount has been shared by the participant, except when the intangible property is recognized to have been transferred to the other participants.”

2.3. Risk and capital

At this time, there has been no change in the Japanese domestic TP rules in terms of the BEPS Actions 8–10. However, the NTA currently evaluates the compensation for risk and the return on capital very carefully.

As an example, there was an important TP tax dispute at the level of the tax tribunal in relation to the pharmaceutical industry (Takeda Pharmaceutical Company Ltd v. NTA in the Osaka Tax Bureau) in 2013. In that case, the Osaka Tax Bureau levied penalty tax on the cross-border product supply transaction between Takeda Ltd and its 50 per cent owned US subsidiary, TAP pharmaceutical products Inc. After the NTA failed to negotiate with the US competent authority (IRS) a mutual agreement Takeda Ltd made an objection against the Osaka Tax Bureau to the Osaka Tax Tribunal. On 25 March 2013 the Osaka Tax Tribunal approved Takeda’s claim. As a result, the NTA withdrew the penalty tax completely and Takeda Ltd received approximately JPY 57 billion.33

31 See section 2.2.2.
32 §3-17 of the TPGL. See above.
33 It was unusual that the NTA did not file a petition further to the (normal) court.
2.4. High-risk transactions

2.4.1. CUP and quoted prices for cross-border commodity transactions

Usually, in relation to commodity transactions in Japan the CUP method is not raised, but rather another method similar to the CUP method is used. Consequently, there is nothing to change in Japan following BEPS Actions 8–10 at this time.

As a precedent in relation to TP transactions dealing with commodities, the Tokyo High court decided in favour of the NTA on the use of the contribution PS method (one of the PS methods) in Pacific Fruits Ltd v. NTA. The facts related to the comparability of banana purchase prices between those imported from the Philippines and those imported from Ecuador and the case turned on the fact that although the plaintiff imported bananas from Ecuador to Japan exclusively there were a lot of distributors of bananas imported from the Philippines. However, there remains discussion in Japan as to the availability of the other methods being still open.

2.4.2. Intra-group services

The general rules dealing with loan transactions within MNE groups are prescribed in §66-4(7)-5 of the STMA directive. Furthermore, §3-6 of the Japanese TPGL prescribed precisely as follows: (a) loans to which CTA Directive 9-4-2 (“regarding Loans without interest for reconstructing a subsidiary, etc.”) is applicable will also be treated as legitimate transactions in transactions under TP taxation; (b) in cases where the maturity date of a transaction with foreign affiliate is unknown, the period of the loan shall be reasonably calculated in light of the purpose of the loan. As an exceptional case, §3-7 of the Japanese TPGL states as follows:

“In conducting examinations on lending and borrowing activities between a corporation and a foreign affiliate, in cases where neither party is engaged in lending or investment activities in the course of trade and also where none of the methods prescribed in STMA Directive 66-4(6)-4 are applicable, whether or not the interest rate applied to the lending or borrowing is appropriate shall be examined by regarding the interest rate, calculated as follows, as the arm’s length interest rate.”

Meanwhile, the treatment of intra-group services is prescribed in §3-9 of the Japanese TPGL as follows:

“(1) In cases where the corporation performs the following activities regarding management, finance, business and administration for a foreign affiliate,

34 Tsunoda and Fujieda, op. cit., p. 82.
35 Tokyo High Court Decision on 28 March 2013 (First instance Tokyo district court on 27 April 2012).
36 This exceptional case will be applied to loan transactions using methods other than those prescribed in §66-4(7)4 of the STMA directive.
whether the activities are deemed to be the provision of services shall be judged on the basis of whether the activities have economic or commercial value of the foreign affiliate. Specifically, it shall be judged on the basis of whether it can be deemed that a non-affiliate under similar circumstances as the foreign affiliate would need to perform the same activities for itself if the corporation did not perform the activities: (a) planning and coordination; (b) budgeting and/or budgetary control; (c) accounting, tax, and/or legal services; (d) management and/or calling of credit; (e) operation, maintenance, and/or management of computer networks; (f) supervision of cash flow and/or ability to pay; (g) investing and/or raising of funds; (h) management of interest and/or exchange rate risks; (i) assistance in the fields of production, purchases, distribution, and/or marketing; (j) recruitment, assignment and/or trading of employees; (k) matters concerning remuneration, insurance, etc. of employees; (l) advertisement (excluding assistance in the field of marketing listed in (i)).”

Additionally, in cases where a corporation continuously maintains staff and equipment that are ready to provide services for a foreign affiliate upon request at any time, it shall be noted that maintaining this state of readiness itself is also deemed to be the provision of services. Nevertheless, the following factors are excluded as intra-group services: (a) where the corporation performs activities for the foreign affiliate that duplicate the services provided by a non-affiliate for the foreign affiliate or activities set forth in the paragraph above that are performed by the foreign affiliate itself; (b) such activities as follow that relate to the exercise of a right or the performance of an obligation under laws and regulations by a corporation holding a status as shareholder: (i) activities performed by the parent company under laws and regulations that it is obliged to follow, such as the holding of shareholders meeting and issuing of shares; (ii) activities performed by the parent company to prepare a securities report and other report based on the Financial Instruments and Exchange Act.

Finally, it should be noted that to date there has been no amendment following the BEPS Action Plan on this topic.

2.4.3. PS in the context of value chains

As mentioned above, in Japan traditionally the CUP method and RP, CP methods were applied in TP disputes. The PS method and the TNMM method were not so popular in practice. Thus, it seems that only in rare cases is the consistency between the corporation and its comparable corporation taken into account, i.e. in which sector/hierarchy they belong or where they exist in the MNE’s value chains is taken into account.38

Until 2012, the ROS operating margin and the ROTC were allowed in the Japanese TP rules.39 In addition, since 2013 the Berry ratio has also been applicable using the TNMM method.40 Generally, the Berry ratio is applied to verify/indic-
ate the distributors’ profit. However, it is not applied in every TP distributor’s case, but it should be applied with consideration of the assets used and the risk which the company has undertaken. According to example 6 of the Japanese TPGL issued by the NTA, it should be applicable only when the value of functions of the sellers or that of buyers of the inventories in relation to the relevant cross-border transaction: (a) is recognized as relevant to operating expenses; (b) is not significantly influenced by the value of the products and has no connection with the sale; (c) it is recognized that it does not have any function which relates to operating expenses.  

The other methods in the OECD TPGL (e.g. ROVAC, ROA, RONA, ROCE) are not explicitly prescribed in the Japanese TPGL. However, given the interpretation of the newly introduced §3-9 of the Japanese TPGL (the comparability of transactions in the TNMM method) it should be possible to use the ROSGA in the future.

It should be noted that in September 2016 the Japan Foreign Trade Council made a public comment on BEPS Actions 8–10, especially regarding the revised guidance on the PS method, a draft of which was released by the OECD on 4 July 2016. The Council has an essentially positive view of the proposal in that draft (i.e. to shift from the TNMM method to the PS method). However, the Council emphasizes its limits as follows:

“However, the guidance is still unclear in many points. It is essential that these be clarified to ensure consistent application of the PS method. … it is difficult to reach consensus on its application between a taxpayer and the tax administration of two (or more) countries. We are concerned that taxpayers might suffer additional burdens, which may unduly harm the competitiveness of taxpayers. We are also concerned that the difficulty in applying the PS method leads to inefficiency in tax enforcement. Therefore, the PS method should not be readily applied solely because it is difficult to identify reliable comparables given the complexity of value chain or business integration.”

2.5. TP documentation

As mentioned above, the BEPS Action 13 has had a considerable impact on Japanese MNEs. For instance, the scope of the new TP documentation rule (Bun-sho-ka rule) is, in comparison to that of the old Japanese documentation rule (2010–2016), remarkably extended. The requirement for CbCR and to create a master file are completely different from the old documentation rule. Consequently, the OECD’s new three-tier approach creates considerable administrative burdens for most Japanese MNEs. For technical/administrative reasons, Japan is to introduce the new TP documentation rules step by step. The requirement of for CbCR and master files is applicable to a qualified parent company of an MNE whose fiscal year starts from 1 April 2016. The requirement for a local file will come into force one year later (1 April 2017).

41 Mori, op. cit., p. 189.
43 See section 2.1.
2.5.1. CbCR

According to §66-4-4 of the STMA Japanese domestic parent companies and foreign corporations with PEs located in Japan with annual consolidated income more than JPY 100 billion should make CbCR (Kunibetsu Hōkoku jikô), if they meet the following four conditions:

(a) the consolidated group is qualified as a “corporate group” within the meaning of §66-4-4(4)1 of the STMA and §39-12-4(2) of the STMA Ordinance;
(b) the corporate group is qualified as an “MNE” within the meaning of §66-4-4(4)2 of the STMA and §39-12-4(3) of the STMA Ordinance;
(c) the “MNE” is qualified as a “specified MNE” (Tokutei Takokuseki Kigyô) within the meaning of §66-4-4(4)3 of the STMA;
(d) the parent company is qualified as a “member company” (Kôsei Gaisya) within the meaning of §66-4-4(4)5 and §39-12-4(5) of the STMA.

According to §66-4-4(5) of the STMA, the above-mentioned qualified companies should carry out CbCR and file it together with the master file (see section 2.5.2) with their local tax office electronically (by e-tax) within the following year after the next day of the closing date of the last fiscal year which is stated in the “notification of the ultimate parent company” (Saishû Ōyagaisha tou Todokeide Jikô).

The deadline of the notification on the parent company is not the same as that of the CbCR and master file, but it should be submitted by the closing date of its fiscal year by e-tax. It should be also noted that the document of notification addressed to the parent company is to be written in Japanese, while the CbCR is to be created in English. This ensures that the CbCR of the Japanese domestic parent companies are able to be provided to the foreign tax authorities upon their request in accordance with the exchange of information clause of tax treaties (treaty method).

Parent companies or their agent companies that reside outside Japan will be exempt from the need to file CbCR to the Japanese tax office, as the NTA is able to access the original information via its foreign tax authority (the competent authority) pursuant to the treaty method.

Nevertheless, as an exceptional rule, where the resident state of the parent or agent companies does not conclude an exchange of information agreement with Japan, they must create and file CbCR and a master file with the tax office in their resident state.

Finally, where the taxpayers do not submit their CbCR by the due date without reasonable excuse, they will be fined up to JPY 300,000.45

2.5.2. Master and local files

According to §66-4-5(1) of the STMA, Japanese domestic MNEs and foreign MNEs with PEs located in Japan, must file their master files (Jigyô Gaikyô Hôkokusho) by e-tax within one year after the next day of the end of their fiscal year starting after 1 April 2016.

Usually, the following items should be stated in the Japanese master file: the global business structure of the MNE group, MNE group business overview, MNE

44 That means not exactly equal to the consolidated company.
45 §66-4-5(3) of the STMA.
group financial condition, other information described in §22-10-5(1) of the STMA Ordinance.

Where Japanese MNE groups and foreign MNE groups with PEs located in Japan have several affiliations/domiciles all over Japan, a special rule is applied; those companies may choose one of those affiliations/PEs as a “representative” and only that affiliation/PE should submit the master file to the local tax office. This is an exceptional rule to reduce the compliance costs on taxpayers. In such a case, according to §22-10-5-3- of the STMA Ordinance, taxpayers must state in the master file the following information: the name of the corporation presenting the master file, the domicile of the parent corporation, the newly introduced Japanese corporate tax identification number (Hôjin number, i.e. each corporate taxpayer in Japan has been assigned automatically 13 digits); the name of the person lodging on behalf of the representative company (normally the CEO); the name of the other corporations on whose behalf the master file is submitted; main domicile; corporate tax identification number and the names of the representatives of the affiliates. As explained above, this new rule shall not be applicable to group companies (MNEs) whose annual consolidated income is less than JPY 100 billion.

Finally, master files should be able to be submitted either in Japanese or in English. Where taxpayers do not submit their master files by the due date without reasonable excuse, they will be charged a fine up to JPY 300,000.

Although the local file requirement is not yet in effect in Japan it is to be applied to corporate taxpayers of Japanese MNE groups which conduct transactions with their foreign affiliated companies. A local file is to be created by the due date of filing the (consolidated) corporate tax return starting the fiscal year after 1 April 2017. The contents of the local file are the documents which are needed to evaluate the arm’s length price. Taxpayers must keep the original documents referred to in the local file in their local office for the subsequent seven years from the next day after the due date. Where the original documents are issued in Japan, taxpayers should keep the original local file in the office, while where the original documents are issued in foreign countries, the taxpayers should keep a copy in the office of those affiliates. There is no restriction as to language. However, where the local file is not written in Japanese, but written in a foreign language, the tax office may ask the taxpayers to translate it into Japanese. Regarding the due dates for filing the local file the new Japanese rule has set two different dates depending on whether transactions with foreign affiliations are qualified by the need for contemporaneous documentary:

(a) where the local file is recognized as a contemporaneous document, the documents which are necessary to calculate arm’s length price must be filed within 45 days after being so designated by the tax investigator; alternatively,

46 §64-4-5(2) of the STMA.
48 §22-10-5(2) of the STMA Ordinance. If the master file is written in English, the tax office may ask taxpayers to submit the additional Japanese translation later.
49 §66-4-5(3) of the STMA.
50 §22-10(1) of the Ordinance for Enforcement of the STMA (sozei tokubetsu sochi hô sekou kisoku).
51 §22-10(2) of the Ordinance for Enforcement of the STMA.
local files considered to be important to calculate the arm’s length price must be filed within 60 days after so requested by tax investigator;

(b) where the local file is not recognized as a contemporaneous document, the documents which are considered to be important to calculate the arm’s length price must be filed within 60 days after being requested by the tax investigator (the exemption rule).

Case (b) will be applied to transactions between a domestic affiliation and its foreign affiliation where (i) the total amount of the transactions between the two entities in the previous (or this) fiscal year is less than JPY 5 billion or (ii) the total amount of intangibles transactions between the two in the previous (or the current) fiscal year is less than JPY 300 million.

Where a taxpayer is not able to submit the relevant documents until after the deadline, the tax office may levy taxation by estimate or has the right to make inquiries of other companies in the same trade.

2.5.3. Compliance costs

As mentioned above, Japanese MNE groups will incur considerable administrative costs to prepare for the BEPS new three-tier documents (CbCR and master file and local file). Until 2016, foreign affiliates of Japanese MNEs created their TP documents individually. Thus, even though the risk management of each affiliate is strictly controlled, there is neither consistency with TP policy nor comprehensive tax management strategies for the whole group. Usually, the CEO of the Japanese headquarter has not been responsible for the tax planning and risk control of their foreign affiliates. After BEPS, CEOs of Japanese MNEs need to change their approach and Japanese MNEs may need to restructure their internal control systems.

It should be also noted that one of the reasons for the traditional lack of central management by traditional Japanese MNEs (e.g. car, ship, electronics manufacturing) in comparison with their US and European competitors is that the foreign entities enjoy much more independence. Consequently, Japanese MNE groups were/are less interested in aggressive tax avoidance.

Finally, the new Japanese TP rule will allow the NTA to use estimated taxation where a taxpayer has not lodged a local file.

2.6. TP-related measures in other BEPS actions and other measures against BEPS

First, the BEPS documentation rule in Japan links to BEPS Actions 5–7. In particular, the NTA will cooperate with foreign tax authorities within the exchange of information framework of existing tax treaties when the NTA needs additional information regarding the local files of Japanese MNEs in other jurisdictions. In general Japan concludes tax treaties on a bilateral basis, but after BEPS the multilateral treaties seem to also be an attractive solution to avoid double non-taxation.

Secondly, the amendment of taxable treatment of intangibles (including “intangible transactions”) is also discussed in an internal official meeting of the METI and the MOF. In this context, to define the new rule for the above-mentioned notions (intangibles, etc.) in relation to the BEPS Action 6 and BEPS Action 1 will also be important.
Finally, as mentioned above, the strict requirement to create CbCR and a master file for Japanese MNE groups will bring about the transparency and consistency of the consolidated tax returns of those MNEs in the future, even though the cross-border consolidated tax return is not currently allowed in Japan. As in Japan the financial accounting and the tax accounting are not strictly divided at this time (likewise in continental European countries), this may also be discussed in the future.

2.7. Can BEPS work in favour of MNEs?

It should be noted that until today most Japanese MNEs have not strictly controlled their foreign affiliates from the headquarters in Japan. The reason may be that usually employees in traditional Japanese MNEs are employed for quite a long period of time (ca. 30 years or more) and the representatives of their foreign affiliates are not head-hunted, but rather those who are ranked among the senior staff or executives of the headquarters are appointed. That means the CEO/CFO of the parent company in Japan trusts them to make decisions in foreign countries by themselves. Thus, the requirement for consistency to create documentation compels a change in business strategy, including the TP policy, of Japanese MNEs. Nevertheless, it should also be noted that this does not always mean that the Japanese MNEs try to circumvent the international tax burden intentionally.

3. What is the future of TP?

First, as the next step of the BEPS project (i.e. “post-BEPS”), the accuracy of the given information regarding the relevant TP transactions will become important because it sometimes works in accordance with the exchange of information between the (competent) tax authorities.

Secondly, as Japanese TP taxation develops pursuant to the BEPS project, it may change the behaviour of Japanese MNEs; internal controls and total management within the groups will be an important issue.

Thirdly, the so-called super-royalty clause will be prescribed in the Japanese TP rule soon. However, it is still unclear whether that regulation works efficiently. In general, as most of (bona fide) taxpayers in Japan choose the unilateral APA before they enter cross-border intra-group transactions, the new rule will not necessarily apply to normal Japanese TP disputes. It will make sense only against harmful international tax avoidance by an aggressive corporate taxpayer (e.g. IT industries, especially so-called game creator companies).

Finally, the ongoing discussion between the formulary approach (PS method) and the arm’s length approach in the world will affect the future Japanese TP rule, even though Japan has had relatively few TP disputes in the past thanks to the CCA and APA rules.
Appendix: recent important TP disputes in Japan

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<td>Second instance 14 March 2013</td>
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*a* The *Honda* case is a precedent on location savings. The Japanese motorcycle manufacturing company Honda has its subsidiary A and sub-subsidiary B in the Manaus free trade zone in Brazil. The NTA levied additional corporate tax on Honda according to the residual PS method. The plaintiff insisted that the residual PS method was not an appropriate method to be applied in this situation since the taxable benefit which Sub B and Sub-sub C enjoyed was due simply to the market conditions in Manaus where company A and B carried on their business. The NTA considered the contribution of the Japanese parent company (plaintiff) to the profit of subsidiaries to be significant. The courts permitted the plaintiff’s claim.
Summary and conclusions

As a member of the OECD and the G20 group, the Republic of Korea is one of the early adopters and committed observers of the OECD’s transfer pricing (TP) guidelines for multinational enterprises and tax administrations. The Law for the Coordination of International Tax Affairs (LCITA), which regulates TP rules in Korea, was enacted in 1995, following the first publication of the OECD TP guidelines. Several legislative revisions of the LCITA and its presidential decree (LCITA-PD) regarding TP policies have been made, reflecting the changes of the OECD TP guidelines. Likewise, Korea is supportive of the TP outcomes of the BEPS project and closely monitors their development. Korea is implementing the BEPS Action Plan in response to the OECD’s schedule and has set a priority on the minimum standard for implementing the BEPS Action Plan, such as Actions 5, 6, 13 and 14.

There is no definition of “intangibles” for TP purposes in the LCITA. Instead, article 6(6) of the LCITA-PD provides the points to be further considered in a comparability analysis of intangible assets. If a domestic corporation transfers intangibles to a foreign related party, the recognition of income from the transaction should be made at the time when the legal ownership has in fact been transferred. So far, no changes have yet been made concerning either the definition of intangibles or the TP rules on intangibles, even though the BEPS report on intangibles was published in October 2015. However, once the revised OECD TP guidelines reflecting the outcome of the BEPS project are officially released, Korea is expected to implement those changes, if necessary by amending the relevant domestic laws.

Korean tax law provides for a substance-over-form rule that allows the tax authority to recharacterize a related party transaction based on its substance, where the tax burden of a company has been unjustly reduced. The *Hanocal* case (Supreme Court Decision 2013Du21373, decided on 23 July 2015) may serve as a good example that shows Korea’s substance-over-form approach in TP practices. On the other hand, Korean tax law does not provide for specific mechanisms to identify group synergies in the application of TP rules, and no measures to
improve the valuation of hard-to-value assets following the Action 8–10 Reports have yet been adopted. When the OECD TP guidelines are amended to update the outcome of the BEPS project, Korea is expected to implement those measures by amending its domestic tax laws, if necessary.

As for TP rules concerning intra-group services in Korea, the income tax rules under the Corporate Income Tax Act (CITA) allow the deduction of expenses only if they are either “generally accepted as ordinary” or “associated directly with revenue”. With the increase in the number of foreign multinational companies (MNEs) operating businesses in Korea and domestic MNEs investing overseas, the amended LCITA-PD of 2006 apparently included additional considerations on intra-group services from the perspective of the TP rules, reflecting the relevant parts of the OECD TP guidelines. However, regardless of the legislative progress on intra-group services, the National Tax Service (NTS) has, since around 2010, taken an aggressive position in tax audits on the issue of deductibility of intra-group service fees paid to foreign associated enterprises. The OECD’s BEPS report on low value-adding intra-group services published in 2015 may shed light in the future on resolving the issue of documenting intra-group services in Korea by allowing taxpayers a small amount of mark-up as a safe harbour without requiring burdensome documentation for such services. So far, the Korean government does not seem to have established its position on this issue. But it is expected that the Korean Ministry of Strategy and Finance (MOSF) will decide its position on this issue within a couple of years.

Full legislative implementation of country-by-country reporting (CbCR) is expected soon in Korea. On 30 June 2016, the Korean MOSF signed the Multilateral Competent Authority Agreement on the exchange of CbCR (CbC MCAA). On 28 July 2016, the Korean MOSF released a tax law amendment bill, which includes the CbCR rules and requires CbCR by the ultimate Korean parent company of an MNE group, if the MNE group’s revenue for the preceding year exceeds KRW 1 trillion.

In the meantime, following BEPS Action 13, the LCITA revised in December 2015 requires the submission of a combined report of international transactions which consists of a master file and a local file. Under the current tax law, the combined report must be submitted by the filing due date of a corporate income tax return, which is three months after the fiscal year-end. The tax law amendment bill of 2016 extends the due date to 12 months from the close of the fiscal year. Further, transactions that are covered by an advance pricing agreement (APA) will be exempt from inclusion in the local file. The revised rule will be effective for the master file and local file submitted to the Korean tax authority on or after 1 January 2017.

Overall, with the implementation of the BEPS project, OECD member countries, including Korea, are expected to strengthen their tax sovereignty in order to secure their revenue against MNEs’ tax strategies. Administrative interference by the Korean tax authority in taxpayers’ TP practices and, as a consequence, relevant tax disputes, will probably increase as well. There is great concern in the private sector that Korea’s and other countries’ general tendency to secure their taxing rights on corporate profits under BEPS will intensify double taxation, given that double tax resolution has a limited priority in the BEPS project. As for tax controversy and dispute resolution in the TP area, the current mutual agreement proce-
dure (MAP) mechanism will probably no longer be regarded as an efficient measure for tackling tax disputes and instead, tax arbitration procedures as well as other procedures complementary to the MAP, which enable taxpayers to reach speedy tax dispute resolutions, will probably be preferred by MNEs.

1. Current TP regulation and practice in Korea

Korea has been one of the early adopters and committed observers of the OECD’s TP guidelines. It would be fair to say that the Korean MOSF has made the utmost efforts to ensure that Korea’s TP rules and regulations are consistent with the details of the OECD TP guidelines, leaving aside how these guidelines are implemented by the NTS.

The LCITA, which regulates TP rules in Korea, was enacted in 1995, following the first publication of the OECD TP guidelines. The introduction of the LCITA was in connection with Korea’s entry into the OECD in 1995 because the Korean government believed that the prompt legislation of the OECD TP guidelines would expedite Korea’s accession to the OECD. Even after joining the OECD, the Korean MOSF has been keen on complying with the OECD TP guidelines by reflecting its changes upon domestic laws, so that no significant difference can be found between the OECD guidelines and the LCITA. Several legislative revisions of the LCITA and its presidential decree (LCITA-PD) regarding TP policies have been made. One of the notable amendments made in 2006 was the introduction of the TP rules for intangibles and intra-group services provided in the 1995 OECD TP guidelines, which were intended to provide taxpayers and the tax administration with detailed guidance on more sophisticated TP practices.

Another remarkable amendment was made in 2010, implementing the OECD TP guidelines revised in that year. Major changes include the following: (a) increase in the penalty for non-submission of requested documents from “up to 30 million Korean won (KRW)” to “up to KRW 100 million”; (b) consistency in the application of a TP method by the tax authority in a tax audit; (c) the abolition of the hierarchical order for the selection of a TP method; (d) considering interrelated (or integrated) transactions to be one transaction; and (e) the use of multiple-year data.

Provided below are the major building blocks of the Korean TP regime included in the LCITA and the LCITA-PD.

1.1. Adjustment of TP based on an arm’s length price (ALP)

The LCITA empowers the tax authority to adjust transfer prices based on an ALP and to determine or recalculate a taxpayer’s taxable income when the transfer price of a taxpayer and its foreign related party is either below or above the ALP. Here, “foreign related party” means a non-resident or foreign corporation (excluding a domestic place of business of a non-resident or foreign corporation), which has a “special relationship” with a resident, a domestic corporation, or a permanent establishment of a foreign company.

The LCITA and the LCITA-PD recognize a “special relationship” under the following circumstances:
(a) equity ownership test:
• where a foreign company directly or indirectly owns 50 per cent or more of the voting shares of a taxpayer; or
• where a taxpayer directly or indirectly owns 50 per cent or more of the voting shares of a foreign company; or
• where a corporation (or an individual), which directly or indirectly owns 50 per cent or more of the voting shares of a foreign company, directly or indirectly holds 50 per cent or more of the voting shares of a taxpayer; or

(b) substantial control test:
• where one transaction party substantially controls the business policy of the other transaction party or vice versa, and at the same time they share the common interest; or
• where the same third party substantially controls the business policy of both transaction parties, and at the same time both transaction parties share a common interest.

1.2. TP methods and selection criteria

Korea has implemented the TP methods suggested by the OECD TP guidelines into its domestic law. According to the LCITA, an ALP should be determined by the most reasonable method applicable to the situation, whether it is the comparable uncontrolled price (CUP) method, the resale price method (RPM), the cost plus method (CPM), the profit split method (PSM), the transaction net margin method (TNMM) or any other method. The LCITA-PD sets out the following criteria for selecting the most reasonable method:
• The level of comparability between the transactions of related parties and those of independent parties should be high.
• Accessibility or availability of the comparable data to be analysed should be high.
• Consistency between the assumptions made in the process of comparing the related parties’ transactions with those of independent parties and the actual economic situation of the parties should be high.
• The effects of errors included in the data to be used or in the established assumption on the calculation of the ALP should be minuscule.
• Compatibility of the related parties’ transaction with the applied TP methods should be high.

In the process of comparability analysis, factors which may affect prices or profits, such as types and features of goods or services, functions of business activities, risks accompanying trade, assets to be used, contractual terms, economic situations and business strategies, should be analysed.

1.3. Compensating adjustment

If the actual inter-company price established by a taxpayer and its foreign related party differs from the predetermined price established in accordance with the arm’s length principle, the taxpayer can file its tax return based upon that predetermined price after correcting the actually recorded price.
1.4. APA approval (Korean version of APA)

If a taxpayer wishes to obtain an APA for transactions with its foreign related parties, then it should submit an application for an APA to the NTS by the end of the first fiscal year concerned. Once the NTS has approved the application of a certain method for determining an ALP, both the NTS and the taxpayer are bound by the method agreed upon in the APA.

A taxpayer that applies for an APA may request that the NTS invoke an MAP with the competent authorities of the country in which its foreign related party is a resident under the relevant tax treaty (bilateral APA). However, the NTS may grant an APA without undergoing an MAP for the taxpayer’s convenience (i.e. a unilateral APA). Having obtained an APA, a taxpayer may file an amended tax return that reflects the change from its prior intercompany price with a related party and the price determined under the APA.

In the case of a bilateral APA, the roll-back application of the APA is permitted up to the prior five years, while the unilateral APA limits the roll-back period to up to three years. An applicant for an APA is allowed to withdraw its application for an APA or change the particulars of the application at a later stage. Any data submitted by taxpayers with the application for an APA should be used only for the purpose of the proper establishment and operation of the APA programme. Thus, if an application for an APA is rejected or withdrawn, such data shall be returned to the applicant in order to safeguard the taxpayer’s right to confidentiality. Where an APA is obtained, a taxpayer is required to file an annual report which shows the intercompany price being actually determined by the method agreed upon under the APA within six months of the annual tax return submission due date.

1.5. Secondary adjustment

If the tax authority adjusts the transfer price between a taxpayer and its foreign related party based upon an ALP or increase the taxable income of the taxpayer, and if the foreign party has not returned the amount equal to the additional taxable income to the taxpayer, the tax authority will give the foreign related party a 90-day period during which it may return to the Korean company the amount plus interest accrued up to the point of the return. If the foreign related party fails to do so within the period, the amount equivalent to the additional taxable income will be mostly treated as dividends, even if the foreign party is a related company of the taxpayer, other than a shareholder.

1.6. Corresponding adjustment

According to the LCITA and the LCITA-PD, if a foreign government, on the basis of an ALP increases the taxable income of a foreign company which is an associated enterprise to its Korean counterpart, the Korean government will correspondingly reduce the taxable income of that Korean company, if the two governments have agreed upon an ALP applicable to the case through an MAP. In such a case, a taxpayer may apply for a downward adjustment in his taxable income by filing a notification of the MAP results with the tax authority.
1.7. Adjustment with regard to a cost contribution agreement (CCA)

International standards used to verify the appropriateness of a cost contribution between a resident and its foreign related party have been reflected in the LCITA. Where a taxpayer makes an agreement with a foreign related party on the allocation of cost, expenses, risks for the joint development or securing of an intangible asset and proceeds with the project, the competent tax authority may adjust the cost, etc. allocated to the taxpayer based on an ALP to determine or rectify the taxable base and tax amount of the resident, if the cost allocated to the taxpayer is less or more than the allocated amount in the ALP (the cost based on the ALP is tax deductible).

The allocated amount at arm’s length here means an allocated amount applicable or deemed applicable to an agreement that a taxpayer would make with a foreign unrelated party on the allocation of ordinary cost, expenses, and risks, and the cost, etc. for developing an intangible asset, which should be allocated in proportion to the “benefits expected” from the intangible asset, provided that the price for using the intangible asset owned by parties to the agreement on allotment of cost, etc. and the interest accrued and paid when borrowing the allotted amount is excluded from the allocated ALP.

1.8. Sanctions imposed regarding a TP adjustment or documentation requirements

There are certain penalties for failing to comply with the obligation to submit documentation requested by the NTS. On failure to provide documentation requested by the NTS by the required due date, a taxpayer is subject to a penalty of up to KRW 100 million.

Also, the LCITA provides for two types of penalty associated with TP adjustment: an underreporting penalty and an underpayment penalty:

- The penalty for underreporting is approximately 10 per cent of the additional taxes resulting from a TP adjustment, which can be exempted if the taxpayer keeps the contemporaneous documentation requirements or if the taxpayer is concurrently regarded as bearing no blame for the underreporting by the NTS and the other country.
- The penalty for underpayment, which is an interest payment in nature, is calculated as 0.03 per cent of the additional taxes on a TP adjustment per day on the cumulative days. The counting of cumulative days of the underpayment starts from the day after the statutory tax filing due date, which comes three months after the fiscal year end, and ends on the date that a payment for tax assessment is made.

2. The impact of the BEPS project on TP

2.1. Introduction

As a member of the OECD and the G20, Korea is supportive of the TP outcome of the BEPS project and is closely monitoring its development. Korea is implement-
ing the BEPS Action Plan in response to the OECD’s schedule and has set a priority on the minimum standard for implementing the BEPS Action Plan, such as Actions 5, 6, 13, and 14.

Korea’s tax authority, legislators, and academic community generally agree upon the OECD’s BEPS initiatives as the right way to address current international tax issues, and have committed to their consistent implementation in domestic tax law. Korea’s business sectors, however, are concerned about the overall effect that the domestic implementation of the BEPS Action Plan will produce in the future. However, the position of Korean MNEs is that, although they have never been active, unlike their global counterparts, in taking advantage of the current international tax rules to gain leverage on tax avoidance strategies, they are unfairly obliged to sustain the hardships of compliance burdens and tax disputes, which will be likely to increase significantly as the implementation of the BEPS project outcomes unfold. Korean corporations are concerned that the rapidly expanding scope of information to be disclosed to tax authorities due to the BEPS project may infringe their rights to confidentiality. Further, they are afraid that BEPS-related measures, especially unilateral measures, which could be introduced by a number of countries, may give rise to double taxation and tax disputes, which would probably undermine their business competitiveness.

Legislative changes in Korea will be required for the proper implementation of changes in the OECD TP guidelines as a consequence of the BEPS project outcomes. The Korean government has formed a task force consisting of NTS officers and tax professionals to plan for the effective implementation of the BEPS project recommendation.

### 2.2. Challenges of transactions with intangibles

#### 2.2.1. Definition of intangibles

No definition of “intangibles” for TP purposes is found in the LCITA. Instead, article 6(6) of the LCITA-PD provides the points to be further considered in a comparability analysis of the intangible assets as follows:

- How much income is expected to be added or costs to be saved due to the intangible assets?
- Are there some limits on the scope of rights to be exercised?
- Is the retransfer or sublicence of the rights permitted?

Under the provisions of CCAs in the LCITA, the following “intangible assets” are applicable to the CCA: that is, patent rights registered under the Patent Act, utility model rights registered under the Utility Model Act, design rights registered under the Design Protection Act, trademark rights or service mark rights registered under the Trademark Act, copyright registered under the Copyright Act, or any other intangible asset, including a design, model and knowhow, usable as it is or conveyable or licensable for use by a third party.

#### 2.2.2. Transactions with intangibles

If a domestic corporation transfers intangibles to a foreign related party, the recognition of income from the transaction should be made at the time when the legal
ownership has in fact been transferred. A general principle under the LCITA states that income should be recognized at the time when rights and obligations are settled, which will be applicable to the recognition of income from transactions with intangibles as well. The recognition of transfer of assets other than commodities should be made at the time when the settlement is made. Where the registration of the ownership of the property is due to the transfer of its title, the delivery of the relevant assets, or the use of the relevant assets by the other party takes place before the date on which the settlement is made, it will be the registration date of the transfer, the date of delivery, or the date on which the other party started to use the relevant assets, whichever is sooner.¹

So far, no changes have yet been made concerning either the definition of intangibles or the TP rules on intangibles, even though the BEPS report on intangibles was published in October 2015. However, once the revised OECD TP guidelines reflecting the outcome of the BEPS project are officially released, Korea is expected to implement those changes, if necessary, by amending the relevant domestic laws.

2.2.3. “Substance-over-form” approach towards intangibles

Korean tax law provides for a substance-over-form rule that allows the tax authority to recharacterize a related party transaction based on its substance, where the tax burden of a company has been unjustly reduced.² Article 2(2) of the LCITA stipulates that in the case of a cross-border transaction, if a person to which any taxable income, revenue, property, activity or transaction is attributable in name is different from the person to which such income, revenue, property, activity or transaction is attributable in substance, the latter-mentioned person will be the taxpayer, and tax treaties will be applied accordingly. Further, if a cross-border transaction is recognized as having been carried out for the purpose of unduly claiming benefits under tax treaties and the LCITA by way of indirect means involving a third party or the use of two or more activities or transactions, tax treaties and the LCITA will be applied by regarding it as being entered into directly or as a single continuous activity or transaction, depending on the economic substance.

The Hanocal case may serve as a good example that shows Korea’s substance-over-form approach in TP practice.³ Hanocal Holding BV and IPIC International BV (the plaintiff) are related companies, both of which are established in the Netherlands and wholly owned by the International Petroleum Investment Com-

¹ Art. 68, para. 1(3) of the Presidential Decree of the LCITA.
² The Constitutional Court of Korea sees the “substance-over-form” rule as one of the important constitutional principles in tax law, which derives from the principle of equality under art. 11(1) of the Constitution (KCCR Case nos. 89HunMa38; 92HunBa49 and 2007HunBa76).
³ Supreme Court Decision 2013Du21373 decided 23 July 2015. Apart from this case, Hanocal and IPIC International BV filed for request of arbitration at ICSID against the Korean government seeking compensation for taxes paid in 2010 (ICSID Case no. ARB/15/17, 20 May 2015). However, the claimants filed a request for the discontinuance of the proceeding, and the case was closed by the Tribunal’s subsequent order for the discontinuance of the proceeding on 5 October 2016.
pany (IPIC), the UAE state-owned company, through Flagellum OY (Finland) and IPIC Holdings GmbH (Austria) respectively. Hanocal purchased 50 per cent of the shares of Hyundai Oil Bank in 1999, and transferred 20 per cent of them to the plaintiff in 2006. Later, Hanocal reported to the NTS the capital gains from the transfer as tax-free income under the tax treaty between the Netherlands and Korea. The NTS did not accept Hanocal’s report and levied corporate income tax on those capital gains of Hanocal. The NTS considered that Hanocal and Flagellum OY were “conduit companies” under the control of IPIC, and that IPIC was a substantive owner of the income from transfer of the shares between Hanocal and the plaintiff. The plaintiff argued that, as IPIC was both substantive transferor and transferee under the logics of the substance-over-form rule of Korea, capital gains subject to the LCITA did not exist.

The Supreme Court, in the Hanocal case, ruled in favour of the NTS. The Court ruled that the substance-over-form rule was supplementary to and inseparable from the principle of “no taxation without law”, and therefore that the legal effect of the transfer in this case was not denied by the substance-over-form rule as long as there was no intention of tax avoidance. The Court ruled therefore that, considering all the relevant legal and factual circumstances, the transferor, a conduit interposed for the purpose of tax avoidance, should be denied while the transferee, another seeming conduit but without tax avoidance purpose, should not be denied. Also in this vein, the ALP calculated by the NTS was treated as legitimate.

In another Supreme Court case, an ALP calculation case for which the taxpayer selected the CUP method and the tax authority determined a “comparable uncontrolled transaction” regarding the CUP method for a transaction of bond issuance between a taxpayer (a domestic corporation, plaintiff) and its foreign related party, the tax authority chose the loan transaction by the taxpayer from a domestic bank YY, which was a domestic transaction, as a comparable uncontrolled transaction for an ALP calculation by the CUP method. The taxpayer argued that the decision of the tax authority was not right because, according to tax laws, only an international trade should be selected as a comparable uncontrolled transaction. The Court in this case determined that not only an international transaction but a domestic transaction could be chosen as a comparable uncontrolled transaction in calculating an ALP by the CUP method, if the reasonableness of the taxable income adjustment, which could remove differences between the international transaction and the domestic one, remained valid. The Court also noted that the relevant tax laws were not interpreted as intending to exclude a domestic transaction from the category of comparable uncontrolled transactions. Considering the facts established by the lower court that the transaction of bond issuance in this case and the loan transaction, which was a comparable uncontrolled transaction for the ALP calculation, shared the same purpose and features as monetary debts, and that both transactions were made within a short period of time, in unchanged economic conditions and business circumstances, the Court concluded that the loan transaction with YY bank in this case could be accepted as a legitimate “comparable uncontrolled transaction” for the ALP calculation.

4 Supreme Court Decision 2009 Du 15357, decided 13 October 2011.
2.2.4. Comparability and group synergies

The Korean tax law does not provide for specific mechanisms to identify group synergies in the application of TP rules. When the OECD TP guidelines are amended to update the outcomes of the BEPS project, Korea is expected to implement those changes by amending domestic tax laws, including the LCITA, if necessary.

2.2.5. Hard-to-value intangibles

No measures to improve the valuation of hard-to-value assets following the report on Actions 8–10 have yet been adopted in Korea. When the OECD TP guidelines are amended to update the outcome of the BEPS project, Korea is expected to implement those measures by amending domestic tax laws, if necessary.

2.2.6. CCAs

As seen above, the LCITA and the LCITA-PD provide for TP rules to CCA. Korea is expected to implement the outcomes of the BEPS project concerning CCAs, if necessary, following the revision of the OECD TP guidelines in the future.

2.3. Risk and capital

The LCITA has not yet included any TP measures advocated by the report on Actions 8–10 to properly reflect the real value creating activities of associated enterprises or transactions to be in line with the substance-over-form principle. Once the relevant parts of the OECD TP guidelines are revised and published, Korea is expected to consider implementing those TP measures through the amendment of domestic tax law, if necessary.

2.4. High-risk transactions

2.4.1. CUP and quoted prices for cross-border commodity transactions

In Korea, domestic TP regulations on general transactions are also applicable to transactions with commodities. As cross-border commodity transactions have not been an important source of Korean economic activity, the impact of this topic included in the Actions 8–10 report seems likely to be relatively small on Korea’s TP rules provided in the LCITA.

2.4.2. Intra-group services

In Korea, the income tax rules under the LCITA allow the deduction of expenses only if they are either “generally accepted as ordinary” or “associated directly with the revenue”. The Supreme Court of Korea in 2002 held that management service

See art. 15, s. 2 of the LCITA.
fees that were calculated based on a reasonable allocation of common costs, payable by a taxpayer to a foreign related company were deductible.\(^6\) Before that decision was made, however, it had generally been understood that only a direct charge method was supposed to be accepted as a deductible one, which meant that an expense should be substantiated by the documents of services actually rendered in direct relationship with each payment to satisfy the requirement of “associated directly with the revenue”. Following the 2002 Supreme Court decision, the NTS, under the approval of the Korean MOSF, released a new provision of the basic rule that management service fees might be deductible if certain conditions were satisfied (former basic rule of the LCITA, article 4-0...2).\(^7\)

With the increase in the number of foreign MNEs operating businesses in Korea and domestic MNEs investing overseas, the amended LCITA-PD of 2006 apparently included additional considerations on intra-group services from the perspective of TP rules, reflecting the relevant parts of the OECD TP guidelines. According to article 6(2) of the LCITA-PD, where the price for a transaction of service (business management, financial advice, payment guarantee, computing or technical support, or any other service transaction deemed necessary for the business concerned) between a taxpayer and a foreign related party is one for the transaction of service that meets all the following requirements, this price will be deemed the ALP and recognizable as a deductible expense provided:

- there is a prior agreement for the provision of intra-group service, and that service is provided subsequently in accordance with the agreement;
- there will be “expected benefits” from the service provided;
- the payment for the service should be at arm’s length; and
- pertinent documents on the above conditions are properly documented.

Regardless of the legislative progress on intra-group services described above, the NTS has taken, since around 2010, an aggressive position in tax audits on the issue of deductibility of intra-group service fees paid to foreign associated enterprises. Even though tax auditors do not challenge the legal basis of service fee charges due to the rule change mentioned above, it is often criticized that the tax authority usually disallows intra-group service charges based on its subjective judgment of the sufficiency of the documentation. In other words, the tax authority often requests details of costs incurred and allocation keys and documents to support the benefit of the services and their relevance to the Korean entity. However, the deductibility of most of the intra-group service fees has been frequently denied on the ground that it is still not sufficient to prove the deductibility. Tax auditors have required 100 per cent apparent proof for validating the deductibility, which is often extremely difficult in real situations. As a consequence, a number of dispute cases with the issue of insufficiency in documenting the intra-group services are pending at either the Tax Tribunal or the courts.

The OECD’s BEPS report on low value-adding intra-group services published in 2015 may shed light in the future on resolving the issue of documenting the intra-group services in Korea by allowing taxpayers a small amount of mark-up as


\(^7\) According to the basic rules, to be accepted as a deductible expense, the provision of a specific service had to be proved with evidence; the service provided has to be either “generally accepted as ordinary” or “associated directly with the revenue”; and the payment should be at arm’s length.
a safe harbour without requiring burdensome documentation for low value-adding intra-group services. However, the Korean government does not seem to have established its position on this issue yet. It is expected that the Korean MOSF will decide its position on this issue within a couple of years. Whether the fees paid by a foreign subsidiary for a credit guarantee service provided by a Korean parent company are at arm’s length has become one of the hot controversial issues in Korea today. The NTS developed a formula model to calculate the ALP for credit guarantee services in 2012, which later caused a number of serious disputes between the NTS and many taxpayers. The lower courts have upheld the arguments of the Korean parent companies, noting that the NTS model did not conform to the TP methods or the comparability analysis provided in the LCITA and the OECD TP guidelines. Many related cases are currently pending in the higher courts.

2.4.3. Profit splits in the context of value chains

Korea does not have any special rules concerning the application of TP rules to MNEs’ value chains. Currently, Korea is highly involved in the OECD’s BEPS consultations, and is expected to consider adopting new profit split scheme, if necessary, once the revision of the OECD TP guidelines reflecting the report on Actions 8–10 is completed.

2.5. TP documentation

Full legislative implementation of CbCR is expected soon in Korea. On 30 June 2016, the Korean MOSF signed the CbC MCAA. On 28 July 2016, the Korean MOSF released a tax law amendment bill, which includes the CbCR rules and requirements for CbCR by the ultimate Korean parent company of a MNE group, if the MNE group’s revenue for the preceding year exceeds KRW 1 trillion.

The Korean subsidiary of a foreign-based MNE group is required to submit the CbCR to the Korean tax authority, if the country of residence of the ultimate parent company does not have CbCR filing requirements, or the country of residence of the ultimate parent company has not entered into a multilateral agreement on the exchange of CbCR. The CbCR should be filed by 12 months after the relevant fiscal year-end (e.g. the CbCR filing due date for the calendar year 2016 is by the end of 2017). From 2018 and thereafter, CbCR will be exchanged between countries that have entered into the multilateral agreement on the exchange of CbCR. The revised rule will be effective for CbCR filed on or after 1 January 2017.

2.5.1. Master and local files

Following BEPS Action 13, the LCITA revised in December 2015 requires for the submission of a combined report on international transactions which consists of a master file and a local file.

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Under the current tax law, the combined report must be submitted by the filing due date of a corporate income tax return, which is three months after the fiscal year-end. The tax law amendment bill of 2016 extends the due date to 12 months from the close of the fiscal year. Further, transactions that are covered by an APA will be exempt from inclusion in the local file. The revised rule will be effective for the master file and local file submitted to the Korean tax authority on or after 1 January 2017.

According to article 11 of the LCITA and article 21(2) of the LCITA-PD, a taxpayer whose transaction volume with a foreign related party and turnover therefrom in the relevant taxable year exceed a certain amount must submit a combined report which includes business activities, details of transactions, etc. Entities that satisfy both criteria specified below must prepare and submit a combined report on international transaction information: (a) individual entities with annual revenue exceeding KRW 100 billion (approximately USD 100 million); (b) foreign related party transactions exceeding KRW 50 billion (approximately USD 50 million).

The scope of information to be covered by the local file and the master file provided in the LCITA is similar to that of BEPS Action 13. That is, all domestic corporations and foreign corporations with domestic business that meet the criteria are required to submit the local file. Only the ultimate parent company within the same business group of the entities that file individual local files is required to submit the master file. The local file is a report on related party transactions and TP policy. Major details include descriptions of individual entities within affiliated groups, TP related information on overseas related party transactions and financial status. The master file is a report on the entire structure of the MNE, including the organizational structure of the affiliated group, business description, intangible assets, financial transactions, corporate finance and tax status.

The local file and the master file should be prepared in the Korean language. But the master file is allowed to be prepared in English under the condition that a Korean-translated report is submitted within one month from the time it is requested. The reports should be electronically submitted to the tax authorities in the taxpayer’s jurisdiction and be updated on an annual basis. Failure to file an entire or part of the consolidated report or submission of false information will be subject to a penalty of KRW 30 million (approximately USD 30,000).

2.5.2. Compliance cost

As of October 2016, there seems to have been no specific information yet on how BEPS Action 13 has affected compliance and the cost for MNEs operating in Korea. However, it is strongly anticipated among Korean business representatives that the recent implementation of BEPS Action 13 will lead to a significant rise in domestic corporations’ burden of compliance work and its cost.

2.6. TP-related measures in other BEPS actions and other measures against BEPS

As of October 2016, Korea has not taken any specific measures to prevent BEPS through TP that could be adopted unilaterally in the context of the BEPS project.
2.7. Can BEPS work in favour of MNEs?

As of October 2016, no discussion has been found among Korean tax authorities and tax professionals concerning the potential use of the BEPS platform to benefit MNEs with information that is in the possession of other countries. The general opinion of the Korean business sector appears to be unfavourable to the BEPS project because it is considered a significant factor in increasing the tax compliance burden of domestic MNEs.

3. What is the future of TP?

As a committed member of the OECD and the G20, Korea seems highly likely to adopt most of the measures recommended by the BEPS project. Korea plans to gradually implement the BEPS Action Plan by revising its domestic tax laws and renegotiating tax treaties, following the OECD TP guidelines update. This signals that the future of TP in Korea is closely connected to the BEPS outcomes.

Overall, with the implementation of the BEPS project, OECD member countries, including Korea, are expected to strengthen their tax sovereignty in order to secure their revenue against MNEs’ tax strategy. Administrative interference by the Korean tax authority in taxpayers’ TP practices and, as a consequence, relevant tax disputes will probably increase as well.

There is a great concern in the private sector that Korea’s and other countries’ general tendency to ensure their taxing rights on corporate profits under the BEPS project will intensify double taxation, given that double tax resolution has a limited priority in the BEPS project. As for tax disputes and dispute resolution in the TP area, the current MAP mechanism will probably no longer be regarded as an efficient measure for tackling tax disputes, and instead, the tax arbitration procedure as well as other complementary procedures of MAP, which enable taxpayers to reach speedy tax dispute resolutions, will probably be preferred by MNEs.
Summary and conclusions

Since its fundamental tax reform which came into effect on 1 January 2011 and subsequent adaptations, Liechtenstein has become a transparent and cooperative jurisdiction with a tax legislation that is compliant with international rules and standards. In the area of transfer pricing (TP), the 2011 Tax Act includes the arm’s length principle and prescribes that all transactions between related parties have to be conducted in accordance with this principle. Furthermore, the 2011 Tax Code includes provisions on the obligations of the taxpayer to cooperate with the tax administration (Mitwirkungspflichten) under which the Liechtenstein tax administration can also ask for documentation to support the arm’s length nature of a taxpayer’s intercompany transactions.

The base erosion and profit shifting (BEPS) project was closely followed by Liechtenstein and already at an early stage Liechtenstein committed itself to implementing all the minimum standards resulting from the BEPS initiative. Having followed the path of increasing transparency and cooperation for the past six years or so, it is only a logical consequence that Liechtenstein is now also taking all the actions required to become “BEPS compliant”. With a direct connection to TP, such actions relate to the abolition of Liechtenstein’s broad scope intangible property (IP) box regime,¹ the introduction of a TP documentation requirement² and the implementation of country-by-country reporting (CbCR) legislation in line with BEPS Action 13. All currently proposed changes to the Tax Code and the implementation of the new CbCR legislation will become effective from 1 January 2017.

Multinational companies (MNEs) based in Liechtenstein welcome Liechtenstein’s proactive approach to ensuring BEPS compliance and also hope that these measures together with all other actions taken in the years following the tax reform of 2011 to boost transparency and cooperation will lead to the increasing removal of Liechtenstein from tax haven “blacklists”, to the abolition of discriminatory

¹ It is currently subject to further analyses and discussions whether a new patent box regime is in compliance with the OECD’s modified nexus approach and/or whether input-related R&D incentives should be implemented at a later stage.

² The actual form and type of the TP documentation will be clarified by decree (Verordnung). TP documentation has to be submitted upon request by the Liechtenstein tax administration.
measures (e.g. the application of higher withholding tax rates) because Liechtenstein is still considered as a tax haven and as non-cooperative or non-transparent, and to enhanced cooperation with other jurisdictions, particularly to avoid double taxation (e.g. the negotiation of additional double tax treaties).

Nevertheless, it is also expected that the BEPS project will lead to more double taxation, tax audits and disputes and to higher compliance costs. In the absence of a broad network of double tax treaties, this will be particularly challenging for Liechtenstein headquartered MNEs. The number of cases of dispute and the resulting double taxation in the area of TP is also expected to rise because the arm’s length principle will increasingly come under pressure as alternative and often diverging fundamental principles are being applied (e.g. different forms of formulary apportionment) by tax authorities on different sides of the same intercompany transaction.

1. Background and current TP rules

For many years, Liechtenstein had the reputation of being a tax haven, given various special tax treatments which were available under the old Tax Act of 1961. However, effective 1 January 2011, Liechtenstein has implemented a fundamental tax reform with the ambition of complying with generally accepted international standards and requirements but also remaining attractive for corporates and other investors. For legal entities, this attractiveness was achieved through a flat corporate income tax rate of 12.5 per cent as well as by the introduction of some other instruments which were also implemented by various other jurisdictions, particularly in the EU, such as a notional interest deduction mechanism and an IP box regime.

Besides the 2011 tax reform, Liechtenstein has taken various additional measures to become more transparent and to become known as a cooperative jurisdiction in tax matters. In this context, Liechtenstein became a member of the Global Forum on Tax Transparency and Exchange of Information for Tax Purposes, signed and ratified the Multilateral Convention on Mutual Administrative Assistance in Tax Matters (MAC), signed and ratified a multitude of bilateral tax information exchange agreements as well as various double tax treaties, both with European and non-European jurisdictions. Despite all these developments, Liechtenstein is still seen as a tax haven or as non-cooperative by various jurisdictions, which is hard to understand given all the transparency and cooperation measures taken by Liechtenstein in the past few years. Liechtenstein’s being “blacklisted” in some jurisdictions also gives MNEs headquartered in Liechtenstein a tough time – like the reporter’s employer, an industrial company founded in Liechtenstein in 1941 by two brothers and nowadays present in most countries worldwide with over 23,000 employees – due to, inter alia, an increased risk of tax audit and, consequently, of

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3 The same as the statutory corporate income tax rate in Ireland, a member of the EU. Liechtenstein is a member of the European Economic Area (EEA) but not of the EU. Nevertheless, being located in the heart of Europe, compliance with EU tax rules and standards was key when drafting the 2011 tax code.
double taxation. This also hinders the investments of such Liechtenstein-headquartered companies in other jurisdictions, e.g. due to the double taxation risk or high profit repatriation costs.

Given the still attractive but also internationally compliant, transparent and cooperative tax environment in Liechtenstein, so far there has been no actual need for specific TP regulations and the focus of the Liechtenstein tax administration on TP matters has been limited. However, the 2011 Tax Code includes the arm’s length principle (article 49 – *Fremdvergleichsgrundsatz*) and provides that transactions between related parties (domestic and cross-border) have to be conducted in accordance with the arm’s length principle. Furthermore, article 97 of the 2011 Tax Code contains further regulations on the obligations of the taxpayer to cooperate with the tax administration (*Mitwirkungspflichten*). Under these obligations to cooperate, the Liechtenstein tax administration can also ask for documentation to support the arm’s length nature of a taxpayer’s intercompany transactions. Apart from this, however, the Liechtenstein tax rules have not included any specific TP documentation requirement thus far.

2. Impact of the BEPS project on TP

2.1. Introduction

In the endeavour to remain compliant with international standards and to further demonstrate its transparent and cooperative behaviour, the BEPS project will have an impact on TP in Liechtenstein. Liechtenstein is committed to implementing all minimum standards resulting from the BEPS project.

Liechtenstein has closely followed the developments of the BEPS project and proposed various changes to the 2011 Tax Code in May 2016, such as:
- the introduction of the correspondence principle for dividends to avoid double non-taxation (BEPS Action 2);
- the abolition of the existing IP box regime (BEPS Action 5);
- a definition of the term “ruling” (BEPS Action 5);
- the introduction of a TP documentation requirement (BEPS Action 13).

In addition to the above, Liechtenstein also proposed the introduction of a CbCR obligation in a separate piece of legislation (BEPS Action 13). Liechtenstein was among the first signatories of the OECD Multilateral Competent Authority Agreement on the Automatic Exchange of Financial Account Information on CbCR (MCAA CbCR) in January 2016.

All proposed changes will become effective from 1 January 2017.4

With respect to TP, the abolition of the IP box and the changes related to BEPS Action 13 in particular are worthwhile looking at in more detail.

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4 Theoretically, a facultative referendum could be called against the changes to the Tax Code and the introduction of the new CbCR legislation (in accordance with the Constitution of Liechtenstein). Such a referendum would delay the implementation of the laws. However, this should not be the case in practice as so far no political party or any other stakeholders have announced that a referendum should be held.
2.2. Abolition of IP box

As mentioned above, the IP box was introduced in 2011 as a special regime to further enhance Liechtenstein’s attractiveness in the context of the 2011 tax reform (article 55 of the 2011 Tax Code). Similar IP boxes were also introduced by various EU members but also by non-European countries and, therefore, the IP box concept was considered to be in line with EU rules and standards. The Liechtenstein IP box regime was previously also presented to the surveillance authority (ESA) of the European Free Trade Association for a review in respect of compliance with state aid rules and ESA approved the appropriateness of the instrument.

However, Liechtenstein’s IP box has a broad definition of IP under which patents, trademarks, designs, software, technical and scientific databases are covered. IP that was developed or acquired after 1 January 2011 could be covered under the IP box regime. The wide scope of eligible IP under Liechtenstein’s IP box, however, is not compliant with the OECD’s modified nexus approach. Therefore, the current IP box regime is proposed to be abolished, while there will be a transitional provision until the end of taxation year 2020 for taxpayers which applied the IP box regime before 30 June 2016. This transitional period is also in line with the criteria developed by the OECD in the context of BEPS Action 5.

It is currently subject to further analyses and discussions by the tax administration and other stakeholders whether Liechtenstein should introduce a new patent box regime which is in compliance with the OECD’s modified nexus approach and BEPS Action 5. In this context, it is also analysed and discussed whether input-related R&D incentives (e.g. R&D tax credits, super-deduction of R&D expenditures) should be introduced in Liechtenstein, either as a substitute for the current IP regime or in addition to a new, OECD-compliant patent box regime.

2.3. TP documentation rules

With the proposed changes to Liechtenstein’s 2011 Tax Code, the current article 49, which stipulates that transactions between related parties have to be conducted in compliance with the arm’s length principle, is to be amended by two additional paragraphs. The existing first paragraph of article 49 is amended by a clarification that the arm’s length principle will not only apply to transactions between related companies but also to transactions with related permanent establishments.

The first of the additional paragraphs under article 49 provides that taxpayers engaging in transactions (domestic and cross-border) with related parties (including separate legal entities as well as permanent establishments) have to document the appropriateness of the applied transfer prices for material transactions in specific TP documentation. The second of the additional paragraphs states that the government will clarify by means of a decree (Verordnung) the details with respect to appropriate transfer price determination and the type and form of the required TP documentation.

There will be no general filing obligation of the TP documentation but the TP documentation would need to be submitted to the Liechtenstein tax administration upon request. Furthermore, the TP documentation requirement will generally only apply to large companies. Large companies are defined according to the criteria of article 1064 of the Liechtenstein Persons and Companies Code (Personen- und
Based on the currently applicable thresholds under the PGR, at least two of the following three values have to be exceeded to qualify as large companies:

- a balance sheet total of CHF 25.9 million;
- net sales of CHF 51.8 million;
- number of employees (business year average): 250.

For companies which do not qualify as large taxpayers based on the above criteria, relaxed documentation rules will apply (to be determined in the decree).

With respect to the general content of the TP documentation for large companies, it can be expected that the decree will stipulate that appropriate TP documentation has to be prepared in accordance with the general OECD guidance as described in the final report on BEPS Action 13. The Liechtenstein government’s comments on the proposed changes to the Tax Code make direct reference to the master and local file concept proposed by the OECD under BEPS Action 13 as well as to the OECD TP guidelines and also include a summary of the general content of the master and local file in accordance with the final report on BEPS Action 13. However, at the time of the preparation of the present branch report (October 2015) no further official guidance has been published in connection to the actual type and form of the TP documentation under the proposed amended article 49 of the Tax Code.

In assessing TP matters, it can furthermore be expected that also the Liechtenstein tax administration will consider the results of the BEPS work in connection with Actions 8–10 and the new OECD TP guidelines.

### 2.4. CbCR legislation

In addition to the proposed changes to the tax code as summarized above, the Liechtenstein government also proposes the introduction of CbCR legislation in response to the BEPS project. Like the changes to the tax code, the new CbCR legislation will enter into force effective from 1 January 2017.

As mentioned above, Liechtenstein was part of the first group of countries to sign the MCAA CbCR on 27 January 2016. To actually implement this, which is based on the MAC, it is required that domestic transposition legislation is introduced. In August 2016, the Liechtenstein government proposed the ratification of the MCAA CbCR and the introduction of new CbCR legislation.

Due to the introduction of the proposed CbCR legislation, some additional minor adjustments to the Tax Code are required in respect of the provisions on the administrative assistance (Verwaltungshilfe; article 84 of the Tax Code), the disclosure requirements (Anzeigepflicht; article 85 of the Tax Code) and data processing (Datenbearbeitung; article 86 of the Tax Code). These articles currently only make specific reference to the FATCA agreement and the automatic exchange of information. The articles will be amended to that effect that they cover all international agreements, including agreements in connection with the CbCR. These changes to the Tax Code will become effective on the same date as the CbCR legislation.

While the wording and provisions of the MCAA CbCR are predefined by the internationally agreed standard, the proposed CbCR legislation was drafted to

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5 Liechtenstein ratified the MAC in August 2016.
cover the relevant provisions and definitions of the model CbCR legislation proposed by the OECD under BEPS Action 13 and taking into account certain domestic legislative requirements. The legislation largely follows the proposed Swiss CbCR legislation.

The structure, content and information requested of the CbCR under the proposed Liechtenstein legislation are fully in line with the OECD’s recommendation under BEPS Action 13. Also the definitions contained in the CbCR legislation follow the OECD’s model legislation. Liechtenstein headquartered MNEs with an annual consolidated group revenue of CHF 900 million or more will be required to file a CbCR.6 As the CbCR legislation will enter into force effective from 1 January 2017 and as laws in Liechtenstein generally cannot be implemented with a retroactive effect, Liechtenstein headquartered MNEs will be required to file their first CbCR for taxation years beginning on or after 1 January 2017. Therefore, the first automatic exchange of CbCR is expected to take place during the first half of 2019 containing information related to taxation year 2017. Liechtenstein headquartered MNEs may, however, be allowed to file the CbCR for taxation year 2016 with the Liechtenstein tax administration for exchange purposes on a voluntary basis.

The CbCR has to be filed within 12 months following the end of the reporting period with the Liechtenstein tax administration. The proposed CbCR legislation contains comparatively severe penalties in the case of non-compliance. The maximum penalty can be as high as CHF 250,000.

Liechtenstein’s proposed CbCR legislation also includes a secondary filing mechanism under which the Liechtenstein tax administration can request a CbCR from a Liechtenstein “constituent entity” of a foreign headquartered MNE if the Liechtenstein tax administration does not obtain the CbCR for this particular MNE from the tax authority of the ultimate parent entity (or, potentially, from the tax authority of a surrogate parent entity designated by the MNE) or if there is a “systemic failure” in the reporting entity’s jurisdiction.

Furthermore, the proposed CbCR legislation also allows for surrogate filing as also suggested in the OECD’s model legislation related to CbCR.

2.5. Reception of BEPS project and whether it can work in favour of MNEs

Liechtenstein based MNEs7 generally highly welcome that Liechtenstein assumes an active role in the implementation of the BEPS project and that Liechtenstein committed at a very early stage to introduce the minimum standards of the BEPS project. After the efforts of the 2011 tax reform and the subsequent measures taken by Liechtenstein to become more transparent, cooperative and compliant

6 The conversion from the €750 million threshold stipulated by the OECD to Swiss francs was made based on the exchange rate as of 1 January 2015. This threshold/conversion may be reviewed on a regular basis.

7 As most people probably associate Liechtenstein with banks and financial services, it may be worthwhile noting here that the industrial sector contributes approximately 40 per cent to Liechtenstein’s annual gross domestic product while the financial services sector’s share amounts to roughly 24 per cent (Office of Statistics – Principality of Liechtenstein: Liechtenstein in Figures 2016).
with international rules and standards, it is crucial for Liechtenstein headquartered MNEs that Liechtenstein is considered as “BEPS compliant” and that Liechtenstein complies with new or adapted internationally accepted standards. All this is important to further improve Liechtenstein’s reputation abroad, within the European environment and also in non-European countries, where the positive developments in such a small jurisdiction may not be monitored and recognized and where Liechtenstein is sometimes still considered a non-transparent and non-cooperative tax haven.

Looking at it from this angle, there is at least the hope that the BEPS project and Liechtenstein’s active participation and implementation of the various BEPS measures will lead to the increased removal of Liechtenstein from tax haven “blacklists”, to the abolition of discriminatory measures because Liechtenstein is still considered as a tax haven, as non-cooperative or non-transparent (e.g. incurs the application of higher withholding tax rates), and to enhanced cooperation with other jurisdictions, particularly to avoid double taxation (e.g. negotiation of additional double tax treaties and, as such, also obtain access to mutual agreement procedures and/or arbitration). All this could also be beneficial for the other jurisdictions as further or new investments by Liechtenstein based companies may be boosted in those jurisdictions.

Notwithstanding the above, Liechtenstein MNEs have the same or similar concerns as many MNEs based in other jurisdictions, including the expectation that double taxation, tax audits and disputes and the administrative burden will substantially increase in the “post BEPS” world. Such consequences may be even more severe for Liechtenstein headquartered taxpayers due to the lack of a broad network of double tax treaties. More specifically in the area of TP, there is a concern that – particularly but not exclusively in developing and emerging economies – the arm’s length principle will come more and more under pressure and that (often simplified or rudimentary) profit splits and/or formulary apportionments will be increasingly applied by tax authorities. If diverging fundamental principles and approaches are applied on the different sides of a transaction, this will inevitably lead to more disputes and a higher risk of double taxation, again even more so if no treaty protection is available.

In addition, another major concern is that certain individual countries or supra-national institutions are now taking advantage of the changing environment to implement unilateral measures which go far beyond the consensus reached under the BEPS project and which will lead to even higher compliance costs and, at least to some extent, also prohibit the implementation and/or maintenance of consistent and coherent tax and TP policies. This will, in turn, again affect the ability to defend the appropriateness of a given transaction as there may no longer be an agreed fundamental principle which can be used on all sides of the transaction.

Also the public disclosure of the CbCR is generally not welcomed by MNEs in Liechtenstein, as companies fear that data disclosed could be misinterpreted by the public if not analysed in the context of other relevant information, such as the master and local files or other documentation that a taxpayer may need to provide to the tax authorities during a tax audit.

Some representatives of larger MNEs have recently argued that one positive aspect of the BEPS initiative is that in-house tax managers together with their external consultants are forced to have a closer look at the MNE’s actual business
processes and value chain. While it is true that the new TP documentation requirements under BEPS Action 13 and various revised country-specific TP documentation rules and regulations request substantially more information on the overall business of an MNE and the actual role of the local entities, including a description and – at least in some cases – a quantification of the supply and value chains, an in-depth understanding of the business and a close relationship with all relevant stakeholders of a business should have always been at the core of an in-house tax and TP position. However, it is certainly correct that the outcome of the BEPS project requires in-house tax and TP managers as well as external consultants to run certain structured analyses to support and substantiate previous, relatively high level business descriptions. Furthermore, the BEPS project and the increased media coverage have probably also helped in-house tax people to explain the importance of tax topics and particularly of tax compliance to the top managers, including the C-suite and the board of directors.

3. Thoughts on TP beyond BEPS

The main challenge in the area of TP in a “post BEPS” world will be the application of diverging principles by tax authorities. While the OECD does not cease to stress that the arm’s length principle remains the fundamental principle for evaluating and assessing TP matters and that profit splits are only applicable under a few specific circumstances,8 various forms of formulary apportionment and profit splits are on the rise. One of the reasons why such alternative approaches are on the rise nowadays more than ever before (perhaps with the exception of mainly academic debates on the advantages of formulary apportionment over the arm’s length principle) is the BEPS project itself and its “value creation theory”. Economists and other academics have been contending for quite some time that the arm’s length principle and something like a “value creation theory” are not compatible, because under the arm’s length principle it is not the actual value creation that matters and that drives and determines profit allocation; the arm’s length principle is rather based on the availability of the legal ability and rights (under the freedom of contract) to apportion functions, risks and assets and as a consequence the “created value”. Hence, if one adheres to this assessment, by stressing the importance of aligning TP outcomes with value creation and by underlining that the economic reality and not necessarily the contractual provisions have to be considered, the OECD is directly playing into the hands of the advocates of formulary apportionment. Developing or emerging economies in particular appear to have a flair for certain forms (often rather simplified and rudimentary) of formulary apportionment or profit splits (e.g. based on factors or allocation keys such as revenues, assets and employees or payroll), especially if they help to generate more tax income than if the traditional arm’s length principle and TP methods were applied. However, formulary apportionment is not only popular in some developing and

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8 Mainly in cases in which transactions are too closely interrelated to permit their separate evaluation, in cases in which each party contributes significant non-routine IP to the transactions, or in cases in which both parties share significant risks.
emerging markets, but the EU’s common consolidated corporate tax base (CCCTB) initiative would effectively also lead to formulary apportionment, and the USA and, to a certain extent, also Switzerland already apply forms of formulary apportionment to allocate the state or cantonal taxation of companies or branches that operate across the federal state.

Yet formulary apportionment in the international context would only work if all jurisdictions worldwide agreed on the same tax base calculation and the same formula to apportion the MNE’s global profits. Taking into consideration how difficult it was for the OECD and the G20 countries to reach consensus on the BEPS actions and also considering that even in a “unified market” such as the EU the implementation of the CCCTB faces huge, if not insurmountable obstacles, it is wishful thinking that all jurisdictions will agree on unitary taxation with global formulary apportionment in the foreseeable future. Instead, the problem is that various jurisdictions implement – whether officially or unofficially, e.g. by implementing “alternative” TP methods under the “arm’s length principle” – different forms of formulary apportionment or profit splits and that some jurisdictions (including Liechtenstein) will stick to the “traditional” arm’s length principle. As a consequence, there is now an increased risk that different jurisdictions and their tax authorities will apply different fundamental principles when dealing with TP. As outlined above, this will inevitably lead to higher compliance costs (as different principles have to be considered and a consistent and coherent tax and TP policy will not be maintainable) and more disputes, which will be hard, if not impossible, to resolve and consequently end up with double taxation.

Some time ago, a few South African Members of Parliament suggested banning this thing called “transfer pricing”. We have probably never been further away from this sublime ambition…
Summary and conclusions

Luxembourg being a founding member of the OECD, the Luxembourg tax authorities have referred to the OECD transfer pricing (TP) guidance in applying domestic TP principles. Reference to the OECD TP guidelines for assessing the arm’s-length character of intercompany transactions has been made since 2011 and has covered intra-group financing transactions.

The existing TP framework was formalized with effect from 1 January 2015, to demonstrate the alignment of Luxembourg TP rules with internationally accepted TP guidelines and regulations. To this end, further to the formalization of the Luxembourg TP legislation, profits of associated enterprises, entering into transactions (irrespective of transaction type), should meet the arm’s length principle.

Luxembourg, as an OECD and EU member, actively follows and supports the OECD base erosion and profit shifting (BEPS) action plan as well as EU measures taken to fight BEPS. Luxembourg has always been extremely efficient when implementing EU directives, so that it can be expected that any measure taken or to be taken by the EU (or at OECD level) will be implemented in Luxembourg within the required time frame.

1. Current TP regulation and practice in Luxembourg

Luxembourg being a founding member of the OECD, the Luxembourg tax authorities have referred to the OECD TP guidance in applying domestic TP principles. Indeed, reference to the OECD TP guidelines for assessing the arm’s length character of intercompany transactions has been made since 2011 in Circular No. 164/2 about intra-group financing transactions. In addition, the commentaries regarding TP matters between related parties in the 2015 Budget Law also refer to the OECD TP guidelines as designed to be observed by multinational companies (MNEs) and by tax authorities.

In practice, prior to January 2015, domestic regulations enabled the Luxembourg tax authorities to adjust the taxable income of a Luxembourg enterprise via

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tax assessments, for example if the profit allocation between related parties did not reflect the economic reality of the transaction or when the allocation was not under arm’s length terms.

As indicated above, back in 2011, the Luxembourg tax authorities released two circulars providing guidance on the tax treatment applicable to companies carrying out intra-group financing activities, including all types of financing arrangements, covering bonds and potentially certain cash pooling activities. Circular No. 164/2 clarifies that the arm’s length remuneration of transactions, falling in its scope, has to be determined using article 9 of the OECD model. Moreover, it explains the two main requirements, namely the minimum equity at risk and the minimum substance requirements, and defines the procedure to follow to obtain written confirmation from the Luxembourg tax authorities. Circular No. 164/2 bis clarifies the effect of Circular No. 164/2 on intra-group financing transactions set up prior to its issuance.

The existing TP framework was formalized with effect as from 1 January 2015, to demonstrate the alignment of Luxembourg TP rules with internationally accepted TP guidelines and regulations. To this end, further to the formalization of the Luxembourg TP legislation, profits of associated enterprises entering into transactions (irrespective of transaction type) should meet the arm’s length principle. Therefore prices for the transfer of goods, services or financial arrangements should be determined according to third parties’ open market conditions and taxed accordingly. Hence, both upward and downward TP adjustments in the context of domestic and cross-border transactions are possible. The arm’s length principle is applicable to all taxpayers, regardless of the legal form under which they exercise their activities in Luxembourg (including tax opaque collective undertakings and tax transparent partnerships, and also individuals carrying on business activities and collective undertakings without legal form). Indeed, the amended legislation defines the arm’s length principle in line with the concept provided in the OECD model article 9(1).

With the view to implementing the guidance for the application of the arm’s length principle as set out in Actions 8–10, on 12 October 2016, the Luxembourg government proposed the introduction of a new TP article in the Luxembourg tax legislation. The new article contains the basic principles to be respected in the framework of a TP analysis, indicating the comparability analysis as the starting point for any TP exercise. If adopted in the proposed form, the new article will offer more clarity on the tools and approaches to be considered by taxpayers when applying international TP guidance and standards under Luxembourg law.

2. The impact of the BEPS project on TP

2.1. Introduction

Luxembourg has stated its willingness to be fully compliant with the new international framework, and in particular the TP guidelines in the BEPS Actions Plan, as well as with the OECD’s and EU’s exchange of information requirements for
rulings. Some of the most important recent changes reflected in the Luxembourg tax legislation relate to TP and transparency matters.

BEPS Action 5 contains two measures that have had considerable impact on the Luxembourg tax environment: the substantial nexus rules for patent box regimes and the automatic exchange of information on tax rulings. The patent box measure laid down in Action 5 was partially reflected in Luxembourg by the abolition of the existing Luxembourg intellectual property (IP) regime (as of 1 July 2016, with a grandfathering period of five years). Meanwhile, the government also announced the introduction, at a later stage, of a new regime which would be in line with the nexus approach.1

Furthermore, in the context of Action 5, Luxembourg enables automatic exchange of information related to tax matters. In addition, the existing ruling procedures have been complemented with advance tax clearances and advance pricing agreements requests, which are subject to fees and applications reviews by the Tax Ruling Commission.

Actions 8–10 and 13 have encouraged the Luxembourg tax authorities to proceed towards the formalization of TP requirements in the Luxembourg tax legislation since 1 January 2015. The reworded arm’s length principle aligns Luxembourg regulations with EU law, but also with the OECD guidance, by introducing TP regulations applicable to companies of any legal form and engaged in any type of transaction, either domestic or foreign. Luxembourg will also be implementing country-by-country reporting requirements in line with related OECD guidance and EU-related directives.

In addition, the guidance for applying the arm’s length principle set out in Actions 8–10 is intended to be reflected in the Luxembourg TP legislation through the introduction of a new article, which aims at reinforcing that the methods to be used for the determination of the appropriate arm’s length compensation must take into account the OECD comparability factors and be coherent with the nature of the accurately delineated transactions.

Within the Luxembourg TP environment, Actions 2, 4, and 6 are also of particular importance, due to the fact that they affect the main related party transactions occurring in Luxembourg. In fact, Luxembourg has adopted the revised EU Parent–Subsidiary Directive, restricting intra-EU use of hybrids, effective as of 2016 and the EU Anti-Avoidance Directive that will be enforced prior to its deadline in 2019.2

2.2. Challenges of transactions with intangibles

Increasing awareness has been noted among Luxembourg tax practitioners, taxpayers and tax authorities in the area of transactions involving intangibles. Taxpayers and tax practitioners have become more focused on aligning their business purpose with their economic presence, due to increasing demands from the tax authorities’ side when scrutinizing such transactions.

1 Written answer provided by the Luxembourg Ministry of Finance on 4 February 2016 further to parliamentary question no. 1673.
2 Extended deadlines may apply for certain matters, e.g. interest deductibility, exit tax.
2.2.1. Definition of intangibles

The concept and categorization of intangible assets are not specifically depicted in the Luxembourg tax and TP legislation.

Particular reference to IP categories can be found in the context of the IP regime introduced in Luxembourg on 1 January 2008 (abolished in 2016) and further guidance on its interpretation is mentioned through Circular No. 50bis/1 dated 5 March 2009. The circular defines the legislative framework, which outlines the qualifying types of IP, and also indicates the OECD model article 12 as an additional source of guidance. In particular, software copyrights are indicated as being regulated by the Luxembourg Copyright Law of 18 December 2001 and derive from the initial development of computer software, excluding changes in programming language. Moreover, patents are regulated by the Luxembourg Patents Act (Law of 20 July 1992), qualifying them as new inventions, which in turn implies a creative activity that can also be applied at the industrial level.

Trademarks, designs and models are regulated by the Benelux Convention on IP (signed in The Hague, on 25 February 2005), to which Luxembourg has adhered. Within the Benelux provisions, designs and models represent the appearance of products, to which specific features are attributed. While individual trademarks are referred to as denominations, designs, seals, letters, numbers or other signs which can be graphically represented and which distinguish the products/services of a company, collective trademarks are signs used by an organization to distinguish itself geographically and also by means of other features. Even though domain names are not specifically regulated by a legal provision, they are identified by Circular No. 50bis/1, dated 5 March 2009, as a personalized electronic address, corresponding to a website in the virtual environment.

The IP regime specifically excludes certain types of IP: knowhow (meaning unregistered or non-patentable professional knowledge and expertise), copyrights (other than computer software) and other rights such as original literary and artistic works, plans, formulae and secret processes and the leasing of industrial, commercial or scientific equipment.

Luxembourg generally accepted accounting principles (Lux GAAP) do, however, provide useful guidance, while attempting to shape the current concept of IP for Luxembourg tax and TP purposes and considering the broad principle applicable in Luxembourg legislation, based on which the fiscal balance sheet should in principle follow the accounting one. The Lux GAAP identify intangible assets as items without physical substance, composed of research and development expenses, concessions, patents, licences, trademarks and similar rights and goodwill.

In line with the OECD nexus approach developed in Action 5, the Luxembourg government has abolished the IP regime as of 1 July 2016 (with a grandfathering period of five years). It is anticipated that new measures will apply to specifically defined categories of intangibles.

As such, apart from the inherent changes to be brought forward by the introduction of new IP measures, there have been no specific comments by the Luxembourg tax authorities to define the concept of intangibles in a uniform manner, as a consequence of the BEPS recommendations. Nevertheless, Luxembourg will implement in its legislation the guidelines or directives related to this matter issued by organizations to which it belongs.
2.2.2. Transactions with intangibles

The general principle, by means of which the fiscal balance sheet should follow the accounting one, is generally also applied by tax practitioners in identifying embedded intangibles for Luxembourg TP purposes. A specific intangible is identified for tax and TP purposes, if it has previously been labelled as such for accounting purposes. As per the Lux GAAP, intangible fixed assets are recognized when the control (generally the property rights) is transferred for valuable consideration.\(^3\)

In identifying embedded intangibles for TP purposes, careful consideration should be given to certain provisions of the 2009 Circular clarifying the application of the IP regime. According to this guidance, there may be situations in which contracts involving IP licensing also include the provisions of additional services or rights, which do not fall in the scope of the IP regime. In such a case, emphasis is placed on the necessity of splitting the revenue streams, in order to identify the eligible income.

In the past, a common approach was that the ownership of an intangible was attributed prima facie to the legal owner; however, further analysis was often performed to ensure alignment with economic ownership. Nevertheless, the guidance on the partial exemption of income, derived from qualifying IP rights under the Luxembourg IP regime, clearly refers to the situation in which the legal and economic ownership of the IP rights do not belong to the same person. The guidance notes that, even though in most cases legal and economic ownership generally coincide, an asset should be allocated for taxation purposes to the person who behaves in such a manner as to remove all possibility of the legal owner disposing of this asset.\(^4\) Consequently, the economic owner has to be considered as the owner of the IP, for the purposes of applying the IP regime, and thus only the beneficial owner can claim the benefits of the IP right. In practice, the OECD guidance is also referred to in these situations. This approach is reflected also in IP related case law which refers to the Luxembourg Tax Adaptation Law to highlight that the facts and legal circumstances of a transaction should be analysed according to economic criteria.

In line with the current attempts of the Luxembourg tax authorities to impose stricter conditions, including on IP companies, the OECD TP standards are also applied in the case of transfers of intangibles, irrespective of the jurisdiction to which the IP is being transferred.

2.2.3. “Substance-over-form” approach toward intangibles

Certain anti-abuse regulations as regards transactions involving intangibles are specifically identified in the Luxembourg legislation. \(\text{Inter alia,}\) with the goal of preventing abusive use of the IP regime, Luxembourg legislation provides that taxpayers should evaluate qualifying IP, as well as income paid thereon, by reference to general TP standards. The purpose of this rule is to prevent a transfer of IP to Luxembourg for a below market value, as well as to prevent the overcharging of royalties to the benefit of the Luxembourg taxpayer,

\(^3\) Art. 55 of the Accounting Law, December 2002.

\(^4\) Court Case no. 36612C dated 25 February 2016 of the Luxembourg Administrative Court.
with a view to eroding the basis at the level of the payer in a foreign jurisdiction and to benefiting in Luxembourg from an 80 per cent exemption. In addition, various other conditions were stipulated for the regime to apply, such as the acquisition or constitution date of the IP right being after 2007, acquisition not to be made from a directly related party, as well as recapture of expenses incurred to develop the IP right.

In a broader TP context, the draft law introduced to Parliament on 12 October 2016 provides for situations in which related party transactions (and thus also transactions involving intangibles) may be disregarded for TP purposes. The determining factors for assessing such situations would be the commercial rationality of a transaction’s elements and the impact of such elements on determining the arm’s length price of the transaction. If adopted in the current form, the draft law would implement in the Luxembourg tax legislation the recommendations laid down in the guidance for applying the arm’s length principle set out in Actions 8–10.

2.2.4. Comparability and group synergies

In the light of the legislative reference made to the OECD guidance in the area of TP, the OECD principles are also referred to for the identification of such synergies. No specific measures have been indicated at this stage by the Luxembourg tax authorities further to the BEPS guidance in the area of group synergies and their impact on comparability.

2.2.5. Hard-to-value intangibles

Luxembourg TP legislation does not provide for a specific valuation methodology to be followed in cases involving transactions with intangibles. However, the tax legislation indicates that under the IP regime, when dealing with transactions between related parties, the remuneration must be computed bearing in mind the arm’s length principle. Consequently, any commonly used valuation method for valuing IP rights can be used for this purpose.

In practice, when dealing with hard-to-value intangibles, the valuation tools used in compliance with international valuation standards are of great help. Indeed, the preparation of a tax valuation report to determine the fair market value of such hard-to-value intangibles, in order to best reflect their arm’s length price, allows the taxpayer to gather many factors, such as parties purchases’ strengths, risks assessment, synergies, location savings, innovation and SWOT elements present in open market transactions.

In the absence of other specific valuation methodology indicated for intangibles, the general valuation legislation in Luxembourg can also be applied while analysing transactions involving intangibles from a TP perspective. In this respect, Luxembourg tax legislation distinguishes between fixed assets (which can be depreciated) and others (land, shareholding and current assets). The general valuation rule for the other assets provides that they should be valued at acquisition price or production cost, with certain exceptions being applicable. Luxembourg legislation does not provide for specific regulations as regards hard-to-value

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5 Art. 21 of the Income Tax Law.
intangibles and, at this stage, no immediate measures are envisaged further to the BEPS guidance.

2.2.6. Cost contribution agreements (CCAs)

In light of the legislative clarifications introduced in the Luxembourg tax legislation in the area of TP, as of 1 January 2015, reference can be made to the OECD guidance on CCAs. In addition, in the absence of particular guidance in this respect, differences are not expected to surface while analysing the TP aspects of a CCA compared to other related party arrangements.

At this stage, no specific measures have been announced by the Luxembourg tax authorities further to the BEPS guidance in the area of CCAs.

2.3. Risk and capital

As of the preparation date of the present survey, no tax bill or corresponding draft involving TP measures, aligned with the Actions 8–10 report, to control the return on capital or the compensation for the assumption of risk have been released.

However, back in December 2014, the Luxembourg Parliament approved the draft law on the implementation of the first part of the “Package for the Future”, under which article 56 of the Luxembourg Income Tax Law makes explicit reference to the arm’s length principle, as found in article 9(1) of the OECD model:

“When an enterprise participates, directly or indirectly, in the management, control or capital of another enterprise, or where the same individuals participate, directly or indirectly, in the management, control or capital of two enterprises and where, in either instance, the two enterprises are, within their commercial or financial relations subject to conditions made or imposed which differ from those which would be made between independent enterprises, the profits of these enterprises are to be determined under conditions prevailing between independent enterprises and taxed in consequence.”

Hence, as of 1 January 2015, by law, the recommendations of the OECD TP guidelines to control the return on capital or the compensation for the assumption of risks should have been properly depicted within the TP documentation of Luxembourg taxpayers, in order for enterprises to justify their intra-group transactions and determine their arm’s length taxable income in Luxembourg. However, even before 2015, the Luxembourg authorities applied OECD TP guidance. As mentioned above, back in 2011, the Luxembourg tax authorities released Circular No. 164/2 on the determination of the arm’s length compensation to be performed by Luxembourg companies involved in intra-group financing transactions, wherein explicit provisions to control the return on capital and the entity’s compensation for the assumption of risk were stated.6

6 “Intra-group financing transactions refer to any activity consisting of granting loans or cash advances to associated enterprises, refinanced by funds and financial instruments, such as public offerings, private loans, cash advances, or bank loans.” The term “associated enterprises” is defined in accordance with art. 9(1) of the OECD model (2010).
Indeed, the circular states that a company falling within its scope should have sufficient equity to assume the connected inherent risks, i.e. mainly credit risk, market risk and operational risk. Such equity should be effectively used as soon as the risk related to its financing activities has materialized.

2.4. High-risk transactions

2.4.1. Comparable uncontrolled price (CUP) and quoted prices for cross-border commodity transactions

The Luxembourg tax authorities have not yet provided any specific TP guidance related to commodity transactions. In the Actions 8-10 report preference is shown for the CUP method, which should thus prevail. However, given Luxembourg’s size and market, it would be difficult to base a comparability analysis on mere domestic comparable uncontrolled arrangements.

Therefore, in accordance with the code of conduct on TP documentation for associated enterprises in the European Union, the Luxembourg tax authorities generally accept pan-European comparable uncontrolled arrangements, to the extent that the markets these selected comparables relate to are reasonably similar to the market conditions prevailing in Luxembourg. The aim of any TP analysis, based on the CUP method, is for its result to represent a reliable approximation of a market-based outcome, in line with the arm’s length principle.

Additionally, the Luxembourg tax authorities also use the following sources for interpretation purposes (a) foreign doctrine of EU Member States, (b) relevant ECJ case law decisions, and (c) the OECD final reports/pertinent guidelines, among other legal sources. Therefore, it is reasonable to believe that the OECD TP guidelines 2016 and further revisions, which will comment on transactions with commodities, should be used for the interpretation of the case at hand by the Luxembourg tax authorities, as long as they do not create any distortions in connection with domestic or international binding laws or arrangements signed by Luxembourg.

2.4.2. Intra-group services

The Luxembourg TP practice for intra-group services follows the OECD TP guidelines, under which the selected TP method should be the “most appropriate method” for a particular case.

In practice, the Luxembourg tax authorities also follow the latest developments of the EU Joint Transfer Pricing Forum on low value intra-group services, and as a matter of domestic administrative policy, all TP documents must have a comprehensive economic comparability analysis/benchmark, in line with the nine-step approach, suggested in paragraph 3.4 of the OECD TP guidelines. Therefore, acknowledging that Actions 8-10 and 13 of the BEPS project have been inserted with the 2016 revised version, the reporters believe that the outcomes of other actions of the BEPS project could also be inserted in the upcoming revisions of the OECD TP guidelines (e.g. 2020). This should have an impact on such treatment, in line with the Luxembourg tax authorities’ use of foreign doctrine and OECD TP guidelines, for interpretation on a case-by-case basis.
Moreover, pursuant to the Directorate-General for Competition of the European Commission’s working paper on state aid and tax rulings dated 3 June 2016, the Luxembourg TP treatment of intra-group services needs to reflect a reliable approximation of a market-based outcome, in line with the arm’s length principle, regardless of the TP method used. The approximate nature of the arm’s length principle cannot be used to justify a TP analysis that is either methodologically inconsistent, or based on an inadequate selection of comparables. There are cases where identifying a market outcome is not straightforward and requires the use of an approximation. According to the Commission, this is not a concern as such, as long as the approximation is as precise as it can be under the circumstances.

In closing, the search for a “reliable approximation of a market-based outcome” means that any deviation from the best estimate of a market-based outcome must be limited and proportionate to the uncertainty inherent in the TP method chosen, or the statistical tools employed for that approximation exercise.

2.4.3. Profit splits in the context of value chains

Luxembourg does not yet possess any special guidelines concerning the application of TP rules to MNEs’ value chains.

In practice, the Luxembourg tax authorities welcome the use of the profit split method as a mechanism to allocate profits across the value chain, as long as it is based on an analysis comprising sound risks and which is properly documented by the parties involved in the intra-group transaction or dealing.

Therefore, it is reasonable to argue that the OECD’s work on profit splits will be taken into account by Luxembourg when drafting TP domestic regulations or informally adopting them, for instance when dealing with sophisticated value chain analyses or complex financial transactions that involve physical and virtual teams to generate enterprise economic value. This could be either by making reference to the 2016 revised version of the OECD TP guidelines or by officially adopting the profit split mechanism while applying Luxembourg TP rules.7

2.5. TP documentation

2.5.1. CbCR

Luxembourg is a valuable, implicated and driven player, in pursuit of greater transparency concerning tax matters. Indeed, since January 2015 Luxembourg has been promoting the introduction of the automatic exchange of information for tax purposes as a global standard and has implemented the automatic exchange of information on the basis of the European Savings Taxation Directive.

On 27 January 2016, ministers and top tax officials from 31 countries, including those from Luxembourg, signed the Multilateral Competent Authority Agreement, in order to facilitate the automatic exchange of CbCR called for in Action 13 of the OECD/G20 BEPS project. Consequently, Luxembourg is fully involved in the amended Accounting Directive (Directive 2013/34/EU), as approved by the

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7 Revised guidance on profit splits was published on 4 July 2016.
European Parliament and the Council on 12 May 2016 and 25 May 2016 respectively, in order to implement BEPS Action 13 on CbCR within the EU.

On 2 August 2016, the Luxembourg government submitted the draft bill no. 7031 to the Luxembourg Parliament aiming at transposing the EU Directive 2016/881 dated 25 May 2016 which imposes on Member States the implementation into their domestic laws of mandatory CbCR obligations for MNE groups. If the draft bill is adopted, Luxembourg tax resident entities qualifying as “reporting entities” will have to comply with the CbCR requirements for financial years starting 1 January 2016 and onwards.

The CbCR has a three-tier design:

(a) a master file provides a high-level overview of an MNE’s global operations and TP policies, and is provided to the tax administrations of all the countries concerned;
(b) a local file covers detailed information concerning specific inter-company transactions; and
(c) a separate CbCR, based on a common template, gives all countries a broad picture of how a company operates, including aggregate information on income, taxes paid, total employment, retained earnings and tangible assets in each jurisdiction.

This contextual information will have to be disclosed for every EU country in which a company is active and will remain available for five years.

The implementation will certainly be enacted by Luxembourg soon. Indeed, the deadline for Member States is set on 4 July 2017, thus enabling the preparation for CbCR to commence as from the first fiscal year starting after 1 January 2016.

2.5.2. Master and local files

The Luxembourg government has always highlighted the need to promote a coordinated implementation of the BEPS actions at the international level, to ensure a level playing field worldwide.

Therefore, based on the above directive and the commentary to the law, which refers to chapter V of the 2016 OECD TP guidelines, Luxembourg is likely to include master and local files in the TP documentation requirements, in its upcoming comprehensive tax reform.

2.5.3. Compliance costs

The visibility on this matter is limited since the administrative burden of Action 13 cannot be measured yet.

2.6. TP-related measures in other BEPS actions and other measures against BEPS

Luxembourg, as an OECD and EU member, actively follows and supports the OECD BEPS Action Plan as well as EU measures taken to fight BEPS. Luxembourg has always been extremely efficient when implementing EU directives, so that it can be expected for any measure taken or to be taken by the EU (or at OECD level) to be implemented as such in Luxembourg within the required time frame.
Luxembourg and several other EU Member States and non-EU Member States have adopted or announced the adoption of TP-related measures into their domestic law, and the integration of those rules into double tax treaty conventions.

2.7. Can BEPS work in favour of MNEs?

The automatic exchange of information in the field of taxation is already in place, thus obtaining pieces of information that are necessary for Luxembourg domestic compliance is already a reality.

3. What is the future of TP?

In a general fashion, the future of TP in Luxembourg will most certainly be in line with any legislation, guidelines or directives issued by a body it is part of. An important piece of BEPS-related draft legislation was published on 21 June 2016, which resulted from the political agreement which was reached between all EU Member States on the draft Anti-Tax Avoidance Directive which covers the interest limitation rule, exit taxation, the general anti-abuse rule, the controlled foreign company (CFC) rule and hybrid mismatches.

Subsequently, on 13 July 2016, the Luxembourg government adopted tax reform plans for the year 2017. The last point of the reform states that “international developments will be monitored, particularly the concretization of the implementation of BEPS rules in the EU, to consider the necessary adjustments in the interest of the competitiveness of Luxembourg”.

GILLET, WEFFER
Summary and conclusions

The Malaysian transfer pricing (TP) regime is largely based on the OECD guidelines but there are areas where they differ, principally in the application and interpretation of the OECD standards. The arm’s length principle remains the cornerstone of Malaysian TP legislation, regulations and guidelines.

The 2015 base erosion and profit shifting (BEPS) project’s recommendations are being adopted selectively. To date the only change that is being implemented is country-by-country-reporting (CbCR) as required under Action 13. In this connection Malaysia has signed the Multilateral Competent Authority Agreement (MCAA) in January 2016 to automatically exchange CbCR. Malaysia has also signed the similar agreement in August 2015 to exchange financial information on taxpayers acquired from Malaysian financial institutions. Malaysia has also adopted the common reporting standard to collect such information for the year ending 2017.

On Actions 5–8 Malaysia is yet to adopt the OECD recommendations into its TP legislation, regulations and guidelines. However, the early indications are that the Malaysian authorities are likely to adopt a significant part of those recommendations, although the final changes will only be known when the current TP regulations and guidelines are revised and probably published sometime in 2017. Currently the reporter understands that the regulations and guidelines are being revamped and feedback has been received from interested parties such as the professional institutes.

On intangibles, in the recent budget announced on 21 October 2016 changes were made to the definition of royalty. However, the royalty provisions were not connected to the definition of the intangibles in the TP regulations. Consequently there is a disconnect between the definition of intangibles in the TP regulations and the definition of royalty in the income tax legislation. It is hoped that when the new TP regulations and guidelines are issued on 2017 there will be alignment of the definition in TP practice with the royalty provisions of the income tax law.

The guidance provided on intangibles is generally in line with the OECD guidelines. However, it is very generic and in practice the authorities will rely for guidance on the latest OECD recommendations in Actions 5–8.

Managing Director Tax Crowe Horwath
There is no guidance on how Malaysia will deal with group synergies, hard-to-value intangibles and commodity transactions.

The guidance provided in the Malaysian TP regime on cost contribution agreements (CCAs) is very broad in nature and emphasizes the need to apply the arm’s length principle in transactions between the parties to the CCA.

The recommendations in BEPS Actions 5–8 on risk and capital are likely to be adopted by the Malaysian tax authority as the current TP regulations and guidelines provide them with sufficient leeway to accommodate the recommendations when carrying out enforcement activities through tax audits.

On intra-group services (IGS), Malaysia has not indicated to date whether it will adopt the elective, simplified approach as recommended in the BEPS 2015 report.

Profit splits in the context of value chains are already accepted by the authority, although no specific guidance has been issued on the use of profit splits to avoid the shifting of profits.

Finally we will have to wait for the changes to the TP regulations and guidelines that are expected to be issued in 2017 to really understand the final direction the Malaysian authorities will take in dealing with TP matters.

1. Current TP regulation and practice in Malaysia

Malaysian TP laws, regulations and guidelines are largely based on the OECD TP guidelines subject to differences in order to adhere to requirements under the Malaysian income tax legislation and the Malaysian business environment. Fundamentally the TP regime in Malaysia reflects the OECD TP standards. The areas where they differ are principally in the application and interpretation of the OECD standards.

The 2012 Malaysian TP guidelines acknowledge in the introduction that they are “largely based on the governing standard for TP which is the arm’s length principle as set out under the OECD TP Guidelines”. They carry on later in the introductory paragraph to say:

“Although some parts of the guidelines have been adopted directly from the OECD TP Guidelines there may be areas which differ to ensure adherence to the Malaysian Income Tax Act 1967 (ITA) and the Inland Revenue Board of Malaysia (IRBM) procedures as well as domestic circumstances.”

On the application of the arm’s length principle the Malaysian TP guidelines in the introduction take a clear position that “the arm’s length principle remains as the guiding principle throughout the Guidelines”.

In practice, the areas of difference between the OECD TP standards and the Malaysian TP regime are briefly as follows:

(a) The definition of “control” is wider than the OECD meaning accorded in article 9 OECD model tax convention as the Malaysian definition is based on a definition that was introduced in the ITA that is still in force today. The definition in section 139 of the ITA was meant to define control where one or more persons exercise direct or indirect control of a company for the
purposes of taxation of certain income or treatment of benefits in kind for personal income tax purposes, etc. and therefore there is at times difficulty in establishing whether a party to a TP transaction is an associated person. Section 139 of the ITA coverage is far wider than the OECD meaning accorded in article 9 of the model tax convention.

(b) TP documentation: in practice most TP documentation submitted to the tax authority does not meet the exact standards of IRBM as part of an audit request and therefore in any settlement, penalties, albeit at a lower rate, say at 25 per cent rather than 45 per cent, do arise. This again differs from the OECD position where the OECD TP guidelines in paragraph 5.28 chapter V effectively state that taxpayers should prepare TP documentation to show that the controlled transactions have followed the arm’s length principle and that the tax authority should use this as a starting point to request more information relevant to its tax examination. All this should be conducted in the spirit of cooperation and therefore by implication if basic TP documentation is prepared by the taxpayer that shows that the taxpayer has a basis that meets the arm’s length principle, penalties for any subsequent adjustments that are mutually agreed between the parties should not trigger a penalty as TP is not an exact science.

(c) Comparability adjustments made by taxpayers to eliminate differences in respect of the comparability factors between uncontrolled transactions and controlled transactions are generally not accepted by the IRBM on the grounds that such adjustments are subjective and do not increase the reliability of the results.

(d) Comparability period and contemporaneous documentation: documentation prepared on a contemporaneous basis based on the comparable data available at that time is usually outdated by the time a tax audit takes place some years in the future. The IRBM’s position differs from that of the OECD and from the Malaysian TP guidelines (paragraph 12.1) which merely requires the taxpayer to determine its TP in accordance with the arm’s length principle at the time of determination and not subsequently.

(e) Range: the IRBM has the tendency in most cases to apply the median without considering the use of other measures such as the mean, weighted averages, interquartile range, etc. This happens even when the TP methods produce a range of figures which are relatively equally reliable; the whole range or the interquartile range is not recognized and the tax authority moves back to the median to make its adjustment. However, when cases have been settled out of court, there are occasions where the IRBM has agreed to go below the median under certain circumstances.

(f) Choice of tested party: a local party is preferred as opposed to a foreign party on the grounds of insufficient information being available on the foreign party. This accords with the prescription outlined in paragraph 3.18 of the OECD TP guidelines where the tested party in principle should be the party whose information is most easily verifiable.

(g) Use of multiple year data is allowed but not the use of averages. Comparability in practice is carried out on a year-on-year comparison basis as opposed to taking the multiple averages, i.e. tax adjustments are mostly made by comparing the results to the median. There is also no guidance on
how to deal with long-term contracts where a year-on-year comparison will not be useful.

(h) Profit split methodology is rarely applied and in most cases, the tax authority moves back to the comparable uncontrolled price method or transactional net margin method. The cost-plus and resale minus methods are also not used in practice since gross margins are rarely available in the public domain.

Overall, the application of the TP principles advocated by the OECD is acceptable and these principles are generally acknowledged in Malaysian TP laws, regulations and guidelines. A point to bear in mind is the fact that laws and regulations form part of Malaysian laws that all parties have to adhere to. However, the guidelines are guidance for applying the TP principles and they do not carry a force of law and are not binding on either the tax authority or taxpayers. In practice, the tax authority adopts the guidance in its enforcement activities.

Changes recommended from the BEPS project have not been adopted into domestic legislation or regulations except for the enabling legislation that has been proposed in the 2017 budget announced on 21 October 2016 to implement the exchange of information pertaining to the exchange of CbCR documentation.

The Malaysian tax authority and policy makers at the Ministry of Finance (MOF) have welcomed the TP outcomes of the BEPS project and plan to implement them in stages in future years subject to certain changes to fit the local business environment.

The new CbCR requirements are to be implemented for fiscal years beginning on or after 1 January 2017 to multinational companies (MNEs) with annual consolidated group revenue equal to or exceeding €750 million.

Overall, the general understanding is that the Malaysian authorities are likely to selectively adopt most of the recommendations from the OECD BEPS project under Actions 8–10 and 13.

2. Challenges of transactions with intangibles

2.1. Definition of intangibles

The basic legislation addressing TP issues is in section 140A of the ITA and it merely refers to transactions involving the supply or acquisition of property or services without providing a definition of property or intangibles. In practice, property refers to intangible property.

The definition is provided for in paragraph 11(7) of the Income Tax (TP) Rules 2012. It states that intangible property includes patents, inventions, formulae, processes, designs, models, plans, trade secrets, knowhow and marketing intangibles. In the same paragraph, a marketing intangible is defined to include an intangible that is concerned with marketing activities, which aids in the commercial exploitation of the property or has a significant promotional value for the property concerned.

Currently some of the items included in paragraph 11(7) of the TP Rules under the definition of intangibles overlap with the definition of the items included under
royalty in section 2 of the ITA. The TP regulations make no reference to the royalty definition, which is wide.

A royalty is defined in section 2 of the ITA to include:

(a) any sums paid as consideration for the use of, or the right to use:
   – copyrights, artistic or scientific works, patents, designs or models, plans, secret processes or formulae, trademarks, or tape for radio or television broadcasting, motion films, films or video tapes or other means of reproduction where such films or tapes have been or are to be used or reproduced in Malaysia or other such as property or rights;
   – knowhow or information concerning technical, industrial, commercial or scientific knowledge, experience or skill;

(b) income derived from the alienation of any property, knowhow or information mentioned in paragraph (a) of this definition.

In the recent budget announcement on 21 October 2016 it is proposed to widen the definition of royalty to the following:

“‘royalty’ includes any sums paid as consideration for, or derived from:

(a) the use of, or the right to use, in respect of any copyrights, software, artistic or scientific works, patents, designs or models, plans, secret processes or formulae, trademarks or other like property or rights;

(b) the use of, or the right to use, tapes for radio or television broadcasting, motion picture films, films or video tapes or other means of reproduction where such films or tapes have been or are to be used or reproduced in Malaysia or other like property or rights;

(c) the use of, or the right to use, know-how or information concerning technical, industrial, commercial or scientific knowledge, experience or skill;

(d) the reception of, or the right to receive, visual images or sounds, or both, transmitted to the public by:
   (i) satellite; or
   (ii) cable, fibre optic or similar technology;

(e) the use of, or the right to use, visual images or sounds, or both, in connection with television broadcasting or radio broadcasting, transmitted by:
   (i) satellite; or
   (ii) cable, fibre optic or similar technology;

(f) the use of, or the right to use, some or all of the part of the radio frequency, specified in a relevant licence;

(g) a total or partial forbearance in respect of:
   (i) the use of, or the granting of the right to use, any such property or right as is mentioned in paragraph (a) or (b) or any such knowledge, experience or skill as is mentioned in paragraph (c);
   (ii) the reception of, or the granting of the right to receive, any such visual images or sounds as are mentioned in paragraph (d);
   (iii) the use of, or the granting of the right to use, any such visual images or sounds as are mentioned in paragraph (e); or
   (iv) the use of, or the granting of the right to use, some or all of such part of the spectrum specified in a spectrum licence as is mentioned in paragraph (f); or
Currently the TP regulation which defines intangibles does not align with the royalty definition in the Act.

It is expected that once the TP rules and guidelines are amended in 2017 the definition of intangibles will become clearer and wider to accommodate the new definition of the items included under royalty in the proposed 2017 budget.

It is likely that the Malaysian authorities will follow the changes made to the TP guidelines in 2015 in paragraphs 6.5 to 6.12 in relation to the definition of intangibles in the forthcoming TP regulations and guidelines to be issued in 2017.

Ultimately the legislation has to change in due course to align the definition of intangibles in the TP regulations with the ITA 1967.

2.2. Transactions with intangibles

Currently, the only rules which deal specifically with the recognition of transactions with intangibles are in paragraph 11 of the TP regulations and guidance on these matters is provided for in paragraph 22 of the Malaysian TP guidelines and its subparagraphs.

The TP regulations deal with the situation where the associated person is not the owner but bears the expenses and risks associated with the development of the intangible property; such a person is deemed to be the owner of the intangible property. Secondly, if he is not the owner but develops the intangible property such a person is entitled to an arm’s length consideration for the development of the property. Thirdly, where a person who is not the owner of a trademark or trade name undertakes marketing activities and bears the marketing costs of such a trademark or trade name in excess of those of a comparable independent person, he will be entitled to an arm’s length consideration for undertaking such activities for the owner of the trademark or trade name.

The current TP rules and guidelines deal with both the transfer of intangible property and the use of intangibles.

The Malaysian TP guidelines provide guidance on various aspects of dealing with intangibles and are comprehensive and sufficiently broad to deal with the TP issues surrounding intangibles.

The authorities are likely to take note of changes made to chapter VI of the OECD TP guidelines and are likely to follow the direction of the OECD and ensure that profits from the transfer and use of intangibles are appropriately allocated in accordance with value creation. This is likely to be the direction the authorities will take when they issue the revised regulations and guidelines in 2017.

2.3. “Substance-over-form” approach towards intangibles

Malaysia adopts the substance-over-form approach selectively, otherwise the tax regime relies strictly on the interpretation of law. The areas where this is applied are the general anti-avoidance provision, beneficial ownership and TP. In the case of intangibles, this is evidenced in the TP regulations 11.4, 11.5 and 11.6 and in the
Malaysian TP guidelines paragraph 22, which state that where the associated person is not the owner but bears the expenses and risks associated with the development of the intangible property, that person is deemed to be the owner of the intangible property. Secondly, if he is not the owner but develops the intangible property such a person is entitled to an arm’s length consideration for the development of the property. Thirdly, where a person who is not the owner of a trademark or trade name undertakes marketing activities and bears the marketing costs of the trademark or trade name in excess of those of a comparable independent person, he will be entitled to an arm’s length consideration for undertaking such activities for the owner of the trademark or trade name.

The Malaysian TP guidelines elaborate further on the approach adopted by the tax authority and this is noted in paragraph 22.3.1 where it states that legal registration and contractual relationships are the starting points for determining which members of the MNE group are entitled to the intangible related returns. Where no written contracts exist, the contractual relationships of the parties must be deduced from their conduct and the economic principles that generally govern the relations between independent enterprises.

Paragraph 22.3.2 states that where the legal ownership of intangible property does not vest with the party that has developed the property, the developer of the intangible property would be expected to have received an arm’s length consideration for its development services. This consideration may come in the form of:

(a) a cost reimbursement (with an appropriate profit element), if the developer is a contract developer (effectively a service provider); or

(b) lump-sum compensation (with the intangible related return), if the developer bore all of the expenses and risks of development.

Paragraph 22.5 states that the value of marketing intangibles depends on many factors, including the reputation and credibility of the trademark or trade name fostered by the quality of the goods or services provided under the trademark or trade name in the past, the distribution and availability of the goods or services being marketed and the extent or success of the promotional expenditures incurred in order to familiarize potential customers with the goods or services.

Where a distributor actually bears the cost of its marketing activities, and where those costs and risks incurred as well as functions performed exceeded those that an independent distributor under similar circumstances might incur or perform for the benefit of its own distribution activities, the distributor will be expected to obtain a share of the intangible-related returns from the owner of the trademark or related intangibles.

Paragraph 22.6 (application of the arm’s length principle) states that the transfer of intangible property must take into account the perspective of the transferor/licensor and the transferee/licensee. A transferor should recover the costs associated with developing an intangible and earn a reasonable return. The value of an intangible to the transferee will be the expected benefits (additional profits) that the intangible would generate, which is usually the key consideration in determining the transfer price of an intangible for both parties.

In practice, the approach adopted by the tax authority starts with the legal analysis of the transactions and thereafter moves on to the conduct of the parties and the economic realities of the underlying transaction, i.e. who is entitled to income aris-
ing from the asset and who has control and day-to-day management of the asset, etc. Where the substance of the transaction is different from the form, the substance will prevail as indicated above in various paragraphs in the regulations and guidelines.

Currently as it stands, the development, enhancement, maintenance, protection and exploitation (DEMPE) analysis approach has not been adopted in its entirety. However, there are indications that the Malaysian tax authority may wish to adopt this approach in determining the allocation of the income related to intangibles, which will be clearer once the revised regulations and guidelines are issued.

2.4. Comparability and group synergies

There are no rules or guidance on the effects of group synergies on the comparability analysis and nor are there any provisions in the law, regulations or TP guidelines to recognize the effects of group synergies. The Malaysian TP rules are silent on this area. There has been no discussion by the tax authority on this matter.

In practice, the tax authority has not brought this forward as an issue when carrying out its enforcement activities. There is no guidance on this issue and it is necessary to wait and see the future direction of the tax authority in dealing with this issue.

The current TP laws and regulations are sufficiently broad enough for the tax authority to take this factor into account in its future analysis of the TP transactions. However, since the BEPS final reports were published in October 2015, there have been no indications from the tax authority that this will be a factor to be taken into account when conducting a comparability analysis.

2.5. Hard-to-value intangibles

The current TP regime does not address this issue specifically and therefore the general rules in applying the arm’s length principle have to be applied to such intangibles. There is also no guidance on the valuation of hard-to-value intangibles for the transfer or use of such intangibles. The indications are that this is another issue that may be addressed in the revised regulations and guidelines to be issued in 2017 and the recommendations made by the OECD could be adopted selectively.

2.6. CCAs

A CCA is recognized in Malaysia for TP purposes under the regulations and the Malaysian TP guidelines. The relevant paragraphs are 10 and 21 respectively.

The regulations only state that the allocation of cost should be consistent with the arm’s length principle but no reference is made to the recognition of the expected share of the proportionate benefit to be received under the CCA. However, the Malaysian TP guidelines acknowledge that the share of the expected benefits should also meet the arm’s length test, although, as noted in the introduction, the Malaysian TP guidelines are merely guidance and do not carry force of law.

As the current TP laws and regulations are very broad and general in nature, there is sufficient room for the tax authority to adopt the principles stated in the BEPS 2015 final recommendations when reviewing or auditing a CCA. From past experience, it is likely that the tax authority will adopt the BEPS 2015 final recommendations when scrutinizing a CCA.
However, since the BEPS final reports were published in October 2015, there have been no indications from the tax authority on when it is likely to adopt the proposed changes. From past experience it is considered that the OECD recommendations are likely to be adopted by the authorities.

It should be noted that CCAs are generally confined to MNEs. Domestic MNEs and other domestic groups of companies generally do not appear to use CCAs as a means to share the risks and benefits of any joint development, production or acquired intangibles, tangible assets or services. Therefore in practice, there is not much practical experience in either implementing or scrutinizing CCAs and nor has there been much discussion in the public domain.

3. Risk and capital

The Malaysian tax authority is aware of the possibility of taxpayers attempting to shift profits through the contractual assumption of risk and capital. It has been reviewing such actions on a hindsight basis, i.e. some years after the arrangements have been effected. It has not in practice adopted the six steps outlined in chapter 1 under section D, paragraph 1.6 of the latest TP guidelines relating to the process of analysing risks in their entirety. However, in the past, some of those steps have been adopted and they include examining written contracts to identify the allocation of the risk between the parties and to determine whether the contractual assumption of the risk has been consistent with the conduct of the parties. However, there has been less focus on who controls the risk functions and mitigation functions and who has the financial capacity to bear the risk in the event of the risk materializing.

With the changes made to the OECD TP guidelines in 2015, the tax authority appears to be aware of the need to give greater emphasis to analysing risk in examining TP cases. Although no statement or guidance has been issued in the public domain, the reporter understands that the authority will use the new guidance provided in the 2015 OECD guidelines under chapter 1 of section D in its future examination of cases.

There has not been much focus by the tax authority on whether inappropriate returns have been allocated to a party in a controlled transaction solely because it has provided capital. Again with the new TP guidance from the 2015 OECD guidelines, it is expected that the tax authority will pay more attention to this subject, but again the reporter have not seen any mention of a future direction on this issue.

4. High-risk transactions

4.1. Commodity transactions

Under the current Malaysian TP tax legislation, rules and guidelines, there is no specific mention of how commodity transactions will be dealt with. Malaysia earns significant revenues from the sale of commodities in their natural state or the sale of processed commodities.
When commodity transactions have been under scrutiny in TP audits, the tax authority has relied on the standard methodologies to examine such transactions and quite often it has used either the comparable uncontrolled price method or the transactional net margin method approach to test such transactions.

At the moment, there is no indication on the future direction of the tax authority and whether the tax authority will adopt the 2015 addendum to the OECD TP guidelines provided for in paragraphs 2.16A to 2.16E in chapter II.

It is necessary to wait and see whether the authorities will issue any specific guidance on this matter in the future when the G20 development working group within the OECD issues its findings.

4.2. IGS

There are specific rules on the treatment of IGS and they are provided for in Malaysian TP regulations paragraph 9 and in Malaysian TP guidelines 2012 in paragraph 20 part VI. The guidance provided for in the Malaysian rules and guidelines is along the same lines as the OECD TP guidelines in chapter VII.

This is an issue that the tax authority regularly examines during TP audits and it adopts the principles outlined in the OECD TP guidelines on whether the IGS have been rendered and whether they were in accordance with the arm’s length principle. Full TP analysis has always been the requirement of the tax authority, which has not relied on any safe harbour approach.

Documentation and evidence has been key in such examinations by the tax authority. In many cases, the final decision on the arm’s length charge for such services arrived at between the tax authority and taxpayers has been subjective and finally settled out of court through negotiations. No definitive formula or guidance on the arm’s length price is provided by the tax authority.

To date again there has been no indication by the tax authority as to whether it will adopt the recommendations in BEPS Action 10 which are provided in the 2015 OECD guidelines as a revision to chapter VII. We will have to wait and see whether the authorities will adopt the OECD recommendations.

4.3. Profit splits in the context of value chains

Malaysia acknowledges the use of the profit split method as one of the methods that can be used to determine arm’s length pricing in controlled transactions. This is provided in paragraph 11 part II of the 2012 Malaysian TP guidelines. They go on further to say in paragraph 11.4.1 that the profit split method provides an alternative solution for cases where no comparable transactions between independent parties can be identified. It is added that this will happen when transactions are so highly integrated that they cannot be evaluated separately.

The Malaysian TP guidelines indirectly acknowledge that where transactions are highly integrated in the context of MNE value chains and comparables cannot be found, then the profit split method will be acceptable if it is the most appropriate TP method for producing an arm’s length result.

These are generic statements but the tendency of the tax authority is generally to veer towards a transactional net margin method approach rather than the profit split method.
A general discomfort arises particularly where the contribution analysis approach is used because it is difficult to determine the relative contribution of the parties to the controlled transaction and the approach used will depend on the facts and circumstances of each case. Therefore, due to the high level of subjectivity applied in profit split method, it is not the preferred approach of either taxpayers or the tax authority.

However, when the OECD or the UN comes out with more definitive guidance on the use of profit splits to avoid the shifting of profits using BEPS arrangements, it is to be expected that the Malaysian tax authority will adopt the measures recommended.

5. TP documentation

5.1. CbCR

Currently the Malaysian tax authority has signed a number of agreements to share information and they include the MCAA in January 2016 to automatically exchange CbCR.

The CbCR will be required for companies with financial year ending 31 December 2017 to be filed with the local tax authority by 31 December 2018 or for companies whose financial year end is on a date other than 31 December, it will be one year from the close of their year end. The threshold of €750 million will equally apply in Malaysia.

The domestic legislation to implement the CbCR exchange has been introduced in the recent budget 2017 announced on 21 October 2016. The Malaysian tax authority expects to exchange the first CbCR in June 2019.

Malaysia is keen to actively share and exchange information on taxpayers with other countries to identify taxpayers who do not report tax information and consequently fall into the non-compliance category and other taxpayers who practise aggressive tax avoidance which goes beyond the currently acceptable norms and tax evasion cases.

In this regard, in addition to the MCAA signed in January 2016 to automatically exchange CbCR, Malaysia has also signed a similar agreement in August 2015 to exchange the financial information about taxpayers acquired from Malaysian financial institutions. Malaysia will report using the common reporting standard (RS) provided for by the OECD. Malaysia has committed itself to collecting such information for the financial year ending 2017 and to providing such information to its fellow competent authorities in December 2018.

5.2. Master file and local file

As it stands, most of the requirements for the master file and local file stated in recommendations to Action 13 in 2015 are already incorporated into the existing Malaysian TP documentation requirements which are outlined in appendix A of the Malaysian TP guidelines.
However, when the revised TP guidelines are issued in 2017 we can expect changes and more information along the lines stated in the OECD recommendations to be provided to the IRBM upon request.

5.3. Compliance costs

The compliance costs for companies which need to comply with the requirements in Action 13 have certainly increased. They have had to incur management time to collect data which has not been needed in the past such as cash tax paid, number of employees, tax accruals, etc. and additional information required under the master file. The level of information under the TP documentation requirements of the Malaysian TP guidelines will be sufficient to meet the requirements under Action 13.

Companies have had to incur consultancy costs for two reasons:
(a) they needed guidance since this is the first time they are attempting to collect such information to prepare the three files and requirements under the OECD Action 13 are sometimes ambiguous and the information is not normally collected for filing the annual tax returns or for preparing statutory accounts under the local general accounting standards;
(b) external consultants have had to be used by many tax departments within companies which do not have the manpower and resources to collect and prepare the documentation required.

6. TP-related measures in other BEPS actions

To date no action has been taken by the authorities to implement the non-TP BEPS actions and to implement any of the recommendations made by the OECD in 2015.

It is understood that these actions will be taken on a selective basis and over a time period in the future.

So far the only action taken to implement the BEPS action has been in the area of TP and in particular of Action 13.

Finally the changes to the TP actions and the adoption of the BEPS 2015 Actions 8–10 and Action 13 will become clearer once the revised TP regulations and guidelines are issued in 2017. However, there is a possibility from past experience that there could be a delay in the issue of the revised TP regulations and guidelines, perhaps due to the various levels of reviews by other authorities such as the Ministry of Finance and the attorney general’s office.
Summary and conclusions

Mexico has been actively involved in the base erosion and profit shifting (BEPS) project since its beginnings in 2013. Based on the recommendation of the early stages of the OECD’s action plan on BEPS, a tax bill amending the Mexican Income Tax Law (MITL) came into force on 1 January 2014.

The MITL for 2014 included certain provisions that considered as non-deductible expenses incurred to related parties which would also be deductible for the related party; likewise, expenses incurred to related parties for interest, royalties or technical assistance would not be deductible when in general the related party that received the payment did not consider it as taxable income in its jurisdiction. These provisions derive from the need to avoid the erosion of the taxable base in Mexico.

Moreover, the Federal Tax Code for 2014 includes a provision that establishes that taxpayers should submit information regarding relevant transactions which are, among others, financial derivative transactions, changes in ownership, changes in tax residency, business restructuring and reorganizations and transfer pricing (TP) adjustments. This provision is related to Action 12 of the BEPS plan on mandatory disclosure rules.

In connection with Action 13 of the BEPS project, the MITL for tax year 2016 was modified and included article 76-A, which includes an additional TP obligation consisting of a three-tiered documentation scheme: a master informative return, a local informative return and a country-by-country informative return (CbCR), which are all based on the OECD’s action plan on BEPS.

For fiscal year 2016 large taxpayers which in the immediately preceding year had income equal to or greater than $644,599,005 Mexican pesos (approximately US $34.8 million), taxpayers with issued stock in the financial market, taxpayers included in the integration regime, government companies and foreign entities with a permanent establishment in Mexico, which carry out transactions with related parties, must file with the Mexican tax authorities the following informative returns for tax year 2016 no later than 31 December 2017:

- a master informative return of related party members of a multinational company (MNE), which should include:
• a local informative return of related party members of an MNE; and
• the MNE’s CbCR.

As an exception to the obligation to file the CbCR, article 76-A states that Mexican taxpayers that qualify as MNE controlling entities, this is ultimate holding residents in Mexico, should submit CbCR when the annual consolidated revenue of the MNE group in the immediate previous fiscal year was above $12 billion pesos.\(^2\)

Non-controlling Mexican taxpayers may still be obliged to file CbCR if they were designated to do so by the foreign parent company. In addition, the Mexican tax authorities may request CbCR from other foreign tax authorities through an exchange of information mechanism.

Moreover, if the Mexican tax authorities are not able to obtain the CbCR through information exchange mechanisms with other tax jurisdictions, article 76-A establishes that they may request the Mexican entity to file CbCR and it will have a 120-day period to fulfil this request.

As may be observed from all the tax bills that derive from the BEPS Action Plan, it is clear that Mexico has been actively involved in this project. This involvement derives from the fact that the Mexican tax authorities are encouraged to eliminate BEPS to low-tax jurisdictions and it is expected that in the near future the implementation of the BEPS project regarding the above-mentioned rules in Mexico will become more active.

It may be concluded that in Mexico the BEPS project is not focused on benefitting MNEs with information that other jurisdictions may have already provided; but it has become a significant administrative burden for taxpayers since they have to comply with diverse requirements during the tax year, as well as a significant increase in tax audits.

On the other hand, regarding TP obligations in Mexico, taxpayers which undertake transactions with related parties have to prepare on an annual basis evidentiary documentation to demonstrate that the income generated and the deductions applied were in alignment with the arm’s length standard, that is, they have to prepare a TP study on an annual basis. Likewise, certain taxpayers have to file information about relevant transactions, informative returns regarding their tax situation, tax opinions and multiple informative returns.

The MITL\(^3\) establishes that for the interpretation of the provisions referring to TP issues, the OECD guidelines will be applicable. If the aforementioned guidelines are modified, they may still be employed, as long as they continue to be congruent with the provisions of the law and the treaties entered into by Mexico.

As may be observed, reference to the OECD guidelines is directly included in the MITL for interpretation of the TP provisions included in this law. Nevertheless, further analysis is required in order to determine whether the resulting guidelines from the BEPS project could be applied for interpreting the TP provisions in previous years or could only be applied as of the date of approval by the OECD of such guidelines and beyond. Issues related to the static and dynamic interpretation of the MITL and the OECD TP guidelines should be analysed.

\(^2\) As of May 2016, considering an exchange rate MXN $18.48 per US dollar, this is equivalent to approximately US$ 650 million.

\(^3\) Art. 179 of the MITL.
1. Current TP regulation and practice in Mexico

The Mexican TP provisions included in the MITL establish that taxpayers which undertake transactions with related parties are required for the purposes of the MITL to determine their income and deductions taking into account the prices that would have been used in comparable transactions with or between independent parties.4

For these purposes the MITL establishes that the following methods should be used:5
(a) the comparable uncontrolled price method (CUP);
(b) the resale price method (RPM);
(c) the cost plus method (CPLM);
(d) the profit split method (PSM);
(e) the residual profit split method (RPSM);
(f) the transactional net margin method (TNMM).

According to the provisions of the MITL, the CUP must be chosen as the first alternative when analysing related party transactions. If the CUP is not applicable, any other method may be used provided that it is demonstrated that the CUP is not applicable according to the OECD guidelines or it is demonstrated that the method applied is the most appropriate method given the available information and the OECD guidelines, giving preference to the RPM and CPLM.

The OECD guidelines establish that the selection of a TP method aims at finding the most appropriate method for each particular case.6 In Mexico it is necessary to follow the aforementioned hierarchy for applying a TP method.

The MITL7 requires the procurement and conservancy of evidentiary documentation regarding transactions carried out with non-resident related parties, which in general should consist of (a) the name, domicile and tax residence of the related parties as well as documentation showing the direct and indirect relation between related parties; (b) information regarding the functions or activities, assets and risks assumed by the taxpayer per type of transaction; (c) information and documentation on the main transactions with related parties and the amounts thereof by each party and per type of transaction; and (d) the method applied in accordance with article 180 of the MITL, including the information and documentation on comparable operations and enterprises, per type of transaction.

Notwithstanding that the MITL establishes that the obligation to procure and conserve evidentiary documentation is regarding transactions carried out with non-residents, it also states that taxpayers which carry out transactions with related parties both domestic and non-resident, should determine their income and deductions at arm’s length.8

4 Art. 76, s. XII of the MITL.
5 Art. 180 of the MITL.
6Para. 2.2 of the OECD guidelines.
7Art. 76, s. IX of the MITL.
8The tax authorities issued normative criteria 00/2012/ISR included in ruling no. 600-04-02-2012-57567 dated 23 July 2012 which establishes that taxpayers which carry out transactions with related parties, both domestic and non-resident, should determine their income and deductions
That is, in Mexico the obligation to prepare a TP study on an annual basis should consider transactions carried out with both domestic and foreign based related parties and the analyses should be performed on a transactional basis.

The MITL\(^9\) establishes that for the interpretation of the provisions referring to TP issues, the OECD guidelines will be applicable. If these are modified, they could be employed, as long as they continue to be congruent with the provisions of the law and the treaties entered into by Mexico.

As may be observed, reference to the OECD guidelines is directly included in the MITL for interpretation of the TP provisions included in that law. Nevertheless, further analysis is required in order to determine whether the resulting guidelines from the BEPS project could be applied for interpreting the TP provisions in previous years or whether they could only be applied as of their date of approval by the OECD and subsequently. Issues relating to the static and dynamic interpretation of the MITL and the OECD TP guidelines should be analysed.

2. The impact of the BEPS project on TP

2.1. Introduction

Mexico has been actively involved in the BEPS project since its beginnings in 2013. Based on the recommendation of the early stages of the OECD’s Action Plan on BEPS, a tax bill amended the MITL to come into force starting 1 January 2014.

The MITL for 2014 included certain provisions that considered as non-deductible expenses incurred to related parties which would also be deductible for that related party; likewise, expenses incurred to related parties for interest, royalties or technical assistance would not be deductible when in general, the related party that received the payment did not consider it as taxable income in its own jurisdiction. These provisions derive from the need to avoid the erosion of the taxable base in Mexico.

Moreover, the Federal Tax Code for 2014 includes a provision that establishes that taxpayers should submit information regarding relevant transactions which are, among others, financial derivative transactions, change in ownership, changes in tax residency, business restructuring and reorganizations and TP adjustments.\(^10\) This provision is related to Action 12 of the BEPS plan on mandatory disclosure rules.

Finally, in connection with Action 13 of the BEPS project, on 18 November 2015, the MITL in force starting 2016 was modified and included article 76-A, which includes an additional TP obligation consisting of a three-tiered documentation scheme: a master informative return, a local informative return and a CbCR, which are all based on the OECD’s Action Plan on BEPS.

\(^9\) Art. 179 of the MITL.

\(^10\) This provision refers to the Official Form No. 76.
As may be observed from all the tax bills that derive from the BEPS Action Plan, it is clear that Mexico has been actively involved in this project. This involvement derives from the fact that the Mexican tax authorities are encouraged to eliminate BEPS to low-tax jurisdictions and it is expected that in the near future the implementation of the BEPS project regarding the above-mentioned rules in Mexico will become more active.

2.2. Challenges of transactions with intangibles

2.2.1. Transactions with intangibles

The Mexican TP provisions do not have a specific definition of an intangible asset for tax or TP purposes.

Notwithstanding, the MITL recognizes transactions that involve the exploitation or transfer of intangible assets which should be determined based on the arm’s length standard. For such purposes, the law establishes that the type of intangible asset, i.e. whether it is a patent, trademark, trade name, transfer of technology, as well as the duration and degree of protection of the intangible asset, should be taken into consideration.

Furthermore, the MITL recognizes intangible assets for TP purposes, as they are considered in the RPSM method, which in general terms consists in determining a minimum profit generated by each related party involved in a transaction to determine the minimum profit that each company must generate by routine contributions; any excess profit over the routine profit is defined as the “residual profit”.

The residual profit associated with the controlled transaction will generally be attributable to intangible assets owned by one or more of the participants in the controlled transaction. This residual profit is split among the parties according to the relative value of the intangible property that each contributed to or utilized in the relevant business activity.

As may be observed, the provisions included in the MITL regarding intangible assets are in a certain way limited and do not provide broad guidelines when dealing with intercompany transactions that involve intangible assets, notwithstanding the provisions that govern intercompany transactions that involve intangible property.

Finally and as mentioned above, for Mexican tax purposes the OECD guidelines are a privileged source of interpretation regarding the provisions referring to TP issues for which a reference to such guidelines is included in the MITL.

In this regard, the provisions regarding intangible assets should be complemented with chapter VI of the OECD guidelines which was amended as part of Action 8 of the BEPS Action Plan.

It is important to mention that regarding transactions that consider the transfer of intangible assets for which the consideration was determined based on financial valuation techniques, the Mexican tax authorities, in their assessments which are conducted years later than the actual transaction, have challenged the assumptions included in the valuations.
2.2.2. Cost contribution agreements (CCAs)

In general terms, it should be understood that transactions related to CCAs should be valid from a tax TP standpoint and should be regarded as investments.

On the other hand, with regard to expenses for recurring services in which the considerations are established on a pro rata basis or cost allocation, the MITL in its article 28 section XVIII establishes that expenses incurred on a pro rata basis with foreign entities are non-deductible.

In year 2012, the Federal Tax Court ruled in favour of a Mexican taxpayer in a case involving the deductibility of expenses incurred abroad on a pro rata basis. This particular decision by the Superior Chamber of the Federal Tax Court was successfully challenged by the Mexican tax authorities before the Collegiate Circuit Tribunal. In essence, the Collegiate Tribunal stated that since the MITL also disallowed the deduction of pro rata expenses incurred in Mexican territory to persons who are not income taxpayers, corporate entities and individuals, no discriminatory treatment existed.

This case went to the Supreme Court of Justice and the Second Chamber ruled regarding the deductibility of expenses carried out on a pro rata basis.

Derived from the above, the Mexican tax authorities issued miscellaneous tax rule I.3.3.1.41 applicable for all taxpayers, which establishes that the provision included in article 28 section XVIII of the MITL regarding pro rata expenses incurred with a foreign based entity would not be applicable if all the following requirements were fulfilled:

(a) the expenses were strictly necessary for the taxpayer’s activities;
(b) that the entities to which the expenses were incurred were resident in a country with which Mexico has a broad information exchange agreement;
(c) it was possible to prove that the service related to the expense was effectively rendered;
(d) if the expenses were incurred between related parties, the consideration established should lie within the range of considerations that independent parties in comparable transactions would have established;
(e) that there was a reasonable relationship between the expenses incurred and the benefit received or expected to be received by the taxpayer. For these purposes, the taxpayer should have complied with certain formal requirements;
(f) that certain supporting documentation regarding each transaction in which the consideration was established on a pro rata basis was retained.

This rule establishes that in case of not complying with any of the requirements included therein, the expenses will be governed by the provisions set forth in article 28 section XVIII of the MITL, that is, the expenses would not be deductible for Mexican income tax purposes.

As may be observed, the requirements to consider as deductible pro rata expenses with a foreign based entity may be difficult to fulfil and have a great degree of subjectivity. Taking into consideration that the miscellaneous rule establishes that in the case of not complying with any of the requirements included therein the expenses would not be deductible for Mexican income tax purposes,

Second Chamber of the Supreme Court of Justice resolution regarding Amparo 2424/2012 – Johnson and Son, SA de CV.
making the deduction for such expenses could be a position with a certain degree of risk for the Mexican taxpayer.

2.3. Risk and capital

The MITL requires the performance of a functional analysis when analysing intercompany transactions; specifically, the MITL requires the provision of information regarding the functions or activities, assets and risks assumed by the taxpayer per type of transaction.

Likewise, the MITL considers transactions or companies to be comparable when there are no differences between them that significantly affect the price or consideration amount or the profit margin, or when such differences are eliminated through reasonable adjustments; to determine these differences, the following elements, among others, will be considered:

(a) The characteristics of the transactions, including:
   • in the case of financing operations, factors such as the amount of the principal, term of the financing, collateral, creditworthiness of the debtor and interest rate;
   • in the case of the provision of services, factors such as the nature of the service and whether or not it requires experience or technical knowledge;
   • in the case of the use, enjoyment or sale of tangible goods, factors such as the physical characteristics, quality and availability of the goods;
   • if the use of an intangible asset is granted or an intangible asset is transferred, factors such as whether a patent, brand, trade name or technology transfer is involved, as well as the duration and the degree of protection; and
   • in the case of sale of shares, factors such as the updated shareholders’ equity of the issuing entity, the present value of profits or projected cash flow, or the stock-market quote of the last event of the day of the disposition by the issuing entity;

(b) the functions or activities of each of the parties involved in the transaction, including the assets used and risks assumed therein;

(c) the contractual terms;

(d) the economic context; and

(e) the business strategies, including those related to market share, permanence and growth.

As may be observed, there are significant elements to consider for purposes of determining whether a consideration between related parties complies with the arm’s length standard in which a thorough functional analysis has to be performed.

Furthermore, the position of the Mexican tax authorities additional to the aforementioned elements is aligned with what is established in Action 9 of the BEPS project regarding the position to ensure that inappropriate returns will not accrue to an entity solely because of contractually assumed risks or the fact that it has provided capital.

In this regard, specifically for companies that only assume the risk of providing capital to a related party, the Mexican tax authorities have established the position that they would only be entitled to receive a risk-free return for this activity; that is, they would only receive a risk-free interest rate on the capital provided and any excess return would not be reasonable.
The Mexican tax authorities in their assessments specifically review the functions, assets and risks borne by the parties in a transaction so as to define the return that should be received by each party. It is important to mention that in connection with these functional analyses, the elements to be considered should be supported with legal elements, based on the MITL and supported with the recommendations included in the OECD guidelines.

2.4. High-risk transactions

2.4.1. CUP and quoted prices for cross-border commodity transactions

For Mexican TP purposes, all the considerations established in related party transactions, including commodity transactions, should be determined based on the arm’s length standard. For purposes of the analysis of these transactions, the hierarchy of the methods included in the MITL should be considered.

In practice, for the purposes of determining whether the consideration established between related parties in commodity transactions, the CUP is used based on recognized market prices; this is according to Action 10 of the BEPS project which suggests the application of the CUP with market information.

As previously mentioned, according to the provisions of the MITL, the CUP must be chosen as the first alternative when analysing related party transactions; therefore, the recommendations of Action 10 of the BEPS project as well as the common practice for the analysis of these transactions are aligned with the provisions set forth in the MITL regarding the analysis of related party transactions.

In connection with the above, it is important to mention that in Mexico the commonly known as the sixth method which is used in various countries for the analysis of transactions involving commodities does not apply.

2.4.2. Intra-group services

The MITL considers intra-group services transactions; the law establishes that for comparability purposes, the nature of the service and whether or not it requires experience or technical knowledge should be taken into consideration.

Action 10 of the BEPS plan suggests the application of an analysis for low-value added services in which a 5 per cent mark-up over total costs and expenses would be reasonable from an arm’s length perspective and would not require a full TP analysis.

In this regard, it is important to mention that while the MITL establishes that for the interpretation of the TP provisions the OECD guidelines should be applicable, it should be analysed whether the simplified methodology for low-value added services included in the OECD guidelines is congruent or not with the provisions set forth in the MITL as well as with the treaties entered into by Mexico.

2.4.3. Profit splits in the context of value chains

As previously mentioned, the MITL includes the PSM as well as the RPSM for purposes of analysing intercompany transactions.
In this regard, as discussed in section 1, the MITL provides a hierarchy of the TP methods to be applied for purposes of analysing intercompany transactions; the CUP must be chosen as the first alternative when analysing related party transactions and if the CUP is not applicable, it should be demonstrated that the method applied is the most appropriate method to analyse the related party transaction in accordance with the available information and the OECD guidelines, giving preference to the RPM and CPLM.

Taking into consideration the revised guidelines on profit splits which amend chapter II of the OECD guidelines which give guidance on the application of the profit split methods, and based on the fact that the OECD guidelines are applicable for interpretation of the provisions referring to TP issues, it should be understood that the elements included therein would be applicable when analysing intercompany transactions based on the profit split methodology in Mexico.

2.5. TP documentation

Taxpayers in Mexico which undertake transactions with related parties have to prepare on an annual basis evidentiary documentation to demonstrate that the income generated and the deductions applied were in alignment with the arm’s length standard, i.e. they have to prepare a TP study on an annual basis.

Likewise, certain taxpayers have to file information about relevant transactions, an informative return regarding their tax situation, tax opinions, and a multiple informative return.

Additional to the above-mentioned documentation requirements, in connection with Action 13 of the BEPS project, on 18 November 2015, the MITL was modified and included article 76-A, which includes an additional TP obligation consisting of a three-tiered documentation scheme: a master informative return, a local informative return and a CbCR, which are based on the OECD’s Action Plan on BEPS.

For fiscal year 2016 large taxpayers which in the immediately preceding year had income equal to or greater than $644,599,005 Mexican pesos, taxpayers with issued stock in the financial market, taxpayers included in the integration regime, government companies and foreign entities with a permanent establishment in Mexico, which carry out transactions with related parties, must file with the Mexican tax authorities the following informative returns for tax year 2016 no later than 31 December 2017:

- a master informative return of related party members of an MNE, which should include:
  - the organizational structure;
  - a description of the MNE’s business, intangibles and financial activities among related parties;
  - their financial and tax position;
- a local informative return of related party members of an MNE, which should include:
  - a description of the organizational structure, business strategies and related party transactions;
  - financial information of the taxpayer, as well as of the comparable companies or transactions used in the TP analysis;
a CbCR of the MNE, which should include:
– an overview of allocation of income, taxes and business activities by jurisdiction;
– a list of all the constituent entities members of the MNE.
As an exception to the obligation to file CbCR, article 76-A states that Mexican taxpayers that qualify as MNE controlling entities, i.e. are ultimate holdings resident in Mexico, should submit CbCR when the annual consolidated revenue of the MNE group in the immediate previous fiscal year is above $12 billion pesos.\(^{12}\) Non-controlling Mexican taxpayers may still be obliged to file it if designated by the foreign parent company. In addition, the Mexican tax authorities may request CbCR from other foreign tax authorities through an exchange of information mechanism.

Moreover, if the Mexican tax authorities are not able to obtain the CbCR through information exchange mechanisms with other tax jurisdictions, article 76-A establishes that the Mexican tax authorities may request the Mexican entity to file the return, for which it will have a 120-day period to fulfil this request.

It is important to mention that the penalties for not filing or filing these returns with errors or omissions these returns may range from an economic fine up to a prohibition on entering into contracts with the public administration or the potential cancellation of registration in the imports and exports registry.

It is expected that the Mexican tax authorities will issue specific rules and formats regarding the above-mentioned informative returns, specifically for the master informative return since this requires information about the MNE as a whole, which may represent an extraterritorial and unenforceable rule, since a subsidiary of an MNE does not have access to the information for completing the master file.

In this regard, it is important to analyse the rules and formats that will be issued by the Mexican tax authorities derived from the fact that article 76-A, as of today, grants the tax authorities the faculty to request the Mexican entity to file the CbCR where they cannot obtain this information by means of the information exchange mechanisms with other tax jurisdictions, even though the Mexican subsidiary is not obliged to have or file the CbCR.

On the other hand and regarding advance pricing agreements (APAs) in Mexico, on 14 July, 2016, the Mexican tax authorities issued a rule\(^{13}\) in the Third Resolution of Modifications to the 2016 Miscellaneous Tax Resolution which establishes that when the Mexican tax authorities observe that the information or documentation provided by the taxpayer in connection with the request of a TP resolution in terms of article 34-A of the Federal Tax Code (APA) is not sufficient, contains irregularities or inconsistencies or if the authorities want to verify the information, they are empowered to perform a functional analysis in the domicile of the taxpayer in order to gather, evaluate and corroborate the consistency and truthfulness of the information provided by the taxpayer.

The actual procedure to request an APA in Mexico is very time and documentation consuming; with the issuance of this specific tax rule, it is expected that the

\(^{12}\) As of May 2016, considering an exchange rate of MXN $18.48 per US dollar, this is equivalent to approximately US$ 650 million.

\(^{13}\) Rule 2.12.8.
procedure will become more complex since the authorities more likely than not will exercise their faculty of performing a functional analysis in the domicile of the taxpayer in order to verify the information and data submitted by the taxpayer.

2.6. TP-related measures in other BEPS actions and other measures against BEPS

As mentioned above, there have been changes in the tax legislation in Mexico which derive from the Action Plan on BEPS since its early stages. In this regard, it is expected that in future years there will be further amendments and clarifications of the new provisions included in the Mexican tax legislation. Likewise, it is expected that in the near future the Mexican tax authorities will start audit procedures regarding the new provisions of the law.

2.7. Can BEPS work in favour of MNEs?

In connection with the modifications to the MITL derived from the BEPS project and as described in the explanatory statement of the tax bills, such amendments derive from the need to avoid the erosion of the taxable base in Mexico.

In this regard, it may be understood that the TP obligations for taxpayers derived from the BEPS project are implemented so as to give the tax authorities the analytical tools and data in order to avoid the erosion of the taxable base in Mexico by means of audit procedures to taxpayers.

In connection with the above, it may be concluded that in Mexico the BEPS project is not focused on benefiting MNEs with information that other jurisdictions may have already provided but it has become a significant administrative burden for taxpayers since they have to comply with diverse requirements during the tax year, as well as a significant increase in tax audits.

2.8. What is the future of TP?

The BEPS project has already had an important impact in Mexico; as mentioned, derived from the Action Plan on BEPS, some laws have been amended and obligations derived from the BEPS Action Plan have been incorporated in law.

It is expected that further modifications based on BEPS will certainly be driven by the results of the BEPS project.
Addendum

In connection with the new TP informative tax returns, in October 2016 the Mexican tax authorities, through the Mexican Taxpayer’s Ombudsman (PRODECON) issued a project of administrative rules which was subject to public consultation.

The interested parties have already sent comments and on 31 January 2017, a technical meeting will be held between taxpayers, tax authorities and the office of the tax ombudsman to discuss these rules and afterwards, the Mexican tax authorities should issue the definitive administrative rules defining how Mexican taxpayers should file the applicable master informative return, local informative return and CbCR informative return with the Mexican tax authorities.

On the other hand, on 23 December 2016, the Mexican tax authorities issued the 2017 Miscellaneous Tax Resolution (MTR), which includes rules regarding TP adjustments. These miscellaneous tax rules respond to the lack of TP provisions and guidelines in the Mexican tax legislation regarding TP adjustments.

The MTR defines a TP adjustment as as any change in prices, consideration or profit margins regarding transactions carried out between a taxpayer and its related parties in order to comply with the arm’s length principle. It is recognized that such adjustments could imply no cash or other material assets being delivered between related parties.

Likewise, the MTR establishes the tax implications derived from TP adjustments as well as the requirements that should be fulfilled by a taxpayer to allow a tax deduction derived from such adjustments.

Furthermore, the rules establish that in general terms, TP adjustments that increase authorized deductions should be carried out by taxpayers no later than the date of the submission of the annual tax return, this is, 31 March of the immediate following year.

If a taxpayer chooses to file the annual tax report or is obliged to submit a tax situation informative return, the TP adjustments may be performed no later than the date for the submission of such documents.

If the adjustment is performed later than these dates, the MTR establishes that the adjustment may be considered provided that it is derived from a TP resolution in terms of article 34-A of the Federal Tax Code (advance pricing agreements).

The issuance of these rules represent a step forward towards a more sophisticated and complete TP system that should provide a higher level of tax certainty to taxpayers. Of course, there are still topics pending for analysis such as the effects on other taxes and secondary adjustments, among others, which is it hoped the tax authorities or legislators will consider for analysis.

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14 Master informative tax return, local informative tax return and CbCR informative tax return.
Summary and conclusions

The Netherlands incorporated the arm’s length principle into the Corporate Income Tax Act 1969 (CITA) in article 8b CITA in 2002. Before this, the arm’s length principle already applied in the Netherlands on the basis of article 3(8) of the Income Tax Act of 2001 and its predecessor, article 7 of the Income Tax Act of 1964 which defined the total profits of an enterprise. The introduction of article 8b, which is almost identical to article 9(1) of the OECD model tax convention, dispelled any remaining doubt that there may have been that the arm’s length principle forms an integral part of the Dutch tax system. With this new article, a requirement for taxpayers to maintain transfer pricing (TP) documentation was also introduced.

In enforcing the arm’s length principle, the Netherlands generally follows the guidance provided in the OECD TP guidelines, even though they are not part of Dutch law. Where the OECD TP guidelines leave room for interpretation or are unclear, the Dutch government aims to provide supplementary guidance and clarification in the form of decrees which are issued by the Dutch State Secretary of Finance. The latest decree on the subject of TP was issued in November 2013.1 In it, the State Secretary of Finance states:

“Because the OECD Transfer Pricing Guidelines provide an internationally accepted interpretation of the arm’s length principle, I consider the OECD Transfer Pricing Guidelines to be a suitable interpretation and clarification of the principle described in Section 8b CIT Act 1969.”

The effect of this statement is that the Dutch tax authorities use the OECD TP guidelines for the interpretation of the arm’s length principle and adhere to the clarifications and policies reflected in the Dutch Transfer Pricing Decree 2013. An interesting point is that a Dutch court may still find that the TP guidelines are authoritative opinions only.

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1 Transfer Pricing Decree, IFZ2013/184, November 2013; earlier decrees were issued in 2001 and 2004.
The explicit commitment to the internationally accepted arm’s length principle and the OECD TP guidelines is indicative of the broader Dutch tax environment in which certainty, reliability and good faith towards treaty partners play a pivotal role. Taxpayers in the Netherlands are encouraged to discuss TP questions up front and certainty is improved by advance pricing agreements (APAs). The Netherlands also enables taxpayers to initiate a mutual agreement procedure in response to an adjustment imposed by the Netherlands before all domestic legal remedies have been exhausted. In practice this means that most TP disputes are resolved outside the Dutch courtroom.

For the Netherlands, the TP-related outcomes of the BEPS project are, by and large, not new; they closely reflect the economic approach that the Dutch government and tax administration have already propagated in the evaluation of inter-company profit allocation. Following the publication of the final base erosions and profit shifting (BEPS) reports in October 2015, the State Secretary of Finance sent a letter\(^2\) to the Lower House of Parliament describing the Netherlands’ position in respect of the BEPS outcomes. With respect to TP rules, the State Secretary of Finance wrote that the BEPS outcomes relating to TP would lead to hardly any changes in respect of the way in which the Dutch tax authorities apply the OECD TP guidelines and that Dutch TP policy, as outlined in the Transfer Pricing Decree 2013, is almost fully aligned with the new TP guidance published by the OECD. Consequently it is not anticipated that Dutch TP policy will be dramatically affected by the BEPS Actions 8–10. At the time of writing this report the Transfer Pricing Decree 2013 is still in force and it is unclear whether it will be updated or replaced.

The Netherlands was one of the first countries to introduce country-by-country reporting (CbCR) rules into law and align the CIT with the other outcomes of BEPS Action 13 (master file and local file). In a letter to the Dutch Parliament the State Secretary of Finance underlined the fact that transparency is one of the most important tools against BEPS. This was met with strong support in the Dutch Parliament where a majority even requested public CbCR.

Overall, it is the Netherlands’ intention to continue to align its policies in the field of TP with international developments such as those developed by the OECD. It can be expected that the clarified guidance will bring about a shift in countries with a more legal approach to a more economic approach to TP. With the higher level of subjectivity that comes with an economic approach, it will be even more important for the OECD’s guidance to include descriptions of concrete examples illustrating the economic principles underlying the guidance. At the same time, an increased and improved level of international cooperation will be paramount to ensuring that the fight against BEPS does not result in an unwanted increase in double taxation for taxpayers. The Netherlands is a proponent of developing new ways to resolve or preempt international tax disputes. Recent years have seen pilots including joint audits and, where possible, early discussion with other tax authorities to come to a mutual understanding of the case at hand. These developments aside, the Netherlands strives to include binding arbitration in all its tax treaties to provide a clear legal framework within which double taxation can be resolved.

1. Current TP regulation and practice in the Netherlands

The Netherlands incorporated the arm’s length principle into the CITA in article 8b in 2002. Before this, the arm’s length principle already applied in the Netherlands on the basis of article 3(8) of the Income Tax Act of 2001 and its predecessor, article 7 of the Income Tax Act of 1964, which defined the total profits of an enterprise. The introduction of article 8b, which is almost identical to article 9(1) of the OECD model tax convention, dispelled any remaining doubt that there may have been that the arm’s length principle forms an integral part of the Dutch tax system. With this new article, a requirement for taxpayers to maintain TP documentation was also introduced.

In enforcing the arm’s length principle, the Netherlands generally follows the guidance provided in the OECD TP guidelines, even though they are not part of Dutch law. Where the OECD TP guidelines leave room for interpretation or are unclear, the Dutch government aims to provide supplementary guidance and clarification in the form of decrees which are issued by the Dutch State Secretary of Finance. The latest decree on the subject of TP was issued in November 2013 in the Transfer Pricing Decree of that year. In it, the State Secretary of Finance states:

“Because the OECD Transfer Pricing Guidelines provide an internationally accepted interpretation of the arm’s length principle, I consider the OECD Transfer Pricing Guidelines to be a suitable interpretation and clarification of the principle described in Section 8b CIT Act 1969.”

The effect of this statement is that the Dutch tax authorities use the OECD TP guidelines for the interpretation of the arm’s length principle and adhere to the clarifications and policies reflected in the Dutch Transfer Pricing Decree 2013. An interesting point is that a Dutch court may still find that the TP guidelines are authoritative opinions while a taxpayer may rely on them under the principle of legitimate expectation.

The explicit commitment to the internationally accepted arm’s length principle and the OECD TP guidelines is indicative of the broader Dutch tax environment in which certainty, reliability and the good faith towards treaty partners play a pivotal role. Taxpayers in the Netherlands are encouraged to discuss transfer pricing questions up front and there are various platforms through which certainty is improved, for example, APAs and the horizontal monitoring programme. The Netherlands also enables taxpayers to initiate a mutual agreement procedure in response to an adjustment imposed by the Netherlands before all domestic legal remedies have been exhausted. In practice this means that most TP disputes are resolved outside the Dutch courtroom.

The Netherlands, as a member of the European Union (EU), must ensure that its laws comply with EU law and the freedoms that are guaranteed under EU law.

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3 Transfer Pricing Decree, IFZ2013/184, November of 2013. Earlier decrees were issued in 2001 and 2004.
Until recently, involvement with respect to TP at a specifically European level was confined to the European Union Joint Transfer Pricing Forum (EU jTPF), working within the framework of the OECD TP guidelines and operating on the basis of consensus to propose to the European Commission (EC) pragmatic, non-legislative solutions to practical TP problems. However, in the context of state aid cases against Member States, the subject of TP has gained publicity and it has become clear that in a European context there is substantial room for interpretation of the OECD TP guidelines. While the European Commission has explicitly endorsed the guidelines as a source to be regarded in evaluating the potential granting of state aid under tax rulings, it is clear that the EC is emerging as a more prominent stakeholder in the TP arena.

2. The impact of the BEPS project on TP

2.1. Introduction

Following the publication of the final BEPS reports in October 2015, the State Secretary of Finance sent a letter to the Lower house of Parliament describing the Netherlands’ position in respect of the BEPS outcomes under the three overarching pillars of coherence, substance and transparency. With respect to TP rules, the State Secretary of Finance wrote that the BEPS outcomes relating to TP would lead to hardly any changes in respect of the way in which the Dutch tax authorities apply the OECD TP guidelines and that Dutch TP policy, as outlined in the Transfer Pricing Decree 2013, is almost fully aligned with the new TP guidance published by the OECD. Consequently it is not anticipated that Dutch TP policy will be dramatically affected by the BEPS Actions 8–10. At the time of writing this report the Transfer Pricing Decree 2013 is still in force and it is unclear whether it will be updated or replaced.

2.2. Challenges of transactions with intangibles

2.2.1. Definition of intangibles

The Netherlands takes a relatively broad, open and TP specific view on the definition of intangibles for the purpose of TP analysis. This is evident from the fact that the Netherlands does not have a specific definition or categorization of intangibles in relation to TP, and nor is a connection made to intangibles definitions according to accounting rules or civil law. As a consequence accounting rules or civil law interpretation of the definition of intangibles should not be determinative in the context of TP analysis and conversely, TP analysis may require the identification of intangible assets which would not qualify as such under accounting rules or civil law. Similarly the Netherlands does not distinguish specifically between routine and non-routine intangibles.

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4 Commission Notice on the notion of state aid as referred to in art. 107(1) TFEU, 19 May 2016.
Although nothing has been announced, at the time of writing this report it seems that the BEPS guidance on intangibles does not necessitate a change to the Dutch approach to intangibles, or the lack of specific definition rules. The new guidance leaves room to apply the open norm for TP as used by the Dutch tax authorities.

2.2.2. Transactions with intangibles

Under the general Dutch approach to TP analysis involving intangibles, the central question to be addressed is whether something of value has been transferred to or utilized by a group company that was not responsible for its creation, development or maintenance. This question should be analysed based on the perspectives of both parties in the transaction. In this regard it is important to note that value is different from the arm’s length price. In transactions between independent parties, the agreed price will normally lie somewhere between the value for one party and the value for the other party in the transaction. When the value for the seller is higher than the value for the buyer the transaction is likely to come under discussion by the tax authorities because it is economically irrational and thus would not be encountered in the marketplace.

In a situation where profits drop as a consequence of a business restructuring there is no rule that a transfer of an intangible will be automatically be hypothesized. Based on a full analysis of the facts and circumstance of the case it should be assessed whether rights and/or obligations have been transferred. In a business restructuring where the activities (going concern) are transferred to a related party it will be hypothesized that the total value of the business is not equal to the sum of the value of the individual assets. The goodwill (or badwill) should be included in the taxable profit of the party affected as a consequence of such a restructuring.

Ultimately the price paid for intangibles should reflect what a third party would have been willing to pay for (the use of) the intangibles. In this regard no consideration is given to the qualification of the intangible; goodwill will not be excluded from the arm’s length price as long as unrelated parties would be willing to pay for that part of the value in a comparable transaction.

2.2.3. “Substance-over-form” approach towards intangibles

In the Netherlands, transactions involving intangibles are analysed in the same way as other intercompany transactions. This entails that the analysis of the transaction revolves not so much around the form, including the definition of the intangible or the legal form of the transaction (i.e. service, licence or outright transfer), but more around the economic substance of the interactions between the parties involved, their contributions and the benefits construed under a particular relationship.

As with other inter-company transactions, the contract is the starting point for analysis of transactions involving intangibles unless the actual behaviour or conduct of the parties differs from the contract in place. That is the reason why the Dutch tax administration places an emphasis on understanding the business. The tax inspector is expected to understand the multinational company’s (MNE’s) global activities and the context of the Dutch taxpayer’s activities within the global value chain in order to properly perform the TP analysis.
To the extent that countries can be considered to follow a more legalistic approach versus a more economic approach, the Netherlands can be considered to belong to the latter group. The contract, supplemented by the actual conduct of parties, will define the type of transaction identified between related parties with respect to intangibles in an MNE. When the conditions of the transaction reflect conditions that would be acceptable for unrelated parties the economic analysis should find an arm’s length price based on a comparability analysis.

When the conditions between the related parties are not based on arm’s length commercial behaviour the Dutch tax authorities will seek to adjust the conditions to reflect those that would have been agreed upon between unrelated parties. Think in this respect about a risk allocation which would not be accepted by unrelated parties in a comparable situation. In this situation the Dutch tax authorities would try to find conditions which would be accepted by unrelated parties in a comparable situation. Based upon the adjusted conditions, the final step in such a process is to find a price based on a comparability analysis.

In exceptional cases, in which unrelated parties would not have entered into the transaction and – considering the manner in which the transaction has been structured – no arm’s length conditions can be found, it is possible for the tax authorities to call into question the transaction as such. This approach is applicable with respect to all intercompany transactions, but in the Transfer Pricing Decree 2013 a new chapter was introduced explaining this approach with respect to intangibles. In the introduction of this chapter the State Secretary of Finance gives an important statement with respect to this issue:

“If (in)tangible fixed assets are transferred to a group company while this group company does not add any value to the respective assets because the required functionality is absent and is therefore not able to control the risks with regard to the (in)tangible fixed asset, the criteria of the arm’s length principle will not have been satisfied.”

This statement is based on general economic theory that transfers of intangibles only take place when the expected value for the buyer is higher than the expected value for the seller. The economic idea behind this is that in a commercially rational transaction the expected total profit (before tax) of the buyer and the seller will increase as a consequence of the transaction. When the buyer is not able to add value to what has been acquired it seems commercially irrational to enter into the transaction. In the Transfer Pricing Decree 2013 the State Secretary of Finance explains this:

“The expected profit increase can only take place if the purchaser adds value in one way or another. This is only possible if the purchaser has the required functionality and the purchaser is able to use it to control the relevant risks (the relevant functionality). If there is no expected increase in the cumulative profit the bid price of a potential purchaser will be less than the asking price of a potential vendor. In that case transfer of the asset is commercially irrational and will not come about partly because the transfer will also involve transaction costs. Such
a transaction between associated enterprises will therefore not meet the criteria of the arm’s length principle."\(^7\)

When a price cannot be found, given the fact that the value for the buyer is lower than the value for the seller, both parties have the available (and realistic) option not to enter into the transaction. The State Secretary of Finance is aware that in these situations transactions often take place with companies established in low-tax jurisdictions. However, he emphasizes that a lower tax rate cannot be the decisive reason for entering into the transaction.

In such a situation, where there is no functionality in the company of the buyer to increase the value of the intangible, it is completely clear to the State Secretary of Finance that the negative effect on profits caused by applying conditions that would not have been agreed by independent enterprises must be eliminated from the taxable profit of the Dutch vendor. In making a comparison with example B in paragraph 9.190 in chapter 9 in the OECD TP guidelines the conclusion can only be that little or no remuneration at all should be allocated to the company in the tax haven. The profit related to the intangible should not be allocated to the company in the low-tax jurisdiction. The Transfer Pricing Decree 2013 does not elaborate on what substance would be deemed appropriate in order to allocate part of the intangible related profits to the tax haven company.

From the published guidance in the Transfer Pricing Decree 2013 it is clear that Dutch policy follows a “substance-over-form” approach. The contract is the starting point of the analysis but never the end. After analysing the contract the actual conduct of the parties involved is important. But even after analysing the contract and conduct together it is not always the case that the transaction should be priced without further analysis. When unrelated parties would not enter into such a transaction because of an (commercially) irrational risk allocation the substance of the transaction will prevail over the form as deduced from the contract and the actual conduct. For transactions related to intangibles it is even more important to assess whether there are sound economic reasons for entering into such a transaction.

The existing approach of the Dutch tax authorities has a strong correlation with the OECD approach in the BEPS project which stated that profits should be allocated where value is or has been created. Barring exceptional cases, the Dutch tax authorities will respect the transaction as such. According to the new OECD guidance the parties who are responsible for the so-called DEMPE functions should be remunerated at arm’s length. It is not to be expected that the guidance of the State Secretary of Finance, as given in the Transfer Pricing Decree 2013, will change in principle as a consequence of the outcome of the BEPS project.

2.2.4. **Comparability and group synergies**

The Transfer Pricing Decree 2013 addresses group synergies in three specific areas. It can be concluded, therefore, that even before the outcome of the deliverables of the BEPS project the Dutch tax authorities had a focus on issues relating to allocation of group synergies which could lead to BEPS.

\(^7\) *Ibid.*
This focus is apparent in the paragraph about intra-group procurement. As with all intercompany transactions, one of the key starting points is the functional analysis of the procurement company. The Transfer Pricing Decree 2013 explains that if the activities of the procurement entity are of a routine nature, it will not be exposed to significant risk and will not be entitled to residual profit in the value chain. The Transfer Pricing Decree 2013 gives the following examples of routine activities related to the procurement function:

- the selection of potential suppliers;
- the (local) coordination with suppliers;
- the quality control of the purchases;
- arranging transport and other logistics activities.

In relation to profits generated through discounts or rebates granted by suppliers as a result of bundled group volumes, which is the consequence of the synergy, the Transfer Pricing Decree 2013 is also very clear:

“This extra benefit cannot in principle be allocated to the purchasing entity. Such a benefit must be allocated to the members of the group enabling the purchasing entity to realize such (extra) discounts by their joint purchase volumes. Only if and insofar as (extra) discounts are realized by the specific knowledge and skills present at the purchasing entity, will allocation of a part of this to the purchasing entity be at arm’s length (see in this context also the Supreme Court 23 April 2004, no. 39 542).”

A similar approach can be seen in the paragraph about guarantees provided by related parties in relation to loan agreements. In this paragraph the State Secretary of Finance distinguishes between an implicit and an explicit guarantee:

“If the group company is deemed to be able to raise a loan independently, it must be assessed to what extent it would be able to successfully negotiate more favourable loan conditions without a so-called explicit guarantee from an associated company, in comparison to a comparable independent company, merely due to the fact that the former is a member of a group. These more favourable loan conditions are considered to be granted on the basis of a so-called implicit guarantee.”

Only when an explicit guarantee provided by a related party leads to an even lower interest rate for the loan granted by an unrelated party, can it be at arm’s length to implement a guarantee fee. The idea behind this guidance is that the discount on the interest rate which is solely a consequence of being part of the MNE cannot lead to an intra-group payment. This advantage of the synergy should be allocated to the group company taking on the loan.

The third area where the Transfer Pricing Decree 2013 provides guidance in relation to synergies is internal (re-)insurance activities. Part of the guidance about the so-called passive poolers has a strong relation to synergy. After describing the typical functions of the passive pooler the Transfer Pricing Decree 2013 concludes

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8 Ibid., s. 9, November 2013.
9 Ibid., s. 10, November 2013.
that these activities can be compared to the intra-group procurement entity whereby the activities of the captive are of a routine nature and the residual profit which has been generated by pooling risks in the captive cannot be allocated to the captive insurance company but should be allocated to the companies which pool these risks.

2.2.5. Hard-to-value intangibles

There is a lot of debate about hard-to-value intangibles and there are several reasons why in the tax world these kinds of intangibles cause complicated discussions; uncertainty about the future, asymmetry of information between taxpayers and tax authorities, and the fact that it is hard to find comparable transactions. Given that there is a lot of uncertainty surrounding the value of the intangibles, and that important functions remain in the business of the seller, these kinds of transactions are very rare in the “unrelated world”.

In practice the Dutch tax authorities have often taken the view that the first question in such a situation should always be whether unrelated parties would enter into a similar transaction. The control over the important risks (when the DEMPE functions do not change after the transfer of the intangibles) with respect to these intangibles is very often still in the company of the seller. Under these circumstances it is questionable whether the transaction can really be regarded as a transfer of an intangible and whether (based on a substance-over-form approach) there should be another characterization or a recharacterization of the transaction.

When the intangibles are difficult to value and the DEMPE functions remain in the company of the seller, it is fair to expect that the buyer has a higher discount rate applying the DCF method as a consequence of a higher risk than the seller because of the fact that the buyer has less control over the risks than the seller. In such a situation the highest price the buyer is willing to pay is lower than the lowest price the seller wants to receive.

In the Transfer Pricing Decree 2013 specific attention is paid to the arm’s length price for intangible transfers when the value at the time of the transaction is highly uncertain. For such cases the State Secretary of Finance writes, in conformity with what has been stated in the OECD TP guidelines, that if independent enterprises in comparable circumstances would have demanded a price adjustment clause, the tax administration should be allowed to determine the pricing on the basis of such a clause. Under certain circumstances the Dutch tax administration will also take the position that it is not arm’s length to agree a fixed price when the valuation is highly uncertain at the time of the transaction, since independent third parties in a similar situation would not have agreed such a fixed price. Under specific circumstances the Transfer Pricing Decree 2013 contains the following fiction:

“In the situation whereby an intangible asset is transferred to a (foreign) intra-group company and subsequently this intangible asset is largely (i.e. for more than 50%) licensed to the transferring Dutch company and/or to associated entities of this company established in the Netherlands, a price adjustment clause will be deemed to have been agreed unless the taxpayer can substantiate that i) there are business motives for the transaction and ii) the valuation at
the moment of entering into the agreement can be determined to such an extent that independent enterprises would not have demanded a price adjustment clause.”

This passage in the Transfer Pricing Decree 2013 shows the position that the tax authorities will take when they encounter such a fact pattern. It is, however, unknown whether a Dutch judge would support this message as a correct interpretation of the arm’s length principle.

It is Dutch policy that a price adjustment clause can lead to an upward as well as a downward adjustment of the price originally agreed. In general it can be concluded that the Dutch tax authorities will try to determine whether unrelated parties would have had a price adjustment clause or any other provision to adjust the price(s) in a comparable situation. When the actual profits or losses differ materially from the expectations in the valuation(s) this will attract the special attention of a tax auditor, but will not automatically lead to an adjustment. For the Netherlands it will very often also be problematic to make an adjustment to the price of the original transaction because of the statute of limitations. At the time of writing this report it is unclear whether the Dutch policy with respect to hard-to-value intangibles will change as a consequence of the new guidance of the OECD.

2.2.6. Cost contribution agreements (CCAs)

The Transfer Pricing Decree 2013 includes a section with supplementary guidance on CCAs. The main message in chapter 7 of the Decree is that the consideration or compensation for contributions made by participants in a CCA should not differ (materially) from the consideration or compensation which the participant would receive if it were to perform its activities outside the CCA.

Under the OECD Transfer Pricing Guidelines before 2016, it was not completely clear whether the cost price or the market value of a party’s contribution should be taken into account by the MNE when measuring the contribution of the participants. That is why the State Secretary of Finance specifically addressed this topic in the decree, which has now been addressed in the final BEPS reports:

“According to the Netherlands the arm’s length principle entails that the relative share of each participant in the contributions to the CCA as well as the relative share of that participant in the total benefits expected is determined on the basis of the value in the open market.”

Another important issue discussed during the BEPS project was the question of who could be a participant in a CCA. This is an important question because as a consequence of the way a CCA works every participant is in one way or another ultimately entitled to intangible related returns (economic owner of the intangible(s)). With the help of five examples the Transfer Pricing Decree 2013 explains how the arm’s length principle will be interpreted with respect to CCAs. For example, a

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10 Ibid., s. 5, November 2013.
11 Ibid., s. 7, November 2013.
situation is sketched whereby one party is active in the development, production and sale of consumer products and another party employs two persons with a financial and administrative background and has only a funding role with respect to the R&D activities. From this example it becomes clear that the party providing funding without having the required functional expertise to manage the risk associated with the R&D activity at its expense cannot be a participant. The compensation to be received by the parties must be in line with the functions they perform and the associated risks. When a party does not control the risk associated with the R&D activity it cannot be entitled to the intangible related returns.

It seems that this interpretation deviates somewhat from the outcome of Action 8 of the BEPS project where the funder of an intangible project can be a participant of a CCA. It is not clear whether and how the Dutch guidance will be adjusted.

2.3. Risk and capital

Paragraph 2(2) describes the interpretation given by the Dutch tax authorities to the allocation of risks in relation to functions and control. The shifting of risks to companies which are not able to control these risks and which do not have the financial capacity to bear them is not arm’s length and can be challenged by the Dutch tax authorities.

In the Netherlands there is a lot of discussion about the allocation of capital, the deduction of interest and the amortization of loans with respect to financial transactions between related parties. Although the Netherlands has measures in place to limit the deduction of interest costs beyond the arm’s length principle, these measures should be considered a secondary step subsequent to the analysis of the arm’s length nature of the financial transaction(s) as such.

The Transfer Pricing Decree 2013 states that it is necessary to evaluate whether the conditions (including the price) under which the financial transaction has occurred correspond with the conditions which would have been agreed by independent third parties in comparable circumstances for a comparable transaction. If this is not the case, this could lead to an adjustment of the interest rate or other conditions of the loan. The analysis should take into account a two-sided perspective; the position of both the lender and the borrower should be evaluated. While a loan might be very attractive from the perspective of a lender (high risk, high interest rate) from the perspective of the borrower it may still fail to meet the arm’s length standard because the high interest rate leads to a situation which unrelated parties would never enter into.

The rationale in the Transfer Pricing Decree 2013 is that an independent borrower would generally not enter into a loan transaction which would cause its credit rating to drop below the level of investment grade/BBB– as such a credit rating means that a party will have difficulty attracting external funds or will only be able to do so at exorbitant cost. Furthermore, this would limit the company’s ability to cope with contingencies and would increase its overall risk of bankruptcy.

When the taxpayer does not succeed in evidencing that the loan has been agreed under arm’s length conditions, it is conceivable that the tax inspector will make an adjustment. The Transfer Pricing Decree 2013 does not specify how the adjustment should be made. Under Dutch case law a loan can only be recharacterized into
equity under very specific circumstances and it is debatable whether the criteria as stated by the State Secretary of Finance justify such recharacterization in all cases. Another possibility could be that the interest costs are adjusted without recharacterization of the loan. To date, the Dutch court has not presided over cases where the outcome of the above principles stated in the Transfer Pricing Decree 2013 have been at stake.

So far, the policy of the State Secretary of Finance has been focused on the (arm’s length) deduction of interest. The implicit policy is that taxpayers in the Netherlands that are part of an MNE should have an allocated capital (debt equity ratio) befitting the functions, assets and risks of the company and that this policy (which has been published) prevents the shifting of capital to group companies without (or with minimal) functions, assets and risks.

2.4. High-risk transactions

2.4.1. Comparable uncontrolled price (CUP) and quoted prices for cross-border commodity transactions

The commodity sector does not provide a particularly significant source of economic activity for the Netherlands. This might explain why Dutch TP guidance does not pay specific attention to TP in relation to intra-group commodity transactions. The CUP method is accepted in practice for commodity transactions if the taxpayer can evidence that the economically relevant characteristics of the controlled transaction and the uncontrolled transaction are comparable in substance and form. The new guidance published under the BEPS reports with respect to commodity transactions is not expected to change the way in which the Dutch tax authorities evaluate transactions of this type; they reinforce an approach which would already have been applied by the Dutch tax authorities.

2.4.2. Intra-group services

The Netherlands’ position on intra-group services has been aligned with the OECD TP guidelines since the introduction of TP rules in 2002. Supplementing the OECD’s guidance on intra-group services, Dutch TP guidance published by the Ministry of Finance in TP decrees has demonstrated a relatively practical stance towards the pricing of intra-group services.

The Dutch guidance follows the OECD TP guidelines’ general principle that an intra-group service exists where an activity is undertaken on behalf of a group entity that provides an economic or commercial benefit to that group entity for which it would normally have been willing to pay. Shareholders’ activities do not meet this criterion. In the Transfer Pricing Decrees published in 2004 and 2013, the Netherlands provides additional guidance on the identification of shareholder activities. The decree lists the activities that are considered shareholder activities for which it is in general not appropriate to charge costs or a fee to group companies. While the list is not limitative, it demonstrates a more defined interpretation of shareholder activities than the OECD TP guidelines. The new and more detailed guidance published by the OECD in relation to shareholder activities is in line with the interpretation already applied in the Netherlands.
Regarding the method of allocation, the Dutch guidance acknowledges the OECD’s preference for the direct method for allocating costs but also recognizes that it will often be difficult to apply in practice. Therefore, the Netherlands is willing to accept an indirect allocation method based on allocation keys such as revenue, employees, employee expense. A profit based allocation key is generally considered not to lead to an outcome in line with the arm’s length principle.

In respect of the TP method to be applied to intra-group services, the Netherlands’ position has clearly developed and become more nuanced since the inception of TP regulations in 2001. Each of the TP decrees issued in 2001, 2004 and 2013 has contained sections on intra-group services supplementing the OECD TP guidelines. While the new OECD guidance on low value-adding intra-group services will require changes, the current Dutch TP guidance already reflects a clear distinction between high value-adding and low value-adding services.

In an approach reflective of the concept of low value-adding services, Dutch guidance provides for the possibility to charge certain “supporting” services to beneficiaries at actual cost on the basis of paragraph 7.37 of the OECD TP guidelines. The Transfer Pricing Decree 2013 identifies accounting, legal, tax and human resources services as types of intra-group services that would generally qualify as “supporting” services which can be charged to benefiting group companies based on the actual full costs incurred, rather than with a profit mark-up. This simplified treatment would not, however, apply in cases where the service formed part of or added more than marginal value to the primary business processes (generally defined as production, procurement, sales, marketing, product development and R&D) of the company or if the service was also rendered to third parties on a more than incidental basis. Acknowledging that there may be other intra-group services that qualify as “supporting” services, the Transfer Pricing Decree 2013 further provides taxpayers with the possibility of requesting the approval of the tax authorities up front to qualify other types of services as “supporting” and subject to the same simplified TP approach.

The distinction between high value-adding and low value-adding services is also implied in the Transfer Pricing Decree 2013 which for the first time specifically states that the cost plus methodology for the pricing of intra-group services will only be applicable in the case of more routine type activities. This suggests that where intra-group services are more value-adding, the Dutch tax authorities would expect to see a pricing mechanism that reflected the added value of the service, for example, a percentage of sales. Interestingly, with the BEPS observation that current – often cost-based – intra-group service charges might open up BEPS opportunities to MNEs, a more value-based approach for high value-adding services by the Netherlands is even more likely to come under the scrutiny of governments already suspicious of intra-group service charges.

Although the Dutch regulations contain an approach reflective of the concept of low value-adding services, this is not exactly the same as the simplified approach as has been described in the new chapter VII of the guidelines (section D2) with a fixed mark up on costs of 5 per cent. At the time of writing this report it is not clear what amendments to existing guidance will be made.
2.4.3. Profit splits in the context of value chains

The current Dutch guidance on TP which is published in the Transfer Pricing Decree 2013 does not provide specific supplementary guidance on the application of profit splits in the context of value chains. In practice, a taxpayer’s use of the profit split method as its primary method to substantiate the arm’s length nature of inter-company profit allocation will not be automatically rejected by the Dutch tax authorities where the economic facts and circumstances of the situation clearly support its use. In this regard it can be surmised that the profit split method may not be employed as a sort of “method of last resort” in cases where TP analysis is technically challenging, for example when appropriate comparables are lacking. The profit split method should be applied based on its own merits and its specific suitability to the case at hand.

2.4.4. TP documentation

In 2002, together with the codification of the arm’s length principle, a TP documentation requirement was introduced in the Netherlands. Under subsection 3 of article 8b taxpayers transacting with related parties are required to retain documents with regard to TP. The objective of this article is to ensure that the taxpayer can demonstrate to the tax authorities that the prices and conditions of the inter-company transactions are at arm’s length. The article itself does not specify the form or content of the documentation but the parliamentary history in relation to the codification of the article explains that the documentation should consist of:

• a description of the five comparability factors of intra-group transactions as described in chapter I of the OECD guidelines;
• a substantiation of the choice of the TP method applied;
• a substantiation of the conditions, including the price, which have been agreed in the transactions.

One can see the Dutch documentation requirements of article 8b as an open norm. This approach fits with the Dutch government’s policy that the principle of proportionality should play an important role to avoid imposing an unduly heavy administrative burden on taxpayers. However, because an open norm can also leave taxpayers in uncertainty, in the Transfer Pricing Decree 2013 the State Secretary of Finance gives the possibility of obtaining certainty from the competent tax inspector with regard to the question of whether the taxpayer’s documentation complies with article 8b subsection 3 of the CITA 1969.

In 2016, a few years after the introduction of the Dutch documentation requirement, the Council of the European Union adopted the code of conduct on TP documentation for associated enterprises in the European Union (EU TPD). This documentation framework introduced the master and the local file concepts which have also been introduced more recently under the BEPS Action 13. In the Transfer Pricing Decree 2013 it was clarified that taxpayers that retain documentation based on the EU TPD framework are compliant with the Dutch documentation rules, although there is no obligation to follow the EU TPD framework. However, because the EU TPD framework is more detailed and extensive, generally leading
to higher compliance costs, in practice few taxpayers in the Netherlands have chosen to follow it.

2.4.5. CbCR

The Netherlands was one of the first countries to introduce CbCR rules into law. In a letter to the Dutch parliament the State Secretary of Finance underlined the fact that transparency is one of the most important tools against BEPS. This was met with strong support in the Dutch parliament where a majority even requested public reporting of CbCR. The State Secretary of Finance responded that he only was willing to take this step in cooperation with the other EU Member States.

The Dutch government codified the CbCR requirement into law (section 29b–29h of the CITTA) on 1 January 2016 and simultaneously issued a decree in which more practical rules and guidance were given regarding the template for CbCR. The section in the CITTA and the decree are, barring small differences, a translation of the model legislation which was published by the OECD as a consequence of Action 13 of the BEPS project.

It is clear that the Dutch government wants to embrace the new transparency rules in such a way that there cannot be any doubt regarding the Dutch position in this field. It may be that the international criticism, especially from non-governmental organizations on the APA/ATR ruling practice, was one of the reasons why the Dutch government wanted to make a statement through quick adoption and implementation. As a result of the Netherlands’ swift adoption of CbCR it is conceivable that many MNEs subject to the requirement will file their CbCR for the year 2016 in the Netherlands as long as the country of the parent company has not introduced a CbCR requirement into law. The fact that the Netherlands has signed the multilateral instrument for the exchange of CbCR and has a sizeable treaty network can also play an important role here.

2.4.6. Master and local files

Although the master and local file concept was not new to taxpayers in the Netherlands, with the codification of the master and local file in the law (section 29b–h CITTA) in 2016 it became an obligation for MNEs with a consolidated income greater than €50 million. For these companies the Dutch documentation requirement is no longer an open norm. The decree on documentation stipulates specifically which information should be maintained in the administration of the taxpayer. As before, there is no requirement in the Netherlands to file the documentation with the tax authorities, but it should be available upon request. Similar to the CbCR rules the Dutch rules on the master and local file are very close to the texts in the implementation package of Action 13 of the OECD.

Smaller companies with a consolidated income of less than €50 million are not subject to this new obligation. They should continue to comply with the existing rule of article 8b. The proportionality principle plays a more important role in section 8b than with the master and local file and it is the expectation that for larger companies compliance costs will increase.
The Convention on Mutual Administrative Assistance in Tax Matters is in force in the Netherlands. The Netherlands has signed the OECD’s multilateral competent authority agreement for the automatic exchange of CbCR in January 2016. Based on the principles of this agreement the Netherlands will work on an effective and efficient exchange of the reports.

2.4.7. Compliance costs

Taking into consideration the fact that CbCR is a new fiscal obligation for MNEs, for those companies with a consolidated income of more than €750 million the compliance costs will rise with the introduction of this new obligation in 2016. In the explanatory memorandum (Memorie van Toelichting) accompanying the draft law it was estimated that the extra costs for Dutch business as a consequence of the implementation of CbCR will amount to €6 million annually. For drafting of the master file and local file the Secretary of State estimated an amount of €2 million and €3 million respectively.12

2.5. TP-related measures in other BEPS actions and other measures against BEPS

The interaction between TP and other measures against BEPS will be an important factor to bear in mind as countries – and in the case of Europe, also the EU – determine which measures to implement in the context of BEPS. It is also clear that, while the BEPS project has provided significant clarification in respect of the interpretation of the arm’s length principle, a number of weighty TP topics are still to be addressed in the OECD’s follow-up work which have a direct interplay with other BEPS measures. For example, the anticipated work on attribution of profit to permanent establishments and pricing of intercompany financial transactions will bear a strong relationship to the outcomes of measures implemented in relation to Actions 7 and 4 respectively.

The Netherlands is a country that places importance on the coherence of its tax system, and as such realizes that the effective application of such measures should always go hand in hand with the determination of the arm’s length result. In the same way, the Netherlands explicitly recognizes the importance of coordinating the implementation of BEPS-related measures internationally in order to ensure that the objectives of the BEPS Action Plan are achieved. In this context the Netherlands is not expected to announce one-sided or preemptive measures against BEPS that would put additional pressure on coherence between domestic tax systems in a post-BEPS environment.

In practice, the Netherlands often strives to solve BEPS-related issues by applying the standards of the arm’s length principle. This means, for example, that where there is an alleged deficiency in international profit allocation that can be adjusted through TP, the Dutch tax authorities will generally pursue this approach, as opposed to, for example, a deemed permanent establishment. The advantage of this approach is that it will generally provide the taxpayer with a greater chance

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12 Wijziging van enkele belastingwetten en enige andere wetten (Overige fiscale maatregelen 2016), Memorie van Toelichting., no. 34,305 no. 3.
of resolving the resulting double taxation that arises. In this respect it is worth noting that the Dutch tax administration acts not only from a motivation to prevent non-taxation but also has consideration for the unwanted effect of double taxation.

2.6. Can BEPS work in favour of MNEs?

The BEPS deliverables usher in a new era of transparency. The tax authorities will have access to more information than ever before and so, at least in theory, will be in a better position to evaluate compliance with (domestic) TP rules and regulations. The transparency pursued by the BEPS project will be assisted by an envisaged increase in the flow of information between tax authorities, by way of automatic exchange.

In the Netherlands, the government has pronounced its support for initiatives to improve transparency and automatic exchange of tax related information as important weapons in the fight against tax avoidance. In his letter to the Lower House of Parliament following the publication of the final BEPS reports in October 2015, the Dutch State Secretary of Finance reiterated the intention of the Netherlands of taking an international lead with respect to these subjects.

While such mechanisms will undoubtedly have effect with respect to their primary purpose of helping the tax authorities assess the TP risks within MNEs, the question is whether such mechanisms can also benefit MNEs. At the time of writing this report there are no direct indications that the exchange of information will directly benefit MNEs operating in the Netherlands, for example by providing them with information that will be used for domestic compliance.

3. What is the future of TP?

For the Netherlands, the TP-related outcomes of the BEPS project are, by and large, not new; they closely reflect the economic approach that the Dutch government and tax administration have already propagated in the evaluation of inter-company profit allocation. In this regard it is the Netherlands’ intention to continue to align its policies in the field of TP with international developments such as those of the OECD.

Overall, however, it can be expected that the clarified guidance will bring about a shift in countries with a more legal approach to a more economic approach to TP. With the higher level of subjectivity that comes with an economic approach, it will be even more important for the OECD’s guidance to include descriptions of concrete examples illustrating the economic principles underlying the guidance.

At the same time, an increased and improved level of international cooperation will be paramount in ensuring that the fight against BEPS does not result in an unwanted increase in double taxation for taxpayers. The Netherlands is a proponent of developing new ways to resolve or preempt international tax disputes. Recent years have seen pilots including joint audits and, where possible, early discussion with other tax authorities to come to a mutual understanding of the case at
hand. These developments aside, the Netherlands strives to include binding arbitration in all its tax treaties to provide a clear legal framework within which double taxation can be resolved.

Ultimately, the future of TP in the Netherlands will be shaped by the economic forces surrounding it. However, in a world of big economies the Netherlands might yet have a role to play in helping to navigate and shape the global TP policies with Dutch reason and pragmatism.
Summary and conclusions

Transfer pricing (TP) legislation has been in effect in New Zealand for almost 20 years. Inland Revenue endorses the OECD TP guidelines and has an active and ongoing risk assessment and compliance programme.

There are, however, aspects of New Zealand’s current TP regulation and practice that differ from the OECD TP guidelines. In particular:

- New Zealand has not directly incorporated the OECD guidelines into its domestic legislation. While the legislation refers to the OECD methodologies, it neither defines them nor indicates which method should be preferred. It is unclear whether the New Zealand courts would be willing to use the OECD guidelines to assist in the interpretation of the relevant domestic legislation. The better view is that the guidelines could be referred to as an interpretive guide in much the same way as other commentaries and texts, but could not be used to modify or read down the text of the legislation.

- There is an exception to the usual burden of proof in tax matters in the case of TP. If the taxpayer has determined the arm’s length amount using one or a combination of the permitted methodologies, then (unless the taxpayer has not cooperated with Inland Revenue) the onus is on Inland Revenue to demonstrate that another amount would be a “more reliable measure of the arm’s length amount” than the amount determined by the taxpayer.

- Inland Revenue provides certain guidance to reduce the TP compliance costs of taxpayers (effectively akin to a safe harbour) on low-value or non-core services and low-value loans. This guidance does not have legislative authorization but rather is issued pursuant to Inland Revenue’s general powers of administration.

- There is currently no legal requirement to prepare or file TP documentation. New Zealand has been active in responding to BEPS concerns. New Zealand is highly dependent on corporate tax receipts and has recently adopted or proposed numerous measures to buttress its corporate tax base.

So far, those measures have included broadening the scope of the thin capitalization rules and reducing the safe harbour gearing levels, removal of certain

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exemptions for foreign source income and eliminating exemptions and concessions in respect of interest withholding tax and broadening the circumstances in which interest withholding tax applies. Future reforms may include measures to counteract hybrid mismatch arrangements (corresponding to BEPS Action 2), potential interest deductibility limitations (reflecting BEPS Action 4) and country-by-country reporting (CbCR) (BEPS Action 13).

So far, New Zealand has not seen amendments to the TP rules (other than measures to implement CbCR) as a priority. Looking ahead, however, TP law and practice are unlikely to be immune from pressures related to BEPS concerns and New Zealand’s desire to maximize corporate tax receipts.

This report focuses on TP issues arising from BEPS Actions 8–10 that will be most relevant in New Zealand. Some issues canvassed in Actions 8–10, such as hard-to-value intangibles and cost contribution agreements (CCAs), are not as relevant to New Zealand and significant legislative changes to implement the recommendations in Actions 8–10 are not expected.

New Zealand has already begun its exchange of unilateral advanced pricing agreements (APAs) and has initiated a dialogue with New Zealand headquartered groups that will be subject to CbCR requirements. It is now clear that New Zealand will introduce legislation to implement CbCR with legislation expected to be introduced in early 2017 and enacted later that year. New Zealand has already signed the Multilateral Competent Authority Agreement on the Exchange of Country-by-Country Reports to allow for the exchange of CbCR.

It is unclear whether any BEPS initiatives relating to TP will benefit MNEs. One possible advantage that the report identifies is New Zealand’s continued commitment to unilateral APAs and the possibility that, with the exchange of these APAs, MNEs will be notified at an early stage if foreign tax authorities disagree with the New Zealand position. Inland Revenue takes the same principled approach to concluding unilateral APAs as it takes in respect of bilateral APAs or in mutual agreement procedure (MAP) deliberations and has stated that it will support any unilateral APA in any MAP with a foreign revenue authority.

Looking ahead, Inland Revenue has signalled that it may propose amending the law regarding onus of proof so that the onus will rest with the taxpayer in all respects. If the law is amended in that way, it is likely that Inland Revenue will pursue more aggressive positions in TP audits and disputes, given the tactical advantage of requiring the taxpayer to prove that Inland Revenue’s position is not consistent with the arm’s length standard.

Increased uncertainty as to how the legislative provisions apply also seems likely. The revised OECD TP guidelines (and in particular the emphasis on substance) raise potentially difficult questions of interpretation, since New Zealand’s TP provisions do not expressly incorporate the guidelines and under general principles of interpretation should be applied to the actual terms of the arrangement, not to its substance or the terms of an economically equivalent arrangement. A related question is to what extent Inland Revenue could successfully invoke the general anti-avoidance rule to recharacterize an arrangement to support an adjustment under the TP provisions.

Were New Zealand to amend its TP provisions to include a power to recharacterize an arrangement, even greater uncertainty could result. The terms of the arrangement as recharacterized would become a new avenue for dispute which
would need to be resolved prior to the question of whether the arrangement is priced consistently with the arm’s length standard.

Given these considerations, it would seem that there will be greater potential for disputes concerning TP. Litigation will often be an expensive and uncertain means of resolving such disputes and accordingly there may be an increased use of MAPs. Greater legal uncertainty and increased enforcement could also be expected to result in a greater use of APAs.

1. Current TP regulation and practice in New Zealand

On the spectrum of TP legislation, practice and enforcement, New Zealand can best be described as a mature market. TP legislation has been in effect in New Zealand for almost 20 years. Inland Revenue endorses the OECD TP guidelines and has an active and ongoing risk assessment and compliance programme.

While New Zealand’s TP legislation does not specifically reference the OECD TP guidelines, the OECD approach has been endorsed in Inland Revenue’s TP guidelines issued in 2000 and in ongoing public comments made by Inland Revenue. Further, the New Zealand legislative framework refers to the OECD methodologies. Section GC13(2) of the Income Tax Act 2007 provides that:

“The arm’s length amount of consideration must be calculated under any 1 or a combination of—
(a) the comparable uncontrolled price method;
(b) the resale price method;
(c) the cost plus method;
(d) the profit split method;
(e) the comparable profits method.”

The Income Tax Act, however, does not further describe or define those methods. There is, as yet, no case law concerning the interpretation of section GC13. It is therefore unclear how a New Zealand court would interpret this section, and what weight would be given to the OECD TP guidelines.

In cases concerning the interpretation of a double tax agreement (DTA), the New Zealand courts have taken into account the commentary to the OECD model convention. For example, the Court of Appeal has observed that the “OECD Convention rules have an international currency” and that provisions of the relevant DTA “should be construed on broad principles of general acceptation and having appropriate regard to the Commentary and any travaux préparatoires”. Taking into account the OECD commentary (or similar guidance) when construing a DTA is also consistent with orthodox principles governing the interpretation of international treaties generally. The approach generally permits taking into account background materials as well as subsequent practice in a treaty’s application.

When construing domestic legislation, however, the principles differ. Except in cases where the relevant Act expressly refers to international guidelines, the

1 Commissioner of Inland Revenue v. JFP Energy Inc. (1990) 12 NZTC 7,176 at 7,179.
starting point would usually be that OECD or other guidelines have a similar status to academic commentary and can be referred to as a guide in interpreting (but not to contradict or in any way read down) the relevant legislation. For that reason, in future cases before the New Zealand courts, it is likely that taxpayers and Inland Revenue would need to call evidence explaining the link between the reference in section GC13(2) to the five methodologies and the principles recorded in the OECD TP guidelines, rather than relying on the court being prepared to simply accept the guidelines as authoritative in relation to the interpretation of the TP provisions.

New Zealand law and practice include certain features that do not follow the OECD TP guidelines. One feature (which is reflected in the Income Tax Act) concerns the burden of proof. Another feature (which is reflected in Inland Revenue’s practice and published guidance) concerns certain low-value or non-core services.

The Income Tax Act provides for the transfer of the burden of proof from the taxpayer to Inland Revenue to prove a “more reliable measure of the arm’s length amount”. The relevant provision (section GC13(4)) states that:

“Initial determination by the taxpayer
(4) The arm’s length amount of consideration is determined by the taxpayer under subsections (1) to (3), and the amount determined is the arm’s length amount for the purposes of sections GC7 to GC11, unless either—
(a) the Commissioner can demonstrate that another amount is a more reliable measure of the arm’s length amount; or
(b) the taxpayer has not cooperated with the Commissioner in the Commissioner’s administration of sections GC6 to GC14 in relation to the taxpayer, and the non-cooperation has materially affected the Commissioner in that administration.”

The transfer of the burden of proof is therefore predicated on the taxpayer making a determination of the arm’s length consideration for a transaction in accordance with the requirements of the TP legislation, and cooperating with Inland Revenue in its administration of the TP rules. This shift in the burden of proof was initially legislated to provide an incentive to taxpayers to complete TP documentation. It is anticipated, and Inland Revenue has indicated, that this aspect of the TP legislation may be reviewed with a view to the taxpayer retaining the burden of proof, if New Zealand’s TP legislation is amended in the future.

A second feature of New Zealand law and practice that differs from the OECD TP guidelines is the limited provision of certain specific guidance to reduce TP compliance costs of taxpayers (effectively akin to a safe harbour) on low value or non-core services and low value loans. For example, Inland Revenue guidance (as at October 2016) stated that for small value loans (i.e. cross-border associated party loans by groups of companies for up to NZ$10 million principal (approximately €6 million) in total per year), Inland Revenue considers 250 basis points (2.5 per cent) over the relevant base indicator to be 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.

While there is no explicit legislative requirement for TP documentation to be prepared by taxpayers in New Zealand, this requirement is implicit in the requirement
for taxpayers to be able to demonstrate their compliance with the arm’s length standard, and to fall within section GC13(4) which shifts the burden of proof to Inland Revenue. Inland Revenue guidance (as at October 2016) states:

“if a company’s documentation inadequately explains why its transfer prices are considered to be consistent with the arm’s length principle, we are more likely to audit those transfer prices in detail. The lack of adequate documentation may also make it difficult for the company to rebut an alternative arm’s length transfer price proposed by us and is likely to result in penalties in the event of an adjustment to taxable income.”

Similarly, there is no mandatory TP filing requirement in New Zealand (such as the international dealings schedule in Australia). TP information is therefore generally supplied to Inland Revenue following a specific request for information in a review or audit context, or in the course of an APA application.

The practice of TP enforcement in New Zealand is very much a function of the nature of the New Zealand economy. Corporate taxes make up a significant part of the total tax take for New Zealand, being just over 15 per cent of the government’s tax take. New Zealand is highly reliant on foreign trade and investment, and has a large concentration of foreign-owned entities with operations in New Zealand. TP risk assessment is therefore an intrinsic element of corporate tax compliance for these taxpayers, and all large taxpayers are subject to an annual compliance review by Inland Revenue.

TP enquiries will also routinely be made during risk reviews or audits of small to medium-sized entities, albeit generally on a less frequent basis. The extension of the TP review focus to smaller businesses demonstrates the importance placed on TP by Inland Revenue.

In relation to outbound trade, New Zealand exports are primarily agricultural products and commodities, with manufactured goods and technology products making up a relatively small proportion of exports. Exports of services (e.g. tourism, education, software, engineering and professional services) tend to involve relatively lower volumes of cross-border related party transactions. As a result, the TP considerations associated with New Zealand’s outbound intercompany transactions tend to be relatively simpler than for many of New Zealand’s trading partners. In particular, such transactions are less likely to include significant intangible value and its resultant TP complexity.

New Zealand owned multinationals of scale are also relatively rare, with only a handful having operations outside of Australia and New Zealand. These larger entities are subject to the same annual compliance review from Inland Revenue as referred to above.

Inland Revenue’s practice of conducting annual compliance reviews for large businesses is supported by statutory information gathering powers. These powers have been construed broadly by the courts in Inland Revenue’s favour, so that taxpayers may be required to provide large volumes of documentation and other information to Inland Revenue. The only categories of information not required to

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2. New Zealand Government 2016 Budget, corporate tax $11.6 billion out of total taxes of $71.9 billion.
be disclosed pursuant to these powers are legally privileged documents and certain
documents containing tax advice prepared by non-lawyers. Inland Revenue there-
fore has good oversight of and access to information concerning the tax and trans-
fer pricing affairs of New Zealand’s largest multinationals (MNEs).

Inland Revenue has employed a small but experienced team of TP specialists
for many years. To date, Inland Revenue has operated a largely cooperative
approach to TP compliance, with strong encouragement of taxpayers to seek APAs
and to raise complex TP matters with Inland Revenue in a timely and transparent
manner.

The majority of APAs are agreed on a unilateral basis, primarily due to the cost
and time delays that can be experienced in bilateral APAs. Inland Revenue has,
however, clearly stated that it will support a position it has agreed to in a unilateral
APA if a TP adjustment arises in a foreign jurisdiction in relation to a transaction
for which a unilateral APA has been granted, and the MAP is invoked.

2. The impact of the BEPS project on TP

2.1. Introduction

In a similar vein to most Western countries, the BEPS initiatives have received
media attention in New Zealand, with an ongoing focus on the tax affairs of pre-
dominantly foreign-owned entities with New Zealand operations and the broader
“tax morality” debate. This has provided a level of media coverage seldom seen
before in New Zealand on TP and international tax matters.

This media attention was further heightened following the leak of the Panama
Papers. The papers included reference to New Zealand’s foreign trust rules, under
which foreign-source income derived by New Zealand resident trustees is not sub-
ject to New Zealand tax provided no settlement on the trust was made by a New
Zealand tax resident and the income is not distributed to a New Zealand resident
beneficiary. The publicity associated with the Panama Papers led to some com-
mentators questioning the disclosure requirements for trustees of trusts settled by
persons that are resident outside New Zealand and Australia, and indeed, whether
New Zealand was operating a harmful tax regime.

This resulted in a review of New Zealand’s foreign trust rules by tax expert John
Shewan. The tax treatment of foreign trusts, as described above, is in fact consist-
ent with orthodox tax policy positions: where income is non-New Zealand sourced,
is derived from capital settled on the trust by non-New Zealand residents, and is not
derived by a New Zealand resident beneficiary, it is appropriate for New Zealand
not to tax the income. The fact that one or more trustees of the trust may be tax res-
ident in New Zealand is seen as an insufficient basis for New Zealand to tax the
non-New Zealand sourced income, because the trustee is performing a manage-
ment and administrative role, as distinct from the settlors who have contributed the
capital to the trust.

Mr Shewan’s review concluded, however, that the existing disclosure rules
for foreign trusts should be enhanced, to address the risk of the regime being used
to avoid or evade foreign taxes or for other illegitimate purposes. The New Zealand
government accepted almost all of the recommendations made by Mr Shewan, particularly in relation to transparency, disclosure, reporting and the increased enforcement of rules in relation to foreign trusts.

The level of discussion and debate in New Zealand between tax academics, tax practitioners, large taxpayers and Inland Revenue will continue as New Zealand’s tax policy and legislation evolve following the BEPS project. There is active engagement with Inland Revenue policy officials and government by the business community on the BEPS project, through industry groups such as Chartered Accountants Australia and New Zealand, the Corporate Taxpayers Group (a group of corporate taxpayers that advocates on tax policy issues relevant to its members), the New Zealand Law Society as well as directly by some larger MNEs.

From the outset, Inland Revenue has been supportive of the OECD’s BEPS project, with a commitment from senior officials to represent New Zealand at the OECD and active engagement in many of the BEPS work streams. The implementation of BEPS initiatives is being given due consideration and will be prioritized according to the actual (or potentially the perceived) weaknesses and risk areas relevant to New Zealand.

A number of the BEPS actions have been given a lower priority by Inland Revenue as a result of existing New Zealand legislation. For example (and of relevance to BEPS initiatives relating to substance), New Zealand already has a general anti-avoidance rule (GAAR), with a significant body of case law having developed over time. The report addresses the GAAR and its relevance to TP matters below. New Zealand also has comprehensive controlled foreign company (CFC) rules which subject specified passive income earned in CFCs to tax in New Zealand. The areas where Inland Revenue has indicated that detailed tax policy work will be undertaken in New Zealand concern hybrid mismatch arrangements (corresponding to BEPS Action 2) and potentially interest deductibility limitations (reflecting Action 4).

In relation to the BEPS TP measures, it is anticipated that legislation to implement CbCR will be introduced (see section 2.5 below). However, Inland Revenue currently considers that it has good information available to it through its information gathering powers, cooperative arrangements with taxpayers and audit processes. Therefore, it is not expected that CbCR filings will necessarily identify new risks or provide significant additional new information. Nonetheless, it is considered important to support international CbCR developments and the multilateral exchange of CbCR information.

The wider multilateral exchange of information process has already commenced for unilateral APAs entered into and certain other rulings given by Inland Revenue. In February 2016, Inland Revenue confirmed that it would begin implementing this exchange of information, including in respect of past rulings and APAs issued on or after 1 January 2010 and still in force as at 1 January 2014.

Whether further legislative changes to the TP rules will be proposed is still under consideration. Any such changes would be subject to the generic tax policy process (or GTPP). The GTPP is a standard policy development process applied by Inland Revenue and the New Zealand Treasury; it is designed to enable the consideration

\[3\] In addition to unilateral APAs, the categories of rulings required to be exchanged are the those specified in the OECD’s Action 5: final report (para. 91).
of all aspects of tax policy proposals and their impacts, and to ensure opportunities for public consultation.

The GTPP includes consideration of the strategic, tactical, operational and legislative aspects of tax policy development and implementation requirements of new legislation. In practice, the GTPP requires public consultation on reform proposals (by reference to a discussion document or issues paper) at least several months in advance of draft legislation being introduced to the House of Representatives.

One interesting issue that the BEPS TP measures raise for New Zealand arises from references in the Actions 8–10 final report to the substance of a transaction, and/or to the need to consider the conditions that “would be agreed” on between independent parties for a comparable transaction, as opposed to the conditions that the parties to the controlled transaction in fact agreed on. The question is whether New Zealand’s TP provisions can be construed so as to require an arm’s length price to be ascertained based on the so-called “substance” of the arrangement or the arrangement that “would” be agreed.

Under New Zealand law, the starting point when considering the tax consequences of any transaction is to apply the tax rules to the legal rights and obligations in fact created under the transaction. The Income Tax Act contains both specific rules and a GAAR that provide Inland Revenue with the ability to strike out and/or recharacterize the transaction if (under the GAAR for example) the transaction has a more than incidental purpose or effect of tax avoidance. But unless an anti-avoidance or other provision permitting recharacterization applies, the TP provisions should apply based on the arrangement actually entered into.

Because, as explained above, New Zealand’s TP provisions do not expressly incorporate the OECD TP guidelines, in the event of any inconsistency between the legislative provisions and the guidelines, the legislative provisions (interpreted in the usual way) would prevail. That said, the legislative provisions might provide some opening for an analysis that depends on recharacterization. The provisions apply to an “arrangement” and “arrangement” is defined more broadly than “transaction”: it means an agreement, contract, plan or understanding, including all steps and transactions by which it is carried into effect. The breadth of the definition arguably permits Inland Revenue to have regard to broader considerations than just the strict legal position.

New Zealand has had no decided cases as yet in respect of its TP provisions. It accordingly remains unclear to what extent a New Zealand court might be prepared to consider the substance of a transaction and its broad effects. It is likely, however, that for the reasons set out in section 1 above, the provisions will not be interpreted in a way that gives primacy to the OECD TP guidelines. Rather, any interpretation will need to be justified by reference to the text of the statutory provisions.

2.2. Challenges of transactions with intangibles

New Zealand is a small capital-importing nation. It does not generally face the same challenges as other jurisdictions with respect to transactions with intangibles. Given the small size of the New Zealand economy and its distance from major

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4 The New Zealand GAAR can be found in section BG1 of the Income Tax Act.
markets, it is very unusual for intellectual property of significant value to be developed and matured within New Zealand. More typically, the development of internationally valuable intellectual property is followed by the owner of the property either: (a) relocating its New Zealand business to a larger market in North America, Europe or Asia in order to better access foreign capital and marketing opportunities, or (b) selling its business to a larger foreign-based organization that is better able to globalize the developed technology.

It is against this backdrop that the following comments about transactions with intangibles need to be understood. New Zealand simply does not encounter some of the issues involving intangible property transactions that concern other jurisdictions. So while New Zealand wishes to be a “fast follower” of BEPS recommendations, it is not expected that any changes to New Zealand law (at least insofar as intangibles are concerned) will be made over and above the minimum changes necessary to ensure that the BEPS Actions 8–10 recommendations can be followed.

2.2.1. Definition of intangibles

Intangible property is defined for some purposes in the Income Tax Act. For example the term “depreciable intangible property” is extensively defined for the purposes of determining types of intangible property that may be depreciated for New Zealand tax purposes. However, this definition does not apply for the purposes of New Zealand’s TP laws.

Given New Zealand’s endorsement of the OECD TP guidelines and its support for the BEPS project, it is expected that at least as a matter of practice, Inland Revenue will have regard to the description of an intangible as described in the amended guidelines set out in the Actions 8–10 final report. That is, an intangible is (paragraph 6.6 of the amended guidelines): “something which is not a physical or financial asset, which is capable of being owned or controlled for use in commercial activities, and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances”.

It is not, however, expected that any changes will be made to the Income Tax Act to reflect this concept of intangible. Instead New Zealand is expected to endorse the findings of BEPS Actions 8–10 as a matter of practice and without making any changes to its tax legislation. This raises an interesting issue: it is possible to envisage a tension between the revised guidelines (which require “determination of the conditions that would be agreed upon between independent parties for a comparable transaction” rather than “focusing on accounting or legal definitions”) and the TP legislation which requires that an arm’s length price be determined for the arrangement in fact entered into, not an arrangement that “would be agreed upon” between independent parties.

As indicated above, while the question has not yet been considered by a New Zealand court, the orthodox view is that the OECD TP guidelines (which are not incorporated into the Income Tax Act) cannot be relied on to contradict or read down the legislation. If the OECD TP guidelines would lead to a different outcome from that prescribed by the legislation, it is the legislation that should prevail.

2.2.2. Transactions with intangibles

There are no specific rules for the recognition of transactions with intangibles in New Zealand and no developments are expected in this area in the foreseeable future. Therefore, in the absence of a finding of tax avoidance or some other legal basis for recharacterizing the arrangement, New Zealand will generally proceed on the basis that the economic benefit of intangibles will flow to the legal owner of the intangible property, without pursuing a more substance-based enquiry into whether other members of an MNE may have performed functions, used assets or assumed risks that have contributed to the value of the intangible property. This reflects the usual approach taken under New Zealand law to the characterization of an arrangement for tax purposes (as described above) and also the fact that New Zealand generally does not encounter any significant issues or concerns with intangible transactions.

Inland Revenue does tend to carefully consider whether identifiable intangible property has been created locally. This is done through a close examination of R&D costs and remuneration data when a taxpayer is subject to a review or audit by Inland Revenue.6 However, given that New Zealand is a capital-importing nation most of Inland Revenue’s focus is on issues involving the inbound licensing of intangibles. In respect of these types of transactions, Inland Revenue’s focus is generally directed at the quantum of royalty payments made to a foreign related party owner of intangible property that is being licensed to a New Zealand affiliate. Where large royalty payments are being made, Inland Revenue will expect the property to add significant value to the New Zealand operation, that the use of the intangible profit will contribute to the profit of the New Zealand operation and that the New Zealand operation will still be sufficiently profitable after payment of the royalties.7

To aid in the consideration of the appropriate royalty rate, Inland Revenue places a high degree of weight on the so-called “25 per cent rule”. Under this rule the amount of royalty payable is equal to 25 per cent of channel profits. In the view of Inland Revenue this industry practice is considered to be a “useful check” for either the comparable uncontrolled price method or the residual profit method as it is considered to be common practice in New Zealand.8 Tax practitioners, however, dispute the appropriateness and applicability of this ratio.

2.2.3. “Substance-over-form” approach towards intangibles

As noted above, New Zealand tax law generally proceeds on the basis that a transaction’s tax consequences are to be determined based on the legal arrangements actually entered into rather than on the basis of the transaction’s economic substance or the terms of some economically equivalent transaction. An important

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exception to this principle is if the GAAR or another provision expressly permit-
ting recharacterization applies.

The application of the GAAR turns on whether an arrangement has a more than incidental purpose or effect of tax avoidance. The courts have held that an arrange-
ment’s “purpose or effect” must be ascertained from broader considerations than just the terms of the legal arrangement. Also relevant is the “substance” of the arrangement and the extent to which it has been structured in an artificial and con-
trived way. While a court’s approach in applying the GAAR will always depend on the facts of the case, an approach that has featured prominently in recent cases is the so-called parliamentary contemplation approach. On that approach, the GAAR may apply to an arrangement that, viewed in a commercially and economically realistic way, uses (or circumvents) the relevant specific provisions of the Income Tax Act in a manner that is not consistent with Parliament’s purpose in respect of the provisions in question.9

The New Zealand GAAR is regularly applied in tax disputes and Inland Rev-
enue has been successful in upholding a finding of tax avoidance in a number of recent high profile court cases. Accordingly, the Income Tax Act already contains sufficient scope for Inland Revenue to take a substance-over-form approach in con-
sidering transactions involving intangibles. The broad scope of section BG1 allows Inland Revenue to consider the functions related to the development, enhancement, maintenance and exploitation of intangibles within a multinational group, as these would all fall within the “arrangement” in question. If the relevant arrangement is found to have tax avoidance as its purpose or effect, then Inland Revenue has the power to recharacterize the transaction and deny the tax benefit that the arrange-
ment provides to the taxpayer.

In cases involving intangibles to which neither the GAAR nor any other rechar-
acterization power applies, Inland Revenue would need to proceed on the basis of the legal arrangements actually entered into rather than on the basis of the substance. Nonetheless, as mentioned above, because the TP provisions are based on the more broadly defined concept of “arrangement”, there may be scope to look beyond the strict terms of the legal documentation. One example of this, in the context of intangibles, would be if it could be established that there was an “understanding” (and therefore an “arrangement”) for an intangible to be used by a particular group member even if there were no legal agreement to that effect.

There has been no discernible change in the analysis for TP purposes of trans-
actions involving intangibles as a result of the BEPS project. Nor is any change in the law expected. This reflects the broad recharacterization powers available to Inland Revenue under the GAAR in cases of aggressive tax planning as well as the relatively low level of material transactions involving intangible property in the New Zealand context.

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9 See for example Ben Nevis Forestry Ventures Ltd v. C of IR (2009) 24 NZTC 23,188 (SC) at para. [107]. See also Inland Revenue’s interpretation statement IS 13/01: Tax avoidance and the interpre-
2.2.4. **Comparability and group synergies**

New Zealand endorses the view that where corporate synergies arising from deliberate and concerted group actions provide MNE group members with a material advantage or burden that would not be typically found in an independent company, then that benefit or detriment needs to be identified and divided among the members of the group. Furthermore, New Zealand endorses the view that such an allocation should only be among group members that contribute to the benefits or detriments and that this should be done in proportion to the contribution to the synergy.

Examples of group synergies commonly recognized in New Zealand include pricing discounts, longer payment terms and implicit parent company support in intercompany loan pricing. While Inland Revenue is unlikely to recognize the deductibility of charges for the benefit of any such group synergies, Inland Revenue is actively enforcing the recognition of some group synergy benefits.

In particular Inland Revenue is active in scrutinizing and challenging the pricing of intercompany loans advanced to New Zealand affiliates of foreign owned MNEs. Inland Revenue believes that the value of implicit parent company support must be recognized in pricing intercompany loans, where the New Zealand borrower is owned by an MNE group that has better creditworthiness than the individual New Zealand borrower. It is not uncommon for Inland Revenue to argue (albeit that the argument is contested by taxpayers in many cases) that a relatively small New Zealand borrower is “core” or “highly strategic” to the MNE group and accordingly should be able to borrow from another group company with debt priced on the basis that the New Zealand borrower has the same credit rating, or a rating only one-notch lower, than its ultimate parent company.

Existing TP laws provide sufficient scope for Inland Revenue to identify and challenge the allocation of group synergies. Accordingly, no changes to domestic laws or regulations with respect to this issue are expected as a consequence of the BEPS project.

2.2.5. **Hard-to-value intangibles**

New Zealand does not have any significant concerns about hard-to-value intangibles. Consequently, New Zealand is not expected to introduce any measures to improve the valuation of hard-to-value intangibles as a consequence of the BEPS Actions 8–10 report.

2.2.6. **CCAs**

Very few material CCAs exist in New Zealand. Where a CCA does exist, the usual New Zealand tax rules must be followed. For example consideration must be given to whether the expenditure is deductible for New Zealand tax purposes.

As a result, New Zealand is not expected to introduce any specific rules with respect to CCAs. At most it is expected that New Zealand will endorse the OECD position with respect to CCAs outlined in the BEPS Actions 8–10 report.

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2.3. Risk and capital

BEPS Actions 8–10 has as one of its aims the adoption of TP rules or special measures to ensure that inappropriate returns will not accrue to an entity solely because it has contractually assumed risks or has provided capital. This raises the question of how countries address strategies that artificially shift profits away from the countries where value is created.

Under current New Zealand law it could only be through application of the GAAR, and the associated powers of reconstruction, that Inland Revenue could attempt to ensure that inappropriate returns do not accrue to entities solely because of contractually assumed risks or the provision of capital. Otherwise (and as described above) Inland Revenue must apply the TP provisions based on the legal arrangements actually entered into, even if those arrangements are motivated or structured to shift profits.

The criteria for applying the GAAR are summarized in section 2.2.3 above. Where a tax avoidance arrangement is found to exist (i.e. the GAAR applies) the arrangement is void against Inland Revenue. In addition, Inland Revenue may (if necessary) use the powers of reconstruction under section GA1 of the Income Tax Act to counteract any tax advantage obtained by the taxpayer. In cases where deductible expenditure is at issue the voiding of the arrangement will often be sufficient to counteract the tax advantage and no reconstruction will be necessary. In other cases, reconstruction will be necessary to counteract the tax advantage.

It is beyond the scope of this report to provide a detailed account of the reconstruction powers under section GA1. It suffices to say that this section provides Inland Revenue with the power to adjust the amount of income, allowable deductions, balance of available tax losses, or the amount of any tax credit for any person affected by a tax avoidance arrangement. The adjustment can be made in any way that Inland Revenue thinks appropriate. It has also been found by the New Zealand courts that the power of reconstruction is not limited to the actual parties to the arrangement and that anyone who has benefited (in the sense of enjoying a tax advantage from or under the arrangement) can be subject to reconstruction.

A challenge for Inland Revenue in applying the GAAR is that despite recent success in the courts, there is still a relatively high threshold to meet. The court must be satisfied that the arrangement results in the use (or circumvention) of the relevant tax laws in a manner that cannot have been within the contemplation and purpose of Parliament when it enacted the relevant laws. This will usually require some level of artificiality or contrivance in the structuring of the arrangement. Consequently, it is easier for Inland Revenue to successfully invoke the GAAR in respect of arrangements that have some commercially unusual or obviously tax driven features.

This threshold needs to be compared to the outcome of the BEPS Actions 8–10 report and the resulting revisions to chapter I of the OECD TP guidelines. At a high level the new chapter I guidance is intended to ensure that:

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11 S. GA1(5).
12 Per s. GA1(2).
13 _Ben Nevis Forestry Ventures Ltd v. C of IR_ (2009) 24 NZTC 23,188 (SC) at [168].
14 _Ibid._ at [107].
15 OECD BEPS project Actions 8–10 final report at p. 13.
TP is not based on contractual arrangements that do not reflect economic reality. Instead actual transactions between associated enterprises must be identified;

• contractual allocations of risk are respected only when supported by actual decision-making;

• capital will generate no more than a risk-free return when not supported by any functionality.

Importantly, the revisions to chapter I stress the need for tax administrations to be able to disregard transactions between associated enterprises in these sorts of scenarios. The revision to chapter I notes that:16

“the key question in the analysis is whether the actual transaction possesses the commercial rationality of arrangements that would be agreed between unrelated parties under comparable economic circumstances, not whether the same transaction can be observed between independent parties…”

Where the allocation of risk and capital between related parties is not commercially rational, the new guidance envisages tax administrations having the power to recharacterize the transaction so that what is recognized for TP purposes replaces the actual transaction entered into with one that is as close to the actual facts as possible but which is also commercially rational. The reporters have discussed Actions 8–10 with Inland Revenue policy officials who share their view that the current New Zealand GAAR, while providing broad powers to recharacterize a transaction, is a higher threshold than the new chapter I envisages.

Legislative changes would therefore be required to implement the Actions 8–10 recommendations into New Zealand law in order to broaden the circumstances where Inland Revenue can recharacterize a transaction. It is currently unclear whether New Zealand will proceed with this legislative change. Broad recharacterization rules have been introduced in Australia but these have been widely criticized.17 New Zealand is therefore proceeding with caution as to how to reconcile the Action 9/chapter I recommendations with its lack of a broad recharacterization rule and the question of whether there is a real need to introduce one.

2.4. High-risk transactions

2.4.1. Comparable uncontrolled prices (CUP) and quoted prices for cross-border commodity transactions

Agriculture makes up a significant portion of the New Zealand economy and represents the bulk of its exports.18 New Zealand’s reliance on agriculture makes it unusual among developed countries. New Zealand is therefore watching developments with respect to agriculture carefully.

16 Ibid. at p. 39.
18 In 2015, agricultural exports made up approximately two thirds of New Zealand’s exports, with dairy (23.5 per cent) and meat (13.9 per cent) exports making up the largest components of this figure (http://www.treasury.govt.nz/economy/overview/2016/25.htm).
New Zealand agrees that the CUP method is appropriate for establishing the arm’s length price for the transfer of commodities, but again is not experiencing any difficulties with taxpayers being unable or unwilling to apply this methodology in practice. As a result, New Zealand’s existing TP laws are considered sufficient to deal with commodity transactions and the BEPS Action 8–10 report has had no impact on New Zealand’s approach to TP for commodity transactions.

2.4.2. Intra-group services

Intra-group service charges are an important issue for New Zealand. This is because of the capital-importing nature of the New Zealand economy which results in a large number of MNEs operating relatively small subsidiary operations in New Zealand. It is not uncommon for New Zealand subsidiaries to have few staff, with many back office functions such as finance, administration and human resources provided by larger regional operations in Australia or elsewhere in the Asia Pacific region. In accordance with the arm’s length principle it is observed that most of these subsidiary companies are charged for the provision of these types of intercompany services.

Service charges are therefore an active area for Inland Revenue enquiry when reviewing or auditing a New Zealand subsidiary of a foreign MNE. Substantial guidance is provided by Inland Revenue to MNEs operating in New Zealand with a ten point checklist accessible on Inland Revenue’s website. To summarize, the checklist broadly makes the following points:

• the importance of understanding and documenting the nature and reason for the charge;
• generally a cost plus approach is recommended, with a fair mark-up. Third party costs should not be marked up and differential rates should be applied for low value versus high value services;
• a warning not to charge for duplicated services – i.e. intercompany service charges should not be made for services that the New Zealand entity can already perform itself;
• a warning not to charge for foreign “shareholder” or “stewardship” types of costs;
• the method of allocating costs to New Zealand should result in a charge that is proportionate to the benefit received. Arbitrary measures such as turnover may be too simplistic and may not focus on the value of the benefit to the New Zealand subsidiary;
• with respect to branches, as these are not separate legal entities, any service “charge” should in fact only be a cost allocation, with no mark-up.

With respect to the cost plus methodology endorsed by Inland Revenue, a “safe harbour” mark-up rate of 7.5 per cent is accepted by Inland Revenue for intercompany service charges for non-core services (provided the service charge is not more than 15 per cent of the total accounting expenses of the New Zealand recipient) or where the service charges are less than NZ$1 million. This safe harbour is

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expected to be reduced to 5 per cent in accordance with OECD recommendations. The NZ$1 million *de minimis* amount is aligned with a similar concession available in Australia and is under continual review by Inland Revenue.

The key issue for New Zealand with respect to intercompany service charges is whether the total fee is reasonable. Inland Revenue often observes global or regional charges allocated to subsidiaries that an MNE may have in New Zealand, based on some arbitrary measure such as turnover. While New Zealand is mindful of the need to minimize compliance costs and complexity, equally in order to protect the New Zealand tax base it expects MNEs to only charge fees that are reasonable and represent the provision of real value.

Inland Revenue therefore expects recipients of inter-company services charges to undertake an “in-market reasonableness test” to confirm whether the New Zealand entity has actually received benefits of equivalent value to the service charge. If a New Zealand subsidiary could have purchased the services locally for an amount significantly less than the intercompany charge, its full deductibility is likely to be challenged by Inland Revenue.

New Zealand endorses chapter VII of the OECD TP guidelines with respect to this issue. Further, in its own published guidance Inland Revenue provides a lengthy list of examples of service charges it does not consider to be deductible if incorporated into a service charge to a New Zealand group member. These include global restructuring costs, Sarbanes–Oxley costs, global or regional cost allocations without any supporting rationale for the charge, and IT charges where the New Zealand subsidiary makes no or limited use of the relevant IT application.

New Zealand agrees with the OECD that inter-company service charges are a major potential source of BEPS. Therefore with respect to the BEPS Actions 8–10 report, New Zealand is supportive of the changes to chapter VII. As noted above New Zealand is expected to lower its safe-harbour service charge mark-up to 5 per cent and to endorse the new section D on low-valued adding group services.

### 2.4.3. Profit splits in the context of value chains

New Zealand does not have any specific rules dealing with profit splits in value chains. To date, in New Zealand’s experience, traditional OECD methods of determining the appropriate allocation of income are broad enough to address the transactions it has observed.

As a result there has been no reaction to the OECD’s work on profit splits and there is no expectation that some form of profit split mechanism will be adopted into New Zealand’s TP laws.

### 2.5. TP documentation

#### 2.5.1. CbCR

New Zealand has committed itself to implementing the CbCR recommendations set out in the BEPS Action 13 final report. In May 2016, New Zealand affirmed its commitment to implementing Action 13 and signed the Multilateral Competent Authority Agreement on the Exchange of Country-by-Country Reports.
Under section 2.1 of that agreement, the competent authority of each signature state will automatically exchange, on an annual basis, the CbCR received from each reporting entity that is tax resident in its jurisdiction. The information will be exchanged with competent authorities of all other jurisdictions with which New Zealand has the agreement in effect if (using the information in the CbCR) one or more constituent entities of the group of which the reporting entity is a member is either tax resident in that jurisdiction or subject to tax on a business carried on in that jurisdiction through a permanent establishment. The agreement provides for the mechanics of information exchange, including by reference to electronic data transmission with encryption standards.

New Zealand had previously (in 2012) signed the multilateral Convention on Mutual Administrative Assistance in Tax Matters, as amended by the 2010 protocol. That convention came into force for New Zealand on 1 March 2014, and was effective for criminal law matters from 1 March 2014 and for other exchange of information matters generally from 1 January 2015.

It was initially unclear whether New Zealand would enact domestic legislation to implement CbCR. It is understood that consideration was initially given to relying on Inland Revenue’s general powers to obtain the necessary information. The relevant statutory power (section 17 of the Tax Administration Act 1994) provides for Inland Revenue to require any person to furnish in writing any information and produce for inspection any documents that Inland Revenue considers necessary or relevant for any purpose relating to the administration or enforcement of the Inland Revenue Acts or to any matter connected with any function conferred on Inland Revenue.

Despite the breadth of this existing statutory power, it has not traditionally been used to enforce or impose a periodic reporting obligation. Possibly for this reason, the New Zealand government, in documents released in June 2016, has signalled its intention to implement the CbCR measures through legislation. It is likely that that legislation will be introduced to the House of Representatives in early 2017 and enacted later that year.

If New Zealand takes the same approach to legislating for CbCR as is being taken to its domestic legislation implementing the common reporting standard, the legislation to implement CbCR can be expected to cross-refer to (rather than repeating the detail of) the requirements set out in the OECD TP guidelines. This approach may pose challenges for both taxpayers and Inland Revenue given the risk that future changes to the OECD TP guidelines may automatically apply under New Zealand law, without consideration being given to the consequences of those changes for New Zealand and whether consequential amendments to the domestic legislation should be made.

CbCR requirements will probably apply to New Zealand headquartered corporate groups with annual consolidated group revenue of €750 million and above. New Zealand is likely to follow the OECD guidance and apply the revenue threshold in euro rather than following the Australian approach of legislating in local currency. This ensures consistency of reporting obligations for members of MNE groups.

Inland Revenue estimates that the CbCR requirements will affect around 20 New Zealand headquartered corporate groups.20 A significant number of New Zealand

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20 IRD, Large Enterprises Update: Number 33 (20 November 2015).
subsidiaries will also be affected, to the extent that their offshore parent companies are required to prepare CbCR in their home jurisdictions. These New Zealand subsidiaries will probably be required to contribute the local country information for completion of the parent’s CbCR.

Inland Revenue advised MNEs headquartered in New Zealand to start collecting data for CbCR for the 12-month period beginning on 1 January 2016 (for groups with a 31 December balance date), 1 April 2016 (for groups with a 31 March balance date), and 1 July 2016 (for groups with a 30 June balance date). The first CbCR exchange is scheduled to take place in the 2018 calendar year, in line with the OECD’s recommended timetable.

Taxpayers will be required to file CbCR within 12 months of the end of the reporting period. Inland Revenue will then submit these reports to the appropriate foreign tax authorities within a further six months.

2.5.2. Master and local files

As noted in section 1 above, there is no legal requirement for taxpayers to prepare TP documentation although Inland Revenue expects that taxpayers will do so in order to be able to demonstrate compliance with the arm’s length standard. Given the absence of mandatory documentation requirements under domestic law, it is likely that New Zealand will follow the OECD’s proposed master file/local file approach and not impose additional documentation requirements over and above the Action 13 requirements.

Taxpayers preparing master and local file documentation will need to be aware of any variations in local requirements in the jurisdictions in which they operate and may need to customize the master or local files accordingly. For example, if a group has a less common structure (such as that it operates as a cooperative or mutual) it may be advantageous to disclose that fact, as it may help to explain arrangements or financial results that would otherwise appear unusual.

2.5.3. Compliance costs

Inland Revenue believes that the majority of companies subject to TP rules have maintained TP documentation.\(^{21}\) For those companies, it is expected that much of the underlying information required to comply with the master and local file requirements will already be available, although additional work will be required (and compliance costs incurred) in order to present the information consistently with the new requirements.

2.6. TP-related measures in other BEPS actions and other measures against BEPS

Over the past few years, reforms affecting the taxation of MNEs investing or operating in New Zealand have had a strong focus on broadening the tax base and limiting exemptions and tax planning opportunities. Particular measures have included:

\(^{21}\) Inland Revenue “Multinational Enterprises: Compliance Focus” (October 2016) at 4 which shows 79 per cent of MNEs in New Zealand had TP documentation.
broadening the scope of the thin capitalization rules so the rules apply not only to New Zealand groups controlled by an MNE but also to New Zealand groups owned by a group of investors that coordinate as to the provision of debt funding to the New Zealand group;

• reducing the safe harbour gearing levels for groups to which the thin capitalization rules apply, so that the level of debt that is permitted before interest deductions will be disallowed is lower than was previously the case;

• removing the foreign dividend exemption for dividends that are deductible to the payer, removing an opportunity for tax arbitrage between New Zealand and other jurisdictions;

• removing the conduit tax relief regime which allowed New Zealand subsidiaries controlled by foreign shareholders to flow foreign income through New Zealand with no New Zealand tax or partially relieved New Zealand tax;

• from 1 October 2016, the goods and services tax applies to cross-border services – including e-books, music, videos and software purchased from overseas websites;

• eliminating exemptions and concessions in respect of interest withholding tax and broadening the circumstances in which interest withholding tax will be imposed. These measures include: (a) further restricting the availability of relief from withholding tax on interest paid to non-associated persons; (b) imposing withholding tax on interest at the point of accrual (rather than when paid) in the case of certain arrangements under which interest payments are deferred (even if the deferral is for commercial reasons unrelated to tax); (c) removing a long-standing exemption from withholding tax on interest paid by foreign branches; (d) subjecting notional interest charged under inter-branch arrangements to the interest withholding tax rules;

• amending the Income Tax Act to permit Inland Revenue to override DTA relief otherwise available by invoking the GAAR;

• enhanced disclosure requirements in relation to trustees of trusts settled by foreign residents (as discussed in further detail in section 1 above).

Such measures have not been pursued directly in response to the OECD’s BEPS project but rather the more general strategy noted above of broadening the tax base and limiting exemptions and tax planning opportunities in respect of inbound investment in particular. Many of the measures significantly increase the complexity of New Zealand’s tax laws.

As noted in section 1 above, it appears that New Zealand will enact amendments to its Income Tax Act to implement BEPS Action 2 (Neutralizing the effects of hybrid mismatch arrangements). Initial indications are that these amendments, too, could involve considerable complexity. As also noted in section 1, in the TP context, it is possible that the current law (providing that Inland Revenue has the onus of demonstrating a more reliable measure of the arm’s length amount) will be amended so that in all cases the taxpayer bears that onus.

Inland Revenue is also promoting compliance and governance-related measures that reflect BEPS concerns. These measures are not dependent on legislative amendment.

Inland Revenue has continued to issue questionnaires to MNEs as a means of gathering intelligence and identifying issues for further investigation. Inland Revenue has introduced a questionnaire on international tax matters which it has
issued to at least 292 foreign-owned companies to collect further information about financing, debt and TP.

In August 2016, Inland Revenue affirmed its endorsement of the guidance on tax control frameworks released by the OECD’s forum on tax administration. Inland Revenue recommended that boards of directors (with a view to “setting the right tone from the top”) consider endorsing a set of overarching principles. By way of example, Inland Revenue has referred to the Business and Industry Advisory Committee (BIAC) Statement of Tax Principles for International Business as an example of such a statement of principles.22

Finally, financing costs have always been a priority BEPS concern for Inland Revenue. In addition to considering the BEPS Action 4 recommendations (as indicated in section 1 above) New Zealand could consider other measures, such as amendments to the thin capitalization rules and/or the TP rules.

It is possible that the thin capitalization rules could be further reviewed. That review could address the definitions of assets and debt (which are used to determine the group debt percentage) and the way interest deduction limitations are determined for certain types of businesses. For example, in 2005, special rules were introduced for banks and a question that arises is whether special rules should similarly apply to other businesses in the financial sector.

The thin capitalization rules limit interest deductions by limiting the amount of debt (and level of gearing) a group may have. Another concern Inland Revenue has identified, which is not as readily addressed through the thin capitalization rules, is high priced debt. Inland Revenue has been active in seeking to apply the existing TP rules to what it perceives to be high priced related party debt. But it is understood that Inland Revenue may consider the merits of amending the TP rules so as to include an express recharacterization power, such as has been introduced in Australia (see section 2.3 above).

2.7. Can BEPS work in favour of MNEs?

One aspect of the BEPS project that should work in favour of MNEs arises from the BEPS Action 14 recommendations regarding dispute resolution. These include:

• ensuring that treaty obligations related to the MAP are fully implemented in good faith and that MAP cases are resolved in a timely manner;
• ensuring the implementation of administrative processes that promote the prevention and timely resolution of treaty-related disputes; and
• ensuring that taxpayers can access MAP when eligible.

Inland Revenue has released its own MAP guidance including information about the process and what taxpayers can expect when an MAP complaint is filed. In addition New Zealand has committed, in principle, to binding arbitration being included in its DTAs. Currently, only two of New Zealand’s DTAs (with Japan and Australia) provide for binding arbitration and in the case of Australia binding arbitration is available only on issues of fact. It is expected that the multilateral

instrument\textsuperscript{23} will be the vehicle for implementing binding arbitration in other DTAs, to the extent the relevant contracting states agree to binding arbitration.

At this stage, there have been no further BEPS initiatives relating to TP to benefit MNEs, such as by facilitating access to information held by other countries that could assist an MNE with its New Zealand TP compliance. Generally, Inland Revenue takes the position that information exchanged with foreign countries may not be disclosed even to the affected taxpayer, except where there is a particular process that necessitates disclosure (such as an application for an APA, or under an MAP).

As noted in section 1 above, Inland Revenue has encouraged taxpayers to seek unilateral APAs because unilateral APAs can generally be completed more quickly and efficiently than bilateral APAs. Inland Revenue takes the same principled approach to the terms of a unilateral APA as it would in negotiating a bilateral APA, or in a dispute in which the MAP is invoked.

As indicated in section 2.1, unilateral APAs are subject to a new exchange of information requirement. This raises the question of whether other tax authorities may seek to test or challenge the terms of a unilateral APA and whether this may in turn result in taxpayers being less inclined to seek unilateral APAs in future. Against that, one possible advantage of the new obligation to exchange unilateral APAs is that taxpayers should have earlier warning if another tax authority disagrees with a unilateral APA agreed with the New Zealand Inland Revenue, and will be able to take earlier steps to resolve any such disagreement.

3. What is the future of TP?

New Zealand is highly dependent on corporate tax receipts. Consequently, from a tax policy perspective, New Zealand does not see the attraction of corporate groups simply as a means of generating business activity that will enhance other tax revenues (such as taxes on labour and consumption). New Zealand is therefore likely to continue adopting measures to buttress its corporate tax base, even though some measures may result in increased complexity and compliance costs. TP law and practice are unlikely to be immune from these pressures.

In the short term, Inland Revenue may propose amending the law regarding the onus of proof so that the onus in TP matters rests with the taxpayer in all respects. If the law is amended in that way, it is likely that Inland Revenue will pursue more aggressive positions in TP audits and disputes, given the tactical advantage of being able to require the taxpayer to prove that whatever position Inland Revenue takes is not consistent with the arm’s length standard.

Increased uncertainty as to how the legislative provisions apply also seems likely. As noted in this report, the revised OECD TP guidelines (and in particular the emphasis on an arrangement’s substance) raise potentially difficult questions of interpretation, given that New Zealand’s TP provisions do not expressly incorporate the OECD TP guidelines and under general principles of interpretation should

\textsuperscript{23} BEPS Action 15: final report at p. 12.
be applied to the actual terms of the arrangement, not to its substance or the terms of an economically equivalent arrangement. A related question, which has yet to be tested in the New Zealand context, is to what extent Inland Revenue could successfully invoke the GAAR to recharacterize an arrangement in parallel with pursuing an adjustment under the TP provisions.

Were New Zealand to amend its TP provisions to include a power to recharacterize an arrangement even greater uncertainty could result. The terms of the arrangement as recharacterized would become a new avenue for dispute which would need to be resolved prior to the question of whether the arrangement was priced consistently with the arm’s length standard. In the litigation context, it might be more efficient for the court to determine the recharacterization question first, prior to the question of quantum, although the existing dispute resolution process for tax matters does not seem compatible with such an approach.

Given these considerations, it seems that there will be greater potential for disputes concerning transfer pricing. Litigation will often be an expensive and uncertain means of resolving such disputes and accordingly we may see increased use of MAP. Greater legal uncertainty and increased enforcement could also be expected to result in greater use of APAs.

Addendum

Overview of more recent developments as at 1 February 2017

Since the New Zealand branch report was completed in October 2016, the following material developments have occurred.

The New Zealand government has released a cabinet paper prepared by the Ministers of Finance and Revenue recommending further possible reforms to address BEPS. Further details on these possible reforms are set out below.

It now seems likely that the government will not seek to enact legislation implementing CbCR and instead it appears that CbCR will be implemented by relying on Inland Revenue’s general powers to prescribe forms and require the provision of information. The exercise of these existing powers will operate to require the relevant MNEs to provide the relevant information on an annual basis.

Inland Revenue has announced the expansion of an aspect of its annual compliance review programme to include all foreign-owned enterprises with over NZ$30 million (approximately €20 million) in gross revenue. Inland Revenue expects that this will increase the number of enterprises being reviewed annually from 600 to approximately 900 taxpayer groups. This measure is being used to target possible BEPS in medium-sized enterprises.
Possible reforms to TP rules and to address avoidance of permanent establishment status

The cabinet paper foreshadows possible reforms to address the avoidance of permanent establishment status and to further strengthen the TP rules. The paper discusses the diverted profits tax (DPT) measures being implemented in Australia and the UK but recommends that, instead of enacting a separate DPT, New Zealand should proceed with a tailored package of amendments to its income tax laws. The package is likely to include provisions countering the avoidance of permanent establishment status along with amendments to the TP rules. The cabinet paper does not, however, rule out the introduction of a separate DPT at a later stage.

Three amendments to the TP rules are suggested as possibilities: (a) amendments to facilitate the collection of “better information”; (b) amendments requiring Inland Revenue and the courts to look to the economic substance of an arrangement when applying the TP rules; and (c) an amendment to the onus of proof in TP matters.

As regards the onus of proof, as indicated in the branch report, under current law, if the taxpayer has determined the arm’s length amount of consideration under an arrangement in accordance with one or more of the five methods recognized by OECD practice, the amount so determined is the arm’s length amount unless Inland Revenue can demonstrate that another amount “is a more reliable measure of the arm’s length amount”. The Ministers of Finance and Revenue have recommended to cabinet that the current position be reversed and ensure that “Inland Revenue does not have the burden of proof in transfer pricing cases”.

The government expects to release a discussion document in early 2017 detailing its proposals and inviting submissions from interested parties. New Zealand is due to hold a general election later in 2017 and it is unlikely the measures will be passed into law until late 2017 or early 2018, after the election.
Summary and conclusion

The OECD transfer pricing (TP) guidelines are by law included as a legal basis for the interpretation and application of the arm’s length principle in Norway. With the exception of country-by-country reporting (CbCR), the final reports on base erosion and profit shifting (BEPS) Actions 8–10 and 13 will automatically apply, not necessitating changes to Norwegian law. Norway does not have very specific regulations on TP, but rather a general provision of the arm’s length principle in the General Tax Act¹ article 13(1). This provision applies to all transactions and dealings between parties that may have a community of interest that could influence the pricing of a transaction or a dealing. Accordingly, it is not to be expected that detailed regulations will be implemented in relation to BEPS Action 8–10.

The master file and local file concept under BEPS Action 13 will require an update of the current administrative regulations in accordance with the new documentation guidelines. The introduction of CbCR will require a new provision in the Tax Administration Act, expected to be enacted by the end of 2016. This will come in addition to current TP specific filing obligations.

While the formal impact of the BEPS project will be limited, there is reason to believe that the impact on tax practice will be significant, leading to a marked change of the tax practice and the application of the arm’s length principle.

The combination of increased transparency and the new analytical framework for analysing transactions will lead to a significant change in terms of the application and understanding of the arm’s length principle. It will provide Norwegian tax authorities with a new analytical framework and a powerful toolbox enabling them to analyse and assess intercompany transactions in a much more detailed and sophisticated way than before.

The new analytical framework and increased sophistication will affect how multinational companies (MNEs) will have to deal with intercompany transactions, not only with regard to the pricing of the transactions, but also how such transactions are structured, implemented, operated, monitored and documented. This will be necessary to withstand the ever-increasing scrutiny by the tax authorities, powered by the new framework.

The Norwegian Ministry of Finance has clearly stated that the new guidelines may be applied retroactively, i.e. when auditing and assessing intercompany transactions predating the new guidelines. Having said that, if the outcome of a retroactive application of the new guidelines would result in a different outcome from under the old guidelines, this would probably not be considered permissible by the Norwegian courts, as this would violate the principle of legal certainty.

To sum up, it is expected that tax practice in Norway will change as a consequence of the BEPS project, and that the new OECD TP guidelines and analytical framework following the BEPS project will be applied by Norwegian tax authorities. The new OECD TP guidelines clearly open the door for a more subjective interpretation on the application of the arm’s length principle by the tax authorities, in particular related to understanding the functional contribution of the parties in relation to the DEMPE\textsuperscript{2} functions, and also in relation to the control over contribution from risk and capital. Combined with a long-standing tradition of applying “substance over form” with the fact that some of the new guidelines concerning how to attribute value to intangibles and capital and risk may be questionable from an arm’s length perspective, the foundation for more tax disputes, litigation and double taxation has been laid.

The report aims at providing a high-level overview of the current situation in Norway and what the future can be expected to look like. The report will not address the technical aspects of BEPS Actions 8–10 or 13, but will focus on the practical implications of the new guidance from the OECD for MNEs operating in Norway. It is still too early to say how matters will develop in Norway. However, the report tries to provide the reader with insight, based on the current legal situation and tradition, and last but not least, experience.

1. Current TP regulations and practice in Norway

The arm’s length principle is codified in the General Tax Act (GTA) article 13(1). According to this provision, the income of a taxpayer may be discretionarily reassessed by the tax authorities if it has been reduced due to a direct or indirect community of interests with another party. The income may be discretionarily reassessed by the tax authorities to what the parties would have agreed if they did not have a community of interest (cf. GTA article 13(1) section 3).

The GTA article 13(1) applies to all intercompany transactions and dealings, cross-border transactions as well as domestic transactions, including intercompany transactions that take place between entities in different domestic special tax regimes, such as companies covered by the Norwegian Petroleum Taxation Act,\textsuperscript{3} the tonnage taxation provisions in the General Tax Act\textsuperscript{4} or the power and utilities tax regime.

\textsuperscript{2} New OECD TP guidelines 6.32 et seq.

\textsuperscript{3} Petroleumsskatteloven 13 June 1975 no. 35.

\textsuperscript{4} Skatteloven 26 March 1999 no. 14 (GTA) art. 8(10) to 8(20).
The OECD TP guidelines have been an accepted legal source of interpretation of the law since recognized as such by the Supreme Court in the Agip case. In this case, the court stated that the OECD TP guidelines should be viewed as providing more specific guidance on the application of GTA article 13(1). In 2007, reference to the OECD TP guidelines in general (i.e. no specific year of publication) was included in the law (cf. GTA article 13(1) section 4). The reference in the law to the OECD guidelines does not mean that the OECD TP guidelines have the status of law, but clarifies that they should be applied for the purposes of interpretation and application of the arm’s length principle under Norwegian law.

The Norwegian documentation requirements are in general consistent with the recommendations of the OECD TP guidelines, with some exceptions.

The Tax Administration Act (TAA) article 4(12) imposes an obligation on Norwegian taxable entities i.e. both legal entities and permanent establishments, to file certain information with the tax return and to maintain and submit TP documentation to the tax authorities upon their request, within 45 days. There are exemptions to both the documentation and filing requirements for smaller businesses.

The Ministry of Finance has issued several regulations in relation to TAA article 4(12). These regulations provide further details related to the documentation and filing requirements, such as the content of the documentation required to be prepared.

The filing requirement is a mandatory form to the annual tax return (RF-1123), which requires a listing of all intercompany transactions, including amounts, types of transaction, transaction parties, etc. The form serves as one of several sources for the Norwegian tax authorities when identifying candidates for TP tax audits or follow up questions to the tax return. The filing requirements are applicable for all transactions reported in the tax return, i.e. cross-border transactions as well as domestic transactions.

In addition, covered taxpayers are obliged to prepare TP documentation that describes how the transfer prices have been established between associated enterprises. The documentation needs to include sufficient information to enable the Norwegian tax authorities to assess the arm’s length nature of the transfer prices applied between associated enterprises. TP documentation is to be prepared for cross-border transactions as well as domestic transactions.

2. The impact of the BEPS project on TP

2.1. Introduction

Overall, the general reception of the TP outcomes of the BEPS project in Norway has been positive. The Norwegian Parliament has asked the government to ensure a prompt and complete implementation of the BEPS recommendations, to the extent possible.

5 Norwegian Supreme Court, Agip case, Rettstidende 2001 s. 1265.
6 Ligningsloven 13 June 1980 no. 24.
In the eyes of the Norwegian tax administration, the new OECD TP guidelines originating from BEPS are considered to provide better and more comprehensive guidelines and framework for the assessment of intercompany transactions and application of the arm’s length principle. The tax authorities embrace the focus on the actual conduct between the parties of a transaction, in line with a long-standing practice in Norway of “substance over form”.

The general TP outcomes of BEPS will not require any significant changes to the legislation as such, with the exception of new legislation on CbCR.

The Ministry of Finance has made it clear that it believes that the new OECD TP guidelines may be applied retroactively, i.e. be applied when assessing transactions that predate the new OECD TP guidelines. The Ministry of Finance thus takes the position that the new guidelines do not imply any change of law, but rather provide for more specific guidance on the application of the arm’s length principle. While this may be true for new OECD TP guidelines in general, the application of certain parts of the new guidelines\(^7\) may in certain cases clearly lead to a different outcome from that under current practice and application of the old OECD TP guidelines. Where this is the case, a retroactive application of the new OECD TP guidelines should in principle not be allowed, as this would be contrary to the principle of legal certainty. However, it will probably be the Norwegian courts that will have to draw the line on the permissible retroactive application of the new guidelines.

In general, the business community in Norway, including professional TP advisers, seems to understand and accept many of the changes suggested by the OECD in the BEPS project. In particular, the new documentation requirements following from BEPS Action 13 are not considered controversial. On the other hand, CbCR is seen by most companies as a burdensome obligation, where companies and advisers question the benefit of the report in its current form. Furthermore, there is a general perception that the emphasis on functional contribution and control over assets and risks may lead to subjective, incorrect and arbitrary allocations of profits that are not consistent with the arm’s length principle. Clearly, some of the new guidance on intangibles, cost contribution arrangements (CCAs), risk and capital is perceived as a significant change to the current practice, and should not be applied retroactively. There is also a general consensus that the OECD seems to underestimate the value and risk attributable to capital. Furthermore, there is a general perception that the new OECD guidelines open the door for too much subjective interpretation by the tax authorities of what is a significant contribution. Hence, taxpayers fear that this may in some cases lead to more arbitrary and unreasonable reallocation of profits or losses, which again will lead to double taxation for taxpayers. It is also believed that the new guidelines will require more work by the taxpayer in terms of how transactions are structured, implemented, executed and documented. Accordingly, the new OECD TP guidelines will be more burdensome to apply in practice for the taxpayer than the current situation.

\(^7\) Examples: new OECD TP guidelines chapter I, D1.2 \(et\ seq\), chapter VI CCA, 8.23 \(et\ seq\).
2.2. Challenges of transactions with intangibles

2.2.1. Definition of intangibles

There is currently no clear legal definition of intangibles for TP purposes in Norway. Historically, accounting and legal definitions have been applied and accepted. Income related to intangibles is taxed according to the GTA article 13(1).

The BEPS Actions 8–10 report is not expected to result in a new definition of intangibles being enacted. However, as the OECD TP guidelines are included in GTA article 13(1) section 4, the definition of an intangible provided in section 6.6 of chapter IX of the new OECD TP guidelines will be applicable in Norway. It has already been observed that the new OECD definition has been applied by the tax authorities retroactively in recent audits.

The main area of controversy has been related to whether goodwill, or at least part of what has been classified by the company as goodwill, may be attributed to certain intangibles in transactions involving the transfer of intangibles assets. The tax authorities have taken a position very similar to that of the OECD. The tax authorities have in several tax cases argued that a loss of profit potential following intercompany transactions involving intangibles, that cannot otherwise be explained, proves that part of the value characterized as goodwill by the company must be attributed to the intangible assets of the transaction, and that this profit potential would have been compensated between unrelated parties.

Accordingly, while the definition in point 6.6 of the new OECD TP guidelines is new, the Norwegian tax authorities have for some time applied the same or a similar definition in several tax cases. Accordingly, the new OECD definition seems to provide support and authority to a practice that has developed over some years.

2.2.2. Transactions with intangibles

There are no specific rules for the recognition of transactions with intangibles in Norwegian tax legislation. According to the Ministry of Finance, no new rules or regulations are expected to be introduced that will address this. The general perception is that this is not required under Norwegian tax law.

As the BEPS guidance on transactions with intangibles is still new, the experience with regard to changes in practice is limited. Having said that, the Norwegian tax authorities have for some time, since the introduction of chapter IX of the OECD TP guidelines, applied a broader definition of intangibles, also for the purpose of identifying transactions involving intangibles, much in line with the new guidance from the OECD. Accordingly, legal or accounting definitions of intangibles have not been deemed to limit the tax authority’s ability to claim that certain intangible assets, or something of value, have been transferred. At arm’s length, for such transfer, independent parties would otherwise have agreed on higher compensation than what was agreed in the related party transaction.

This broad definition of intangibles, or should we say lack of definition, has primarily been applied to intercompany business restructurings, where certain functions, assets and/or risks has been transferred out of Norway, and where the tax

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8 New OECD TP guidelines 6.28.
authorities believe that something of value has been transferred without any compensation or with insufficient compensation. The best example of this is the watershed Cytec case\(^9\) in 2007, involving the restructuring of a Norwegian full-risk manufacturer into a tolling manufacturer. Following the restructuring, the taxable profits of the Norwegian entity dropped significantly. The taxpayer claimed that no intangible assets were transferred as part of the restructuring. The tax authorities, on the other hand, argued that the reduction in profit was evidence that intangibles had been transferred. The tax authorities claimed that the goodwill associated with the underlying functions, assets and risks that were transferred as part of the business restructuring, in addition to how the intercompany transactions were structured and priced, was also transferred as part of the restructuring, and increased the income accordingly. The tax authorities won the case in the Appeals Court. The case illustrates well that the courts will allow that a loss of profit potential that otherwise cannot be explained may be evidence of an underlying transfer of unidentified intangible assets, much in line with the new definition of the OECD.

The reporter has also observed that the same approach, i.e. the broad definition in line with the new OECD TP guidelines, has been applied in multiple tax audits of business restructurings, especially in cases where intangibles have been transferred out of the local Norwegian company following a third party acquisition of the Norwegian company. In these cases the remaining profit potential of the Norwegian entity has been reduced beyond what can be attributed to the compensation for the intangible asset that was transferred. In such situations the Norwegian tax authorities have taken the position that the loss of profit potential beyond what was compensated in the intangible transaction, and which otherwise cannot be explained, is evidence of non-arm’s length pricing. The reasoning is that goodwill that can be attributed to the use of the intangible assets that were transferred has in reality been transferred without compensation.

2.2.3. “Substance-over-form” approach towards intangibles

In Norway, the “substance-over-form” approach is not controversial per se. Having said that, the starting point for the assessment of any transaction is always the agreement between the parties. To the extent that the agreement reflects the underlying reality, including the intention of the parties, and seems to be commercially rational for both parties, the Norwegian courts seem to put great emphasis on the agreement in tax and transfer pricing cases.\(^10\) However, if the form does not represent the substance or underlying reality of the transaction or is otherwise not commercially rational, it is in line with a long-standing practice that the assessment of a transaction is based on the substance of the transaction and the actual conduct of the parties, rather than the form. This also applies to transactions involving intangibles, whether a transfer of certain intangibles or the use of intangibles.

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\(^9\) Eidsivating Appeal Court, Cytec case, Utv. 2007 s. 1440.

\(^10\) Norwegian Supreme Court, Dell case, Rettstidende 2011 s. 1581. The so-called Dell case, on whether the Norwegian subsidiary of Dell operating as a commissioner in Norway on behalf of the Irish principal constituted a dependent agent PE under the treaty, illustrates well that form may trump substance.
Having said that, based on the reporter’s experience, it has been observed that the tax authorities tend to apply the principle of “substance over form” in an opportunistic and arbitrary manner, based on what provides the most preferable outcome from a Norwegian tax point of view in the case at hand.

In post-acquisition restructuring, whereby typically intangible assets are transferred out of the acquired entity to another group company, the acquisition price and purchase price allocation will always be a relevant starting point for assessing the value of the intangible asset that is transferred.

Although it may be possible to identify comparable transactions and prices for an intangible, whether it is use or sale, the tax authorities will in general assess the reasonableness of the agreed remuneration based on the impact on the profitability of the Norwegian entity.

It is clear that the new analytic framework for identifying and delineating transactions, and understanding risks and control of such risks will change the way audits will be conducted and the basis for the assessment in cases involving the valuation of intangibles, or the value of contribution to such intangibles. It is apparent that the tax authorities have applied the new framework on recent audits, although the transactions under audit go back several years. It will be interesting to see whether such a retroactive application of the new analytical framework will be allowed by the courts. While there may be merits to the DEMPE framework, it is clearly introducing new elements that may not have been taken into account by the taxpayer at the time of the transaction.

The reporter is also aware that the Norwegian tax authorities expect that taxpayers in the future will apply the analytic framework as defined by the new OECD TP guidelines when structuring and pricing intercompany transactions involving intangibles, and document the transactions accordingly.

2.2.4. Comparability and group synergies

The guidance and recommendations from the OECD on comparability and group synergies are consistent with current practice in Norway, and as such are expected to be applied by the Norwegian tax authorities.

Currently, there is no legal guidance on how to define or treat comparability issues or group synergies, and no such guidance is expected, beyond the general arm’s length principle in GTA article 13(1). Because of the reference to the OECD TP guidelines in GTA article 13(1) paragraph 4, we can assume that Norwegian tax authorities will refer to the new OECD TP guidelines for guidance on the assessment of such issues.

There is a long-standing practice that group synergies that are created by group companies contributing functions, assets or risks should be shared among the participants contributing to the creation of the synergy. The new guidance on group synergies is aligned with the Norwegian case law on the topic. Practice from the tax offices, especially practice from the Petroleum Tax Office, reflects the same view as is expressed in the new guidance (cf. the Fina case\textsuperscript{11} and in the ConocoPhillips case\textsuperscript{12} (Cash Pool)).

\textsuperscript{11} Borgarting Appeal court, Fina case, Utv. 2003 s. 531.
\textsuperscript{12} Borgarting Appeal court, Conocophillips case, Utv. 2010 s. 199.
2.2.5. Hard-to-value intangibles

No specific measures in Norway on how to define or treat transactions involving hard-to-value assets have been adopted following the Actions 8–10 report. Furthermore, consistent with what has been said above, the reporter does not expect that any such detailed regulations will be implemented in Norway. The Norwegian tax authorities will rely on the guidance in the OECD TP guidelines with regard to assessment and valuation of hard-to-value intangibles.

In general, hindsight, i.e. post-transaction developments or facts, is not relevant for the valuation and assessment of an intangibles transaction. The basis for a valuation should always be based on facts and circumstances from the time of the transaction.

Having said that, the reporter is aware that the Norwegian tax authorities have been allowed to apply hindsight in the sense that they may question the reasonableness of the assumptions made at the time of the valuation, based on post-transaction developments.

The tax authorities have also been allowed to rely on facts and circumstances, including comparable data, from the time of the transaction, for the purposes of testing and assessing whether a valuation was at arm’s length, even though these data were not known or otherwise available to the taxpayer at the time of the valuation.

The reporter has also seen in several tax cases that the tax authorities have argued that transactions involving hard-to-value assets would normally have an adjustment clause. It has turned out in many of the cases that this view has been unfounded, and primarily been based on the reference to this in chapter VI of the OECD TP guidelines. We may expect the tax authorities to use the new guidance on hard-to-value intangibles as strong support for such a view. However, as also advised by the OECD, at the end of the day it all comes down to whether the taxpayer can document that the parties to the transaction acted in a commercially rational way at the time, and can show that proper consideration was given to all available facts and circumstances at the time.

2.2.6. CCAs

There are no specific legal regulations on CCAs in Norway. The Norwegian tax authorities have traditionally applied chapter VIII of the OECD TP guidelines when assessing CCAs, and are expected to continue to do so with the new guidance as well. Accordingly, no regulatory changes are expected as a result of the new guidance in the area of CCAs.

Due to the incorporation of the OECD TP guidelines in GTA article 13(1) section 4, the new chapter VIII of the OECD TP guidelines on CCAs will be applied by the tax authorities when assessing CCAs. Accordingly, the reporter expects that new CCAs will have to use the value of a contribution, rather than the cost of the contribution, when measuring the contribution of the parties to a CCA. But the reporter also believes that costs may still be applied as a measure of contribution if the taxpayer can document that the value of the contributions are of similar value, so that cost is just as representative of the contribution as the value of the contribution.
It is hard to see that the revision of the OECD TP guidelines on how to assess contributions from the parties to a CCA can be viewed as only a clarification on the application of the arm’s length principle on CCAs that may be applied retroactively, i.e. when assessing CCAs predating the new guidelines. The application of the new guidelines on CCAs where cost has been used as the basis for measuring contributions may clearly result in a different outcome from that reached under the application of the old OECD TP guidelines.

As for now, there have been no signals from the Norwegian tax authorities on what to expect with regard to the assessment of CCAs that have been structured in accordance with the old OECD TP guidelines. In the reporter’s opinion, it will be in breach of the principle of legal certainty to apply the new guidelines retroactively on CCAs predating the new guidelines. Having said that, it is just as clear that taxpayers will have to amend existing CCAs and measure contributions based on the value of the contribution, rather than the cost, if the outcome is different.

2.3. Risk and capital

The guidance on return on risk and capital as presented in the Actions 8–10 report will be adopted and applied by Norwegian tax authorities subject to GTA article 13(1) section 4. As mentioned above, the guidance is not expected to result in amendments to the law as such, as this is not required from a Norwegian perspective.

That said, the ramifications of the new guidelines for the allocation of returns to risk and capital as described by the OECD in the BEPS Actions 8–10 report may have severe impacts on how returns are currently allocated within a group. In particular, groups where a significant part of the group’s returns are attributed to asset owning companies, such as IP, shipping and rig companies, will probably be scrutinized in the years to come. If such asset owning companies are not able to demonstrate sufficient functional and financial capacity to effectively manage those assets and associated risks, it can be assumed that the tax authorities will try to reallocate profits to other companies within the group where the assets and associated risks are actually managed according to the tax authorities. This will be very relevant in Norway, which has a large offshore and shipping industry, where typically the vessels are owned by asset owning companies in low-tax jurisdictions or the Norwegian tonnage tax regime, and the management company is located in Norway and taxed under the normal tax regime. In light of this, it may be expected that companies will have to look at how they are currently operating the business and managing the assets and associated risks. Accordingly, it is safe to assume that the new guidelines on attribution of profits to risk and capital will have significant impact on tax practice in Norway.

2.4. High-risk transactions

2.4.1. Comparable uncontrolled price (CUP) and quoted prices for cross-border commodity transactions

Currently, the general Norwegian TP provision in GTA article 13(1) applies to transactions with commodities. The reporter does not expect any specific measures
or provisions for the pricing of commodities as a consequence of the new guidance from the OECD. The general reference to the OECD TP guidelines in GTA article 13(1) section 4 will probably ensure a practice in line with the recommendation of the OECD for such transactions.

Having said that, the pricing of oil produced on the Norwegian continental shelf is regulated by a special provision for the norm price of oil (cf. the Petrol Tax Act article 4). For transactions that fall within the scope of this rule, the tax assessment is based on a stipulated price set by an administrative body. The standard prices are based on criteria such as comparable prices obtained, quality of the product, costs of transportation, etc. The system applies for controlled transactions as well as transactions between third parties. The prices are set according to rules provided in administrative regulation, and are believed to correspond to the guidance under the arm’s length principle.

2.4.2. Intra-group services

There are no special provisions for the pricing of intra-group services in Norwegian law. The general Norwegian TP regulations as stipulated in GTA article 13(1) apply to intra-group services transactions. The new OECD TP guidelines on the pricing of intra-group services, including the recommendation for low value-added services, will be applicable in Norway (cf. GTA article 13(1) section 4). Accordingly, we assume that the new guidelines on low value-added services will in general be accepted and applied by the Norwegian tax authorities on services that fall within the scope of the report.

However, it is the reporter’s understanding that the tax offices will not be bound by the new guidance for pricing and assessing low value-added services, and may still audit and assess the pricing of such services if they have reason to believe that the services or basis for allocation are not in line with the scope of the report. The reporter understands that in particular the oil taxation office will still have the opportunity to scrutinize low value-added services, although they meet the criteria for simplified assessment in the report. The oil taxation office has a long-standing practice of challenging charges for intercompany services, refusing to accept mark-up on costs incurred.

2.4.3. Profit splits in the context of value chains

There are no specific provisions in Norway concerning the application of certain methods, or for the application of profit split methods in the context of value chains. The general arm’s length principle as stipulated in GTA article 13(1), including the reference to the OECD TP guidelines in section 4, will provide sufficient basis for applying the recommendations of the OECD. Consequently, it is not expected that any special legislation concerning the use of profit splits to value chains will be adopted.

The Norwegian tax authorities have been seen in several TP audits to argue that a profit split method would be appropriate to apply where the local business is relatively integrated into the value chain of the MNE, although with limited success so far. The reporter has also seen that profit split methods have been applied to test the reasonableness of the profitability of the local entity. In the light of the
new guidelines on integrated value chains and profit split, it is expected that this line of argumentation will be applied more often by the tax authorities when assessing highly integrated value chains in the future.

2.5. TP documentation

2.5.1. CbCR

On 6 October 2016, the Norwegian government published its proposal for the 2016 Fiscal Budget, including a proposal to introduce CbCR in Norway with effect from 2017 based on figures from 2016. In short, all MNE groups with annual consolidated group revenue equal to or exceeding NOK6.5 billion (approximately US$730 million) will be obliged to file CbCR.

The proposal is aligned with the proposal for CbCR regulations issued by the OECD in its final report for Action 13. The first CbCR should be submitted to the Norwegian tax Authorities by 31 December 2017 based on figures from 2016.

The Ministry of Finance proposes that the rules on CbCR are implemented in the form of new provisions in article 4(13) no. 24 of the Tax Administration Act and related regulations.

Norway, together with 30 other countries, has signed the Multilateral Competent Authority Agreement on 27 January 2016. The agreement will be in effect from 2017. The necessary implementation of the CbCR provision in Norwegian law is expected during 2016.

2.5.2. Master and local files

The Norwegian documentation requirements are codified in the Tax Administration Act article 4(12), and are detailed further in the associated regulations.

According to the Ministry of Finance, the current documentation requirements are assumed to sufficiently cover the new documentation requirements as described in the new OECD TP guidelines, and hence no change is required. As the specific requirements to the contents of TP documentation is provided in the form of an administrative regulation, a new and updated regulation will be issued by the Ministry of Finance to comply with the new OECD recommendations for the master file and local file. A new regulation is expected either later this autumn or early next year. From what the reporter understands, taxpayers will be required to submit documentation to the Norwegian tax authorities according to the new documentation requirements for the financial year 2017. Currently, TP documentation will only be submitted to the tax office within 45 days upon written request. As far as is known, this will not change.

2.5.3. Compliance costs

There is no information available on how BEPS Action 13 has affected or will affect the compliance costs of Norwegian companies. From what is understood the

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13 Proposition to the Norwegian Parliament regarding taxes, duties and customs (Prop. 1 LS), s. 14 and p. 278.
Ministry of Finance is of the opinion that an increase in cost and burden for Norwegian entities should be fairly limited in the light of the current Norwegian documentation requirements and based on an assumption that the information required in the CbCR should be already readily available for most companies. In the reporter’s opinion, and based on discussions with taxpayers, the impact in compliance cost and compliance burden is underestimated.

2.6. TP-related measures in other BEPS actions and other measures against BEPS

In Norway, no formal procedures have been initiated with regard to TP driven by any of the non-TP BEPS actions. It is probable that some of the other actions, such as the changes to article 5 of the OECD model tax agreement on the definition of permanent establishments, and the discussion on the digital economy, may have an impact on TP practices. However, no such influence has been observed yet. Such influence is likely to be revealed after the implementation process of the BEPS measures has started.

Some measures have been proposed in Norway to counteract BEPS that are not a result of the OECD BEPS project as such. Norway recently adopted a limitation on interest deduction which go further than the measures recommended by the OECD in Action 4.14 It will be interesting to see whether the interest limitation rules will be amended to comply with the OECD BEPS recommendations.

Other anti-BEPS measures that are currently being evaluated by the Norwegian Ministry of Finance are the following:15

• imposing withholding tax on interest and royalties;
• expanding the domestic definition of royalties in order to include bare-boat leasing payments;
• introducing limitations on deduction of bare-boat lease payments, similar to those imposed by the United Kingdom (UK).

Furthermore, there is a proposal to codify the general anti-avoidance doctrine.16 Norway has for a long time had a non-codified anti-avoidance rule developed by tax practice and case law. The general arm’s length principle as codified in the GTA article 13(1) has also been applied by the tax authorities as an anti-avoidance rule in TP cases as a legal basis to restructure or completely disregard intercompany transactions and the pricing of such transactions. It is expected that a new codified anti-avoidance rule will draw a clear line between the arm’s length principle and pure anti-avoidance situations, thereby effectively limiting the use of GTA article 13(1) as an anti-avoidance rule. In fact, in a recent Supreme Court case, in the so-called IKEA case,17 the Supreme Court stated that GTA article 13(1) could not be applied as a general anti-avoidance rule for the purposes of disregarding equity transactions that were otherwise legal. This statement was an important

14 GTA (Skatteloven 26 March 1999) art. 6(41).
16 A discussion paper on codification of the anti-avoidance rule was published in March 2016 (NOU 2016:5 Omgåelsesregel i skatteretten).
17 Norwegian Supreme court, IKEA case, HR 2016 2165.
limitation of the reach of GTA article 13(1), much in line with the proposed codification of the anti-avoidance rule mentioned above.

Although these proposed changes will be of great importance for Norwegian companies and MNEs operating in Norway, they are not likely to be adopted multilaterally. The nature of the suggested rules are not suitable for multilateral agreements, as they are of a domestic character. However, the initiatives may of course influence other countries, in the same manner as the Norwegian legislator and tax authorities have been influenced by initiatives made at a domestic level in other jurisdictions.

2.7. Can BEPS work in favour of MNEs?

The reporter is not aware of any information gathering initiatives that may to some extent be used by MNEs to obtain information necessary for their domestic compliance, and that as such would be of benefit to the MNEs. It is of course possible that MNEs, as a consequence of both the new documentation requirement and CbCR, will obtain a better overview of their total tax situation and TP practice, which again may enable them to better manage their tax risk. However, whether this is truly a benefit or not for the MNEs will probably vary from company to company.

3. What is the future of TP?

As is clear from the above analysis, no significant changes to the current Norwegian TP regulations are expected as a consequence of the BEPS project. This has to do with the very general nature of the current Norwegian TP regulations, and the incorporation of the OECD TP guidelines as a legal source for the interpretation and application of the arm’s length principle. Having said that, the reporter believes that the BEPS project and new TP guidelines to some extent already have and will in the future have a significant impact on the practices of the Norwegian tax authorities.

The new guidelines provide the tax authorities with a much more detailed analytical framework for analysing intercompany transactions and the pricing of such transactions, that will enable the tax authorities to better assess whether transactions are conducted at arm’s length.

The new substance requirements, in particular related to control of risks and assets, will change and affect how companies structure and conduct their business, both from a legal and operational point of view. As such, the BEPS project will over time change the behaviour of MNEs.

A major concern of taxpayers and advisers is that this new framework is highly vulnerable to subjective interpretation and application by the tax authorities. This is especially true for the assessment of functional control and contribution in relation to intangibles, risk and capital. This subjectivity in the interpretation and application of the arm’s length principle will lead to increased double taxation.
Accordingly, it will be critical that effective bi- and multilateral measures are adopted for resolving double taxation issues and also to have guidance on the interpretation and application of the new OECD TP guidelines. Without the establishment of proper and efficient ways of dealing with this, taxpayers will be the victim of tax authorities’ subjective interpretation and application of the OECD TP guidelines, and consequently suffer from increased double taxation and controversy.

Whether less profit will be shifted out of Norway as a consequence of the new rules or whether the tax base will increase in Norway as a consequence of the BEPS initiative, remains to be seen.
Summary and conclusions

Since their inception in 2001, transfer pricing (TP) rules in Peru have been in constant evolution, having gone through different modifications over time. The main focus of the evolution of the rules has been, on the one hand, to provide clarity and predictability to taxpayers and, on the other hand, of course, to defend the Peruvian tax base.

The reporters believe the base erosion and profit shifting (BEPS) project will be crucial for reshaping Peruvian local TP rules and local TP practice. In fact, legislative changes are currently being drafted in order to introduce the BEPS TP suggestions into Peruvian local TP rules.

When the recently elected president of Peru, Pedro Pablo Kuczynski, gave his inaugural speech, on 28 July 2016, he announced, as part of his promise to build a modern country, that “By 2021 … Peru will be a member of the OECD.”

In the days following this speech, Kuczynski obtained permission from the national congress to issue legislation related to different issues, one of which was to adopt the suggestions of the OECD BEPS plan, which would be aligned with the country’s goal of becoming a full OECD member in the near future.

Formally, the proposal to modify the legislation includes the objective “to adapt the national legislation to the international standards and recommendations issued by the OECD on the exchange of information for tax purposes, international taxation, the base erosion, transfer pricing, and the fight against tax avoidance.”

In spite of the fact that there is a clear political intention to adhere to the OECD’s suggestions, the reporters believe that a degree of tension exists between some of the recommendations arising from the BEPS Action Plan and the omnipresent national objective of defending the Peruvian tax base. This tension becomes evident in issues such as commodity transactions, the analysis of intangibles and intercompany services.
In the case of commodity transactions, their relevance to Peruvian GDP makes them a main focus for the tax authorities, who want to make sure that prices are being set at arm’s length and that the country is not losing any tax. This perception has led to measures designed to keep close control on these transactions, such as the Peruvian version of the “sixth method”, where there was no problem in deviating from the arm’s length principle in order to reach the objective of defending the domestic tax base. From a different perspective, the new OECD TP guidelines, after incorporating suggestions from the BEPS Action Plan, have acknowledged the importance of these transactions, but have also reinforced the validity of the arm’s length principle as the guiding light even in these complex cases, thus diminishing the ability of local tax authorities to set different criteria for evaluating domestic transactions. As a result, Peru currently has local rules that clearly differ from the BEPS suggestions and it remains to be seen whether the legislator will want to align its rules to the OECD’s suggestions. In the meantime, this tension has led to a situation where no one is applying the local “sixth method” rules, as everyone is expecting new rules to come into force in the near future.

As for transactions involving intangibles, Peru is in a situation where very few intangibles are generated locally. So most transactions involving intangibles are some kind of payment to foreign companies who own these intangibles. In most cases, withholding taxes apply to these payments, so there is a feeling that the domestic tax base is somehow protected. In practice, this situation, together with the complexities associated with the TP analysis of intangibles, has led to a situation where these transactions have not yet been heavily audited by the tax authorities. The reporters believe the recommendations of the BEPS Action Plan will help shape the way these transactions are dealt with and will indicate the way in which they will be treated in the future.

Regarding intercompany services, the tension is also evident. While developed countries believe it is time to adopt a simplified approach, especially for low value-added services, developing countries such as Peru may feel the opposite. Domestic tax authorities are significantly worried about the expenses being registered by domestic companies when receiving these services, so instead of simplifying their analysis, they have an incentive to ask for more and more information and documentation to prove that the services really existed. Hence, it could be difficult for countries such as Peru to opt for a simplified analysis. In any case, modifications regarding intercompany services are expected very soon, as a result of the BEPS plan, and it is necessary to wait and see in which direction the domestic legislator decides to go.

On the other hand, if there is one field where there seems to be a close alignment with the suggestions of the BEPS plan it is the requirements for documentation. It seems as though the adoption of Action 13 in Peru will happen soon. The major challenge for this information to be really useful will be for Peru to modify its rules in order to be able to share this information with other countries, thus gaining access to the information to be shared by foreign countries as well.

In conclusion, the reporters believe that the future of TP in Peru will be shaped, to a great extent, by the recommendations of the BEPS Action Plan. It will probably be difficult to adopt all of the suggestions of the plan, as there are some evident tensions, so it is expected that TP will continue to generate discussion and debates, making it a dynamic and challenging topic in the years to come.
1. Current TP regulation and practice in Peru

TP rules were first published in Peru in August 2001 and were effectively applicable for the first time in fiscal year 2002. From this very first moment, it was crystal clear that the OECD TP guidelines inspired the Peruvian TP rules. Not only was the arm’s length principle broadly adopted as the standard, but also the TP methods proposed by domestic legislation were almost the same as those designed and suggested by the OECD.

Furthermore, Peruvian rules contain an explicit reference to the OECD TP guidelines. In fact, according to letter (f) of article 32A of the Peruvian Income Tax Law, the OECD TP guidelines are applicable for interpreting the law, as long as the guidelines do not contradict domestic rules. In practice, and taking into account the fact that local rules are quite general and do not go into much detail regarding many issues, the proposed use of the OECD TP guidelines as a “source of interpretation” made them an obligatory reference, not only for taxpayers and TP practitioners, but also for the tax authorities, who constantly refer to this document when performing TP audits.

Of course, some discussions have arisen on how to use the OECD TP guidelines. For example, there is the discussion on whether one should refer to the latest OECD TP guidelines available (in this case, those containing the modifications suggested by the BEPS plan) or whether one should go back to the version of the guidelines that was available at the time the Peruvian rules originally came into effect. This discussion is usually referred to as to whether this reference to the OECD TP guidelines in Peruvian legislation is “static” or “dynamic”. Even when there is no formal consensus on this discussion, in practice most professionals refer to the latest OECD TP guidelines available. Another discussion comes up when the domestic TP rules do not contain clear specific guidance on an issue (e.g. intragroup services or the valuation of intangibles). In these cases, the question that arises is whether the OECD TP guidelines can or cannot be used to fill these “blanks” in Peruvian rules, or whether their function is only to help interpret something that has effectively been sufficiently discussed in the domestic rules.

In addition to the previous discussion, and despite the fact that the spirit of the Peruvian rules has been inspired by the OECD TP guidelines, there are many particularities in the Peruvian TP rules that need to be taken into account when looking into TP matters. These include the following:

- TP rules are applicable not only to international controlled transactions, but also to controlled domestic transactions and even to non-controlled tax haven transactions. The reason why tax haven transactions have been included into the scope of TP rules is the difficulty in obtaining reliable information from these jurisdictions to confirm whether the parties are economically related.

- It is mandatory to use interquartile ranges where there is more than one comparable observation. The only exception for this rule occurs in the context of using a comparable uncontrolled price (CUP) method. In this case, a coefficient of variation must be computed from the set of comparable observations. If this coefficient turns out to be less than 3 per cent, then the application of interquartile methodology is not mandatory. In every other case, the use of interquartile ranges is compulsory.
In 2013, a special version of the CuP method was introduced, applicable only to transactions involving the import or export of commodities, where an intermediary with no substance intervenes. Colloquially, this is known as the “sixth method”.

Unlike the OECD TP guidelines, the profit split method was paradoxically split into two different methods for Peruvian purposes, one of which was called the profit split method, while the other was called the residual profit split method.

Domestic rules introduced suggestions on the selection of the best method, indicating which methods are compatible with which kinds of transaction. As a result, to mention only one example, it turned out that transactions involving intangibles were not compatible with the application of methods such as the CuP, the transactional net margin method (TNMM), or the profit split method, which in many cases leaves the residual profit split method as the only method compatible with the analysis of intangibles.

Formal obligations constitute one important focus of Peruvian domestic rules. It is mandatory for most multinational companies (MNEs) to file a TP study (in the Spanish language) and a TP return every year. In addition, further documentation must be kept by the taxpayer in order to be able to demonstrate that its controlled transactions were carried out at arm’s length. Unlike the OECD’s recommendations, where the focus is on the most relevant transactions, local rules demand that all intercompany and tax haven transactions are documented, regardless of their size or relevance. In addition, for formal purposes, it is mandatory to perform individual analyses based on segmented financial information, unless one can prove the impossibility to do so.

As for the TP practice, some peculiarities have also been developed over time in Peru. For example, when applying a TNMM, it is recommended to use domestic comparable companies whenever they are available. Another peculiarity is that comparable companies need to have significant supporting documentation, including annual reports, audited financial statements, or 10k reports. Otherwise, they will probably be rejected as valid comparables in the case of a TP audit. Examples like these abound, but just to mention a final one, there have been many disputes on whether the financial information of the tested party should be expressed in its functional currency, as the international reporting standards would suggest, or whether it should be expressed in local currency, which is the profit and loss used as a base for the determination of income taxes.

2. The impact of the BEPS project on TP

2.1. Introduction

When the new president of Peru, Pedro Pablo Kuczynski, gave his inaugural speech, on 28 July 2016, he announced, as part of his promise to build a modern country, that “By 2021 …, Peru will be a member of the OECD”.3

3 Kuczynski, op. cit.
In the days following this speech, Kuczynski obtained permission from the national congress to issue legislation related to different issues, one of which was to adopt the suggestions of the OECD BEPS plan, which would be aligned with the country’s goal of becoming a full OECD member in the near future.

Formally, the proposal to modify the legislation includes the objective “to adapt the national legislation to the international standards and recommendations issued by the OECD on the exchange of information for tax purposes, international taxation, base erosion, transfer pricing, and the fight against tax avoidance”.

Previous to all of these efforts by the new government, the Peruvian tax administration (SUNAT) had actively participated in BEPS working parties and officers from the tax authority had expressed the intention of implementing measures suggested by the BEPS plan.

From the paragraphs above, it is clear that there is an intention to include changes suggested by the BEPS plan in Peruvian domestic rules in the short term. New regulations must be issued before 31 December 2016, which is the deadline the government obtained from Congress for legislating on these issues. It is still not known which of the BEPS suggestions will come into force or what form they will adopt.

One of the expected changes is related to high-value intangible analysis. This is because Peruvian domestic rules still provide very limited information for the identification of valuable intangibles as well as for the determination of their arm’s length value. Changes are expected to include specific criteria for the intangible concept and alternatives for using TP methods different from the residual profit split method (which according to Peruvian domestic tax rules would be the only method accepted for this purpose, although it is virtually always inapplicable in Peruvian tax practice). Additionally, it is expected that domestic rules will specifically allow and define the application of different methods or valuation techniques commonly used for the determination of the market value of intangibles.

Secondly, modifications related to “the sixth method” are also expected to occur. This needs to happen in order for this “method” to be applicable in practice and for taxpayers to have a legal framework to establish market prices for commodity transactions with certainty. It is important to mention that the “sixth method” is a particular approach of the CUP method introduced in Peruvian legislation only for the analysis of the import and export of commodities; nonetheless, the legislation on this regard seems to be incomplete, and thus not yet applicable. In this sense, the reporters expect that the sixth method included in Peruvian domestic rules will adopt the recommendations proposed by the OECD in relation to commodity transactions. This may imply an important challenge for Peruvian rules since the recommendations proposed in the BEPS plan have a more flexible approach, in particular, in relation to the “pricing date” criteria as they are described by the OECD.

Thirdly, the reporters consider that Peruvian domestic rules should incorporate the suggestions of the OECD about intra-group services, specifically those related to the definition of intra-group services and low value-adding intra-group services, selection of the most appropriate method and supporting documentation for such services. Although there are concerns about the introduction of the “simplified approach” proposed by the OECD, it is expected that this approach will be limited to situations where costs do not exceed certain specific thresholds.

Congress of the Republic of Peru, op. cit.
Finally, regarding Action 13 (documentation requirements) and in order for it to be applicable, it is necessary that Peruvian domestic tax rules require the three levels of documentation suggested by the OECD: master file, country by country report (CbCR) and local file. Changes are expected to occur in the local rules to be in force starting 2017 or 2018. Also, these new documentation requirements will imply modifications to the sanctions regime related to non-compliance with the TP formal obligations.

2.2. Challenges of transactions with intangibles

2.2.1. Definition of intangibles and transactions involving intangibles

In the Peruvian TP rules, an accurate definition is not available; it is only indicated that, as part of the comparability analysis,\(^5\) for the case of permanent cession or licence of intangible assets, the identification of an intangible should be considered as “intellectual property rights” or “industrial property rights”, as well as the description of any method, program, procedure, system, study or other type of technology transfer. Therefore, it can be noted that Peruvian TP rules are very generic regarding the identification of the intangible.

Also, referring to the Peruvian Income Tax Law (ITL), there is still no clear and accurate definition for the concept of intangibles. In this regard, Peruvian regulations only provide some examples of intangible assets whose useful life is limited by law or their nature.\(^6\)

Additionally, it is worth mentioning that the Tax Court, in several pieces of jurisprudence,\(^7\) in order to determine the existence of an intangible asset, has used as support the provisions set forth by international accounting standards (IAS).

In this regard, based on IAS 38 on intangible assets,\(^8\) accounting regulations indicate the elements that allow an asset to be classified as intangible: intangible assets do not have a physical nature, they are identifiable, control is exercised over them and they contribute to the generation of future economic benefits.

Even though these elements are considered for the definition of intangibles for accounting and tax purposes, it is important to mention that the definition of intangibles for TP effects, according to BEPS, has similar elements to characterize something as intangible, and also indicates that it is not a physical asset\(^9\) and that it has the capacity to be controlled, but also includes other criteria to be considered in order to ensure the existence of the intangible in operations performed between related entities.

Action 8 indicates that an intangible is an asset whose use or transfer would be compensated in an operation performed between independent third parties in comparable circumstances. It is also indicated that the definition of intangibles does not depend on accounting or legal considerations, so it puts emphasis on the

\(^5\) Art. 110 of the Regulations of the ITL.
\(^6\) Para. (a) of art. 25 of the Regulations of the ITL.
\(^7\) Tax Court Resolutions (RTF) Nos. 21510-4-2012, 04717-1-2015, 03316-1-2015, 19029-3-2012, 05223-2-2014, among others.
\(^8\) In the version approved by the Accounting Standards Committee by virtue of Resolution No. 034-2005-EF/93.01.
\(^9\) It is worth mentioning that the OECD’s guidelines also indicate that it is not a financial asset either.
need for the analysis of TP to actually ensure the existence of an intangible and whether it has been used or transferred in an operation performed between related entities.

For example, in this regard, it is mentioned that not all R&D activities generate an intangible and that not all marketing activities create an intangible. Also, it is indicated that the sole presence of agreements or legal property does not ensure the existence of an intangible for TP purposes.

Therefore, BEPS suggests a thorough functional analysis that identifies relevant intangibles, the way in which they contribute to the value creation of the transactions under analysis and also the way in which they interact with other intangibles and the business operation to create value. Consequently, it would be expected that new regulatory changes will include elements that allow the existence of an intangible in a controlled operation to be determined accurately.

2.2.2. “Substance-over-form” approach towards intangibles

Regarding the analysis of permanent cession or licence of intangible assets, the current Peruvian TP rules suggest several methods for conducting the comparability analysis, which is based on the evaluation of characteristics of operations and the evaluation of functions and risks. As noted, the purpose of the Peruvian rules is that the TP analysis is oriented to a substance approach. However, in practice, it is difficult to apply this approach appropriately due to the information limitations that arise during the execution of the analysis. For example, in some cases, there is no available information about the functions, assets and risks involved in the development of the intangible, and also, in several cases, it is necessary to have a detailed level of qualitative and financial information centralized in parent companies, which is difficult to access, as well as financial information regarding the contributions made by each party during the development and maintenance of the intangible.

Therefore, in Peruvian domestic practice, we can note a partial application of the substance approach focused on the identification of the intangible, on the benefits expected to be obtained from its use and on the payment capacity of the intangible. This means that this is an analysis mainly supported from the perspective of the party using the intangible. As a result, in order to make a thorough analysis under the substance approach, it is necessary that companies are more open to giving in detail the functions and risks involved by the parties in the development, maintenance and use activities of the intangible, and thus to evaluate the contribution of each party when creating value from the intangible and determine compliance with the arm’s length principle in operations performed with intangibles.

In addition, it is also important to mention that Peruvian rules suggest that the residual profit split method (RPSM) is the most suitable for the analysis of operations involving significant intangibles, which is an aspect to be reconsidered due to the low feasibility of the effective application of this method to Peruvian practice. In this regard, it is relevant to evaluate how much the activities performed by Peruvian subsidiaries are related to the global or international development of the intangible so that it is worth conducting an analysis with such complexity. For example, Peruvian subsidiaries are usually focused on activities with domestic impact which hardly contribute significantly to the development of the brand or intangible at an international level.
As a result, in domestic tax practice, the RPSM is virtually inapplicable, so the most frequently used methods remain the CuP and TNMM. Even though Peruvian domestic rules indicate that neither method is compatible with operations involving significant intangibles, the application of the CuP, based on the availability of public information (such as the analysis of licence agreements for the use of intangibles), is supported by the OECD TP guidelines, which establish that any of these methods may be the most appropriate for the analysis of the transfer of intangibles, and also by the experience of other practices in other countries that do not constrain the use of the CuP for operations involving intangibles. Regarding the use of the TNMM, according to the indications above, its use is mainly supported by the assumption that the contribution of Peruvian companies in the global development of the intangible is not relevant, so if the RPSM is applied, the results would be similar to those obtained from the application of the TNMM.

2.2.3. Comparability and group synergies

Peruvian TP rules do not make an explicit reference to group synergies and their relevance as a comparability factor in TP analysis. However, article 32A of the ITL establishes certain general comparability elements, and some of them may be interpreted to the effect that they may include a group synergy component like the synergies referred to by BEPS: passive association or deliberate concerted actions. Those general comparability elements indicated by the ITL are contractual terms, economic or market circumstances and business strategies.10 Also, article 110 of the ITL regulations indicates several elements to be considered for the comparability analysis per type of transaction: financial operations, provision of services, operations with tangible goods and intangible assets, and others. In this regard, the reporters have observed that some comparability elements may refer to the concept of group synergies.

For example, in financial operations, article 110 of the ITL regulations recommend considering in the comparability analysis elements such as guarantees, the solvency of the debtor and risk rating.11 In this regard, guarantees qualified as deliberate concerted actions are those that may grant the guaranteed entity a better credit rating than it would be granted in a stand-alone situation. However, the solvency of

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10 ITL, art. 32A, para. d: “In order to determine whether transactions are comparable, the entity should take into account those elements or circumstances that reflect, to a greater extent, the economic reality of transactions, based on the selected method, considering, among others, the following elements:
(i) Characteristics of operations.
(ii) Duties or economic activities, including used assets and assumed risks in operations, of each one of the parties involved in the operation.
(iii) Contractual terms.
(iv) Economic or market circumstances.
(v) Business strategies, including those related to the introduction, permanence and expansion of the market.”

11 “(a) In the case of financial transactions, the following elements should be considered: (i) the amount of the principal; (ii) the amortization term or period; (iii) guarantees; (iv) the solvency of the debtor; (v) the interest rate; (vi) the amount of commission; (vii) the risk rating; (viii) the country of residence of the debtor; (ix) the currency; (x) the date; (xi) any other payment or charge, made or paid by virtue thereof.”
the debtor and risk rating are elements that may be influenced by belonging to an economic group, in other words, by passive association. Since Peruvian regulations do not specify the incorporation of synergies as part of the TP analysis, in practice, several TP analytical approaches are identified for the documentation of financial operations (loans); that is, some of them are based on a stand-alone approach and others include the effect of synergies.

Regarding the provision of services and operations with tangible goods, comparability elements associated with group synergies established in the regulations may be the volume of supply and the manner in which the service is provided. Both elements can generate passive benefits that affect comparability directly.

### 2.2.4. Hard-to-value intangibles

As mentioned above, regarding the analysis of operations involving significant intangibles, the Peruvian TP regulations do not allow the use of several methods, so virtually the only method left compatible with those operations is the RPSM. Also, Peruvian regulations do not suggest specifically the use of other valuation methods commonly used in the market to value intangibles.

Additionally, the reporters can note that Peruvian regulations are even more limited when they deal with the analysis of permanent cession of intangibles or sale of intangibles. In these cases, none of the methods specified in the law is adjusted to the analysis of these operations. As indicated above, in accordance with Peruvian regulations, the RPSM is the only method compatible with these types of operation. However, due to its nature, this method is only applicable when the analysis of operations implies the overall development of an intangible, which does not usually occur when the sale of an intangible is at issue.

Therefore, due to the limitations set out by the regulations for the analysis of these operations, in domestic tax practice, for the preparation of TP studies, standard financial methods are often used to value intangibles used internationally. These methods consist of three approaches: the market approach, the cost approach and the income approach. The latter is the most used, which determines the value of the intangible based on the present value of future flows of benefits generated by the use of the intangible.

With regard to the use of these methods for the evaluation of intangibles, we can note that in Peruvian practice, due to the level of specialization required for their implementation, in some cases, expert appraisers in the market have been engaged. Even though Peruvian TP regulations do not expressly indicate it as an accepted choice for the analysis of these specific operations, in practice, the studies con-

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12 "(b) In case of the provision of services, the following elements should be considered:
   (i) Nature of the service. (ii) Length of the service. (iii) Characteristics of the service. (iv) Manner the service will be provided.
   (c) In case of transactions that imply the transfer, lease or any other type of assignment for use of tangible assets, the following elements should be considered:
      (i) Physical characteristics. (ii) Quality and availability of assets. (iii) Volume of supply. (iv) Geographical location of the asset."

13 In this regard, art. 110(1)(d) of the Regulations of the ITL only indicates that the elements to consider as part of the comparability analysis are the benefits expected to be obtained from the use of the intangible.
ducted by those experts have been used in some cases as the best approximation for the determination of the market value of transfer operations of intangibles performed between related entities. However, care should be taken in these cases that these experts consider the tax aspects of the transaction and the formal matters required by TP rules.

Another matter to discuss refers to those intangibles traded in an integrated or combined manner with other operations where one single price is agreed for the whole operation. For example, this is the case of the import of products whose purchase price not only includes the payment for the product itself but also considers implicitly a remuneration for an intangible component (brand, knowhow, among others). According to Peruvian TP rules, a separate evaluation is suggested for each component of the operation in order to determine the market value of each element independently. In practice, if information is not available, it is not possible to suggest a disaggregated or specific analysis as required by the regulations. Agreements mostly contain very general information or else the information held by Peruvian companies is very limited. In these cases, it is fairly difficult to be aware of information about functions, assets and risks assumed by the parties domiciled abroad, as well as to have access to information about price determination for each element of the combined transaction from abroad.

2.2.5. Cost contribution arrangements (CCAs)

Peruvian TP rules do not make explicit reference to CCAs. The regulatory framework that is most similar to the CCA is established in the General Business Law regarding association agreements; however, this is applicable to related entities as well as to independent third parties which have a purpose in common and it is not required to incorporate an independent legal entity. This law (from articles 438 to 448) makes a distinction between a joint venture agreement and a consortium agreement. In a joint venture agreement, the management of the project or business, as well as risks, will be centralized in one of the parties, and in case of a consortium agreement, risks will be allocated according to the functions of the parties. In both agreements, the profit-sharing system will be established in the agreement and it is assumed to be proportional to the contributions of participants.

2.3. Risk and capital

During recent years, the OECD has made efforts to come up with guidelines regarding the estimation of arm’s length returns in increasingly complex business situations currently affecting MNEs, including situations arising from business restructuring scenarios, where functions, risks and capital are reassigned between different entities of a corporation. Thus, in 2010, a new chapter (chapter 9) was introduced into the OECD guidelines regarding business restructuring.

In Peru, no formal modification was made to the domestic TP rules to account for the OECD’s suggestions regarding business restructuring. However, as previously mentioned, the OECD TP guidelines are referred to in Peruvian domestic regulations.

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14 Regulations of ITL, art. 112(1)(d).
rules as a “source of interpretation” of such domestic rules. So, in practice, despite the debates on whether the law should be read in a “static” or “dynamic” fashion and although some concerns arise about whether some dispositions in this chapter are far beyond the mere interpretation of Peruvian domestic rules, in practice some of the concepts introduced by chapter 9 of the OECD guidelines are being used to shed some light on technical discussions regarding TP aspects of business restructuring.

As for the BEPS plan, one of the important modifications suggested in Action 9 of the plan refers to the criteria to be used for identifying commercial or financial relations between the parties. In practice, it is no longer enough for such relations to be established and described by intercompany contracts. It is now required that MNEs show that the real conduct of the parties is aligned with the arm’s length principle and that the assignment of functions, assets, risks, people, and capital is aligned with the economic returns obtained by the parties, which means there will also be an alignment with the taxes paid in each jurisdiction.

From Action 9, tax administrations should gain the power to recharacterize transactions, especially when the intercompany agreements do not reflect the economic reality of the transactions and the real conduct of the parties.

In Peru, even though the TP rules do not specifically address this issue, the Tax Code includes a criterion that enables the tax administration to recharacterize the facts for tax.

This criterion, which until some time ago was captured by norm VIII, is now included in the first paragraph of norm XVI of the Tax Code. It indicates that in “order to determine the real nature of the taxable fact, the Tax Administration will take into account the acts, situations and economic relations that are effectively carried out, pursued, or set by the Taxpayers”.

From the application of this rule, there is abundant jurisprudence where the economic reality is prioritized over the formality established in contracts. However, most of this jurisprudence is still far from the TP environment, since TP audits have still not pursued these cases.

2.4. High-risk transactions

2.4.1. CUP and quoted prices for cross-border commodity transactions

The Peruvian economy is heavily dependent on the export of commodities. In fact, most of Peruvian GDP is explained by primary economic activities such as mining, fishing, agricultural products, etc.

A significant amount of the exports of commodities goes to related parties or tax havens, so these transactions have become an important focus of TP for the Peruvian tax authorities. This focus became evident in 2012, when new TP legisla-

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15 Law 30230 has indefinitely suspended the application of norm XVI, with the exception of the first and last paragraphs, which refer to simulated acts and the ability of the tax authority to recharacterize facts that are relevant for tax purposes, based on their economic reality.

16 For example, Tax Court Resolutions 5468 (case of lease-sale), 4315 (case of research expenses), 18364 (case of a fabric seller), 5301-4-2002 (services). Jurisprudence provided by César Talledo (2009).
tion was introduced in order to better control the imports or exports of commodities through intermediate entities that were located in places different from the final destination of the goods. This new piece of legislation became informally known as the “sixth method”, since it was inspired by a trend which started in Argentina, where the rules were in the sixth paragraph of the relevant law, and then spread all over Latin America.

Whenever new legislation is introduced in Peru, there is a document explaining the reasons why there is a need for this change. In this case, according to this document, the “sixth method” was needed in order to fight an aggressive tax planning strategy used by some taxpayers known as the “price to be fixed” strategy.

This aggressive tax avoidance strategy consists in sending the commodities to a related party abroad without a previous agreement on the price of the commodities being exported. Later, when the development of international prices for commodities was known, the related parties would retrospectively agree on a date when the price was the lowest possible, as a reference to set the price of the export. In this way, the export was made at the lowest price possible, resulting in the lowest income tax possible in Peru.

According to the Peruvian tax authorities, many cases of use of this strategy were spotted during tax audits, so the “sixth method” or “CUP for commodity transactions” was introduced.

Since the main problem was the date of reference the parties were selecting for establishing the price, the solution also focused on the date. The “sixth method” introduced some criteria for establishing the date of reference, giving four possible options.

However, in practice, this “sixth method” turned out to be very difficult to apply. First of all, the dates provided by the legislation could be far removed from the dates third parties were using in different markets, so the method could produce results very far removed from the arm’s length principle. Second, the market for commodity products can be very complex, especially when it comes to mining products. In the Peruvian case, the country mainly exports mineral concentrates, which are not themselves a commodity. Instead, the mineral concentrate is the raw material from which the commodities will be obtained after a complex refining process. Thus, it can be quite difficult to obtain an estimate of the price of the mineral concentrate from the international quotes of the commodities, since many adjustments and treatment charges must be included in the equation. It is very difficult for a single piece of legislation to capture all of these complexities, so in practice the law was short on describing how it would work in practice. As a result, it was not possible to apply this approach.

While these difficulties were being discussed domestically, the OECD decided to include a discussion on this topic as part of the BEPS developments. So, for local purposes, the strategy was to just wait and see what the result of the BEPS suggestions would be.

When the final documents of the BEPS plan were ready, it became evident that the OECD’s approach was different from the one adopted in the domestic legislation. The most important difference was, once again, related to the date to be used as a reference to set the price based on a commodity quotation. In this case, the OECD went for a more flexible approach. Instead of picking a fixed set of dates, it
suggested using the date effectively used by the taxpayer, as long as the taxpayer could demonstrate, with reliable evidence, that the price was agreed beforehand. If there are inconsistencies with this approach, the OECD suggested that the tax administration could use a date consistent with the date that third parties would use under similar circumstances. Finally, if it is not possible for the tax administration to establish such a date, the third and final option would be to use the date of shipment of the merchandise as a referential date.

It seems that the approach suggested by the OECD does not necessarily please the domestic tax authorities, who wanted to have more control over these transactions. However, in the Peruvian case, there is some political commitment to adopting most of the OECD’s suggestions.

So, currently, most of the TP community is expecting new legislation regarding the analysis of commodities. It is still unknown in which direction this new legislation will move.

2.4.2. Intra-group services

Even though intra-group services are commonly present in MNEs in Peru, the Peruvian TP rules have not included any specific provisions for them.

As a result of this lack of definition, different opinions have arisen on whether the OECD TP guidelines provisions on intra-group services are applicable in Peru.

Being a country that hosts many subsidiaries, intra-group services are usually received from abroad, generating deductible expenses for Peruvian entities. The amounts charged for these services can sometimes be quite large. So, in practice, there have been many tax audits of these transactions.

However, most tax audits have focused on whether the services have actually been received. The usual audit consists of challenging the taxpayer to show documentation and evidence that the related party abroad has effectively rendered the services. This documentation is sometimes difficult to obtain, since some services are of an intangible nature. The lack of sufficient documentation can eventually lead to the taxpayer not being able to deduct the expense for tax purposes at all.

Unlike the OECD guidelines and certainly unlike the BEPS Action Plan suggestions, Peruvian TP legislation does not contain specific dispositions for intra-group services yet. Nor does it contain any differentiation or simplified approach (cost + 5 per cent) for low value-added services.

In practice, these transactions have a very relevant impact on the determination of income taxes for Peruvian subsidiaries, so the reporters believe these transactions are one of the main issues to be analysed by the Peruvian tax authorities. Taking into account the relevance of these transactions, and based on the tax audits the reporters have seen regarding intra-group services, it could be difficult for Peruvian legislation to adopt a simplified approach, such as that suggested by the BEPS Action Plan, since from the Peruvian perspective this could generate a window for the erosion of the tax base in Peru.

It is expected that the legislative changes to be issued before 31 December 2016 will include some dispositions for intra-group services.
2.4.3. Profit splits in the context of value chains

During the development of the BEPS plan, there was a growing interest in how to discover effective ways to apply profit split methodologies, especially in the context of global value chains, where the application of other methods could lead to misleading results. There is some consensus regarding the fact that profit splits should be more useful in the future, as long as practical ways to use them are discovered. However, this is a complex issue that requires further development by the OECD.

In Peru, the TP rules indicate that the profit split method is only applicable for complex operations, where there are functions closely shared between the parties that make it difficult to individualize the results for each party. The reporters believe that this domestic disposition is aligned with the BEPS plan suggestion. However, in practice, there are very few cases where it has been possible to effectively use a profit split. According to the information provided by the Peruvian tax authority, obtained from the TP returns submitted by Peruvian taxpayers in 2007 and 2008, which is the most up to date information publicly available, only 1 per cent of the total reported intercompany transactions have been analysed by applying a profit split or an RPSM. In other words, the use of profit splits in Peru is almost non-existent. As a consequence of this, there is still no jurisprudence on the use of profit splits.

In this sense, it is a significant challenge for the new TP rules to come into force soon to incorporate mechanisms that make the use of these methods feasible.

2.5. TP documentation

2.5.1. CbCR, master file and local file

One of the most significant changes introduced by BEPS refers to the introduction of new TP documentation standards. These new considerations imply that MNE economic groups should disclose more information about their operations to tax administration authorities. For this reason, three levels of documentation have been established: the master file, local file and CbCR.

Even though Peru is not a member of the OECD to date, it is government policy to become a member in the medium term. In this regard, the Peruvian tax administration authority is clearly interested in making progressive changes to Peruvian regulations to include new documentation requirements mentioned above. In fact the current tax reform project seeks to align Peruvian legislation with the new standards and recommendations suggested by BEPS.

In order to reinforce in Peru the three documentation levels indicated above, changes would be expected in the ITL which would become effective from 2017. Also, if new documentation requirements are included in the Peruvian rules, they should be accompanied by amendments to the sanction regime for non-compliance with TP formal obligations.

Fuente: SUNAT (2010), Presentación en CIAT. El tratamiento de los precios de transferencia en el Perú.
It is important to highlight that these amendments that could be made to document-
ation aspects would imply relevant changes for Peruvian economic groups. This happens since, as new documentation has a global nature, information about all the companies that comprise the group in all the jurisdictions in which it operates should also be disclosed to the tax authority. This will lead to the fact that those groups must establish and monitor stringently their TP policies from a global point of view.

New systems or processes may be developed to control and monitor in advance the results of TP analysis on a global basis. Groups will also have to make sure that the CbCR, master file and local file provide information consistent with one another about global and local operations and TP policies.

Even though Peruvian regulations take a while to be amended, Peruvian economic groups which maintain activities or holding companies in countries where changes were implemented in regulations locally, may be required to meet these new documentation standards. Additionally, the exchange of tax information that promotes these documentation initiatives may cause the automatic application of information exchange clauses agreed in current double taxation treaties and also the execution of new double taxation treaties between tax administration authorities.

2.5.2. Compliance costs

One of the distressing issues related to the adoption of new documentation require-
ments refers to additional resources to be arranged by taxpayers to prepare for these new compliance standards. This preparation may mean allocating significant resources for the adoption of information systems, data collection and validation, among other processes necessary to meet new requirements that involve a lot of information regarding global operations which was not previously provided to tax administration authorities.

According to BEPS suggestions, new formal requirements would be expected to be mandatory for economic groups that exceed certain consolidated revenue lim-
itations. As a result, since these groups are also the most susceptible taxpayers for the application of BEPS standards, they would also be able to allocate more resources to meet the new documentation standards.

Considering the threshold of €750 million of revenue generated as a group, the demand for the preparation of the CbCR would be applicable for the roughly 15 Peruvian economic groups with operations in more than one country.

2.6. TP-related measures in other BEPS actions and other measures against BEPS

In Peru, most of the discussions around the BEPS plan have directed their attention to Actions 8, 9, 10 and 13. The reporters believe it is still early to see what other TP-related measures in other BEPS actions will come into play.

2.7. Can BEPS work in favour of MNEs?

Given the higher level of information to be disclosed by MNEs to tax administra-
tions and the sensitive nature of such information, BEPS will promote a culture of
greater transparency. This may generate more interest from MNEs in entering into advanced price agreements (APAs) with tax administrations in order to obtain more certainty in their fiscal results.

Additionally, BEPS suggests, in some cases, a flexible analysis approach which, if incorporated by Peruvian regulations, would be a benefit for taxpayers. As mentioned above, Peruvian regulations contain several specific aspects that, in some cases, may be considered as restrictions for TP analysis. Therefore, if Peruvian regulations were aligned with BEPS recommendations, the approach of Peruvian analysis would more accurately reflect the economic situation of businesses.

Finally, the reporters consider that BEPS will encourage MNEs to redefine their business strategies in order to create efficiencies different from those obtained through tax savings, which will reduce the reputational risk to MNEs.

3. What is the future of TP?

Since their inception in 2001, TP rules in Peru have been in constant evolution, having been through different modifications over time. The main focus of the evolution of the rules has been, on the one hand, to provide clarity to taxpayers and, on the other hand, to defend the Peruvian tax base.

The reporters believe that the BEPS project will be crucial for reshaping Peruvian domestic TP rules and local TP practice. The importance of the BEPS project for Peru is reinforced by the fact that Peru is willing to become a member of the OECD by 2021, so it needs to show consistency and adhere to its initiatives.

However, it is believed that a degree of tension exists between some of the recommendations arising from the BEPS Action Plan and the omnipresent domestic objective of defending the Peruvian tax base. This tension becomes evident in issues such as commodity transactions, the analysis of intangibles and intercompany services.

In the case of commodity transactions, their relevance to Peruvian GDP makes them a priority focus for the Peruvian tax authorities, who want to make sure that prices are being set at arm’s length and that Peru is not losing any tax. This perception has led to measures designed to exercise close control over these transactions, such as the Peruvian version of the “sixth method”, which had no problem deviating from the arm’s length principle in order to reach the objective of defending the domestic tax base. From a different perspective, the new OECD TP guidelines, after incorporating suggestions from the BEPS Action Plan, have acknowledged the importance of these transactions, but have reinforced the validity of the arm’s length principle as the guiding light even in these complex cases, thus diminishing the ability of the local tax authorities to set different criteria to evaluate these transactions. As a result, Peru currently has domestic rules that clearly differ from the BEPS suggestions and it remains to be seen whether the legislator will want to align the rules to the OECD’s suggestions. In the meantime, this tension has led to a situation where no one is applying the local “sixth method” rules, as everyone is expecting new rules to come into force in the near future.

As for transactions involving intangibles, Peru is in a situation where very few intangibles are generated domestically. So most transactions involving intangibles
are some kind of payment to the foreign companies that own these intangibles. In most cases, withholding taxes apply to these payments, so there is a feeling that the domestic tax base is somehow protected. In practice, this situation, together with the complexities associated with the TP analysis of intangibles, has led to a situation where these transactions have not yet been heavily audited by the tax authorities. The reporters believe the recommendations of the BEPS Action Plan will help shape the way these transactions are dealt with and will indicate the way in which they will be treated in the future. They also believe the BEPS plan has opened a window of opportunity for improving Peruvian TP legislation related to intangibles. As mentioned above, Peruvian domestic rules currently mandate using residual profit split analyses, but these are almost impossible to apply in practice. In addition, forcing residual profit split analyses in a country that does not host significant intangibles could erode the domestic tax base rather than defend it. This issue could be resolved soon if the domestic legislator uses the opportunity to adopt BEPS suggestions on this matter.

Regarding intercompany services, the tension is also evident. While developed countries feel it is time to adopt a simplified approach, especially for low value-added services, developing countries such as Peru might be feeling the opposite. From the reporters’ experience, it seems as though the domestic tax authorities in such countries are really worried about the expenses being registered by local companies when receiving these services, so instead of simplifying their analysis, they have an incentive to ask for more and more information and documentation to prove the services really existed. Hence, it could be difficult for countries such as Peru to opt for a simplified analysis. In any case, modifications regarding intercompany services are expected very soon, as a result of the BEPS plan, and it is simply necessary to wait in order to see which way the local legislator chooses to go.

On the other hand, if there is one field where there seems to be a close alignment with the suggestions of the BEPS plan it is the requirements for documentation. It seems as though the adoption of Action 13 in Peru will happen soon. The major challenge for this information to be really useful will be for Peru to modify its rules in order to be able to share it with other countries, thus also gaining access to information available to be shared by foreign countries.

All of these changes will happen in a context where we expect TP audits to increase, which will push many TP cases into the tax courts, where there have only been a few cases so far, which in turn will increase the need for alternative mechanisms for resolving disputes, such as APAs.

In conclusion, the reporters believe that the future of TP in Peru will be shaped, to a great extent, by the recommendations of BEPS Action Plan. It will probably be difficult to adopt all of the suggestions of the plan, as there are some evident tensions, so it is expected that TP will continue to generate discussion and debate, making it a dynamic and challenging topic in the years to come.
Summary and conclusions

In general, Polish transfer pricing (TP) regulations, in their wording binding until the end of 2016, follow the pre-base erosion and profit shifting (BEPS) OECD TP guidelines. The arm’s length principle based on the OECD model, as well as the TP documentation standards, are reflected in the Polish Corporate Income Tax (CIT) and Personal Income Tax (PIT) Acts. Advance pricing arrangements (APAs) are available in the form of unilateral, bilateral or multilateral agreements. Elimination of double economic taxation is provided for under mutual agreement procedures (MAPs) governed by double tax treaties, which are, however, of limited practical use due to the lack of deadlines for the effective closure of such cases. The EU Arbitration Convention is available for intercompany transactions within the EU.

TP regulations apply to both cross-border as well as domestic transactions.

Major deviations between the OECD TP guidelines and Polish rules include a 5 per cent independence threshold (subject to change to 25 per cent as of 2017), a fragmented transaction-by-transaction TP approach with low transaction value thresholds subject to documentation, and a lack of requirement for economic comparable analyses as a part of TP documentation. A specific deviation from the OECD TP guidelines relates to the pricing of financial transactions – loans, guarantees and the like – which according to Polish TP regulations should be priced at the lowest interest/price applicable to comparable financial transactions.

Changes in Polish TP regulations seem to be inevitable to implement the outcome of the BEPS project fully because – under constitutional requirements – all elements of tax structure that affect the amount to be paid should be precisely regulated in statutes adopted by Parliament.

The year 2016 saw a major breakthrough in developments in the adoption of new TP legislation (partly connected with the BEPS reports) as well as TP audit practice due to the increased BEPS awareness of tax inspectors and a new coordi-
nated approach to TP audits. The tax administration started to apply a broader interpretation of the TP rules so that the distinction between TP rules and the general anti-abuse clause (which was absent in Polish tax system until mid-July 2016) ceased to be clear cut.

Major changes have already been introduced in the field of TP documentation. Not only the scope of the documentation itself but also the scope of entities obliged to prepare documentation has been significantly altered. Changes in documentation requirements will probably lead to an increase in compliance costs for multinationals (MNEs). It is difficult to predict whether they will benefit from ongoing changes in the short term. They could definitely gain from the better international cooperation of the tax authorities if this leads to the elimination of economic double taxation.

The long-term future of the TP system in Poland cannot be predicted very easily as it does not rely solely on the implementation of BEPS. For instance, Poland – as a Member State of the European Union – may at some point be required to apply strict formulary apportionment due to the introduction of the common consolidated corporate tax base.

1. Current TP regulation and practice in Poland

In general, Polish TP regulations, in their wording binding until the end of 2016, follow the pre-BEPS OECD TP guidelines. The arm’s length principle as well as the TP documentation standards are reflected in the Polish CIT\(^1\) and PIT Acts.\(^2\) APAs are available in the form of unilateral, bilateral or multilateral agreements. Elimination of double economic taxation is provided for under mutual agreement procedures (MAPs) governed by double tax treaties, which are, however, of limited practical use due to the lack of deadlines for the effective closure of such cases. The EU Arbitration Convention\(^3\) is available for intercompany transactions within the EU.

TP regulations apply to both cross-border as well as domestic transactions.

Major deviations between the OECD TP guidelines and Polish rules include a 5 per cent independence threshold (subject to change to 25 per cent as of 2017), a fragmented transaction-by-transaction TP approach with low transaction value thresholds subject to documentation, and a lack of requirement for economic comparable analyses as part of TP documentation. The extremely low 5 per cent independence threshold results in the qualification of counterparties as related entities even in cases of transactions undertaken between commercially inde-
pendent businesses and publicly owned companies with low interest stakeholders. The 5 per cent threshold also has an impact on the application of independence criteria in searches for comparable companies – in practice its literal application results in the rejection of otherwise comparable entities and degrades the search results.

A specific deviation from the OECD TP guidelines relates to the pricing of financial transactions – loans, guarantees and the like – which according to Polish TP regulations should be priced at the lowest interest/price applicable to comparable financial transactions. As a result, the use of publicly available data and data requested from financial institutions both by taxpayers as well as by tax authorities during audits is still the predominant way for both the setting up as well as the examination of such transactions.

There are significant TP penalties for the lack of proper TP documentation in case of TP adjustments: the assessed income is subject to a 50 per cent tax rate, instead of the standard 19 per cent CIT rate or progressive PIT rates.

The year 2016 saw a major breakthrough in developments in the adoption of new TP legislation as well as TP audit practice due to the increased BEPS awareness of the tax examiners and a newly coordinated approach to TP audits. There is a major shift in tax authorities’ interest towards TP issues, which has resulted in an increased number of audits and new ways of applying TP rules. A significant change relates to the use of financial data databases by the tax authorities for the determination of external transaction based comparables and profit-based margins. This change has resulted in a shift of the historical focus of the tax authorities from TP documentation to the targeting of business restructuring, substance issues, validation of economic returns versus functional entity profiles, economic ownership of intangibles and the like. The new approach is also applied in audits of pre-BEPS years and is likely to result in increased TP controversy and the need for dispute resolution.

2. The impact of the BEPS project on TP

2.1. Introduction

The works of the OECD on BEPS in the field of TP have been described in professional journals. In the literature the outcome of the BEPS project has been described as a challenge for MNEs. The participation of numerous countries (not only Member States of the OECD) and stakeholders in the work of the OECD has been appreciated. The Ministry of Finance participated actively in the OECD works. Stakeholders did not seem to be particularly active in the process. One association – Centrum Cen Transferowych – presented its remarks.

4 See, for instance, P. Siwiecki and S. Lebda, “Ceny transferowe w centrum uwagi na świecie”, Prawo i Podatki 2014, No. 6, pp. 9 et seq.
6 Ibid.
Concerns have been voiced by the Polish business community regarding a proposal for a Council directive laying down rules against tax avoidance practices that directly affect the functioning of the internal market aimed at introducing anti-avoidance measures throughout the EU. The main objection is that these measures go further than those provided in the BEPS reports.

Changes in Polish TP regulations seem to be inevitable to implement the outcome of the BEPS project. Under the Constitution of the Republic of Poland of 2 April 1997 taxes are imposed by statute. All elements of tax structure that affect the amount to be paid should be precisely regulated in statutes adopted by Parliament (see articles 84 and 217 of the Constitution and the judgments of the Constitutional Tribunal of 11 December 2007 (U 6/06) and of 13 September 2011 (P 33/09)).

Although the OECD TP guidelines (or BEPS reports) cannot be considered to be sources of law in Poland, they should be taken into account by the Minister of Finance when issuing TP regulations (article 11(9) of the CIT Act and article 25(8) of the PIT Act).

Up to a certain point changes aligning Polish legislation with BEPS have already been introduced. Some of the changed provisions entered into force even before the adoption of the final BEPS report. Some of them are directly connected with TP issues (thin capitalization) while others are not, such as controlled foreign company legislation. Some of the recent changes in TP legislation have been identified as aimed at aligning Polish legislation with EU law.

2.2. Challenges of transactions with intangibles

2.2.1. Definition of intangibles

The regulations of the Minister of Finance of 10 September 2009 (the TP regulations) describing TP methods include among other things chapters on the valuation of intangibles and services. Intangibles are not, however, defined in the regulations. The content of the chapters may indicate how the Minister of Finance perceives intangibles and services. The chapters regulate the determining of the market value of intangibles, advertising expenses, financial transactions, R&D

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9 Konstytucja Rzeczypospolitej Polskiej z dnia 2 kwietnia 1997 r., Journal of Laws No. 78, item 483, as amended.
12 One of them applicable to natural persons (rozporządzenie Ministra Finansów z dnia 10 września 2009 r. w sprawie sposobu i trybu określania dochodów osób fizycznych w drodze oszacowania oraz sposobu i trybu eliminowania podwójnego opodatkowania osób fizycznych w przypadku korekty zysków podmiotów powiązanych, Journal of Laws of 2014, item 1176) and the other to corporate bodies (rozporządzenie Ministra Finansów z dnia 10 września 2009 r. w sprawie sposobu i trybu określania dochodów osób prawnych w drodze oszacowania oraz sposobu i trybu eliminowania podwójnego opodatkowania osób prawnych w przypadku korekty zysków podmiotów powiązanych, Journal of Laws of 2014, item 1186).
costs, low added value services as well as the costs of developing intangibles. No fundamental changes connected with BEPS works have been introduced to these chapters so far.

This understanding of intangibles is different from that adopted for CIT Act and PIT Act purposes, where definitions have been introduced for the purposes of the tax depreciation of fixed assets. On the other hand, there is the understanding of intangibles that can be aligned – as a matter of principle – with the TP regulations in the Accounting Law of 29 September 1994. Under article 3(1)(14) intangible assets are understood to mean any property rights acquired by an undertaking, classified as fixed assets, fit for use in business, with a foreseeable useful life of longer than one year, designed for use by the undertaking for its purposes, including in particular:
(a) commercial copyrights, neighbouring rights, licences, concessions;
(b) rights to inventions, patents, trademarks, utility or decorative models;
(c) knowhow.
According to the Accounting Law intangible assets also include any acquired goodwill as well as the costs of completed development.

In commentaries to the TP regulations of the Minister of Finance the following are mentioned among intangibles: trademarks, knowhow and marketing services regarding intangibles.

Certain discrepancies may occur between intangibles as understood under the Polish tax or accounting provisions and the definition contained in the BEPS report Actions 8–10 (paragraph 6.6, p. 69).

2.2.2. Transactions with intangibles

The BEPS report referred to the problem of identifying transactions in intangibles. At the time of writing this report taxpayers are expected to prepare TP documentation with special requirements connected with transactions in intangibles, which means that they have to be capable of identifying such transactions. Under article 9a(1) of the CIT Act (and article 25a (1) of the PIT Act) in the version in force until the end of 2016 taxpayers performing transactions, including (a) the fact of concluding deeds of partnerships, contracts of joint undertaking, or contracts of a similar character, with subjects linked with these taxpayers or transactions in relation to which the payment of sums due as a result of such transactions is made directly or indirectly for the benefit of a subject having its place of residence, seat or management office in a territory or in a country practising harmful tax competition, (b) the fact of concluding by those taxpayers of deeds of partnership, contracts of joint undertaking, or contracts of a similar character, if one of the parties to the deed or contract has its place of residence, seat or management office in a territory or in a country practising harmful tax competition, will be obliged to prepare tax documentation of the transaction(s).

The documentation duty mentioned above refers to transaction(s) between related subjects in which the total amount (or its equivalent) resulting from the contract or the total amount, actually paid in a tax year, of contracts enforceable in the tax year is higher than the equivalent of €30,000 in the case of a contract of services, the sale or licence of intangible fixed assets (article 9a(2)(2) of the CIT Act and article 25a(2)(2) of the PIT Act).

2.2.3. “Substance-over-form” approach towards intangibles

Article 11 of the CIT Act states that if:
(a) a natural person, legal person, or an organizational unit having no legal personality, having its place of residence, seat or management office in the territory of the Republic of Poland, hereinafter referred to as a “domestic subject”, participates directly or indirectly in managing or controlling an enterprise located outside the territory of the Republic of Poland or has shares in its capital; or
(b) a natural or legal person, or an organizational unit having no legal personality, having its place of residence, seat or management office outside the territory of the Republic of Poland, hereinafter referred to as a “foreign subject”, participates directly or indirectly in managing or controlling a domestic subject or has shares in its capital; or
(c) the same natural person, legal person or an organizational unit having no legal personality at the same time participates directly or indirectly in managing or controlling a domestic subject and a foreign subject or has shares in their capital;
(d) and if, as a result of such links, there are agreed or imposed conditions substantially different from those which would be agreed between independent subjects and, as a result thereof, the taxpayer does not disclose any income or discloses less income than might be expected, if such links did not exist, the income of such taxpayer and the tax due shall be assessed without taking into account the conditions resulting from such links (a similar rule is included in article 25(1) of the PIT Act).

As has been mentioned above, intangibles are not defined for TP purposes.

According to article 11(2) of the CIT Act the income referred to in paragraph (a) above will be assessed on the basis of estimation, applying the following methods:
(a) comparable uncontrolled price (CUP);
(b) resale price;
(c) reasonable margin (“cost plus”).

The analogous regulation is worded in article 25(2) of the CIT Act.

Article 11(3) of the CIT Act states that if the application of the methods specified above is impossible, the method of transaction profit will be applied. Article 25(3) of the PIT Act is the equivalent of the quoted rule in provisions regarding the taxation of individuals.

Until recently the possibility of applying the substance-over-form principle could hardly be considered as there was no legal basis allowing the tax authorities to do so. Under article 7 of the Constitution the organs of public authority must function on the basis of, and within the limits of, the law. This principle has
been repeated at a statutory level in article 120 of the Tax Ordinance of 29 August 1997\textsuperscript{15} which says that the tax authorities should act pursuant to the provisions of law. This obviously applies to tax authorities acting in TP matters.

Before mid-July only one article in tax legislation, which might, though it must be emphasized, rather sketchily, resemble a clause allowing reclassification of transactions for tax purposes, was in force, namely article 199a of the Tax Ordinance.\textsuperscript{16} This says that while establishing the meaning of the act in law, the tax authority should take into account both the congruent intentions of the parties and the purpose of the act and not just the literal wording of declarations of intent filed by the parties to such acts. Under article 199a(2), if, while disguised as one legal act, another legal act is performed, the tax consequences will flow from the disguised legal act. Article 199a(3) states that if the evidence collected in the course of proceedings and, in particular, the depositions of a party, unless the party refuses to make depositions, casts doubt on the existence or non-existence of a legal relationship or a right having tax consequences, the tax authority may apply to a common court to ascertain the existence or non-existence of such a legal relationship or right.

Therefore, Polish tax law did not really leave any space for the application of the substance-over-form rule, unless a transaction was considered to be invalid from the perspective of private law. Only in mid-July 2016 was a general anti-avoidance rule introduced into the Tax Ordinance, to supplement the application of the TP regime.

Another point to be made is that soon after the adoption of the BEPS reports a change in the approach of tax authorities towards the interpretation of article 11 of the CIT Act was observed. Previously this article was perceived as allowing the tax authorities to adopt a legal fiction as regards the level of tax deductible costs or revenue.\textsuperscript{17} The tax authorities could issue a decision under which, for instance, tax deductible costs were decreased or revenue increased. They could not, however, disregard a transaction that had been entered into on non-arm’s length conditions. Recently the tax authorities (at least some of them, as tax proceedings are not open to the public in Poland and the reporters do not have a full overview of all TP decisions issued in Poland) have adopted a broader interpretation based on a general understanding of the word “conditions” used in article 11(1) of the CIT Act and article 25(1) of the PIT Act. They assume that a transaction can be disregarded in its entirety, if independent enterprises would not have entered into it.

This approach has at least one drawback, namely that the methods that should be applied as a consequence of the existence of prerequisites from article 11(1) of the CIT Act or article 25(1) of the PIT Act are simply valuation methods.\textsuperscript{18} They

\textsuperscript{15} Ustawa z dnia 29 sierpnia 1997 r. – Ordynacja podatkowa, Journal of Laws of 2015, No. 613, as amended. Translation of provisions of this Act is based on Legalis database by C.H. Beck.

\textsuperscript{16} See B. Brzeziński and K. Lasiński-Sulecki, Poland, in A Comparative Look at Regulation of Corporate Tax Avoidance, ed. K. Brown, Springer, p. 274.

\textsuperscript{17} See, for instance, the judgment of the Regional Administrative Court in Gdańsk (Wojewódzki Sąd Administracyjny w Gdańsku) of 4 February 2015, I SA/Gd 1344/14.

cannot be used to disregard the transaction at all. One could only try to argue, at best, that certain transactions do not have any value for a taxpayer and, therefore, that their valuation should be nil. It is necessary to wait and see whether this new approach of the tax authorities finally receives the approval of the courts.

2.2.4. Comparability and group synergies

Poland has not yet implemented specific comparability requirements with regard to intangibles or group synergy considerations as provided for in BEPS Actions 8–10.

With respect to intangibles, the Polish TP regulations provide that the comparability analysis should take into account the differences in the characteristics of intangibles being compared, to the extent that such characteristics could have an impact on the market value of the intangibles and the method applied. In particular, the form and type of the intangible property transaction, the duration and the degree of protection afforded to the property as well as the benefits expected from its exploitation should be compared.

One particular issue that arises with regard to comparability factors in the case of intangible property is the level of uniqueness of the intangibles. The more unique the intangible the less comparable it is to other intangibles. This poses difficulties in the application of comparable searches and the application of common comparability adjustments. Poland does not have any specific rules to deal with such issues. It can be expected that in the future additional rules will need to be adopted. Such rules could provide e.g. for specific profit split provisions related to the pricing of intangibles as well as for increased use of valuation methods to deal with hard-to-value intangibles.

Group synergies are not addressed by Polish TP rules. Their application in practice is also very rare.

2.2.5. Hard-to-value intangibles

The pricing of hard-to-value intangibles is not addressed under current Polish TP regulations and there is no publicly announced draft legislation that would indicate whether and when Poland plans to adopt measures to improve the valuation of hard-to-value assets following the Actions 8–10 report.

The OECD TP guidelines indicate that:

“When valuation of an intangible or rights in an intangible at the time of the transaction is highly uncertain, the question arises as to how arm’s length pricing should be determined. The question should be resolved, both by taxpayers and tax administrations, by reference to what independent enterprises would have done in comparable circumstances to take account of the valuation uncertainty in the pricing of the transaction.”

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In practice, in third party transactions related to hard-to-value intangibles valuation techniques will often be used for price-setting purposes. Accordingly, such valuation techniques would also often be used by affiliated companies as the first method. Where possible, this can be corroborated by available CUP data, although most probably such data will not provide perfect comparables.

2.2.6. Cost contribution agreements (CCAs)

Basically, CCAs include two major types of agreement, depending on their purpose and outcome. The first relates to CCAs established to pool joint resources in order to perform activities aimed at the creation of some types of intangible that will be exploited by the contributing parties. The second type of agreements are CCAs under which joint activities are performed or financed which do not result in the creation of IP.

Polish domestic TP law addresses both types of CCA.

With respect to CCAs related to development of intangibles, the Polish TP regulations include the OECD TP guidelines recommendations related to the allocation of contributions based on the proportion of expected benefits. In addition, non-expected benefits should also be allocated based on the proportionate share of the consideration paid by the parties. In cases where a participant in the CCA is able to obtain comparable benefits from an unrelated entity for a lower value, this lower value will be taken to determine the fair market value of the CCA consideration due from this taxpayer. The Polish CCA rules do not address the issue of buy-in and buy-out payments.

For CCAs related to the joint development of services, specific reference is made in domestic law to marketing services as well as the pooling of resources for the performance of R&D activities. In the case of jointly incurred marketing expenses, their attribution to the CCA participants will be made based on expected benefits. The determination of the value of expected benefits should take into account such comparability factors as the geographical markets where the marketing activities are carried on as well as the market share of the promoted goods and services sold by the particular CCA participants.

In the case of R&D service CCAs which do not lead to the creation of intangibles, the costs incurred by the entity which launches R&D activities commissioned by other entities should be attributed to those entities based on the potential benefits from the results of the research which are deemed to accrue to contractors. The valuation of the allocations should be priced using the most appropriate method based on comparability factors.

2.3. Risk and capital

As mentioned above, Polish domestic provisions on the arm’s length rule are almost a copy of model provisions from article 9 OECD model. Additionally, more than 80 double taxation treaties include the arm’s length principle with the article 9 OECD model wording. Bearing this in mind, it needs to be also stated that according to article 91(1) of the Constitution, ratified international agreements, after publication in the law gazette, are a part of the domestic legal order and are applied directly, unless their application is conditioned on the issuing of a legal act. More-
over, according to article 91(2) of the Constitution, a ratified international agreement by way of an advance agreement expressed in a legal act has priority over the legal act if this legal act cannot be reconciled with an international agreement.

With respect to this, since the OECD Council approved the amendments to the TP guidelines on 23 May 2016,\textsuperscript{20} they have been used as a common interpretation of the principle among OECD member countries and for OECD recommendations for article 9 OECD model.

As is stated in the Actions 8–10 report, analyses of assumption of risk and return on capital still remain valid within the arm’s length principle. The expectation is to improve the practice of the tax administration with regard to the usage of the whole scope of arm’s length analyses. In Polish domestic law tools are already available to help the tax administration to align the TP outcome with value creation. These tools make arm’s length analyses less susceptible to manipulation by the contractual allocations of functions, assets and risks (though it is subject to debate whether such an improvement in practice is fully possible under current rules).

First of all it needs to be stated that a tax audit is exercised on the legal basis; this basis implies, according to article 122 of the Tax Ordinance, that in the course of tax audit, the tax authority is obliged to take every possible step to explain the fact pattern of the case and to conclude the case in the course of tax audit. This also means that, in accordance with article 187 Tax Ordinance, the tax authority is obliged to gather and in a comprehensive way analyse all documents relevant to the case. This gives the tax authority the right to check the actual activity and to delineate the actual transaction within its arm’s length compliance analyses. On the basis of the actual delineation of transaction, the tax authority is able to use all five accepted OECD methods for the pricing of the transaction. This means that with regard to compensation for risk assumption the standard of risk return trade-off will be used directly within tax audit analyses of arm’s length compliance. The same tools are capable of being used for the purpose of adjusting the level of return to funding provided by a capital-rich MNE group member, where those returns do not correspond to the level of activity undertaken by the funding company.

\textbf{2.4. High-risk transactions}

\textbf{2.4.1. CUP and quoted prices for cross-border commodity transactions}

In Polish domestic law there are no specific regulations on transactions with commodities. General provisions for the arm’s length principle are used, i.e. article 11 of the CIT Act and article 25 of the PIT Act.

The tax administration is at the stage of gathering data considering different aspects of TP analyses. It is expected that at some point these data will help the tax administration to issue some safe harbour provisions, for example relevant to commodities.

\textsuperscript{20} As set out in the 2015 BEPS Report on Actions 8–10, Aligning transfer pricing outcomes with value creation.
2.4.2. Intra-group services

Intra-group services are tested during the tax audit through general provisions regulating cost deductibility. According to article 15 of the CIT Act, only costs incurred to realize revenue or to preserve or secure the source of income are deductible, with some exceptions.

Additionally, some special measures are included in domestic law. According to article 21(1)(2a) of the CIT Act, for some particular services withholding tax to the amount of 20 per cent of service remuneration can be applied. This provision will work in situations where there is no double tax treaty in force and it covers all indicated service payments, without the necessity of proving an association between the payer and payee. The regulation indicates some particular services such as advice, accounting, market research, legal services, advertising, management and control, data analytics, human resources, guarantees, bailment and similar.

With regard to the level of intra-group charges, general provisions for the arm’s length principle are used, i.e. article 11 of the CIT Act and article 25 of the PIT Act. This means that there is the expectation of a mark-up on every intra-group charge. No safe harbour regulations are available.

Specific provisions are available in separate acts, i.e. the TP regulations of 10 September 2009 mentioned earlier in this report that provide tools for making adjustments. Among them the benefit test is regulated. According to §19(1-2) of the TP regulations, when assessing the market price for intangibles or services in transactions between associated companies, the tax authority in the first instance should check whether independent companies acting in rational way would conclude such a transaction under conditions similar to those agreed between the associated companies. When the rationally expected benefits of the entity entering into the transaction are clearly fewer than the expenses incurred, and the entity does not indicate a rational reason that explains the level of these expenses, the tax authority will check the amount.

Taking into account the revision of the chapter suggested by BEPS Actions 8–10 with regard to low value-added intra-group services, it is expected that Poland will implement the simplified approach, taking into account the categorization of services, consistency in allocation key, greater transparency with regard to documentation as well as the benefit test. However, taking into account that the value of services paid to non-resident entities from Poland is six times higher than, for example, for royalties, it is expected that the implementation of the simplified approach will be made with great care.

2.4.3. Profit splits in the context of value chains

In Polish domestic law, the profit split method is indicated as one of five methods to be used to adjust transfer prices, i.e. article 11 of the CIT Act and article 25 of the PIT Act.

Additionally, provisions given in the TP regulations providing tools for making TP adjustments during tax audits regulate in a specific way how the profit split method should be used. In §17 of the TP regulations, it is stated that this method is
based on assessing the total profit that is achieved by all associated parties to the transaction and splitting this profit in a way that independent parties would do. Provisions also indicate that the proportion of the split might be done using residual analyses or participation analyses. Nevertheless, these provisions are rather vague and do not give clear guidance on how the split should be made.

In this case, it is expected that the direct use of the OECD TP guidelines will be a helpful tool for a particular approach in profit split analyses.

2.5. TP documentation

2.5.1. Country-by-country reporting (CbCR)

Poland introduced CbCR rules binding for the tax years commencing as of January 2016. Under local rules, the domestic entities referred to in article 11(1)(1) and (4):

(a) which meet the criteria of a parent company and do not meet the criteria of a subsidiary within the meaning of the accounting provisions;

(b) which constitute entities consolidating their financial statements within the meaning of the accounting provisions;

(c) which possess a foreign permanent establishment or one or more subsidiaries within the meaning of the accounting provisions, outside the territory of the Republic of Poland;

(d) the consolidated revenues of which, within the meaning of the accounting provisions, within and outside the territory of the Republic of Poland, exceeded the equivalent of €750 million in the preceding tax year;

are obliged to submit to the tax office a statement on income and tax paid as well as on places of business in the tax year of the subsidiaries and foreign permanent establishments belonging to the capital group, within 12 months following the end of the tax year of the domestic entity, for which the statement is submitted.

The amounts expressed in euro are converted to Polish currency using the average exchange rate announced by the National Bank of Poland, valid on the last business day of the tax year preceding the tax year for which the statement is submitted.

As a result, as of 2016 tax year Polish tax resident entities meeting the above requirements are subject to CbCR filing in Poland. Poland plans to broaden the CbCR filing requirements as of 2017. Under proposed amendments, the Polish subsidiaries of foreign entities with consolidated revenues above €750 million will be subject to local filing if the foreign entities are domiciled in countries which have not introduced the CbCR requirement, or do not exchange CbCR under exchange of information rules (unless there is a constituent entity in another EU country designated by the parent company to do such filing).

CbCR has to be filed in the Polish language.

Poland is party to the Convention on Mutual Administrative Assistance in Tax Matters under which automatic exchange of TP information can take place.

In addition, specifically with respect to exchange of CbCR, Poland is one of the first signatories of the Multilateral Competent Authority Agreement on the Exchange of CbCR.
2.5.2. Master and local files

As of 2017, under the three-tiered approach to TP documentation, Poland will introduce into its domestic legislation the obligation to prepare a master file and local files in addition to the CbCR requirement introduced as of 2016.

The scope of the required TP documentation will depend on the size of the taxpayer.

Entities with revenues or costs below the equivalent of €2 million in the preceding tax year are exempt from the TP documentation requirements. Entities with revenues above the equivalent of €2 million are required to prepare a local file which follows closely the OECD local file template, however without a benchmarking study. Benchmarking studies are required as part of the local file for entities with revenues or costs above €10 million. A master file is required for entities with revenues or costs above €20 million.

The local file should contain elements that mostly follow the OECD local file regulations. A significant additional requirement is the necessity to provide a reconciliation between the financial data used for price-setting and the audited financial statements.

With respect to benchmarking studies, it is important to note that in order to provide TP penalty protection the required benchmarking studies should be based on Polish comparables, unless the taxpayer is able to demonstrate that such comparables were not available.

The master file requirements under Polish regulations follow the OECD master file content requirements with some minor changes. Apart from the size of the taxpayer, the scope of the required TP documentation also depends on the materiality of the intercompany transactions. The following calculation mechanism applies for determination of transactions deemed material:

- for entities with revenue between €2 million and €20 million – transactions above €50,000 increased by €5,000 per each €1 million of revenues in excess of €2 million;
- for entities with revenue between €20 million and €100 million – transactions above €140,000 increased by €45,000 per each €10 million of revenue in excess of €20 million;
- for entities with revenue above €100 million – transactions whose total value exceeds the equivalent of €500,000 are considered material.

The application of the above mechanism may indicate a tendency for the continuation of the application of current transaction-by-transaction approach even after the introduction of the Action 12 three-tier approach.

Both master file and local files must be prepared in the Polish language.

2.5.3. Compliance costs

Compliance costs are expected to increase significantly as a result of implementation of BEPS Action 13 into Polish law, especially in the first years of implementation of the new rules.

Major expected cost drivers include:

- the increased scope of TP documentation under the three-tier approach;
• the requirement for benchmarking studies introduced for the first time as part of TP documentation;
• the requirement for benchmarking studies to be prepared based on Polish comparable data, unless the taxpayer can demonstrate that such data are not available;
• the requirement introduced in the Polish local file on top of Action 13 requirements, related to reconciliation between the financial data used for price-setting and audited financial statements;
• the requirement for TP documentation not only in respect of transactions with related parties but also third party arrangements concerning events recognized in the books of accounts, where such events have a material impact on the taxpayer’s income (loss), if the terms of such arrangements have been determined (or imposed) by related parties; such third party arrangements may include contracts for finance management (e.g. cash pooling), cost sharing agreements, agreements related to incorporation of entities that are not legal persons, joint venture contracts and other comparable agreements;
• the new requirement for submission of a TP disclosure form (CIT-TP/PIT-TP form) along with the taxpayer’s annual tax return by taxpayers with revenues exceeding €10 million; the form will be used for TP tax assessment purposes by the tax administration and includes such information as: the sector of the taxpayer’s business activity, the taxpayer’s functional profile and the types and values of related-party transactions;
• the new regulations include the requirement to submit to the competent tax office a statement confirming preparation of complete documentation; the statement should be filed not later than by the date of submission of the tax return;
• the translation costs related to the requirement for submission in the Polish language, including the group master file and CbCR.

2.6. TP-related measures in other BEPS actions and other measures against BEPS

It is clearly noticeable that the Polish legislator has recently introduced numerous measures aimed at curbing aggressive tax planning. Some of these measures have already been mentioned in this report (entirely new controlled foreign company (CFC) rules, new thin capitalization rules and GAAR). It is definitely important to note changes regarding the scope of taxation. Some previously transparent entities are now subject to CIT. Further amendments have been proposed, e.g. limiting the scope of exemption currently applicable to investment funds.

2.7. Can BEPS work in favour of MNEs?

The primary objective of the BEPS works related to TP issues is the increase in the transparency, consistency and quality of TP information as well as aligning of TP outcomes with value creation. Thus the expected major outcome of the BEPS works will be to provide the tax authorities with increased volume of in-depth information allowing for the identification and possible assessment of significant TP risks. This may lead to increased TP adjustments, disputes and double economic taxation.
There can be an additional thread of application of the new post-BEPS concepts and rules to tax audits for pre-BEPS years and thus the application of the hindsight approach.

It is more difficult to assess the potential benefits from the MNE side. From the perspective of MNEs, one expected benefit could be increased awareness of TP issues by management bodies of Polish companies that are both local MNEs as well as subsidiaries of foreign-based MNEs. Another benefit can be higher internal transparency within the MNE itself, arising out of the increased sharing of information within the group in the master file as well as local files prepared with larger group support.

Given that expected increased TP audit activity will most probably lead to increased double economic taxation, a true benefit for MNEs would be if TP dispute resolution were improved, including broader access and better functioning of the EU TP Arbitration Convention and MAPs related to TP. A possible benefit could arise from performance of joint audits which would be combined with competent authority activity in the field of elimination of double taxation. In the longer run, automatic exchange of CbCR could potentially lead to reduced TP audit activity and reduce the MNE costs associated with dealing with such audits if fewer audits are performed due to increased pre-screening of MNE TP outcomes and TP risk assessment before the start of audits.

3. What is the future of TP?

Numerous changes in Polish TP rules have been introduced recently. They have ranged from new substantive rules on TP aspects of business restructuring, significant changes in the definition of associated enterprises (in the case of holding a share in the capital of another company the threshold rises from 5 per cent to 25 per cent on 1 January 2017), new thin capitalization rules through amendments to APAs and the amending of TP documentation rules.

The way in which the TP rules are interpreted by the tax authority has also been altered. The TP rules have evolved into a kind of GAAR which Polish tax system lacked until mid-July 2016. At the time of submitting this report the reaction of courts to this new means of interpretation is largely unknown. Moreover, a GAAR was introduced with effect from mid-July 2016, which means that the tax authorities may lose interest in using TP rules as a kind of GAAR.

Transactions in intangibles have been correctly identified by the OECD as those that allow tax planning, including aggressive tax planning, which was not in any way surprising. At the same time tax avoidance with the use of such transactions has been particularly difficult to tackle under the arm’s length principle mainly due to the fact that comparable transactions have been difficult to find (because of the unique character of intangibles and the lack of similar transactions between non-associated enterprises).

One of the problems inherent in the current TP system in cross-border transactions is that efficient mechanisms forcing state parties into double taxation conventions to reach agreement as to the meaning of arm’s length conditions in particular cases have been rather limited, despite the theoretical possibility of rely-
ing on MAPs in nearly all cases and arbitration procedures in some cases. The new system applicable to intangibles, based on value creation, may be even more problematic to use and apply in practice if more than two jurisdictions are involved. Associated enterprises will have to secure their position in a few countries. In a sense, the enterprises will have to look for a formulary apportionment of created value but this will obviously not be a formulary apportionment in the strict sense as the formula is not predetermined by legal provisions.

The long-term future of the TP system in Poland cannot be predicted very easily as it does not rely solely on the implementation of BEPS. For instance, Poland – as a Member State of the EU – may at some point be required to apply strict formulary apportionment due to the introduction of the common consolidated corporate tax base, which cannot be fully ruled out.
Summary and conclusions

Though earlier references to transfer pricing (TP) rules can be found within the Portuguese general tax and income tax legislation, the TP regime was first implemented in Portugal on 1 January 2002, settled through the publication of the Ministerial Order (MO) 1446-c/2001 of 21 December 2001, which, combined with article 63 of the Corporate Income Tax (CIT) Code, established the TP regime applicable in Portugal.

The Portuguese TP regime has evolved throughout the years, reaching a mature state and assuming a consolidated and harmonized set of rules within the Portuguese tax legislation, established in accordance with international standards.

Article 63 of the CIT Code defines the TP methods acceptable in Portugal, as well as the rules that trigger the existence of a special relationship between two entities. In this regard, it is necessary to mention that the Portuguese regime has adopted a more conservative approach to the characterization of special relationships than is most commonly observed in other countries. On the other hand, article 63 also sets documentation requirements and the possibility of correlative adjustments.

MO 1446-c/2001 establishes that the arm’s length principle is the guiding norm of the Portuguese TP regime and defines how it should be applied, defining the hierarchy in which transactional methods have priority over profit base methods. This order has also established the obligation regarding TP documentation, and the corresponding deadlines for submission, listing the detailed information to be included in the ancillary and mandatory support TP documentation.

Complementarily, article 138 of the CIT Code, as well as MO 620-A/2008, of 16 July 2008, determine the framework of application of advance pricing agreements (APAs).

Through the maturity of the current Portuguese TP regime, and facing the current domestic and global economic situation, the Portuguese tax authority (TA) has channelled its attention to a strategic plan to fight against fraud and tax evasion, focusing on a set of guidelines regarding future priorities and areas of TA scrutiny in which communication and information will play a crucial role. As a result, Portugal has addressed the base erosion and profit shifting (BEPS) project

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with a clear focus on Action 13, which is the only BEPS action that has, until now, originated a specific legislative change.

It is important to mention that the Portuguese TA has anticipated several tax issues and concerns, prior to BEPS, through the application of several provisions included in the Portuguese CIT Code to tackle issues raised in Action 2 (namely through article 51 of the CIT Code, which addresses the use of hybrid instruments within the participation exemption regime), Action 4 (limiting base erosion via interest deductions and other financial payments) as well as a specific new law addressing abusive tax planning.

Although the majority of the final BEPS reports have already been published, it is still not possible to anticipate the major changes and effects on the Portuguese TP regime in addition to the changes already established in the legislation.

However, from the Portuguese tax perspective, and especially with regard to the TP regime, it is possible to highlight five main impacts and tendencies.

First, through the implementation of the country-by-country reporting (CbCR) disclosure obligation, starting in January 2016, and the signing of the Multilateral Competent Authority Agreement (MCAA), Portugal aims to further improve the growing collaboration in the exchange of information with other domestic tax authorities, expecting that those new rules will effectively tackle several of the usual tax optimization structures, although the complexity and subjectivity of some of the recommended measures may make the achievement of that objective difficult.

Notwithstanding, the new global tax paradigm and the BEPS action implementation will further pressure both economic agents and the TA into moving towards a more harmonized global tax framework and regulatory consistency, originating changes to standardize and equalize domestic rules.

It is likely that significant changes in the way multinational companies (MNEs) operate will occur and that structures with no substance will probably tend to disappear; but they will probably be replaced by other structures in which part of the relevant functions focused on by BEPS will be developed, as well as the relevant risks assumed. Those structures will still seek to take advantage of taxation differentials between jurisdictions, which are not expected to disappear, as tax authorities and governments will still compete to attract investment and employment, and, as a consequence, tax revenues, through different and attractive tax measure packages.

BEPS measures, particularly the greater consistency deriving from the new documentation requirements and the new guidance, will probably increase and accelerate the already current trend of greater centralization and automatization, and IT integration regarding TP policies and documentation, as opposed to the multiplicity of domestic policies aimed at adapting global policies to address the domestic specificities of domestic TP rules.

In this regard, attention has also moved towards the increased number of APA requests, as the certainty provided by APAs will continue to play an important role in TP risk management. Notwithstanding, from the reporter’s point of view, taking into consideration the extended process, which is both time consuming and bureaucratic, it is necessary to speed up the process and reduce the length of time between filing a request for an APA and its negotiation and completion.

On the other hand, one relevant outcome of the BEPS measures is expected to be on the digital economy, although the public and relevant divergences between,
on the one hand the USA, and on the other hand the European Union and the OECD regarding this issue are likely to drive negotiations and adaptations to the current proposed measures, making it more difficult to predict the outcome.

Lastly, and due to the increased importance that the profit split method is assuming in the new post-BEPS era, it is expected that taxpayers will start considering the application of this method more often when analysing their TP policy and/or defining new intercompany transactions. With this in mind and considering the recent 2016 publication of the final detailed BEPS report on the profit split method, further pressure is expected for change in the Portuguese TP rules actually in force.

1. Current TP regulation and practice in Portugal

On 1 January 2002, the Portuguese TP rules were settled through the publication of MO 1446-c/2001, of 21 December, which, combined with article 63 of the CIT Code, established the TP regime applicable in Portugal.

The rules are based on the OECD TP guidelines and the MO 1446-c/2001 states in addition that “for its application, in cases of greater technical complexity, it is advisable to consult the OECD TP Guidelines”.

Article 63 of the CIT Code defines the TP methods that are deemed acceptable in Portugal, as well as the rules that trigger the existence of a special relationship between two entities, which are more restrictive than those most commonly observed in other countries with similarly mature TP regimes.

Under the provisions of the Portuguese CIT Code, two entities are considered to be in a special relationship if one of them has the power to exercise significant influence (directly or indirectly) over the management decisions of the other, which is considered to be true in the following scenarios: (a) where one entity or individual holds (directly or indirectly) at least 20 per cent of the share capital or voting rights of another entity; (b) both entities are at least 20 per cent owned (directly or indirectly) by the same legal entity or individual; (c) an entity and any entities or individuals which are members of its corporate bodies (administrative, directing, management, or supervisory boards); (d) entities in which the majority of their corporate bodies are constituted by the same individuals; (e) entities connected by a subordination agreement or any other agreement of a similar nature; (f) holding companies as stated in the Portuguese Commercial Companies Code; (g) entities whose legal relationship allows one of them to exercise influence over the other’s management decisions; and (h) a resident entity – or a foreign company’s permanent establishment (PE) – and any entity resident in a jurisdiction listed as a tax haven.

In addition, (a) foreign entities and Portuguese PEs, (b) Portuguese entities and corresponding foreign PEs, and (c) Portuguese PEs and foreign PEs are also deemed to be related parties.

Article 63 also sets out the documentation requirements and the possibility of correlative adjustments that are further developed and detailed in MO 1446-c/2001. This determines that “the arm’s length principle is the guiding tenet of the TP Regime” in Portugal and defines how it should be applied, as well as how the
TP methods of analysis should be applied, defining a hierarchy in which transactional methods (the comparable uncontrolled price (CUP) method, the resale price method (RPM) and the comparable profit method (CPM)) have priority over profit base methods (the profit split method and the transactional net margin method (TNMM)). It also lists the detailed information that should be included in the ancillary and mandatory support TP documentation.

According to the Portuguese TP regime, one entity is obliged to prepare specific documentation if in the previous tax year it registered revenues of at least or more than the threshold of €3 million. In addition, the taxpayer is obliged to prepare and deliver to the Portuguese TA the annual tax and account return, on or before the 15th day of the seventh month after the tax year end.

Regarding the annual tax and account return, the taxpayer must identify and quantify the controlled transactions (by nature), as well as indicating whether the TP documentation obligation has been fulfilled, e.g. that the report was prepared in accordance with the terms stipulated in the Portuguese law. Concerning cross-border transactions the TP method used to demonstrate compliance with the arm’s length principle should be disclosed.

Consequently, the TP documentation must be duly prepared before the deadline imposed for the delivery of the annual tax and account return, but delivery will only be needed upon the specific request of the Portuguese TA.

Lastly, the MO 1446-c/2001 defines how TP adjustments and correlative adjustments can be processed. Regarding the adjustments, it is important to distinguish three different situations, where two can only be triggered by the TA and the other is the taxpayer’s responsibility to disclose:

• primary adjustments: whenever the terms and conditions of a controlled transaction involving a taxpayer and an entity resident in Portuguese territory diverge from those that would normally be agreed, accepted or observed between independent entities, the Portuguese TA has the ability to perform TP adjustments to the taxable income;
• corresponding adjustments: in domestic controlled transactions, when a primary adjustment has occurred and been accepted by the taxpayer, a corresponding adjustment must be made by the TA within 180 days. When the adjustment arises from international conventions concluded by Portugal with other tax authorities, the Portuguese TA may also make the corresponding adjustment, in accordance with the terms and conditions laid down in those conventions. In this case, the taxpayer has the ability to file for a mutual agreement procedure (MAP) (no. 2 of article 9 of the OECD model tax convention) or alternatively to file under the Arbitration Convention as per article 4 of the 90/436/CEE Convention; and
• self-initiated adjustments: whenever the terms of a controlled transaction involving a taxpayer and a non-resident diverge from those that would normally be agreed, accepted or observed between independent entities, the Portuguese taxpayer is obliged to carry out positive TP adjustments in the tax return with the aim of reflecting the tax consequences arising from that divergence. Notwithstanding, negative adjustments, implying a decrease in the taxable income, are not allowed.

Complementarily, article 138 of the CIT Code, as well as the MO 620-A/2008, 16 July 2008, determine the framework of application of APAs.
Although the Portuguese TP rules are closely based on the OECD standards, the Portuguese TA launched, in 2014, some new rules regarding the tax deductibility of some types of costs, namely financial ones, which define a threshold above which those costs will not be tax deductible, even when they comply with the TP rules. This turns out to be the first deviation from the strict application of the arm’s length principle in some specific situations where the TA has faced, through consistent litigation, difficulties in effectively applying the arm’s length based approach.

2. The impact of BEPS on TP in Portugal

2.1. Introduction

The Portuguese TA has approved a new triennial strategic plan to fight against fraud and tax evasion, for 2015–2017. This plan contains a set of guidelines regarding future priorities and areas of TA scrutiny in which communication and information will play a crucial role. As a result, Portugal has addressed BEPS actions with a clear focus on Action 13, which is the only BEPS action that has, until now, originated a specific legislative change.

It is worth mentioning that several other BEPS actions, not exclusively related to TP issues, had already been addressed, prior to BEPS, by the Portuguese TA, through several provisions included in the Portuguese CIT Code to tackle issues raised in Action 2 (through article 51 of the CIT Code, which addresses the use of hybrid instruments within the participation exemption regime), Action 4 (limiting base erosion via interest deductions and other financial payments) as well as new specific law addressing abusive tax planning structures and operations.

The BEPS initiative has also played an important role in terms of local awareness of the damages and consequences of tax evasion and tax fraud.

2.2. Challenges of transactions with intangibles

2.2.1. Definition of intangibles

Portugal, like many other European countries, does not have a rigorous legal definition of the concept of intangibles as a whole, although it does have, within the Code of Industrial Property (CPI), several legal definitions of certain intangible assets such as patents, designs, trademarks, copyrights, for example, while not having a global legal definition of intangible assets as a whole.

Consequently, Portugal has relied on the Portuguese accounting standards (Normas Contabilísticas e de Relato Financeiro (NCRF), which are based on the norms issued by the International Accounting Standards Board, namely IASB-EU and IAS) and the OECD proposed definitions.

NCRF norm 6 includes a definition of intangible assets, and specifies how to recognize and measure them, and is mostly based on IAS 38. In both cases, it is stated that an intangible asset is an identifiable non-monetary resource without
physical substance that is controlled by an entity as a result of past events and from which future economic benefits are expected.

In this regard, it is worth mentioning that, in 2016, a change was introduced to NCRF norm 6 which stipulates that intangible assets with an indefinite life should be depreciated within a 10-year period (this is merely for accounting purposes; for tax purposes, intangibles with an indefinite life and acquired after 2014 are depreciated in a period of 20 years).

For TP purposes, and more generically for tax purposes, Portugal relies on the OECD definition. The changes derived from BEPS Actions 8–10 were assimilated by the Portuguese market players as a more recent and updated definition of intangibles for TP purposes, thus not requiring a specific legislative change (and no such legal change is foreseen or expected regarding these definitions). In many respects, the new guidance (BEPS) does not diverge much from the previous guidelines. It adopts an expansive approach and a broad definition of intangibles to preclude arguments that valuable items might fall outside the scope. It defines an intangible as “something which is not a physical asset or a financial asset, which is capable of being owned or controlled to be used in commercial activities, and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances”.

The new guidance also lists some (non-exclusive) examples of items that are considered intangibles (namely patents, knowhow and trade secrets, trademarks, trade names and brands, rights under contracts, licences, goodwill and ongoing concern value) and some (non-exclusive) examples of items not considered as intangibles (namely group synergies, market-specific characteristics, assembled workforce).

2.2.2. Recognition issues within transactions with intangibles

The requested purpose of this section is to explain how the identification and recognition of transactions with intangibles occurs within the current tax and legal framework in Portugal.

As mentioned above, there are specific, detailed and restricted recognition rules in place in Portugal for intangibles for accounting purposes. Nevertheless, as in several other several jurisdictions, they are not completely aligned with the recognition rules in place for tax purposes.

Prior to analysing the tax deductibility rules in place, it is important to stress that intangible transactions are identified for tax purposes if they are recognized for accounting purposes through methodologies adopted in line with the previously mentioned strict accounting standard rules.

The Portuguese TP rules do not include any specific consideration on intangibles, but, as mentioned above, they contain an explicit remittance rule directly to the OECD guidelines. As such, the suggested guidance regarding how to identify and recognize transactions with intangibles for TP purposes is the OECD guidelines. As a result, the changes originated through BEPS Actions 8–10 were assimilated by the Portuguese market players as a more recent and updated definition of the guidance on how to deal with intangibles for TP purposes, not requiring a specific legislative change (and no such legal change is foreseen or expected regarding intangible definitions).
The absence of such a specific legal definition or framework regarding the legal and economic ownership of intangible could generate some uncertainties and difficulties in the implementation of the most recent OECD guidance, as will be discussed in more detail in section 2.2.3 below.

Consequently, the recognition process has to be based on a detailed functional and risk analysis which will identify the intangibles in the transactions under review, how they contribute to the creation of value and how they interact with other intangibles, with tangible assets and with business activities. The new guidance clarifies that this functional analysis step will have to focus on DEMPE (develops, enhances, maintains, protects, explores) functions and risks, seeking to identify which entity develops those functions, which one assumes the subsequent risks, which one has the control over risk (requiring the ability and resources to perform that control) and which ones are funding the DEMPE functions and/or risks. It also highlights some specific functions deemed as particularly relevant for intangibles, namely design and control over research and marketing programmes, direction of and establishing priorities for creative undertakings, control over strategic decisions regarding intangible development programmes, management and control over budgets, important decisions regarding the defence and protection of intangibles, and ongoing quality control over functions performed by independent or associated enterprises. Similarly, it also highlights some specific risks deemed as particularly relevant for intangibles, namely the risks relating to development, obsolescence, infringement, product liability and exploitation.

Following the identification and recognition of intangibles, it is necessary to analyse the tax treatment and deductibility rules in place in Portugal. The following section will tackle how rights to returns of the intangibles are addressed.

Taking into consideration that tax treatment is a critical factor in any investment decision, in 2014 Portugal launched a tax reform aiming to achieve a more competitive tax framework to attract investment, and promote economic and employment growth. Intangibles were one of the areas in which tax treatment was significantly changed.

Generically, the Portuguese CIT Code considers that any costs incurred by the taxpayer in order to generate taxable revenue are deductible for tax purposes. Nevertheless, regarding amortization, it also requires that the underlying assets are already in use and are fully operational and must have registered effective depreciation, implying systematic losses of value due to their utilization or the passage of time, which is the case for assets with a limited life span. For that purpose, acquisition or production costs will be the basis for the tax deductible depreciation computation. Impairment losses are tax deductible upon request and rely on prior acceptance by the TA regarding losses of value generated by proven abnormal causes, namely disasters, exceptionally rapid technical innovations or significant adverse legal changes.

More specifically, the 2014 tax reform launched a new regime for intangibles through articles 45A and 50A of the CIT Code. Article 45A aimed at recognizing tax effects for intangibles with an indefinite life span. It introduced the recognition, as a tax deductible expense, of a constant depreciation, within the 20 tax years following the recognition, of the acquisition cost of some specific intangible assets (meaning that this only applies to assets acquired – not free of charge – from other entities and only based on the acquisition cost) that have no limited lifetime, namely
patents, brands, licences and permits, production processes, models or other assimilated rights. The same applies to goodwill generated by acquisitions of the shares of other entities or of other entities’ assets and/or liabilities. This regime does not apply to intangible assets acquired within merger and acquisitions processed through the tax neutral regime foreseen in Portuguese law, to intangible assets acquired from an entity located in a tax haven listed location or to goodwill related to shares.

Thus, in situations where the intangible is developed internally, at a primary stage it is not possible to demonstrate that an intangible asset exists; therefore all expenses incurred may be reported as costs as there are no provisions in the accounting standards that establish how the intangible may be valued/recorded in the accounts as an asset. In the development phase, the asset will only be recognized as an intangible asset if the entity is able to demonstrate that it has commercial value and is capable of use or demonstrates how the asset will translate into feasible future economic benefits. Only in this situation will the costs incurred in its development (among others, development costs, labour costs, advertising costs, administrative expenses, legal costs) be accepted to be depreciated when the asset, with a limited life span, is ready and available for use.

Nonetheless, in order to support and demonstrate that the costs were incurred with regard to the intangible development activities, the taxpayer must keep duly organized and documented a business plan and asset ownership evidence to be provided, upon request, to the TA.

Similarly, at the same time (2014), a patent box regime was also introduced which enabled income deriving from the sale or from the temporary licensing of the use of industrial property rights (i.e. patents and industrial drawings and models) to be 50 per cent exempt from CIT. The regime did not apply to income derived from development of trademarks, software, copyrights and knowhow, but applied to industrial property rights derived from R&D developed internally or contracted from third parties, in order to promote R&D investment and the assumption of R&D risk by the taxpayer. Transactions with associated enterprises, including entities resident in blacklisted jurisdictions, were excluded from that regime. In 2016, that regime was amended, following the BEPS Action 5 guidance, introducing a limit on tax deduction, as well as a 30 per cent uplift on the tax deduction of some eligible R&D expenses.

These tax incentive packages have attracted interest and the number of observed transactions involving intangibles has increased, as well as the number of companies/structures created or transferred to Portugal whose function relates to the ownership or management of intangibles.

Nevertheless, a significant number of the intangibles transactions observed in the market relate to intra-group transactions or transactions between related parties. Regarding these, the TA always fears that they may lack effective economic substance and that they may have been artificially structured merely to benefit from tax incentives. Those concerns regarding economic substance have been specifically addressed by some of the BEPS actions.

2.2.3. Legal form versus economic substance principle

Actions 8–10 address TP issues relating to intangible assets, risk and capital allocation and other transactions between related parties. These measures reflect and
enhance the importance of the concepts associated with economic rationale and substance.

Despite the legal form versus economic substance principle being generally foreseen in the Portuguese rules, as stipulated in the General Taxation Law, the issues addressed under these actions are not specifically embedded in the Portuguese TP rules. However, the reporter does not anticipate that the Portuguese TA will formally propose changes in the domestic TP framework. Hence these OECD guidelines are followed, because Portugal is a member state of the OECD and because the Portuguese TP rules include a specific reference to the OECD TP guidelines.

It is important to mention that the Portuguese TP rules are not embedded within the Portuguese anti-abuse rules in place within the Portuguese legal and tax framework. As the application of the legal form versus economic substance principle often implies more than just a pricing adjustment, several Portuguese court decisions have already ruled against the TA’s attempt, based on TP rules, to recharacterize some transactions. Indeed, the Portuguese TP regime does not allow transactions to be recharacterized, as this has to be through the application of Portuguese anti-abuse rules, which are quite complex.

Considering both the complexity of the Portuguese anti-abuse rules and also the fact that the Portuguese TP rules are not embedded within that anti-abuse regime, the effectiveness of the legal form versus economic substance principle in Portugal is limited.

It is still too early to conclude whether the new BEPS guidance can improve this paradigm. However, the BEPS actions emphasize very important concepts such as DEMPE functions and management of risks (among others) that are intended to enforce the legal form versus economic substance principle.

These new concepts and guidelines regarding functions and risks do not imply a revolutionary new approach compared to the previous OECD TP guidelines regarding those subjects, as functions, assets and risks were already considered in those guidelines as a critical part of any pricing procedure. Nevertheless, the new concepts and guidelines do provide some clarity and guidance regarding the path to controlling and verifying the effective economic substance of the operations through a revised and consolidated way of performing the functional and risk analysis that require the development of certain specific tests.

Effectively, the previous guidelines stated the importance of functions and risks but did not provide sufficient guidance on how to test and check whether the functions and risks that were referred to as being developed and borne were effective.

Under the new guidance, a contractual arrangement and the subsequent expected return will only be accepted if each party that is supposed to bear a risk is deemed to effectively control that risk, taking the decisions to take on, lay off or mitigate that risk, and has the financial capacity to bear that risk. As a result, more than ever, functional and risk analysis is regarded as a critical part of the TP analysis. The new guidance calls that analysis the “accurate delineation of a transaction”, comparing what actually results from a written contract and the actual behaviour of the parties.

The new guidance also states that the mere fact that a party is funding an activity or controlling the funding risks does not mean that the entity is entitled to the returns associated with the operational risks deriving from that activity, unless it
exercises control over those risks as well. Control over funding risk is deemed to be about being able to evaluate an investment opportunity as an investor, meaning that as a provider of funds, the entity is entitled to take investment decisions and to set up mitigation procedures for funding risks. As a result, these functions and risks are deemed to be compensated with an appropriate remuneration aligned with what the market usually pays for similar financial functions, which is no more than a risk-adjusted financial return, and not the residual income deriving from operational risks or activities. The new guidance goes even further when stating that if the legal funding entity does not even manage and control the funding risks, due to the lack of resources, but only provides the funds (meaning that some other entity is effectively managing and controlling that funding activity), then it will only be entitled to receive a risk-free rate of return.

Comparatively, control over operational risks implies being able to analyse the consequences of potential alternative operational decisions on the business being developed and on its subsequent returns, having the authority to take those operational decisions and to assess, decide and implement mitigation procedures for those operational risks. Entities assuming operational risks are only entitled to receive residual returns.

All these characteristics imply specific resources and specific operational knowhow, which cannot be found in pure funding structures. As such, decision-makers must be proficient in the subject for which the decision is required, and they must be performing the decision-making function in the location of the entity claiming to control the risk and the associated return. As a result, the mere minutes of a board meeting performed outside of that location, or signature of documents executing the decisions are deemed to be insufficient to demonstrate decision-making functions (this was already enforced by existing rulings in place in Portugal, through the concept of “effective management”).

Traditional “principal vs operational structures”, in which the operational structures were traditionally awarded a return based on a TNMM or a CPM and the funding principal would retain the residual income, might be non-compliant with the new guidance if the principal is merely funding the activity and not managing and controlling the operational risks.

Whenever more than one entity controls the risk that originates the return, then income must be allocated accordingly based on their real contributions to the value creation.

For the purpose of the development of that new revised and expanded functional and risk analysis, the new guidance proposes a five-step test that involves reviews of:
• the contractual terms of the transactions;
• the functions, risks and assets of each participant and how each one of them relates to the value creation;
• the characteristics of the property transferred or services provided;
• the economic circumstances of the parties and/or of the market in which they operate; and
• the business strategies pursued by the parties.

The second step of function, risk and asset analysis itself implies a six-step analysis process:
• identify economic relevant risks;
• determine how those specific and relevant risks are contractually assumed by
  the participants in the transaction;
• determine, through a detailed and factual functional analysis, how the parties
  manage those risks, who controls and develops risk mitigation functions, who
  is affected by the consequences of the risk outcome and who has the financial
  capacity to assume the risks;
• determine, based on the information gathered in the previous steps, whether
  the contractual arrangement is consistent with the factual procedures carried
  out by the parties;
• whenever the conclusion is that the party contractually assuming risks does
  not effectively control the risks or does not have the financial capacity to
  assume the risks, then guidance on reallocating risks based on facts and not
  on contract terms must be applied; and
• reprice the transaction taking into account the adequate reallocation of the
  financial and other risks, appropriately compensating the risk management
  functions.

Having the financial capacity to assume the risk is defined as having funds or
access to funding to take on the negative impacts and consequences of the mat-
terialization of the risks, or to be able to lay off the risk, or to pay for risk mitigation
procedures.

Thus, an entity is deemed to control a risk if it has the capability to perform and
is effectively performing decision-making functions to take on or lay off the risk,
to respond to and to take risk mitigation actions.

Specifically for intangibles, the new guidance recognizes that the payment for the
use of an intangible should be made to the party having the legal rights to it, which,
at first glance, could be seen as a step back in the legal form versus economic sub-
stance paradigm. However, the new guidance also stipulates that, when another
entity has developed or participated in the development of the DEMPE functions,
provided funding or assumed risks, a separate transaction regarding that contribu-
tion must be considered. That assertion implies that the income flow deriving from
the use of an intangible will not be diverted from the legal owner; according to the
new TP paradigm, it will be reallocated to the other entities that are carrying out the
activities that the legal owner is not performing. This new paradigm may lead to the
possibility of leaving the legal owner with little or no profit at all after appropriately
compensating the other group members for their contributions.

The new guidelines also recognize that the legal owner does not need to perform
all the DEMPE functions, as well as independent parties; sometimes entities may
need to subcontract third parties to carry out part of these functions. Thus, in such
cases control needs to be effectively applied over those subcontracted activities
and their performance, through the determination of the objective of the out-
sourced activities, as well as the capability to understand and assess the perfor-
manee of the activity, to the decision taking regarding the selection, hiring, change
and cancellation, as well as to the effective exercise of those functions.

The new guidance also highlights some functions deemed as particularly signi-
ficant in intangible value creation, which should drive relevant compensation, namely:
• design and control of research and marketing programmes;
the direction of and establishing priorities for creative undertakings and research;
control over strategic decisions regarding intangible programmes;
budget management and control;
decision-taking regarding defence and protection of intangibles;
ongoing quality control over functions performed by other parties that may have a material impact on the value of the intangible.

The new guidance also lists some relevant risks deemed as important for transactions involving intangibles:
• risk related to the development of intangibles, namely that it may end up not being successful;
• risk that other technological advances might render the research obsolete;
• infringement risks;
• liability risks;
• viability and profitability risks associated with the returns to be generated by the future exploitation of the intangible being able to generate appropriate returns compared to the R&D costs.

The party actually controlling, managing and assuming the risks will be entitled, through a secondary transaction, to the potential gains and losses deriving from those risks. In contrast, a party that is not controlling, managing and assuming those relevant risks, nor developing the relevant functions listed above, will not be entitled to the gains or responsible for the losses.

2.2.4. Comparability and group synergies

The dynamics inherent in a group organization imply that several synergies are generated within the operation of the group that would not have existed if the group entities were operating as independent entities. In some cases, it may be difficult to find suitable unrelated parties or contracts involving the development of those relevant functions. An example could be when an intangible from one entity is used as a platform to reduce the development time of other intangibles by another entity.

The Portuguese TP rules do not include any specific consideration regarding how to address those group synergies, either before or after the publication of the BEPS actions. But, as mentioned above, the Portuguese rules do include a specific reference to the OECD guidelines that enables the adoption of the considerations of the new guidance issued under the BEPS actions (if these do not require a change in some other specific considerations included in other laws, such as for PEs).

The new guidance is adamant in pointing out that the comparability analysis must consider the options realistically available to each of the parties, and that a one-sided approach will be deemed as insufficient, including the RPM and the TNMM. It further notes that all methods that tend to estimate the value or return of intangibles based on the cost of development must be discouraged because any correlation between the cost of intangibles development and their value or level of return generation once developed is yet to be proved.

The new guidance also states that it is essential to evaluate the unique features of the intangibles while conducting a comparability analysis. The new guidance
questions whether comparable information drawn from public or private databases is sufficiently detailed to satisfy those comparability requirements.

As a result, the new guidance sets more demanding comparability requirements that might prove even more difficult to apply than the CUP method. This is particularly the case whenever group synergies are involved, making it harder to identify reliable comparables.

As a result, the new guidance states that profit split may be the most reliable method to assess the value or level of return of an intangible in situations where reliable comparables are not available.

2.2.5. Hard-to-value intangibles

Portuguese TP rules do not contain any specific consideration regarding intangible valuation, and nor have they adopted any measures to improve or set rules or guidelines regarding valuation of hard-to-value assets since the publication of the BEPS actions.

Consequently, taking into consideration the reference to the OECD guidelines included in the Portuguese TP rules, the consideration of new guidance regarding this issue, briefly presented in the previous section, does apply in Portugal, namely the preference for the profit split method, the increased comparability requirements for application of the CUP method and the requirement that the valuation method selection should be based on a detailed functional and risk analysis that identifies and analyses all factors that contribute to value creation.

The new guidance further provides that it may be possible to use other valuation techniques, such as income-based methods like discounted cash flow methods, to estimate the arm’s length price of intangibles, although these will require special consideration of the following assumptions:

- the accuracy of financial forecasts;
- growth rates;
- discount rates;
- intangible life span and residual value;
- taxes;
- forms and terms of payment.

The hard-to-value intangibles considerations published in the BEPS actions were designed to address the information asymmetries between taxpayers and the TA. Initially, the OECD considered the possibility of addressing this issue through measures outside the scope of the arm’s length principle, namely the recharacterization and anti-abuse provisions. However, in the end, they opted to adopt an approach based on the US commensurate-with-income provision, which operates within the arm’s length approach principle.

The new guidance recommends that pricing adjustment and/or contingent pricing mechanisms should be adopted to mitigate uncertainty whenever the value of the intangible being transferred is highly uncertain.

The new guidance defines hard-to-value intangibles taking into consideration, at the time of the transaction, the absence of reliable comparables and the uncertainty of future cash flow forecasts or of other critical assumptions used in the valuation of the intangibles, namely because:

- the intangible is only partially developed;
• it is not expected to become commercially exploitable until several years after the transaction;
• it is a part of the development of other hard-to-value intangibles;
• it is such a novelty that reliable data from the past development of other intangibles are not available to forecast its future exploitation;
• the transaction is being settled through an unusual remuneration scheme, namely a lump sum payment; and
• it has been developed or is being used through a cost contribution or similar agreement.

The new guidance is that actual financial outcomes will be the base for an ex post valuation of the intangible that will test and adjust the transaction or licence price, assuming that if material differences exist with the forecasts used to define the initial price, then it was not set at arm’s length, unless:
• the taxpayer documentation supporting the projections includes a detailed description of how the projections were forecast and that the probability that reasonably foreseeable events and risks that could affect the valuation were also estimated and taken into consideration. In addition, the taxpayer has to provide reliable evidence that the material differences between the financial forecasts used and the actual figures are due to unforeseeable events or very unlikely foreseeable events;
• the transfer of the asset was covered by a bilateral or multilateral APA;
• the material differences in the financial forecasts used to compute the compensation and the actual outcomes do not produce a deviation of 20 per cent or more of the projected compensation; and
• the acquirer has been registering revenues for at least five years from an unrelated party source and that actual income generation has not deviated by more than 20 per cent from the original financial forecast used to price the original transfer or licensing of the intangible between the related parties.

This methodology has been followed because the TA holds that entities operating as independent parties would tend to include in their contractual arrangement a provision allowing for the review of pricing based on actual outcomes and it thus believes that price adjustment clauses are an inherent part of the arm’s length principle.

This new guidance allows for some measure of relief and some safe harbour rules to delimit when the TA can perform adjustments whenever actual outcomes differ from the original forecasts used in the original pricing of a transfer or licensing of an intangible.

To avoid ex post adjustment, it is highly recommended that taxpayers prepare detailed contemporaneous documentation to support the intangible transactions, identifying all likely and foreseeable risks and estimating probabilities of occurrence. It is also advisable to consider in the transfer or licensing of the intangible some contractual provisions to account for the effects of reasonably foreseeable events and risks, namely pricing adjustment clauses, contingent milestones payments or shorter time frames for the contract.

2.2.6. Cost contribution agreements (CCAs)

The Portuguese TP rules do include a specific chapter on cost sharing agreements, which, apart from the designation discrepancy, is mainly drafted to address CCAs.
This chapter has not yet been amended, and, consequently, changes introduced by BEPS regarding CCAs have not yet been adopted in Portugal (although Portugal does have a specific reference in the Portuguese rules to the OECD guidelines, in this case there are specific considerations in the Portuguese rules, due to the specific cost contribution chapter). As a result, any new considerations from the new guidance that are not merely complementary but may divert or contradict what is specifically foreseen in the Portuguese rules will be disallowed.

The main principle stated in the Portuguese TP rules regarding CCAs is that the sharing of the results or benefits of the joint development will have to be proportional to the contributions that each party has provided. It is also stated that, if this is not the case, complementary compensation should be attributed by the party earning a bigger share of the results than its own share of contributions, from the party earning a lower share of the results compared to its share of contributions.

Payments to a contributor of pre-existing intangibles are deductible and amortizable over the period of use of such intangibles or 20 years (if period of life is not defined).

2.3. Risk and capital

Portugal has not yet adopted any specific measures following the BEPS action publication, apart from the CbCR introduction, which will be analysed later in this report. However, it is worth mentioning that several measures recommended by the BEPS actions were already in place previously to the BEPS actions reports publication, such as, for example, the existence of a limit on interest deductions and other financial payments, as per Action 4 recommendations.

One of the main aims of the BEPS actions is to challenge the ability of MNEs to artificially shift profits by transferring easily movable assets (such as intangibles and capital) and to ensure that inappropriate returns will not be accrued to an entity solely because it has contractually assumed risks or has provided capital.

This topic has already been covered in the legal form versus economic substance section (2.2.3).

2.4. High-risk transactions

2.4.1. CUP and quoted prices for cross-border commodity transactions

Portugal is not a country traditionally registering relevant commodity transactions between related parties. As a result, there is no specific consideration in the Portuguese TP rules regarding commodity transactions, either before or after the publication of the BEPS actions. Additionally, no such specific consideration is expected to be published as, again, these types of transaction are residual in the universe of related parties’ transactions.

The CUP is one of the priority methods listed in the Portuguese TP rules, and the OECD guidelines state that whenever reliable comparables are available this method provides the most reliable means of assessing the arm’s length range of remuneration. It is therefore expected that the CUP method will be deemed to be the most appropriate method to assess the pricing within commodity transactions,
whether it is based on comparable uncontrolled transactions or arrangements, or based on quoted prices or indexes. Until now, the Portuguese TA has accepted both these CUP pricing validation procedures, provided that comparability of the market references used is adequate.

2.4.2. Intra-group services

The Portuguese TP rules include a specific chapter regarding intra-group services that is based on the considerations included in the OECD TP guidelines, which already require the analysis of both the economic substance of the operation (challenging whether the intra-group service has in fact been provided) and the pricing of the operation (including considerations regarding the allocation criteria considered for the indirect costs). However, these have not been amended pursuant to the publication of the BEPS actions.

The only foreseen impacts of BEPS actions regarding intra-group services are:

- low value-added services, for which a 5 per cent safe harbour remuneration is recommended; and
- the legal form versus economic substance principle considerations that have already been presented above.

As mentioned above in section 2.2.3 (to which the reader is referred for a more detailed analysis), changes brought about by the BEPS actions are deemed to have been adopted by the Portuguese TP rules due to the explicit reference to the OECD guidelines that exists in the Portuguese TP rules.

As such, no specific law amendment is expected in the Portuguese TP rules to implement these recommended measures.

2.4.3. Profit split

According to article 4 of the MO 1446-c/2001, the taxpayer should adopt the most appropriate method, which is defined as the method which is likely to provide the highest degree of comparability.

In this regard, the most appropriate method for each transaction or series of transactions is the one that can provide the best and most reliable estimate of the terms and conditions that would normally be agreed, accepted or observed between independent parties.

In particular, the profit split method is said to be adequate to allocate the global profit derived from complex controlled transactions or from a series of strongly connected controlled transactions.

Article 9 of MO 1446-c/2001, in this regard, states the specific situations where the profit split method is considered adequate, namely:

- when controlled transactions are complex and interrelated, making it difficult to evaluate them on an individual basis; and
- when unique and valuable intangibles are involved, making it harder to identify uncontrolled reliable comparables or to apply any of the other methods.

Should these premises apply, and if it is demonstrated that it constitutes the best method based on the facts and circumstances, the profit split method is allowed to be considered under the Portuguese TP rules.

Should that be the case, two types of profit split methodology can be applied.
The comparable profit split method consists of determining the global profit earned by the associated enterprises in a given controlled transaction and allocating it between the parties. The allocation criterion is the relative value of the contribution of each entity carrying out the transaction, bearing in mind the functions performed, the assets employed and the risks assumed by each party. For this purpose, reference will be made to reliable external data showing how independent entities that perform comparable functions, which employ the same kind of assets and that assume the same risks, would have measured their contributions and shared the outcome of the joint development.

The residual profit split method consists in allocating the global profit from the transactions in two stages:

- first stage – each entity is assigned a portion of the global profit that reflects an appropriate level of routine profit for the transaction, based on comparative data obtained from analysis of transactions between independent entities carrying out similar transactions, bearing in mind the functions performed, the assets employed and the risks assumed. This can be classified as the routine profit element. For this part of the analysis, any of the other methods may be applied;
- the remaining, or residual, profit or loss is allocated to each entity in proportion to the value of its contribution, bearing in mind the functions performed, the assets employed and the risks assumed. For this purpose external information will be obtained to provide indications regarding how independent parties share profits or losses under similar circumstances and how the underlying transfer price will be calculated on the basis of the profits thus assigned.

Despite the above, the Portuguese TP legislation defines a formal hierarchy accepting the use of the transactional profit methods (i.e. profit split method and TNMM) and the “other method” only when the traditional transaction methods (i.e. CUP, RPM and CPM) cannot be applied or, if they can, do not provide the most reliable indication of the terms and conditions that would normally be agreed, accepted or observed in a transaction between independent entities.

The reporter’s experience indicates that, although the Portuguese TA considers that this method may provide important conclusions, and for that reason uses it in its risk assessment analysis, the stated hierarchy of methods laid down in domestic legislation inhibits its generalized formal application.

Regarding Portuguese case law, and according to the reporter’s experience, the Portuguese courts have never ruled on splitting profits between related taxpayers under the application of the profit split method. However, there are already some cases regarding financial transactions (e.g. cash pooling structures) where the Arbitration Administrative Court mentions in its decision the adequacy of the profit split method to test the transaction. Nonetheless, due to the current drafting of the Portuguese laws, the courts have concluded that in the above-mentioned hierarchy of methods, there were other traditional transaction methods that could be applied and, thus, were preferable to the profit split method.

The following paragraphs will highlight, as an example, one of those cases. **Entity AG v. Entity SA (2013):** Entity SA is a Portuguese subsidiary of the German Entity AG. Both entities entered into a notional cash pooling agreement where the cash movements were performed by an independent financial institution. Dur-
ing the fiscal year that was subject to the tax audit, Entity SA presented a positive balance position (that guaranteed the negative position of Entity AG) while Entity AG presented a negative balance position. The TA verified that this situation was constant for the life of the agreement. For this purpose the Portuguese TA argued that there was an implicit guarantee was provided by Entity SA. Moreover, it considered that the remuneration that Entity SA was receiving within the scope of the cash pooling agreement was lower than that it could receive from other investments. In this regard, the TA performed the relevant adjustments under the CUP method.

Entity SA argued that the CUP method was not the best method to determine the arm’s length nature of this transaction, but that the profit split method would provide more accurate conclusions. In fact Entity SA argued that the profit split method was the only method that could assess the adequacy to the arm’s length principle of the benefits resulting from the cash-pooling agreement (Entity SA based its argumentation on an article published by BNA).

This argumentation was rejected by the Portuguese TA, suggesting that only the CUP method could determine the arm’s length conditions that would have been applied to the Entity SA surpluses.

The Arbitration Administrative Court did not reject Entity SA’s argumentation but could not but agree with the Portuguese TA in rejecting the applicability of the profit split method as it is not one of the preferable methods as stated in the Portuguese TP legislation and other methods applied.

However, the Arbitration Administrative Court ruled in favour of the taxpayer as the comparable transactions identified by the Portuguese TA were not appropriate.

Portugal will therefore continue, for the time being, to follow the arm’s length standard, as defined in the Portuguese TP rules and in article 9 of the OECD model tax convention.

Following the 2016 publication of the detailed BEPS report on profit split, and taking into consideration both the importance that the profit split method is assuming in the new post-BEPS era and the preference that the Portuguese TA has shown for an increased use of that method, a change in the Portuguese TP rules actually in force is expected, although the extent of the change cannot be foreseen prior to its effective publication.

### 2.5. TP documentation

#### 2.5.1. CbCR

Regarding Action 13, and under the Portuguese Budget Law for 2016, one additional documentation requirement was introduced with the new article 121A of the CIT Code. This new provision implements the CbCR obligation for tax years starting on or after 1 January 2016. This new rule follows the OECD recommendations regarding the CbCR requirements, but no specific provisions are expressed in the legislation with respect to a documentation structure for the master file and for the local file.
This focus on the documentation derives basically from the historic background of the Portuguese domestic TP rules which have, since 2002, been oriented to a local and individual documentation and compliance perspective. The Portuguese government has been very active in the fight against evasion and tax fraud, and in this sense, the advent of CbCR has obviously reinforced this goal, as it provides valuable and worldwide information on how MNEs operate.

Under the goal of improving transparency and collaboration between the TA, on 27 January 2016, Portugal was one of 31 countries to sign the OECD MCAA for the automatic exchange of CbCR. Under the MCAA, signatories may exchange CbCR with other signatories if they have CbCR requirements in place and are a party to the OECD Convention on Mutual Administrative Assistance in Tax Matters.

Considering the size of the Portuguese market and the specificities of the Portuguese business environment characterized by subsidiaries of foreign MNE groups, the €750 million threshold has excluded a significant number of taxpayers from this obligation. Notwithstanding, this requirement is perceived as an important risk assessment tool, in terms of business model and profit allocation analysis.

Within the tax community, CbCR requirements are unclear regarding how to gather the information of multiple countries in a consistent manner, and how to override, from a Portuguese perspective, the gap in CbCR legislation in some countries (e.g. the USA, Switzerland) where some groups operating in Portugal are headquartered.

Whenever a Portuguese entity, which has reached the threshold that mandates the preparation of the CbCR, has a foreign parent company located in a jurisdiction that has already implemented a CbCR obligation and that has an agreement in place for exchange of information with the Portuguese TA, then the legislation considers that the Portuguese entity is not required to submit a local CbCR in Portugal, as the parent company is already obliged to comply with that reporting obligation and that information will be shared with the Portuguese TA. However, that foreign reporting entity should be identified and communicated to the Portuguese TA by the end of the relevant tax period. If one of the two conditions (foreign jurisdiction having already implemented a CbCR obligation and having an exchange information agreement with Portugal) are not met, then the Portuguese entity will have to file a CbCR in Portugal.

2.5.2. Master and local files

The Portuguese TP documentation requirements have been in place since 2002 and are some of the most detailed documentation requirements of all OECD countries. Although there are no provisions regarding the master file and local file structure, the Portuguese TA has been accepting the delivery of TP files adopting such a documentation structure.

The documentation requirements already in force cover and address the information requirements that the OECD recommends including in the master file and the local file, so no relevant specific change is expected to be needed or introduced deriving from this aspect of the publication of the BEPS actions. The only possible change could be the introduction of some limits below which residual transactions would not be required to be disclosed and documented, which has not
been the case up to now, as currently all transactions are required to be documented under the Portuguese TP rules in force.

One other aspect that may change is the limit up to which a taxpayer needs to mandatorily prepare TP documentation and how it is assessed. Until now, that obligation has arisen for tax year N whenever a taxpayer’s total revenue for tax year N-1 reached €3 million or above. The temporal dichotomy between the limit assessment and the exercise to be documented has raised some issues for the Portuguese TA and, consequently, it may seek to adjust this assessment procedure, as well as raise the €3 million limit.

2.5.3. Compliance costs

As a general matter, it is recognized that local filing of CbCR generates more compliance costs for businesses. In this context, business entities have been seeking technology tools that enable the preparation of TP documentation, and simultaneously enable them to comply with the requirements, mitigate penalty risks, and present consistent TP positions to the TA.

The majority of the MNE groups that operate in Portugal will file their CbCR in other jurisdictions. However, it is the Portuguese local entity’s responsibility to ensure the validation of local information reported to the ultimate owner entity/surrogate entity, so that it complies with Portuguese CbCR rules.

When analysing MNE groups headquartered in Portugal, concerns may arise as to what extent information technology systems are prepared to track and deliver the required information for the CbCR, as stipulated in the documentation requirements.

On the other hand, with respect to Action 10, having a business landscape where the Portuguese subsidiaries are a target for receiving intra-group services charges, there is an expectation that the Portuguese TA will provide guidance on how the “low value-adding services” will be considered and analysed, as there is no feedback on how they will administratively deal with the OECD generic principles.

2.6. Other TP-related measures taken in Portugal to counter-attack BEPS

Portugal has not launched other BEPS-related measures not specifically referred to or recommended in the BEPS action reports that are worth mentioning.

2.7. Can BEPS information gathering initiatives work in favour of MNEs?

Although the reporter believes that, broadly due to the complexity and subjectivity of several of its measures, BEPS initiatives can work in favour of MNEs, as they have more funds and specialized tax and TP advisory support to structure their transactions in ways designed to take advantage of BEPS recommendations and still tackle the objectives of the OECD and the TA, regarding information gathering initiatives, as requested in the heading of the paragraph, the reporter does not believe these will, particularly and significantly, work in favour of MNEs.
One foreseeable benefit for MNEs would be regarding negotiations between tax authorities, whether within multilateral APAs or within MAPs or other double taxation relief procedures, in which the exchange of information initiatives might reduce the time frame of conciliation with the TA, mitigate the potential double taxation issues and reduce taxpayer costs with those negotiation procedures.

Another potential benefit for MNEs could be a greater consistency of application of TP rules within the OECD that could derive from the CbCR requirements and the new BEPS guidance, which would reduce global compliance costs and enable a wider application of centralized TP documentation and global policies, contrasting with the current local specificities that often require special local documentation and TP policies.

3. What is the future of TP?

Though it is quite early to have a clear view of what is the foreseeable future of TP deriving from the publication of the BEPS actions reports, the TA certainly does have some expectations that those new rules will effectively tackle several of the usual tax optimization structures that were set up by MNEs to achieve greater tax efficiency. However, as mentioned above, the complexity and subjectivity of some of the recommended measures may make the achievement of that objective difficult.

Bearing in mind all the media attention and the current cases of EU tax disputes with several known and relevant market players it is likely that significant changes in the way MNEs operate will occur and that structures with no substance will probably tend to disappear; but they will probably be replaced by other structures in which part of the relevant functions focused on by BEPS will be developed, as well as relevant risks assumed. Those structures will still seek to take advantage of taxation differentials between jurisdictions, which are not expected to disappear. Tax authorities and governments will still compete between them to attract investment and employment, and, as a consequence, tax revenues, through different and attractive tax measure packages.

The new global tax paradigm and the BEPS actions implementation is expected to encourage further the move towards a more harmonized global tax framework and tax regulatory consistency, namely through the renewed importance of the common consolidated corporate tax base design by the European Commission, which anticipated the consideration of anti-avoidance measures also discussed in the BEPS project and the new guidelines that may originate regulatory changes to standardize and equalize local rules (for example regarding PE and controlled foreign company rules).

As such, BEPS measures, namely the greater consistency deriving from the new documentation requirements and the new guidance, will probably increase and accelerate the already current trend of greater centralization and greater automation, as well as the higher IT integration regarding TP policies and documentation, as opposed to the multiplicity of domestic policies aimed at adapting global policies to address local specificities of local TP rules. In addition, through the implementation of a new three-tiered approach to TP documentation, namely the
implementation of the CbCR reporting, together with the MAPs, increased collaboration will be stimulated and improve the information exchange mechanisms between the Portuguese TA and the tax authorities of other jurisdictions.

In this regard, and considering the enactment of the CbCR requirements starting already in 2016 in Portugal, attention moves towards the increased number of APA requests. Though this trend is already noticeable, following the adoption of the BEPS final recommendation, TP enforcement is actually expected to increase throughout the world. Consequently, the certainty provided by APAs will continuously to play an important role in TP risk management MNE policies.

Notwithstanding, from the reporter’s point of view, taking into consideration the extended process, which is both time consuming and bureaucratic, it is necessary to speed up the process and the length of time between filing a request for an APA and its negotiation and completion.

One very relevant outcome of the BEPS measures is expected to be on the digital economy, although the public and relevant divergences between, on the one hand, the USA, and on the other hand, the European Union and the OECD regarding this issue, which are likely to drive negotiations and adaptations to the current proposed measures, make it more difficult to predict the future.

Overall, it is clear that MNEs are encouraging a greater centralization of the TP issues management, improving the implementation of a centralized and cross-referenced TP policy and documentation. In addition, the regulatory harmonization and the higher degree of transparency and standardization will enable the MNEs and local entities to acquire an awareness and mastery of the TP legislation and its impact on other subjects as well as to improve their ability to address TA queries.

Regarding the TP methods, from the reporter’s point of view it is also necessary to understand how the outcome of the new guidance suggesting a preference for the profit split method will be included in the BEPS reports. As previously mentioned, taking into consideration the reference to the OECD guidelines included in the Portuguese TP rules, such consideration does apply in Portugal. However, in practice, Portuguese TP legislation defines a formal hierarchy accepting the use of the transactional profit methods and the “other method” only when the traditional transaction methods cannot be applied or, if they can, they do not provide the most reliable indication of the terms and conditions that would normally be agreed, accepted or observed in a transaction between independent entities.

As such, due to the increased importance that the profit split method is assuming in the post-BEPS era and the preference already shown by the Portuguese TA, it is expected that taxpayers will start to consider more often the application of this method when analysing their TP policy.
1. Current transfer pricing (TP) regulation and practice in Serbia

TP rules were first introduced in Serbian regulations with the adoption of corporate income taxation in the early 1990s. The initial regulatory framework was rudimentary, with only a basic reference to the need to assess the impact of related party transactions. This framework was not overly conducive to the development of practice in the area, which was essentially on hold. The early version of the current form of TP rules was enacted in 2001 with the most comprehensive changes to TP provisions being introduced into the Corporate Income Tax Law in 2012.

The regulation adopted in the Corporate Income Tax Law provided definitions of related parties and relevant transactions and defined the methods used to establish the arm’s length principle. However, and perhaps most importantly, the law made clear reference to the usage of the OECD transfer pricing guidelines for multinational enterprises and tax administrations as a relevant source of guidance and practice.

In addition to the provisions of the law, a rulebook on transfer pricing and arm’s length methodology was adopted in 2013. This defined the content of the TP documentation which taxpayers were required to submit with their corporate income tax return as proof of the impact of related party transactions on their tax base. The content of the TP documentation generally follows the structure recommendations of the 2010 version of the OECD guidelines, i.e. those prior to the adoption of the base erosion and profit shifting (BEPS) initiative, in particular the content of BEPS Action 13.

The rulebook provides extensive guidelines on the application of the methods to establish the arm’s length price and range of pricing. It prescribes details on how to absorb adjustments potentially arising from related party transactions into the taxable base and also allows for short-form TP documentation based on transaction value thresholds.

With the inclusion of TP rules in the law and the adoption of the rulebook, Serbia has a clearly defined a regulatory framework for TP. This framework is further supported by the efforts of the Serbian Fiscal Society in publishing a translation of the OECD guidelines into Serbian in 2011; this provided the basis for developing practice. However, the practice is still in its nascent stage with no centralized TP
strategy or team within the Serbian tax authorities. As a result, most conversations, both formal and informal, with advisers and the authorities on TP are on an ad hoc basis and depend heavily on the specifics of each individual case.

2. The impact of the BEPS project on TP

2.1. Introduction

The work performed by the OECD as part of the BEPS project has had limited regulatory impact in Serbia. Efforts have primarily concentrated on adopting segments of the BEPS project dealing with double taxation and their effect on the network of double tax treaties that Serbia has in place. Provisions concerning TP have not been at the forefront of regulatory reform.

The relatively limited impact of the BEPS project can be attributed to several factors. The existing set of TP regulations has been adopted relatively recently and is still considered comprehensive and fit for its purpose as it aligns with the general principles of the OECD guidelines. Practice in the area of TP is still developing and some of the more complex issues dominating and motivating the BEPS project are yet to fully manifest themselves in the local application of TP rules. Finally, the Serbian economy and therefore TP is predominantly inbound with local subsidiaries of MNEs usually performing specific, less complex roles within the supply chain.

The BEPS project was received with interest by academia and the broader business community in anticipation of its possible impact on local regulations. However, given the lack of concentrated effort in directly implementing elements of the initiative interest has mostly been reserved for studying the application of BEPS abroad. Following initial communication with the legislature, most stakeholder groups are adopting a reactive approach to BEPS as it is unclear when it will find its way on to the regulatory agenda.

2.2. Challenges of transactions with intangibles

2.2.1. Definition of intangibles

Like many jurisdictions, Serbian regulations do not have a sufficiently clear definition of intangibles. The framework for dealing with intangible property is spread across different pieces of legislation and varies in definition and scope of understanding. In addition, the economy operates mostly through traditional business models and structures and limited R&D efforts are undertaken in the territory. This results in a relative lack of key drivers for furthering the understanding and the impact that intangibles have on business models and practices.

The BEPS project has had no impact on the definition of intangibles in Serbian regulations.
2.2.2. Transactions with intangibles

Transactions involving intangibles are not subject to specific regulation in Serbia. The general framework for related party transactions, particularly cross-border, relies on formal contractual rules as the starting point for analysis. Transactions involving intangibles would need to be contractually defined in order to be adequately considered for TP and more broadly for tax purposes. Lack of a contractual framework and definitions may primarily affect taxpayers’ rights concerning expense deductibility for corporate income tax purposes.

2.2.3. “Substance-over-form” approach towards intangibles

Serbian regulations rely on the contractual framework of any transaction as the starting point of analysis for TP purposes. The “substance-over-form” concept is present in Serbian regulations and is primarily used to assess transactions where it is reasonable to expect that the contractual framework does not reflect the economic nature of the transaction. This concept allows the tax authorities to disregard the contractually assigned legal ownership and also to recharacterize a transaction in line with its economic “substance”. The “substance-over-form” approach is defined rather broadly, allowing for a wide degree of interpretation, but its practical application is fairly limited.

Transactions involving intangibles are not subject to specific rules and would fall under general criteria. The concept allows for an analysis which goes beyond legal ownership, potentially affecting the entitlement to returns deriving from intangibles. In addition, the “substance-over-form” approach would also allow for the recharacterization of transactions involving intangibles.

Practice in Serbia involving the application of the “substance-over-form” principle to intangibles is limited. A few cases involving intangibles have targeted issues of recharacterizing the nature of a transaction in order to limit expense deduction for corporate income tax purposes. However, the approach adopted has not been used widely or often enough to establish a pattern or practice.

Challenges to returns derived from intangibles by legal owners have not been present in practice beyond challenging the methodology applied or the adequacy of the set of comparable data. More specifically, there have been no cases which challenged the allocation of returns derived from intangibles based on how functions related to the development, enhancement, maintenance, protection, and exploitation of intangibles were assigned within an MNE group.

The adoption of the BEPS project has not led to changes in the TP analysis of transactions involving intangibles in Serbia. However, changes to the application of double tax treaties arising from BEPS actions will be implemented in Serbia and may lead to increased scrutiny and the potential disregard of the pure legal ownership when considering the relief offered by treaties. Whether this will also lead to developments in TP analysis remains to be seen.

2.2.4. Comparability and group synergies

Serbian regulations do not contain specific mechanisms for identifying, valuing or assessing group synergies and the impact they may have on comparability. The
legal framework does contain a reference to the OECD guidelines as the relevant source of practice in TP issues; however, the specific area of synergies has not been subject to much practical consideration. Although a reference to the OECD guidelines is present in Serbian regulations, it is unclear at the moment whether their application will be extended to all the provisions envisaged by the BEPS Actions 8–10 report. This suggests that practical guidance on group synergies may be considered in the future but that limitations in existing practice do not facilitate accurate assessment.

2.2.5. **Hard-to-value intangibles**

There have been no measures adopted concerning hard-to-value intangibles in Serbia. As discussed above, overall economic circumstances have a negative impact on the development of sophisticated intangibles and consequently there is no real practice in dealing with such issues.

2.2.6. **Cost contribution agreements (CCAs)**

There have been no changes to practice or interpretation of CCAs in Serbia following the adoption of BEPS deliverables. CCAs do not commonly occur in Serbian business practice and there is consequently no formal experience in dealing with related issues, particularly around measuring the relative contributions of entities and their commensurate reward.

2.3. **Risk and capital**

Serbian regulations have not adopted any TP measures aligned with the BEPS Actions 8–10 report to control the return on capital or compensation for the assumption of risk.

2.4. **High-risk transactions**

2.4.1. **Comparable uncontrolled prices (CUP) and quoted prices for cross-border commodity transactions**

Serbian TP regulations do not specifically govern cross-border commodity transactions. When analysing such transactions the general TP methodology is applied; however, given the nature of the transaction it would be highly probable that the tax authorities would look to use CUP as the most appropriate method.

In that sense Serbian regulations do not depart from the BEPS Actions 8–10 report, which states that “the CUP method would generally be an appropriate transfer pricing method for establishing the arm’s length price for the transfer of commodities between associated enterprises”. Moreover, “under the CUP method, the arm’s length price for commodity transactions may be determined by reference to comparable uncontrolled transactions and by reference to comparable uncontrolled arrangements represented by the quoted price”.¹

The BEPS Actions 8–10 report has not introduced any changes in the way local tax authorities would approach this issue. However, it is worth bearing in mind that there is limited information at a local level for the application of CUP. Commodities markets in Serbia are either not present or have limited trading depth both historically and in terms of volume. As a result suitable comparables may not be readily available. Local practice has developed an approach of relying on similar markets on a regional or pan-European level as a source of comparable information, potentially adjusting the CUP results to reflect comparability considerations (e.g. transport costs, country risk rating etc.). This approach greatly depends on specific circumstances of individual cases, with key issues around the accuracy of the adjustments made.

2.4.2. Intra-group services

Analysis of the provision of intra-group services in Serbia follows the two key issues highlighted in the BEPS Actions 8–10 report: “There are two issues in the analysis of transfer pricing for intra-group services. One issue is whether intra-group services have in fact been provided. The other issue is what the intra-group charge for such services should be for tax purposes in accordance with the arm’s length principle.”

Identifying that a service has actually been provided is the starting point for the TP analysis of charges for the service. Serbian regulations in this respect are quite formalistic, requiring written contracts and relevant invoices as the minimum proof of service. In addition, supporting documentation can be requested depending on the nature of services (e.g. written reports, meeting/call notes, correspondence, etc.) which should corroborate that the services have actually been provided. Failing to submit sufficient evidence of the provision of services results in all relevant costs being considered non-deductible for corporate income tax purposes and being included in the taxable base of the taxpayer.

Once the provision of services has been amply supported, the analysis of intra-group services needs to focus on establishing whether the remuneration is in accordance with the arm’s length principle. Standard TP methodology is applied in such cases, usually requiring a benchmarking analysis to establish an acceptable range of results. Serbian regulations do not specifically recognize safe-harbour ranges for the mark-up/margin used in the case of low value-adding intra-group services. As a result, all such transactions need to be assessed both on the basis of the cost allocation and the mark-up or margin applied. Recent practice has suggested a move towards examining the cost base for the provision of services in more detail; however, any mark-up/margin earned by the service provider would still need to fall within the interquartile range of comparable results.

The outcomes of the BEPS project have not had an impact on the analysis of intra-group services.

2 Ibid., p. 144.
2.4.3. Profit splits in the context of value chains

Serbian regulations envisage the application of the profit split; however, the prescribed format of the rules and their subsequent practical application have suggested that the method should be viewed as a residual profit split. The application of a transactional profit split in the context of an MNE’s value chain has not been used in practice.

The Serbian tax authorities have a preference for dealing with related party transactions on a stand-alone basis. The legislation does allow for a broader lens and for viewing transactions in a value chain context, particularly when dealing with integrated and dependent transactions. However, practice in this area is not developed, and the adoption of the BEPS reports has not had an impact on practice or legislative efforts.

2.5. TP documentation

As discussed above, Serbian TP regulations prescribe specific documentation requirements which are generally aligned with OECD standards. The basis for the alignment, however, is the provisions of the 2010 OECD guidelines and as such they do not necessarily follow the three-tiered approach described in the BEPS Action 13 report, where a “master file”, a “local file”, and a “country-by-country report” will be the essential elements of TP documentation. At the moment there are no indications that Serbia will be introducing legislation to adapt existing rules or to adopt the provisions of BEPS Action 13 directly.

2.5.1. Country-by-country reporting

The Serbian legislature has not taken steps towards adopting country-by-country reporting. While no official response is readily available, it is widely believed that the current documentation requirements are fit for purpose and that additional reporting would represent an unnecessary burden for taxpayers.

The structure of economic activity in the country does to an extent support the notion that most inbound TP can be adequately assessed using the existing reporting framework. However, further development in TP practice and overall levels of business activity may influence the attitude of the legislators in the future. At the moment there are no clear indications that country-by-country reporting will be adopted in the near future.

2.5.2. Master and local files

Serbian TP documentation requirements conform to the OECD standards but do not follow the division into “master file” and “local file”. Nevertheless, there is a fair degree of overlap in terms of the stated goals and content prescribed in the BEPS Action 13 report which states that: “the master file should provide an overview of the MNE group business, including the nature of its global business operations, its overall transfer pricing policies, and its global allocation of income
and economic activity in order to assist tax administrations in evaluating the presence of significant transfer pricing risk”3 and that the “local file provides more detailed information relating to specific intercompany transactions. The information required in the local file supplements the master file and helps to meet the objective of assuring that the taxpayer has complied with the arm’s length principle in its material transfer pricing positions affecting a specific jurisdiction.”4

As a result of the overlap in content, documentation prepared in line with Action 13, TP documentation, may be broadly applicable in Serbia; however, care needs to be devoted to satisfying local specific requirements. The most notable local specific requirements concern the following:
• independence;
• preparation in the local language;
• inclusion of local comparables in the benchmarking analysis;
• inclusion of a specific conclusion on the arm’s length nature of individual transactions;
• provision of a calculation of potential adjustments to the taxable base;
• the possibility of offsetting positive and negative adjustments arising from transactions with the same related party.

The key local requirement, however, is that the documentation is contemporaneous and needs to be submitted along with the corporate income tax return for the relevant period.

At the moment there are no indication that there will be legislative efforts in the near future to fully align Serbian the TP documentation requirements with BEPS Action 13.

2.5.3. Compliance costs

The work done as part of the BEPS initiative has had no effect on compliance costs for taxpayers in Serbia.

2.6. TP-related measures in other BEPS actions and other measures against BEPS

As discussed in the appropriate sections above, Serbia has not adopted any specific regulations in relation to TP as a result of the BEPS action reports. According to the information currently available it is not expected that any legislative efforts will be undertaken in this respect in the near future.

4 Ibid., p. 15.
2.7. Can BEPS work in favour of MNEs?

Although Serbia has made no direct regulatory response to BEPS TP actions, a potential benefit for MNEs in Serbia may arise indirectly. The high profile of the initiative, as well as the inbuilt mechanisms for preparing documentation and information sharing, should ease the way for local taxpayers to be able to collect information on their related party dealings. This may be particularly relevant for subsidiaries of MNEs which prior to BEPS have not had unified TP policies or prepared documentation.

Local entities in Serbia are faced with contemporaneous documentation requests which previously may not have been well received by their group companies. This meant that in certain cases taxpayers would struggle for resources as well as sources of adequate information.

The focus that BEPS has placed on TP and the need to examine the business of an MNE from a value chain perspective should allow Serbian entities to find that central assistance is more readily available. This should in theory lead to a reduction in compliance costs and allow for a more standardized approach to documentation.

An additional potential benefit for Serbian taxpayers in general would be the opportunity for the further development of TP practice. It is reasonable to expect that even though there are currently no specific plans in place, the Serbian legislature and tax authorities will monitor the developments, particularly in the region. Following the initial assessment period it is reasonable to expect that the Serbian authorities would look to emulate developments along its borders and move towards implementing BEPS. As a result MNEs could benefit in the long run from increased and unified practice as well as a reduction in the uncertainty which can emerge from such developments.

3. What is the future of TP?

Serbian TP documentation remains unaltered by BEPS at the moment, although it is difficult to envisage this being the case for too long in the future. Much will depend on the domestic capacity to undertake the transformation required in order to adequately tackle the implications of BEPS. However, it is reasonable to expect that the level of international support afforded to the project will influence decision-making in Serbia. From a local perspective, the Serbian tax authorities stand to benefit from adopting BEPS actions as a means of building up their experience base as well as for information sharing. Taxpayers, on the other hand, will look to standardize their compliance, thus reducing costs but also gaining a degree of predictability emerging from a more developed TP practice.

Key challenges to broader BEPS implementation can be seen in limitations in terms of resources on the side of the legislature and the tax authorities. Implementing wide-ranging changes to legislation as well as building domestic capabilities requires investment for which there may not be sufficient capacity. This is in part due to the predominantly inbound nature of the Serbian economy, which sees MNE subsidiaries performing relatively routine and limited roles within the supply chain.
Under the core proposition of BEPS, such entity functional profiles are unlikely to yield increased profit allocation to Serbia as compared to the current arrangements. This in turn offers little incentive for the tax authorities to adapt the existing regulatory framework, which is essentially viewed as fit for purpose.

The almost tectonic shift in the international tax landscape introduced by BEPS will be difficult for Serbia to ignore. However, at the moment it is hard to assess what the direction of travel will be. Regional developments should give a good indication of Serbia’s ultimate position but the most likely approach for the immediate future is that the authorities will adopt the mantra of “if it’s not broken why fix it”.

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1. Current transfer pricing regulation and practice in Singapore

Section 34D of the Singapore Income Tax Act relates to transfer pricing (TP) and empowers the Comptroller of income tax to make TP adjustments in cases where a Singapore taxpayer’s TP practices are not consistent with the arm’s length principle.

On 6 January 2015, the Inland Revenue Authority of Singapore (IRAS) issued the second edition of its TP guidelines which provide in detail the IRAS TP compliance programme and positions regarding TP matters. It consolidates four previous e-tax guides:

- the first edition of the TP guidelines, published 23 February 2006;
- TP consultation, published 30 July 2008;
- supplementary administrative guidance on advance pricing agreements (APAs), published 20 October 2008; and
- TP guidelines for related party loans and related party services, published 23 February 2009.

The 2015 guidelines were further revised and the third edition was issued on 4 January 2016. The changes to note include additional guidance on the cost plus method (CPM) and enhancements to the mutual agreement procedure (MAP) and APA programmes.

The prescribed Singapore TP guidelines are broadly in line with the OECD TP guidelines for multinational enterprises (MNEs) and tax administrations. The principles and TP methods set out in the OECD TP guidelines are acceptable in Singapore. However, there are certain differences between the OECD TP guidelines and the Singapore TP guidelines. In particular, if related parties have a cost-pooling arrangement, IRAS is prepared to accept the “no mark-up” position subject to certain conditions listed below:

- each participant’s share of the costs must be borne in the form of cash or other monetary contributions;
- the services are not provided to any unrelated party;
- the provision of these services is not the principal activity of the service provider;

* No author biography has been submitted.
the services are listed in Annex C of the Singapore TP guidelines (which lists the routine support services under Singapore’s TP safe harbour for services transactions); and

there is documentation in place demonstrating that the parties intended to enter into the cost-pooling arrangement prior to the provision of the service. A significant highlight of the 2015 Singapore TP guidelines was the emphasis on the requirement for contemporaneous TP documentation to be prepared no later than the date of filing of the tax return for the relevant financial year. This requirement may have arisen from the IRAS observation that as high a figure as 73 per cent of TP consultation cases had inadequate TP documentation.¹ The Singapore TP guidelines, however, provide a number of “exemptions” from TP documentation for certain types of related party transactions (RPT) and amounts below given thresholds. It is also worthwhile noting that IRAS has recently announced² that from year of assessment (YA) 2018, taxpayers must report certain details of RPTs if their value in the audited accounts for the financial year exceeds SGD15 million. IRAS has also issued a preview of the RPT form along with some frequently asked questions. The RPT data will help IRAS in assessing TP risks and improving the enforcement of the arm’s length standard.

Another noteworthy feature of the Singapore TP guidelines is the ability on the part of the taxpayer to perform self-initiated year-end adjustments to comply with the arm’s length standard and the corresponding transactional pricing as stated in its TP policies as long as contemporaneous TP documentation is present, symmetrical adjustments are made in the accounts of affected related parties and these adjustments are made before filing the corresponding tax return.

Taxpayers are encouraged to update their TP documentation at least once every three years, while RPT should be tested annually against arm’s length results.

2. The impact of the BEPS project on TP

2.1. Introduction

Singapore welcomed the final base erosion and profit shifting (BEPS) recommendations as an international approach to combat tax avoidance. Singapore believes that sound implementation of the BEPS principles, with all tax jurisdictions being included in the process, will help to foster free and fair economic competition.

Singapore supports the key principles underlying the BEPS project, namely that profit should be taxed where the real economic activities generating the profits are performed and where value is created.³ On 16 June 2016, Singapore announced

that it would join the inclusive framework for the global implementation of the OECD BEPS project as an associate. As a BEPS associate, Singapore works with other jurisdictions to help develop the implementation and monitoring phase of the BEPS project. As a participant at the OECD’s Committee on Fiscal Affairs since 2013, Singapore has been active in providing input to the design of the BEPS project. Singapore has also worked with the OECD and the G20 to ensure that the new framework for implementing the BEPS project is inclusive.

Singapore has expressed its commitment to implementing the four minimum standards under the BEPS project, namely, the standards on countering harmful tax practices, preventing treaty abuse, TP documentation and enhancing dispute resolution.

An important point to be noted is that presently the Singapore TP guidelines have been issued by IRAS to convey its expectation with regard to the TP documentation and other related matters, and most of the Singapore TP guidelines are “recommendatory/suggestive” in nature. There could be areas where administrative and legislative changes will be required for implementation of the TP proposals arising from BEPS (such as updated TP documentation requirements, the mandatory requirement to file country-by-country reports (CbCR) in certain cases, penalties for non-compliance, legal framework for automatic exchange of information under CbCR rules, etc.) and for that matter, IRAS has been actively engaged in consultation with the industry and the stakeholders and IRAS expects to release details soon. Further, as stated earlier, while Singapore generally follows the OECD TP guidelines, clarifications are awaited from IRAS as to the relevance of the updated guidelines (for example, those specified under Actions 8–10) for TP analysis carried out in the past and for ongoing TP audits.

### 2.2. Challenges of transactions with intangibles

The rise in importance of intangible property and the digital economy has brought significant changes in the way MNEs do business. Applying TP rules to transactions with intangibles has long been a challenge, and it is at the core of BEPS Actions 8–10. In this section, the report discusses the current and possible developments in the Singapore TP guidelines relating to such transactions that have resulted from the BEPS project.

#### 2.2.1. Definition of intangibles

While the Singapore TP guidelines do recognize transactions with intangibles and also emphasize the need for analysis of such intangible assets in functional and risk analysis, there is no specific definition of “intangibles” provided by IRAS for TP purposes.

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4 Under this framework, all state and non-state jurisdictions that commit to the BEPS project participate as BEPS associates of the OECD’s Committee on Fiscal Affairs. BEPS associates have the same rights and obligations as OECD and G20 countries involved in BEPS work. Every jurisdiction that participates in the framework as a BEPS associate will have an equal voice in reviewing and monitoring the implementation of the BEPS measures.


6 Ibid.
Given the ambiguity involved in identifying and valuing the intangibles, the OECD’s emphasis on the need for clear and effective regulations in this regard at country level cannot be overlooked. In light of the commitment by Singapore to align its TP regulatory framework with the TP measures suggested by the OECD in BEPS Action 13, it would only make sense for Singapore to introduce specific guidelines dealing with intangibles which would also include a clear and precise definition of intangibles for TP purposes and necessary guidance on the identification of intangibles.

2.2.2. Transactions with intangibles

As mentioned above, the Singapore TP guidelines do recognize transactions with intangibles and require arm’s length compensation for such transactions. For the comparability analysis of transactions involving intangibles, IRAS states that the nature of the transaction and the characteristics of the intangibles need to be analysed and this could include, for example, the form of the transaction, the type and nature of the intangible property, the duration and extent of the rights provided by the intangible property and the anticipated benefits from its use. The Singapore TP guidelines also recognize the significance of intangibles in the functional and risk analysis. Further, it is important to note that the documentation prescribed by the Singapore TP guidelines contemplates the important drivers of business profits which include a “list of intangibles and the related parties which legally own them” as one of the drivers.

While presently there are no specific rules under the Singapore TP guidelines dealing with intangible property transactions (apart from those discussed above), going forward, it is expected that there will be increasing pressure for IRAS to provide further guidance on complex TP issues, such as the identification and approach to intangibles in the light of the BEPS recommendations.

2.2.3. “Substance-over-form” approach towards intangibles

Transactions involving intangibles have been central to international tax planning. Many of the cases that have gained notoriety in recent years are related to the transfer of intangibles themselves or the right to use them.

This scenario has encouraged a “substance-over-form” approach towards transactions with intangibles, requiring an analysis beyond legal ownership. Therefore, entitlement to returns deriving from intangibles should also be based on a “substance-over-form” analysis. According to the proposed changes to the OECD TP guidelines:

“Although the legal owner of an intangible may receive the proceeds from exploitation of the intangible, other members of the legal owner’s MNE group may have performed functions, used assets, or assumed risks that are expected to contribute to the value of the intangible. Members of the MNE group performing
such functions, using such assets, and assuming such risks must be compensated for their contributions under the arm’s length principle.”9

While there have been instances of cases involving intangibles being scrutinized by IRAS, there has been limited public precedent reflecting the formal position of IRAS as to the “substance-over-form” approach towards intangibles. However, it is expected that IRAS will follow the OECD TP guidelines provided under BEPS Actions 8–10 in this regard.

2.2.4. Comparability and group synergies

Comparability issues normally arise when applying TP concepts to transactions with intangibles. The BEPS Actions 8–10 report suggests that group synergies also play an important role in this area.

According to the report, “In some circumstances, MNE groups and the associated enterprises that comprise such groups may benefit from interactions or synergies amongst group members that would not generally be available to similarly situated independent enterprises”.10

At this stage, there are no specific provisions in the Singapore TP guidelines dealing with group synergies; however, it is expected that IRAS will follow the OECD TP guidelines provided under BEPS Actions 8–10 in this regard.

2.2.5. Hard-to-value intangibles

The BEPS project has raised concerns about the valuation of hard-to-value intangibles. In fact, the valuation of intangibles per se poses several challenges due to problems in comparability.

According to the OECD:

“When valuation of an intangible or rights in an intangible at the time of the transaction is highly uncertain, the question arises as to how arm’s length pricing should be determined. The question should be resolved, both by taxpayers and tax administrations, by reference to what independent enterprises would have done in comparable circumstances to take account of the valuation uncertainty in the pricing of the transaction.”11

As mentioned above, at this stage, there are no official pronouncements by IRAS in relation to the guidelines on intangibles. However, it is expected that IRAS will follow the OECD TP guidelines provided under BEPS Actions 8–10 in this regard.

9 OECD, Actions 8–10, Aligning transfer pricing outcomes with value creation (Paris: OECD, 2015) p. 73.
10 Ibid., p. 47.
11 Ibid., p. 107.
2.2.6. Cost contribution agreements (CCAs)

CCAs are agreements “among business enterprises to share the contributions and risks involved in the joint development, production or the obtaining of intangibles, tangible assets or services with the understanding that such intangibles, tangible assets or services are expected to create direct benefits for the businesses of each of the participants”.\(^{12}\)

CCAs can be a source of BEPS if contributions and benefits to the participant companies are not properly determined. As part of the BEPS project, changes to the CCAs chapter in the OECD TP guidelines have been proposed.

The Singapore TP guidelines comment\(^ {13}\) on the intra-group sharing or “pooling” of costs under a cost-pooling contract among the members, however, specifically clarifies that the comments do not address the CCAs referred to in the OECD guidelines. It further clarifies that unlike cost-pooling contracts, CCAs are often entered into specifically to develop intangible assets while cost-pooling arrangements are for routine support services.

There are no specific rules under the Singapore TP guidelines dealing with CCAs at this stage.

2.3. Risk and capital

While BEPS actions regarding TP are based on the arm’s length principle, the allocation of the fair share of tax to each country where an MNE operates is one of the major goals of the project. Actions 9 and 10 of the BEPS project aim at “adopting TP rules or special measures to ensure that inappropriate returns will not accrue to an entity solely because it has contractually assumed risks or has provided capital”.\(^ {14}\)

At this stage, there is no official announcement from IRAS as to the adoption of measures recommended under BEPS Actions 8–10 with reference to risk and capital allocation. However, IRAS is engaged in private consultation and guidance in this regard is expected in the future.

2.4. High-risk transactions

2.4.1. Comparable uncontrolled price (CUP) and quoted prices for cross-border commodity transactions

Many countries rely on commodity transactions as a relevant source of economic activity. Given the importance of the commodity sector, there is great concern over the artificial control of transactions involving commodities by MNEs, which has been the purpose of several aggressive tax planning schemes.

According to the Actions 8–10 report, “The CUP method would generally be an appropriate transfer pricing method for establishing the arm’s length price for the transfer of commodities between associated enterprises”. Moreover, it states

\(^ {12}\) Ibid., p. 161.
\(^ {13}\) Singapore TP guidelines 2016, p. 74.
\(^ {14}\) OECD, Actions 8–10, op. cit., p. 13.
that “Under the CUP method, the arm’s length price for commodity transactions may be determined by reference to comparable uncontrolled transactions and by reference to comparable uncontrolled arrangements represented by the quoted price”.15

In line with Actions 8–10, the Singapore TP guidelines allow the use of a quoted price as a CUP for benchmarking intercompany transactions relating to commodities.16 This has also been indicated by way of an example given in the Singapore TP guidelines,17 though IRAS clarifies that internal comparables, if available, may have a more direct and closer relationship to the transaction under review.

2.4.2. Intra-group services

In line with the guidance provided under BEPS Actions 8–10, identifying that a service has actually been provided is the starting point for the TP analysis of such charges under the Singapore TP guidelines. The Singapore TP guidelines on intra-group services require application of the “benefit test” to determine whether any related party services have been provided. The guidelines also lay down the factors to be considered in this regard.18 After establishing that a related party service has been provided, the Singapore TP guidelines require the determination of an appropriate charge for the service provided based on the arm’s length principle. The Singapore TP guidelines recognize the CUP method, the CPM and the transactional net margin method (TNMM) as commonly the most appropriate choices to determine the arm’s length fees for the intra-group services.19 The Singapore TP guidelines allow for use of the indirect charge method to approximate the charges where a direct charge is not feasible. Such a method entails the use of an appropriate apportionment basis or allocation key to charge for the service provided. The guidelines require that taxpayers demonstrate that due consideration and analysis have been undertaken in the choice of the allocation key and that the chosen allocation key should be reasonable, founded on sound accounting principles and consistently applied year to year throughout the group unless there are very good reasons for not doing so.

With respect to pass-through costs where a group service provider may arrange and pay for, on behalf of its related parties, services acquired from other service providers (whether independent or related), the Singapore TP guidelines allow the group service provider to pass on the costs of the acquired services to its related parties without a mark-up subject to satisfaction of certain conditions which are aimed at ensuring that the group service provider is merely the paying agent and does not enhance the value of the acquired services.20

To ease the administrative and compliance burden of taxpayers, the guidelines provide a “safe harbour” rule for routine support services. They recognize that typically routine support services do not earn a significant arm’s length mark-up and

15 Ibid., p. 53.
16 Singapore TP guidelines 2016, para. 5.44.
17 Example 2 given in Singapore TP guidelines 2016, p. 88.
18 Singapore TP guidelines 2016, p. 69.
19 Ibid., para. 12.10, p. 70.
20 Ibid., para. 12.19, p. 72.
hence, as an administrative practice, they allow taxpayers to apply a 5 per cent cost mark-up for certain routine support services as a reasonable arm’s length charge when certain conditions\textsuperscript{21} are satisfied. The conditions include \textit{inter alia} that the taxpayer does not provide similar services to unrelated parties (i.e. there is no CUP available) and that all the costs, direct and indirect, are taken into account for the purpose of mark-up. This safe harbour provision helps taxpayers to facilitate their compliance with the arm’s length principle and still maintain a high level of adherence to the principle. It is worthwhile noting that the 5 per cent mark-up for routine support services is given to taxpayers as an alternative to a detailed TP analysis and they always have an option to adopt a mark-up that is different from 5 per cent if supported by detailed TP analysis.

Lastly, as mentioned above, the Singapore TP guidelines also recognize cost-pooling arrangements to share the costs of routine support services. The guidelines allow the charging of a proportionate share of the cost of services to group members without any mark-up subject to satisfaction of the prescribed conditions\textsuperscript{22}.

It is interesting that BEPS Actions 8–10 introduced an elective, simplified approach for low-value adding intra-group services which allows taxpayers to apply a mark-up of 5 per cent on costs subject to certain conditions. The OECD’s simplified approach is similar to Singapore’s administrative practice of a 5 per cent mark-up for intra-group routine support services that has been in place since 2009. However, there are certain differences between the OECD approach and the IRAS approach. For example, the scope of qualifying services is different and the OECD’s simplified approach is applied on a group basis whereas IRAS’s safe harbour is applied on an entity basis. As the OECD’s simplified method is applied on a group basis, MNE groups that adopt the OECD approach will obtain greater tax certainty that TP adjustments will not be made in countries where the OECD’s simplified approach is implemented. Secondly, the OECD has provided guidance on the documentation required for taxpayers following the simplified approach. Under the current Singapore TP guidelines, taxpayers are not expected to prepare TP documentation (though IRAS expects the taxpayers to maintain the appropriate documentation to justify that the services qualify for safe harbour treatment).

It is expected that IRAS will adopt the OECD’s simplified approach (which is by and large similar to the existing IRAS approach), while also retaining its own approach. Possibly, taxpayers will be given a choice to opt for either the IRAS safe harbour approach or the OECD’s simplified approach. The necessary changes in this regard and on other related issues are expected to be reflected in the next updated version of the Singapore TP guidelines.

\textbf{2.4.3. Profit splits in the context of value chains}

The analysis of the potential use of profit splits in the context of value chains considers that MNEs operate in an integrated manner. Therefore the application of traditional TP methods may prove ineffective. A transactional profit split method puts more importance on value creation in highly integrated groups. It is generally used

\textsuperscript{21} Ibid., p. 73.
\textsuperscript{22} Ibid., p. 74.
where the other OECD methods fall short, especially for transactions involving hard-to-value intangibles or unique and valuable contributions from various parties. However, it is to a great extent uncertain how MNEs and tax authorities will apply it in a consistent manner.

The Singapore TP guidelines recognize the profit split method (PSM) and provide that the PSM is particularly useful where:

(a) transactions are so highly interrelated that they cannot be evaluated separately; or
(b) the parties make unique and valuable contributions to the transaction; or
(c) the existence of unique intangible assets makes it difficult to find reliable comparables.

While the Singapore TP guidelines recognize two approaches, namely the residual analysis and the contribution analysis approach, they state that the residual analysis approach should be preferred for the following reasons:

(a) the relative value of the contribution of each party is often more difficult to quantify when one attempts to divide the total profit directly; and
(b) the use of comparable data to allocate part of the total profit in the first stage of the residual analysis approach will generally improve the reliability of the transactional profit split method.

Except for the above, the Singapore TP guidelines do not lay down any special rules with respect to value chains. However, IRAS has been closely following the OECD’s work especially on Actions 8–10 and is also in the process of consultation with industry and all the stakeholders.

2.5. TP documentation

Transparency is the motto of international taxation in the 21st century. If properly applied, tax transparency can be very useful in the allocation of the fair share of tax to each jurisdiction where MNEs operate. In the field of TP, the search for transparency is based on a new set of support documentation, which will be the basis for disclosure of relevant information.

TP documentation preparation is a challenge for both MNEs and tax administrations. The OECD work in this area has suggested a three-tiered approach, where a “master file”, a “local file” and a “CbCR” submission will be the essential elements of TP documentation in line with the OECD standards. Many countries are already implementing these requirements into their domestic legislation and many more will be doing so in the future.

The following sections describe the current and possible developments with respect to the TP documentation requirements in Singapore.

2.5.1. CbCR

CbCR requires MNEs to annually report a variety of information relating to each jurisdiction in which they do business. It relies heavily on the existence of mechanisms for the automatic exchange of information.

\[23\] Ibid., para. 5.62, p. 22.
\[24\] Ibid., para. 5.68, p. 24.
On 10 October 2016, IRAS released an e-tax guide\(^{25}\) with details on the implementation of CbCR for Singapore MNE groups (Singapore tax residents). The CbCR e-tax guide (CbCR guidance) follows to a large extent the guidelines recommended by the OECD in the final Action 13 implementation package issued in October 2015.\(^{26}\) The release of the CbCR guidance aligns with Singapore’s commitment to adopt the four minimum standards under the BEPS project (as a BEPS associate), including the implementation of CbCR, which was announced in June 2016.

Singapore CbCR requirements are applicable for an MNE group if:

- the ultimate parent entity of the MNE group is a tax resident in Singapore for the financial year in which the CbCR is prepared (i.e. only applicable to the Singapore MNE group);
- the consolidated group revenue in the preceding financial year is at least SGD 1,125 million; and
- the MNE group has subsidiaries or operations in at least one foreign jurisdiction.

If a Singapore MNE group fulfils the above CbCR requirements for a financial year, the ultimate parent entity of the Singapore MNE group will be required to submit CbCR to IRAS within 12 months from the end of a financial year. The CbCR rules will be effective for the financial year beginning on or after 1 January 2017 and thus the earliest CbCR would be due to IRAS by 31 December 2018 (for MNEs with financial year ending on 31 December 2017).

As per the CbCR guidance, while the CbCR requirements in Singapore are only applicable to Singapore MNE groups, it is worthwhile noting that the proposed changes to the Income Tax Act\(^{27}\) include an amendment to section 105P to enable IRAS to obtain the CbCR of foreign jurisdiction MNEs if Singapore does not have a CbCR exchange agreement with that country or if Singapore has an exchange agreement with that country but the minister is of the opinion that it is not operating effectively. This provision, once enacted, would give IRAS the right to require the filing of CbCR of foreign MNEs in Singapore.

While Singapore is party to the Convention on Mutual Administrative Assistance in Tax Matters, it is currently not a party to the Multilateral Competent Authority Agreement (MCAA) on exchange of CbCR which was developed by the OECD to set out the rules and procedures for automatic exchange of CbCR among jurisdictions. With respect to exchange of CbCR with other countries, IRAS states that depending on the jurisdictions identified in a CbCR, IRAS will provide a Singapore MNE group’s CbCR to the tax authorities of those jurisdictions that have implemented CbCR if there is an agreement with the relevant tax authority for the automatic exchange of CbCR information. The CbCR guidance indicates that IRAS will enter into an agreement with jurisdictions to exchange CbCR information only after establishing that the jurisdictions have a strong rule of law and are able to ensure confidentiality of the information exchanged and prevent its unauthorized use.


\(^{27}\) Bill No. 34/2016, The Income Tax (Amendment No. 3) Bill, issued on 10 October 2016.
In the absence of CbCR filing in Singapore for 2016, Singapore headquartered MNEs may be subjected to CbCR for 2016 in other jurisdictions under a secondary reporting mechanism. The possibility of IRAS allowing voluntary filing for Singapore MNEs is also under analysis.

2.5.2. Master and local files

BEPS Action 13 recommends adoption of a standardized approach to TP documentation which consists of a master file, local file and CbCR. The master file should provide an overview of the MNE group business, including the nature of its global business operations, its overall TP policies and its global allocation of income and economic activity in order to assist tax administrations in evaluating the presence of significant TP risk.28 The local file provides more detailed information relating to specific intercompany transactions. The information required in the local file supplements the master file and helps to meet the objective of ensuring that the taxpayer has complied with the arm’s length principle in its material TP positions affecting a specific jurisdiction.29

As mentioned above, the Singapore TP guidelines already include a requirement to prepare contemporaneous TP documentation including group level information and entity level information.30 It remains to be seen whether IRAS will further update the Singapore TP guidelines to require Singapore headquartered MNEs to include the group level information in a separate master file document that can be shared under exchange of information requests made by foreign jurisdictions. It would be consistent for Singapore to follow the OECD approach of separate master file and local file as the MNEs headquartered in Singapore would in any case probably be responsible for maintaining and providing the master file to other jurisdictions where they have subsidiaries.

Another potential issue could be that the group level information expected to be maintained under the current Singapore TP guidelines may not be comprehensive enough in the sense that it may not cover some of the information which is otherwise expected to be maintained as part of the master file as required by BEPS Action 13. Accordingly, there could be situations where the group level information maintained under the current Singapore TP guidelines does not meet the definition of master file as per the local requirements of the countries where the subsidiary companies are located. Having regard to these issues, the IRAS should align the guidelines on TP documentation with those specified under BEPS Action 13, specifically, the requirements relating to the master file and local file.

2.5.3. Compliance costs

One of the concerns of MNEs associated with the BEPS work on TP documentation is the increase in compliance costs. The new TP documentation and CbCR requirements will undoubtedly impose a greater compliance burden on them. However, at the same time, looking at it from the group’s perspective, efforts aimed at

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29 Ibid., p. 15.
30 Singapore TP guidelines 2016, p. 31.
achieving the international harmonization of TP documentation could help MNEs avoid costly duplicative work derived from the multiplicity of documentation regulations in different countries.

IRAS acknowledges that taxpayers should not be expected to incur compliance costs which are disproportionate to the amount of tax revenue at risk or the complexity of the transactions. That is the main reason why IRAS has, in the current Singapore TP guidelines, provided some administrative rules to simplify the requirements for TP documentation. This includes, for example, situations where transactions do not exceed specified thresholds, routine services where a 5 per cent mark-up is charged, etc.

While at this stage it is difficult to anticipate the impact of the overall BEPS proposals on the compliance cost of taxpayers, IRAS appears to be mindful of this factor while working on the TP documentation regulations.

2.6. TP-related measures in other BEPS actions and other measures against BEPS

It is a fact that TP is at the core of the BEPS project. Therefore, it comes as no surprise that other BEPS actions rely on TP rule changes to achieve their goals. Singapore is committed to implementing inter alia the standards on countering harmful tax practices which would include, from a TP perspective, an obligation on the part of Singapore to facilitate spontaneous exchange of information on APAs and other tax rulings concerning TP issues. While further guidance is awaited from IRAS in this regard, it is expected that this will have an interaction with TP documentation requirements. For example, in the next update of the Singapore TP guidelines, IRAS might require documentation on the MNE group’s existing APAs and other tax rulings relating to allocation of income among countries.

Another area where the BEPS measures could interlink with TP is the attribution of profits to permanent establishments (PEs). Countries have adopted differing views when interpreting and applying article 7(1) and 7(2) of the OECD model tax convention. The last OECD efforts towards clarifying how the basic rule should be applied resulted in the development of the authorized OECD approach (AOA) which was explained in the 2010 report on the attribution of profits to PEs and revision of the OECD model tax convention with the new version of article 7. However, it is worth noting that relatively few treaties currently include the new version of article 7. The AOA relies heavily on TP principles and the 2010 report on attribution of profits to PEs requires application of the principles laid down, taking into account the guidance in the OECD TP guidelines as modified from time to time. Accordingly, the application of the AOA henceforth may need to take into account the updated guidance on risk, capital and intangibles developed under BEPS Actions 8–10. These multiple methodologies/approaches for attribution of profits to PEs (old article 7 (pre-2010)/new article 7 (post-2010)/updated guidance under BEPS Actions 8–10) could of course produce different results, potentially increasing the chances of tax disputes.

While the approach followed by Singapore for profit attribution is more or less in line with the AOA, there are no official statements to date from IRAS with

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31 Ibid., para. 6.16, p. 34.
respect to the above aspects and it would be imperative on the part of IRAS to come up with necessary clarifications.

The proposal relating to dispute resolution is one aspect for which IRAS has been actively engaged in private consultation with stakeholders and this is assumed to have a major impact. While IRAS has been active in engaging with foreign tax authorities to resolve cross-border tax disputes via the MAP provided in bilateral tax treaties, as a BEPS associate, Singapore is working closely with other jurisdictions to monitor the implementation of minimum standards on dispute resolution developed under the BEPS project. On 20 October 2016, the OECD released key documents, approved by the inclusive framework on BEPS that will form the basis of the MAP peer review and monitoring process under Action 14 of the BEPS Action Plan. The peer review and monitoring process will be conducted by the MAP forum in accordance with the terms of reference and assessment methodology set out, with all members participating on an equal footing. This will complement the other BEPS minimum standards and ensure that taxpayers have access to effective and expedient dispute resolution mechanisms under bilateral tax treaties.

2.7. Can BEPS work in favour of MNEs?

To some extent, the search for transparency in the context of the BEPS project has been one sided, primarily focusing on generating information for tax administrations. However, automatic exchange of information could also work favourably for taxpayers, with tax authorities automatically exchanging information necessary for the application of domestic TP regulations.

While the formal rules on most of the BEPS measures are yet to be enacted in Singapore, it is expected that the BEPS measures would improve the overall flow of exchange of information not only between different participating countries but also among the group companies. This would of course lead to more transparency and easier adoption of the arm’s length approach. BEPS could also work in favour of MNEs in the sense that MNEs could take this opportunity to re-examine their structures, positions, transactions and operations for a hygiene check in the light of the BEPS guidance and the additional tools available to them such as CbCR.

Another aspect of BEPS which could work favourably for taxpayers is the improved, more efficient and transparent and time-bound process for MAP as a result of the mandatory requirements and best practices suggested as part of Action 14 on making dispute resolutions more effective. Also, the proposal relating to adoption of mandatory arbitration proceedings in case of inability of the countries to resolve the dispute under MAP within certain timelines tends to further improve the MAP process. The experience of countries\(^{32}\) having mandatory arbitration in place suggests that the simple availability (or threat) of arbitration has improved the speed with which MAP cases are resolved by the two competent authorities. Singapore has been closely monitoring the developments in this area and the possible adoption of mandatory arbitration by Singapore as part of its tax treaty policy could be a major shift in the coming years. This could also be inferred from the

\(^{32}\) For example, the USA, the UK, Canada.
speech by Ms Indranee Rajah, Senior Minister of State for Law and Finance, at a conference organized by Singapore Management University (SMU) Centre of Excellence in Taxation, where she mentioned that Singapore is open to considering arbitration provisions in tax treaties to provide taxpayers with an additional dispute resolution mechanism.

3. What is the future of TP?

The heightened environment for tax risk is particularly noticeable in the area of TP. The new documentation standard accompanied by the exchange of more information at an international level will give the tax authorities even greater insight into the TP structures of MNEs. While TP has long been a significant focus of corporate tax audits, it has become an even more challenging area and will probably remain so for years to come, especially as countries interpret and implement action items from the OECD’s BEPS project. From the OECD’s BEPS initiatives, new requirements are intended to give tax authorities increased transparency into an MNE’s global operations. The companies that are not equipped to respond may find themselves subject to greater tax scrutiny, possibly damaging brands and resulting in loss of consumer goodwill.

Tax administrations in different countries are continuously looking at alternative and more efficient collaboration with other countries. With the increased transparency and the greater need for improved collaboration between countries, joint or simultaneous tax audits by tax administrations in two countries is an innovative avenue which has been used by various jurisdictions in recent years and is expected to be adopted by many more countries in the coming years. Such an audit could in fact be looked at as an alternative (and even as a prevention measure) to the MAP or arbitration process which seeks to achieve the desired results while restricting the practical challenges posed by the MAP and arbitration processes. Douglas Shulman, Commissioner of the Internal Revenue Service (IRS), USA, in a speech on 8 June 2010 before the OECD, strongly advocated them as part of the “future of international tax administration”, and described them as offering tax administrators the opportunity to increase tax compliance. He emphasized that joint audits allow identification of the issues and understanding of the facts quickly and on a bilateral/multilateral basis, and thus help the adjudication of these disagreements right away and reach a resolution through a much more efficient and effective process. In September 2010, joint audit protocols appeared in an OECD report and a practical guide was issued at the end of the Istanbul meeting of the OECD forum on tax administration. The OECD report identified the need for joint audits and for tax administrators to cooperate and collaborate more closely.

The future of TP in Singapore is very likely to be connected to the BEPS project’s outcomes and one could expect a revamp of the Singapore TP guidelines
in the January 2017 update. Some of the changes/additional guidance expected from IRAS should cover the following issues, for example, in light of the BEPS measures:

- additional guidance on CbCR filings and the mechanism for information exchange;
- the possibility of legislating the requirements of contemporaneous TP documentation (including the updated guidelines for the master file and local file);
- legislation and additional guidance on new reporting requirements for RPT;
- legislating penalty provisions on the failure of taxpayers to comply with the TP documentation requirement and more importantly a TP-specific penalty regime;
- new/updated guidelines/legislation for low value-adding intra-group services under BEPS Actions 8–10 and its interaction with the IRAS current safe harbour for routine services;
- general guidelines on the implementation of BEPS Actions 8–10 in the context of Singapore, particularly on intangible property;
- safe harbour provisions for certain transactions (such as interest on loans, etc.);
- changes to the MAP process in line with the minimum standards and best practices recommended by the OECD under Action 14;
- possible adoption of mandatory arbitration, as a treaty policy, in case of failure to resolve the dispute under the MAP process; and
- further consideration to simultaneous/joint audits.

IRAS has been actively engaged in public and private consultation on the above aspects and one can expect announcements soon for application from 2017.
Summary and conclusions

The South African transfer pricing (TP) regime is set out in section 31 of the Income Tax Act, No. 58 of 1962 (ITA). The regime was first introduced in 1995 and overhauled in 2012 to bring it closer into line with article 9 of the OECD and UN models.

The key principle underpinning the South African TP regime is the arm’s length principle.

Although South Africa is not a member of the OECD and section 31 makes no explicit reference to the OECD TP guidelines or the UN transfer pricing manual, the South African Revenue Service (SARS) does refer to these international standards when applying the arm’s length principle in practice.1

In South Africa the TP regime operates in conjunction with the robust and sophisticated controlled foreign company (CFC) rules, as well as an exchange control regime which plays a key role in policing the flow of funds in and out of the country.

The exchange control regime is of particular importance in the context of cross-border transactions involving intellectual property. More specifically, the regime restricts the export of intellectual property and the payment of royalties to offshore related parties. These restrictions operate over and above the arm’s length principle of the TP regime and other punitive measures introduced in the ITA to combat base erosion and profit shifting (BEPS) via transfers of intellectual property and licensing agreements between related parties.

In 2013, following the announcement by the G20 (of which South Africa is a member) of the BEPS project, the South African Minister of Finance appointed the Davis Tax Committee (DTC) to, inter alia, consider the implications and application of the various recommendations produced by the BEPS project in

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1 Explanatory Memorandum on the Taxation Laws Amendment Bill, 2010 at 5.3; update of the UN transfer pricing manual, coordinator’s report on work of the subcommittee on transfer pricing [E/C.18/2016/CRP.2] (2016), at D.6.2; SARS Practice Note 7.
South Africa. In the context of TP, the DTC published two interim reports in 2014 addressing the BEPS Actions 8–10, and BEPS Action 13 reports (DTC interim reports).

In terms of TP documentation and filing requirements, in line with the recommendations made in the DTC interim report to BEPS Action 13, South Africa is on track to introduce three-tiered reporting requirements which are closely aligned with the OECD’s Action 13 recommendations by 2017. The necessary legal mechanisms are also in place to automatically exchange country-by-country reports (CbCR) under the Multilateral Competent Authority Agreement on the Exchange of CbCR.

Beyond this, South Africa has introduced further TP disclosure requirements in the annual tax return in relation to, inter alia, royalty and service fee payments, as well as additional TP documentation retention requirements.3

The new far-reaching TP documentation and reporting requirements arguably represent the most significant impact of the OECD BEPS actions surrounding TP in South Africa, given that up to their implementation, taxpayers would have been under no legal obligation to file any TP specific documentation with the SARS.

In terms of the BEPS Actions 8–10 recommendations, the SARS has stated that it will apply the guidance arising from BEPS Action 8 in relation to South African developed intellectual property disposed of to offshore related parties, but will not follow the OECD’s simplified approach in respect of low value-adding services.4

As to the other recommendations included in the BEPS Actions 8–10 report, the DTC recommended that the SARS issue a binding ruling clarifying its approach to applying the OECD TP guidelines in practice.5

In practice, the main challenge faced by taxpayers and the SARS alike in applying the arm’s length principle in South Africa has been a lack of domestic comparables (as is the case in many developing economies).

Historically, the SARS’ ability to effectively enforce the South African TP regime has also been hamstrung by a lack of resources and skills, compounded by limited access to TP specific taxpayer information.

Although resource constraints persist (as at April 2016, the SARS TP team consisted of 25 members,7 with this number fluctuating over time), the SARS is actively building capacity in its TP team, with the above-mentioned TP disclosure requirements aimed at addressing the lack of access to information.

As the SARS’ capacity increases, it is likely that the coming years will see a further uptake in the SARS’ TP audit activities.

Given the challenges highlighted above, the potential for double taxation where discouraging TP adjustments are proposed by the SARS and the other revenue authority will, however, remain a concern for taxpayers. Although many of South

3 Note that the additional document retention requirements is per a draft government notice.
4 Update of the UN TP manual, coordinator’s report on work of the subcommittee on transfer pricing [E/C.18/2016/CRP.2] (2016).
5 DTC interim report to Action 8 (2014) at 16.
6 UN TP manual, at 410.
7 Refer to the May 2016 SARS presentation to the Standing Committee on Finance (a parliamentary committee), available from https://pmg.org.za.
Africa’s double tax treaties make provision for mutual agreement procedures (MAPs), South Africa has not committed itself to the mandatorily binding MAP recommendations put forward in the report to BEPS Action 14, and nor has the SARS committed to introducing any advanced pricing agreement (APA) regime in South Africa. In the absence of these measures, taxpayers searching for certainty in their tax affairs might be left wanting.

1. Current TP regulation and practice in South Africa

1.1. The law

The main legislative provisions relating to TP are set out in section 31 of the South African ITA. Since its inception in 1995, the fundamental principle underpinning the South African TP regime has been the arm’s length principle.

The regime was, however, subject to significant reform in the years leading up to 2012. More specifically, section 31 of the ITA was amended with effect from 1 April 2012 to focus on the overarching profit objectives of the relevant parties, instead of placing an emphasis on the “price” of each transaction. This approach is in line with the wording of the “associated enterprises” article in the majority of the tax treaties concluded by South Africa and that of article 9 in the OECD and UN models, which places an emphasis on the economic substance of the arrangements between related parties, rather than the pricing of specific transactions.

The SARS also issued Practice Note 7 of 1999 which sets out the SARS approach to TP. Practice Note 7 is, however, based on the old TP legislation and is, to a large extent, outdated. The SARS is yet to issue revised guidance in respect of the application of the new TP legislation and new guidance is expected once the OECD’s BEPS projects are finalized.

Although South Africa is not a member of the OECD, the SARS accepts, and for the most part, applies the OECD TP guidelines and has previously largely based Practice Note 7 on these guidelines. The SARS has indicated that South Africa will continue to follow the OECD TP guidelines and UN transfer pricing manual with respect to TP.

Section 31(2) of the ITA provides that the TP legislation will apply to any transaction, operation, scheme, agreement or understanding where:

- that transaction constitutes an “affected transaction” and any term or condition of that transaction is different from what would have existed had the transaction taken place between independent persons dealing at arm’s length (an affected transaction is essentially defined as a transaction between a resident and a non-resident, where those persons are connected persons in relation to one another); and

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8 Refer to the May 2016 National Treasury presentation to the Standing Committee on Finance (a parliamentary committee), available from <https://pmg.org.za>.
that transaction, operation, scheme, agreement or understanding results or will result in any tax benefit being derived by a person that is party to the affected transaction.

In these circumstances, the taxable income or tax payable by any person that is party to such a transaction, operation, scheme, agreement or understanding and that derives a tax benefit, must be calculated as if that transaction, operation, scheme, agreement or understanding had been entered into on the terms and conditions that would have existed had those persons been independent persons dealing at arm’s length (also referred to as a primary adjustment).

Essentially, the burden of proof is thus on the taxpayer to show that it has entered into the transaction, operation, scheme, agreement or understanding with connected persons on an arm’s length basis.

The TP legislation also provides for a secondary adjustment on the basis that any “adjustment amount” (i.e. the difference between the tax payable calculated in accordance with the provisions of section 31(2) and otherwise) will, to the extent that the company is a resident and the other company is a non-resident, be deemed to be a dividend consisting of a distribution of an asset in specie declared and paid by the South African taxpayer to the non-resident connected person.

This deemed dividend will be subject to dividends tax in South Africa at a rate of 15 per cent.

The South African TP legislation provides relief from the TP provisions for certain transactions involving capital and intangible property, which relief is discussed in further detail below.

1.2. Documentation requirements

Although there is no explicit statutory requirement to prepare and maintain contemporaneous TP documentation, it is in the taxpayer’s best interest to document how transfer prices have been determined, since the obligation to show compliance with section 31 of the ITA (i.e. the arm’s length principle) is on the taxpayer.

A taxpayer electing not to prepare TP documentation is at risk on two counts. First, the income tax return requires detailed TP disclosures, making it more likely that the SARS will examine a taxpayer’s TP compliance in detail if the taxpayer has not prepared proper documentation. Secondly, if the SARS, as a result of this examination, substitutes an alternative arm’s length amount for the one adopted by the taxpayer, the lack of adequate documentation will make it difficult for the taxpayer to rebut that substitution by the SARS.

In October 2015, the OECD published its final report on BEPS Action 13, TP and CbCR. Following the publication of the BEPS Action 13 report, in April 2016, the SARS and the Ministry of Finance issued draft regulations in terms of the Tax Administration Act, No. 28 of 2011 which, when implemented, will entrench CbCR in South African domestic legislation. The draft regulations largely follow the recommendations of the BEPS Action 13 report. The SARS has also indicated that master and local filing reporting requirements will be introduced in 2017.

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10 See the Addendum to SARS Practice Note 7: submission of TP policy document (2005).
11 See the briefing note to the draft regulations for purposes of para. (b) of the definition of “international tax standard” in s. 1 of the Tax Administration Act No. 28 of 2011.
In terms of additional domestic requirements, in July 2016, the SARS issued a further draft public notice setting out certain additional document retention requirements specifically related to TP.\textsuperscript{12}

The corporate income tax return for companies (ITR 14) also contains a number of TP disclosures, with a number of additional disclosures being introduced in April 2016.

1.3. TP audit environment

Although the TP regime has been in place in South Africa since 1995, the SARS has only in recent years begun to audit TP aggressively. This is primarily due to capacity constraints on the part of the SARS, and, arguably, a lack of ready access to TP specific taxpayer information.

In South Africa, the TP regime operates alongside a robust and sophisticated CFC regime, as well as exchange control regulations – which regulate the flow of funds in and out of South Africa and, to some degree, protects the South African tax base from erosion through non-arm’s length TP.

2. The impact of the BEPS project on TP

2.1. Introduction

Following the announcement by the G20 and OECD of the BEPS project, in 2013 the South African Minister of Finance appointed the DTC to inquire into the role of South Africa’s tax system and to address the developments and the long-term objectives of the BEPS project with a particular focus on South African taxation, balancing the objectives of the BEPS project against the South African National Development Plan.\textsuperscript{13} After the release of the interim BEPS reports, the DTC released its own interim BEPS reports in 2014, analysing the implication and application of the OECD’s BEPS reports in the South African tax landscape.\textsuperscript{14}

Although South Africa is not a member country of the OECD, it was awarded observer status in 2004. South Africa is also a member of the OECD BEPS committee.

In drafting tax rules to address BEPS in South Africa, the legislators have to take cognizance of the fact that the Constitution of South Africa is the supreme law of the country. Any law or conduct inconsistent with the Constitution is invalid. In terms of the Constitution, when interpreting legislation, the court must

\textsuperscript{12} Draft notice in terms of s. 29 of the Tax Administration Act No. 28 of 2011, requiring the persons specified in the Schedule to keep and retain the records, books of account or documents prescribed in the Schedule.

\textsuperscript{13} See the DTC interim report (2014), at 1. The long-term objectives of the National Development Plan are set out in the document “South Africa: National Planning Commissioner: National Development Plan: Vision for 2030” (2011) and it also sets out South Africa’s overall economic strategy and policy which aims to promote economic growth, employment creation, development and fiscal sustainability.

\textsuperscript{14} DTC interim report, introductory report (2014), at 1.
prefer any reasonable interpretation of the legislation that is consistent with international law over any alternative interpretation that is inconsistent with international law.

This is particularly relevant in the context of double taxation agreements, which are classified as “international agreements” and which have to be interpreted in accordance with the rules on interpretation of customary international law.\(^\text{15}\)

In interpreting double taxation agreements, South African courts have recognized and applied the OECD commentary.\(^\text{16}\) However, it should be noted that, as South Africa is not a member of the OECD, the courts have, on occasion, followed approaches which may differ from those set out in the OECD commentary.\(^\text{17}\)

Although there is currently no TP specific domestic case law to refer to in South Africa, this acceptance will arguably extend to the OECD TP guidelines, as well as the UN TP manual.\(^\text{18}\)

The DTC interim report states that addressing BEPS concerns from a South African perspective requires that the country strengthen its tax policy and formulate measures to prevent BEPS. However, these measures should not be adopted without taking into account the need to encourage foreign direct investment in South Africa and the need to preserve the competitiveness of South Africa’s economy, especially as a gateway for investment into Africa.\(^\text{19}\)

Furthermore, the DTC interim report provides that, although Practice Note 7 states that the SARS follows the OECD TP guidelines, it is not a legally binding document. The DTC has recommended that a legally binding ruling be issued to confirm that SARS follows the OECD TP guidelines.\(^\text{20}\)

### 2.2. Challenges of transactions with intangibles

#### 2.2.1. Definition of intangibles for TP purposes

“Intellectual property” is defined for South African TP purposes in section 23I of the ITA as any “patent”, “design”, “trade mark”, “copyright”, any property of a similar nature, and any knowledge connected to the use of such patent, design, trademark, copyright, property or similar right.

The definition of “intellectual property”\(^\text{15}\) therefore includes inventions, patents, designs, trademarks and copyrights protected in terms of South Africa as well as foreign laws.

Furthermore, it should be noted that a “royalty” is defined for the purposes of South African statutory source rules as any amount that is received or accrues in

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\(^\text{15}\) Ibid., at 17.
\(^\text{16}\) Ibid., at 18. See also Secretary of Inland Revenue v. Downing 1975 (4) SA 518 at 525 (AD).
\(^\text{17}\) See AB LLC and BD Holdings LLC v. Commissioner of the South African Revenue Services (13276 [2015] ZATC 2).
\(^\text{18}\) It should be noted that South Africa is not bound in law to follow the OECD TP guidelines. However, various sources, such as Practice Note 7, the DTC interim report, the SARS comments included in the October 2016 progress report to the update to the UN transfer pricing model [E/C.18/2016/CRP.2], and the various explanatory memoranda to South African TP legislation, support the use of OECD TP guidelines in practice.
\(^\text{19}\) DTC interim report, introductory report (2014), at 25.
\(^\text{20}\) Ibid., at 16.
respect of the use, right of use or permission to use any intellectual property (as defined). In terms of the South African statutory source rules, a royalty will be deemed to be from a South African source if, inter alia, the royalty is incurred by a South African tax resident (unless that royalty is attributable to a permanent establishment which is situated outside South Africa).

2.2.2. Transactions with intangibles

2.2.2.1. Exchange control approval

In relation to TP of intangibles, South Africa’s TP legislation exists in close conjunction with the exchange control rules of the SA Reserve Bank (SARB).

The South African exchange control regime plays a key role in safeguarding the South African tax base from erosion – particularly in the context of cross-border transactions involving intangibles.21

The relevant exchange control regulations essentially categorize intellectual property as either inbound or outbound intellectual property. Outbound intellectual property is then dealt with as either the transfer/sale or licensing of intellectual property. A distinction is also drawn between transactions between connected and non-connected persons.

South African residents wishing to sell, cede or transfer intellectual property to unrelated third-party non-residents require prior exchange control approval to effect such a sale, cession or transfer for a fair and market-related price. The exchange control regulations are therefore more far-reaching than the TP legislation, as transactions between third parties also require approval.

South African residents wishing to sell, cede or transfer intellectual property to related non-resident parties will in most instances not obtain exchange control approval.

South African residents wishing to license South African intellectual property to unrelated third party non-residents for a fair and market-related royalty do not require prior exchange control approval, while the licensing of intellectual property to related party non-residents will require prior exchange control approval.

South African residents wishing to make royalty payments abroad must also obtain exchange control approval.

2.2.2.2. TP legislation

Practice Note 7 provides that the SARS considers the guidance provided in chapter VI of the OECD TP guidelines relevant and recommends that taxpayers follow the guidance in establishing arm’s length conditions in international agreements with connected persons involving intangible property. The SARS has also indicated that it is in favour of applying the guidance arising from Action 8 of the BEPS project in this regard – specifically in relation to South African developed intellectual property disposed of to offshore related parties.22

As set out above, the South African TP legislation will apply to transactions between, _inter alia_, a resident and a non-resident where those persons are “connected persons” in relation to one another.

However, the SARS has identified that taxpayers are entering into intellectual property structures which circumvent the South African TP legislation by ensuring that the requirements for the “connected person” test are not met when intellectual property is transferred. The transfer is typically accompanied by an agreement that the South Africa developer retains the benefits of the intellectual property transferred. To address this, the “connected person” threshold was lowered for the purpose of the transactions involving intellectual property under the South African TP regime. Where generally, the “connected person” threshold requires a 50 per cent shareholding, this is reduced to 20 per cent in the context of intellectual property transactions under the South African TP regime.

Certain relief is, however, provided for the licensing of intellectual property between group companies in terms of the TP legislation. More specifically, where a transaction comprises the granting of the use of any intellectual property (as defined in the ITA) by any resident (other than a “headquarters company”) to a CFC, the TP provisions must not be applied if that CFC has a “foreign business establishment” and qualifies for the high-tax exemption.

### 2.2.2.3. Deductibility of royalty payments

In order to prevent tax arbitrage resulting from the assignment of South African intellectual property to entities with a lower effective tax rate followed by the licensing of that intellectual property back to the South African taxpayer, the intellectual property anti-avoidance rules were introduced in section 23I of the ITA.

In terms of these rules, no deduction is allowed in respect of any expenditure for the use or right of use of “tainted intellectual property” if the royalty receipts do not constitute “income” of the licensor. “Tainted intellectual property” is defined,

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23 A foreign business establishment in relation to a CFC means, _inter alia_, a fixed place of business located in a country other than South Africa that is used or will continue to be used for the carrying on of the business of that CFC for a period of not less than one year where:
(a) that business is conducted through one or more offices, shops, factories, warehouses or other structures;
(b) that fixed place of business is suitably staffed with on-site managerial and operational employees of that CFC who conduct the primary operations of that business;
(c) that fixed place of business is suitably equipped for conducting the primary operations of that business;
(d) that fixed place of business has suitable facilities for conducting the primary operations of that business; and
(e) that fixed place of business is located outside South Africa solely or mainly for a purpose other than the postponement or reduction or any tax imposed by any sphere of government in South Africa.

24 In essence, a CFC will qualify for the high-tax exemption to the extent that the aggregate amount of tax payable to all spheres of government of any country other than South Africa by that CFC in respect of any foreign tax year of that CFC during which that transaction exists is at least 75 per cent of the amount of normal tax that would have been payable in respect of any taxable income of that CFC had it been a South African resident for that foreign tax year.
generally, as any intellectual property that was owned or developed by a South African taxpayer or a connected person in relation to that taxpayer.

In essence, therefore, the intellectual property anti-avoidance rules will restrict the deduction available to a South African taxpayer in respect of a royalty payment made to a non-resident where the intellectual property in question was previously owned by that South African taxpayer (or a connected person). A portion of the expenditure may, however, be deducted where withholding tax on royalties is payable.

2.2.2.4. DTC recommendation

The DTC has concluded that the OECD BEPS report on Actions 8–10 (which requires countries to enact legislation to prevent TP manipulation involving intangibles) may not require major legislative attention in South Africa at this stage, given the exchange control regime’s restrictions surrounding the outbound movement of intangibles and royalty payments.25

However, the committee has acknowledged that despite the measures set out above, the potential undervaluation of local intangibles in determining profit splits is a potential concern for South Africa. The DTC recommends that, to address challenges relating to the TP of intangibles, South Africa should align its laws and practices with the OECD TP guidelines on intangibles as set out in the BEPS Actions 8–10 report.

As stated above, the SARS has subsequently indicated that it will apply the guidance arising from BEPS Action 8, specifically in relation to South African developed intellectual property disposed of to offshore related parties.26

2.2.3. Substance-over-form approach towards intangibles

Practice Note 7 provides that, as a general point of departure, an examination of controlled transactions will be based on the transactions actually undertaken. In this regard, the SARS relies on the OECD TP guidelines which provide that, in certain circumstances, it may be appropriate to disregard the structure of the controlled transactions entered into by a taxpayer. This affirmation of the substance-over-form approach is confirmed in the SARS’ country specific comments included in the UN TP manual.27 The SARS will therefore evaluate the substance of the actual transactions undertaken to determine whether the transactions were structured in a way that would not have taken place between independent persons.

In determining the arm’s length return, the SARS’ approach in practice is to focus on the substance of the transaction or arrangement, rather than the form of the agreement which may be in place. In the context of intellectual property, this may include an analysis of the parties that perform the actual development, enhancement, maintenance, protection and exploitation of the intangibles.

26 Update of the UN TP manual, coordinator’s report on work of the subcommittee on transfer pricing [E/C.18/2016/CRP.2], (2016), at D.6.9.
27 UN TP manual, at 10.5.5.
In practice, the SARS has been known to attack structures using the substance-over-form doctrine. The substance-over-form doctrine requires the courts not to be bound by the label which parties give to their agreement or to their subjective perception as to the nature of the agreement, but to determine the legal consequences of any agreement by having regard to the true nature of the rights and obligations agreed to by the parties, i.e. the legal substance. More specifically, South African tax law provides for arrangements or transactions to be challenged on the basis that they may be viewed as a sham or a simulation, or on the basis that the true rights and obligations among the parties pursuant to the relevant transactions will differ from their legal form.

In terms of South Africa’s tax legislation, beyond the TP specific provisions of section 31 of the ITA, an arrangement whereby, for example, a South African entity earns limited remuneration for its research and development activities might also theoretically be challenged by the SARS under the general anti-avoidance provisions contained in sections 80A to 80L of the ITA.

2.2.4. Comparability and group synergies

Practice Note 7 provides that comparability is fundamental to the application of the arm’s length principle. The arm’s length methods are based on the concept of comparing the prices or margins achieved by connected persons in their dealings to those achieved by independent entities for the same or similar dealings. In order for such comparisons to be useful, the economically relevant characteristics of the situations must be highly comparable.

As highlighted by the SARS in their updated country chapter to the UN TP manual, a key challenge faced by taxpayers and the SARS alike in applying the arm’s length principle in practice is a lack of domestic comparables. In the light of the difficulties which may be encountered in obtaining uncontrolled transactions in South Africa, Practice Note 7 provides that the SARS will accept the use of foreign country comparables in taxpayers’ TP analyses. However, taxpayers using such comparables would be expected to assess the impact of geographic differences and other factors on the price.

Thus, while foreign comparables may be useful, taxpayers will need to exercise caution to ensure that appropriate adjustments reflect differences between the South African and foreign markets.

To address the challenges highlighted above, the SARS has committed to working with the OECD in its efforts to develop toolkits for developing countries, as well as with service providers of comparable databases to develop possible solutions.

The DTC interim report has confirmed the principles laid down in the OECD BEPS Actions 8–10 report, specifically confirming that comparability issues, and the need for comparability adjustments, can also arise because of the existence of multinational enterprise (MNE) group synergies. Group synergies may have an

28 See SARS v. NWK 2011 (2) SA 67 (SCA), and SARS v. Bosch & Another 2015 (2) SA 174 (SCA).
31 Ibid.
effect on the determination of arm’s length conditions for controlled transactions and should be addressed for TP purpose as comparability factors. As they are not owned or controlled by an enterprise, they are not intangibles.

Beyond the South African TP rules, the exchange control regime should also be borne in mind. As set out previously, any royalty payments made by South African residents to non-residents must be approved by the SARB. The conditions (and restrictions) imposed by the SARB might also have a significant impact on the royalty rate allowed.

2.2.5. Hard-to-value intangibles

The DTC interim report does not provide specific guidance in respect of hard-to-value intangibles but confirms the guidance provided in the OECD Actions 8–10 report. The DTC interim report acknowledges that, since intangibles are unique in nature, and hence in value, there is no market benchmark against which to conduct an objective comparability analysis. The DTC has also noted the OECD’s recommendation that countries should develop TP rules or special measures for transfers of hard-to-value intangibles, and recommends in the DTC interim report that South Africa should align its laws and practices with the OECD TP guidelines on intangibles. In line with the DTC’s recommendations, the SARS has indicated that it will apply the guidance arising from Action 8 of the BEPS project.32

The OECD’s guidance on hard-to-value intangibles proposes that tax authorities will be allowed to use \textit{ex post} “evidence” (i.e. hindsight), to assess the arm’s length nature of TP arrangements in respect of “hard-to-value-intangibles”. In this regard, the OECD defines hard-to-value intangibles as meaning intangibles or rights in intangibles for which, at the time of their transfer, no sufficiently reliable comparables exist, and there is a lack of reliable projections of future cash flows or income expected to be derived from the transferred intangible, or the assumptions used in valuing the intangible are highly uncertain.33

Hard-to-value intangibles therefore include, \textit{inter alia}, intangibles that are only partially developed at the time of transfer or are not anticipated to be exploited commercially until several years following the transaction, as well as intangibles that are anticipated to be exploited in a manner that is novel at the time of the transfer. As the OECD explains,

\begin{quote}
“an enterprise may transfer intangibles at an early stage of development to an associated enterprise, set a royalty rate that does not reflect the value of the intangible at the time of the transfer, and later take the position that it was not possible at the time of the transfer, to predict the subsequent success of the product with full certainty….”34
\end{quote}

However, as set out above, section 23I of the Act disallows deductions in respect of tainted intellectual property. Therefore, although section 23I does not address how to value hard-to-value intangibles, it does address certain BEPS concerns as no

\begin{itemize}
\item \textit{Ibid.}, at D.6.9.
\item OECD BEPS Actions 8–10 report (2015), at 110.
\item \textit{Ibid.}, at 109.
\end{itemize}
deductions will be allowed in respect of royalty payments for tainted intellectual property transferred out of South Africa. This does not, however, fully protect the South African tax base, as the SARS may still lose out on potential future revenue where the South African company was not remunerated at an arm’s length rate for the transfer of the intangibles.

Again, as mentioned previously, the South African exchange control regime also places significant restrictions on the ability of MNEs to export intellectual property, and royalty rates paid to non-residents are often capped. These measures go some way towards protecting the South African tax base from erosion in the context of cross-border transactions involving intellectual property.

2.2.6. Cost contribution agreements (CCAs)

CCAs are not commonly found in South African in practice. This is perhaps to some extent attributable to the various restrictions placed on the export of intellectual property from South Africa (with the joint development of an intangible asset often being the subject matter of a CCA). The use of CCAs is further restricted by the exchange control regulations which prohibit the use of set-off arrangements.

Practice Note 7 provides that SARS considers the guidance provided in chapter VIII of the OECD TP guidelines relevant and recommends that taxpayers follow the guidance in establishing arm’s length conditions in international agreements with connected persons involving CCAs.

Again, the DTC interim report does not provide specific guidance in respect of CCAs but confirms the guidance provided in the OECD Actions 8–10 report. The DTC has also noted the OECD’s recommendation that countries should develop guidance in respect of CCAs.35

2.3. Risk and capital

In South Africa, the arm’s length principle provided for in section 31 of the ITA extends to intra-group financing, both into and out of South Africa.

In the past, the ITA contained specific provisions addressing thin capitalization and explicitly provided a 3:1 debt-to-equity safe harbour ratio. With the overhaul of the South African TP regime in 2012 (as set out previously), this safe harbour rule fell away and thin capitalization was brought within the ambit of the general arm’s length test.

Following the 2012 amendments, the SARS issued a new draft interpretation note on thin capitalization (dated 22 March 2013). Whereas the previous regime provided for specific safe harbour rates and ratios, the new draft interpretation note stresses that both the quantum of the debt and interest rate levied must adhere to the arm’s length principle. The safe harbours previously provided for will now merely serve as risk indicators for potential audit by the SARS. These indicators include a debt-to-EBITDA36 ratio of 3:1, and interest rates levied beyond the prevailing South African prime interest rate (or relevant interbank rate) plus 2 per cent.

35 DTC interim report to Action 8, at 8.
36 Earnings before interest, tax, depreciation and amortization.
The taxpayer is therefore required to determine appropriate levels of debt, as well as the cost of said debt, from both the borrower and lender’s perspective – considering whether the terms of the transaction are in line with what would be agreed upon between two independent parties dealing at arm’s length.

Excessive interest payments will not be deductible by the taxpayer in question, with the excess amount being subject to a secondary adjustment (as set out previously, the excess interest will be deemed to be a dividend consisting of a distribution of an asset in specie).

As is the case with certain transactions involving intangible property set out previously, it should be noted that section 31 of the ITA exempts certain types of financial assistance from the general TP rules. These exemptions relate to certain forms of financial assistance provided to and by companies falling within the so-called South African “headquarters company” regime, financial assistance provided by South African resident companies to CFCs (under very specific circumstances), and certain “quasi-equity” loans.

In addition to the arm’s length test in section 31, the ITA sets out further provisions aimed at combating excessive interest deductions.

Specifically, in answer to BEPS Action 4, as of 1 January 2015, a formulaic cap applies to the deduction available in respect of interest incurred on debt owed to a connected person where that lender is not subject to tax in South Africa.\(^{37}\) The formula is linked to the South African repo rate, which will fluctuate from time to time. Assuming a repo rate of 7 per cent,\(^{38}\) the formula effectively results in a cap of roughly 44 per cent of EBITDA.

Beyond the provisions of the ITA, the South African exchange control regime will also restrict payment of interest on inbound cross-border loans between connected persons where the payments are deemed to be excessive.

### 2.4. High-risk transactions

#### 2.4.1. Comparable uncontrolled price (CUP) and quoted prices for cross-border commodity transactions

South Africa is rich in natural resources, including mineral and metal deposits (such as platinum, gold, diamonds, iron, manganese, and chromium) as well as agricultural resources.

In terms of South Africa’s mineral and metal wealth, the direct contribution of the mining sector to the South African economy is roughly 8 per cent; however, it is estimated that it indirectly contributes a further 9 per cent (i.e. 17 per cent in total) by way of multiplier and induced effects on other sectors.\(^{39}\)

Although there are numerous tax and other legislative provisions that relate specifically to the mining sector in South Africa, from a TP perspective, there are currently no sector specific rules in place. As set out previously, the arm’s length principle underpins the South African TP regime, with the OECD TP

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\(^{37}\) S. 23M of the ITA.

\(^{38}\) South African repo rate as at 30 September 2016.

\(^{39}\) DTC first interim report on mining to the Minister of Finance (2015), at 29.
guidelines and UN TP manual being applied in practice by both the SARS and taxpayers.

In terms of the TP methods applied in practice, in the South African mining sector, the resale price method is widely used in the context of cross-border commodity transactions (often with reference to the resale price margin realized by an offshore marketing hub).

It should also be noted, however, that the impact and prevalence of BEPS and TP manipulation in the mining sector has been the subject of increased political debate in recent years. The TP policies and practices of mining groups in particular have come under the scrutiny of the SARS, with 13 of the 29 active TP audits (as at May 2016) targeting the mining and quarrying sector – specifically, sales made to offshore subsidiaries.40 Certain political parties in South Africa have also called for the use of the so-called “sixth method” as applied in countries such as Argentina and Brazil.41

In terms of other commodity transactions, the CUP method is more prevalent in the agricultural sector, with a combination of methods being applied in the energy sector (oil, gas etc.).

As to the status of the updated OECD TP guidelines surrounding commodity transactions (released following the finalization of the BEPS Actions 8–10 report) and the application of the CUP method, the SARS has not formally indicated that it accepts and will adopt the new guidance.

A key challenge to applying the CUP method in practice will remain the lack of reliable index prices for certain commodities.

It should also be noted that the DTC is currently reviewing the broader fiscal policy in place surrounding mining in South Africa. Although the committee’s interim mining report makes no specific recommendations surrounding TP measures, the report does allude to the further BEPS-specific work currently being done by the DTC, as set out above.42

2.4.2. Intra-group services

As is the case with all other affected transactions, intra-group services will fall within the all-encompassing arm’s length test of section 31 of the ITA.

The SARS, in Practice Note 7, provides the following guidance as to the practical application of the arm’s length principle to intra-group services: “The Commissioner considers the guidance provided in [chapter VII of the OECD TP guidelines] relevant and recommends that taxpayers follow the guidance in establishing arm’s length conditions in international agreements with connected persons involving intra-group services”.

Although Practice Note 7 was published in 1999, the SARS has in the past, in practice, referred to the guidance as set out in the most recent version of the OECD TP guidelines. In terms of the latest updates to chapter VII of the guidelines following the release of the BEPS Actions 8–10 report, the SARS has, however,

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40 Refer to the May 2016 SARS presentation to the Standing Committee on Finance (a parliamentary committee), available from <https://pmg.org.za>.
42 DTC first interim report on mining for the Minister of Finance (2015), at 66.
stated that it will not be applying the new simplified approach to low value-adding intra-group services.43

The simplified approach would provide for the application of a uniform mark-up of 5 per cent to the relevant cost pool. The SARS’ policy not to follow this approach is in line with its stated apprehension towards the introduction of any safe harbours.44

Beyond the TP rules and guidance set out in the ITA and OECD TP guidelines, the South African exchange control regime also places certain restrictions on outbound payments by South African residents to foreign connected persons in relation to intra-group services. Specifically, for a payment to be allowed by a South African bank, it must be demonstrated that the South African resident in question has benefited from the service and that the fee charged is not excessive (i.e. fair, and market related). In this regard, it is unclear whether the simplified approach will be accepted by the SARB.

Certain other compliance requirements arise where services are provided to South African tax residents by non-residents. Specifically, where those services are provided by the non-resident while physically present in South Africa, and the value of the services (generally speaking) exceeds ZAR10 million, the arrangement must be reported to the SARS. Moreover, non-residents deriving income from a source within South Africa will be required to register as taxpayers in South Africa and file a tax return, even where there is no tax liability.

As per the SARS’ comments included in the UN transfer pricing manual, “the SARS is currently taking a pragmatic but firm approach to evaluating payments for intra-group services and where clear commercial justification or evidence of reasonableness for such payments are lacking, such payments are disallowed”.45

2.4.3. Profit splits in the context of value chains

In Practice Note 7, the SARS indicates that it accepts all of the TP methods recognized by the OECD in its TP guidelines, including the profit split method.

Although no hierarchy of methods is imposed by the ITA, in Practice Note 7 the SARS does indicate that as a general rule, the traditional transaction methods are preferred above the transactional profit split methods, and of the latter, the transactional net margin method is preferred. With reference to the profit split method, the SARS highlights the subjectivity surrounding the allocation of profits as a key weakness of the method and goes further to state that it could result in a less reliable measure of the arm’s length price than an analysis under one of the other methods. Although the exact facts and circumstances surrounding each case would determine which method was most suited to arriving at the arm’s length result, this implied hierarchy would indicate that the SARS would not advocate the use of the profit split method as the default mechanism of first resort.

The SARS has not made any specific public statements regarding its views on the work done surrounding the practical application of the profit split method in

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44 Ibid., at D.6.10.
45 UN transfer pricing manual, at 10.5.3.5.
BEPS Actions 8–10, or on how the outcomes of these BEPS actions might affect the views expressed above.

The SARS has, however, indicated that it is in favour of looking beyond legal contracts or ownership to the real economic substance behind the transaction, i.e. to where the risks are assumed and value-adding activities are performed. In its comments included in the UN transfer pricing manual the SARS points to a perceived trend among MNEs of shifting profits out of South African subsidiaries via year-end TP adjustments made without due consideration of the real functions and risks assumed by the South African subsidiary – leaving it with an unreasonably low guaranteed return, with the residual profit being returned to the parent/related entity.

In the light of the challenges faced by taxpayers and the SARS alike in finding reliable comparable data, the SARS has stated that it will favour a more holistic approach to arriving at the arm’s length price. More specifically,

“by seeking to understand the business model of taxpayers across the whole value chain, gaining an in-depth understanding of the commercial sensibilities and rationalities governing intra-group transactions and agreements it is evident that [the] SARS does not look to comparable data alone or in isolation from other relevant economic factors in determining whether or not the appropriate or arm’s length level of profit has been achieved….”

In the context of its approach to location savings, location specific advantages and market premiums within certain industries, the SARS has specifically stated that it will build on the practices followed in China and India in this regard.

Given the growing emphasis internationally on the use of value chain analysis in the context of TP, it has been noted that some MNEs use the profit split method in conjunction with other TP methods as a means of corroborative analysis of their TP policy (i.e. not as the primary TP method, but rather as a “sense check” or risk assessment tool).

From a disclosure perspective, as set out in section 2.5 of this report, South African taxpayers are required to make certain disclosures to the SARS in addition to any CbCR or master/local file reporting. Where, for example, taxpayers have made adjustments to their taxable income in order to deliver a guaranteed return, this must be disclosed to the SARS in the company’s annual tax return (ITR 14).

Although the SARS’ future approach to the application of the profit split method and any revised OECD TP guidelines in this respect is unclear, the statements made by the SARS (as highlighted above) and increased TP disclosure requirements imposed on South African taxpayers would indicate a heightened focus on

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46 Refer to the May 2016 SARS presentation to the Standing Committee on Finance (a parliamentary committee), available from https://pmg.org.za.
47 UN transfer pricing manual, at 10.5.4.1–2.
49 Ibid.
50 UN transfer pricing manual, at 10.5.4.3.
the part of the SARS on the activities of the broader MNE group and value chain when considering the compliance with the arm’s length principle.

2.5. TP documentation

2.5.1. CbCR

South Africa is on track to implement CbCR requirements by 2017. In 2015, the Tax Administration Act was amended to make provision for CbCR. Following this, in April 2016, the SARS and the Ministry of Finance issued draft regulations specifying the CbCR standards that would be required of MNEs in South Africa. Once finalized, these CbCR requirements will be entrenched in South African domestic legislation.

Per the draft regulations, the CbCR requirement is triggered in South Africa where the ultimate parent entity of an MNE is a South African tax resident and has consolidated group revenue exceeding ZAR10 billion. A constituent entity, tax resident in South Africa, will also be required to report in South Africa should its ultimate parent entity (located outside South Africa) have consolidated group revenue exceeding €750 million and one of the following requirements are met: the constituent entity has no filing obligation outside of South Africa; it receives a specific request to report in South Africa because the information cannot be obtained from the ultimate parent entity’s jurisdiction; or because the constituent entity in question has been nominated to report by the MNE group.

The draft regulations also provide for further reporting obligations to the SARS. A South African tax resident constituent entity must notify the SARS if it is an ultimate parent entity or surrogate parent entity of an MNE group. If neither of these conditions apply, the constituent entity must inform the SARS of the identity of the reporting entity for the MNE group.

As to the content of the CbCR to be filed, the draft regulations refer taxpayers to “annex III to chapter V” of the BEPS Action 13 report. South Africa has in the past indicated that it shares the view of other emerging economies that the CbCR should require the disclosure of additional data regarding certain related party transactions, such as royalties, interest and service fees. The draft regulations make no mention of these additional disclosures (refer, however, to the discussion below in relation to additional domestic disclosure requirements in South Africa).

The draft regulations require the relevant entities to file CbCR no later than 12 months after the last day of the year of assessment in question. Once finalized, the regulations would be effective for years of assessment beginning on or after 1 January 2016, with the first CbCR therefore being filed by December 2017.

In terms of exchange of information, South Africa signed the Multilateral Competent Authority Agreement on the Exchange of CbCR on 27 January 2016. South African domestic legislation does allow for the automatic exchange of information, and South Africa has signed and ratified a number of bilateral and multilateral agreements containing exchange of information mechanisms, including the Convention on Multilateral Administrative Assistance in Tax Matters and Amending Protocol.
The SARS has indicated that master and local file requirements will be introduced in 2017. The exact details surrounding these legislative amendments have not, however, been published yet. In comments to the Standing Committee on Finance made in May 2016, the SARS indicated that further clarification surrounding the master and local file reporting requirements is expected to be released in late 2016.

In addition to the master and local file reporting requirements recommended by the OECD, in December 2015, the SARS released the first draft of a public notice setting out additional document retention requirements for TP purposes. This draft notice was subsequently updated in July 2016.

More specifically, the draft notice imposes additional document retention requirements on persons having entered into a potentially affected transaction (as defined), and the aggregate of the person’s potentially affected transactions for the tax year exceeds (or is reasonably expected to exceed) the higher of 5 per cent of the person’s gross income, or ZAR50 million.

Further requirements are also imposed in respect of any potentially affected transaction that exceeds or is expected to exceed ZAR1 million.

Note that the draft notice does not propose to create an additional filing obligation, but merely requires the taxpayer to keep certain records or documents, which can then be requested by the SARS, for example, as part of an audit.

Given that there is some overlap between the information requested under the OECD’s recommended master and local files and the retention requirements per the draft notice, it could be contended that in many instances that taxpayer should have this information at hand in any event (in order to complete its master and local files, and to demonstrate its compliance with the arm’s length principle). The draft notice does, however, impose certain additional record keeping requirements on taxpayers that go beyond the master and local file recommendations. For example, records in relation to “operational flows including information flow, product flow, and cash flow of the potentially affected transactions”.

A number of requirements are also put in place surrounding financial assistance transactions, such as the requirement to keep an analysis of the financial strategy of the business including how capital is allocated, the relationship between capital and cash flows from operations, any changes relating to the financial assistance transactions, and details regarding principal cash flows and the sources of repayment of debt.

As a further compliance requirement beyond the three-tiered approach, the South African income tax return (ITR14) was also amended in April 2016 to require additional TP-related disclosures. Information required in the return is not subject to any materiality thresholds and includes, among other things:

- a breakdown of royalties, interest and other fees receivable/payable (and the five largest countries involved) (see comments included regarding South Africa’s views on CbCR in section 2.5.1);
- debt to EBITDA ratio, EBITDA to finance cost ratio.

Refer to section 1 of this report for clarification of the term “affected transaction”.

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51 Refer to section 1 of this report for clarification of the term “affected transaction”.

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The following TP-specific questions must also be answered:

- Does the company have TP documentation that supports the pricing policy applied to each transaction between the company and the foreign connected person during the year of assessment as being at arm’s length?
- Was there any change between the company and non-resident connected person since the previous reporting period with respect to the TP methodologies/transaction, operation, scheme, agreement or understanding classification?
- Did the company conduct any outbound transaction, operation, scheme, agreement for no consideration with a connected person that is tax resident outside South Africa?
- Did the company transact with a connected person that is a tax resident in a jurisdiction that has a corporate tax rate that is less than 18 per cent or is a tax haven?
- Did the company conduct any outbound transaction, operation, scheme, agreement for no consideration with a connected person that is tax resident outside South Africa?
- Did the company make a year-end adjustment to achieve a guaranteed profit margin?
- Is the “tested party”, of any transaction operation, scheme, agreement or understanding, a tax resident outside South Africa? How many “tested party/parties” of the transaction operation, scheme, agreement or understanding are a tax resident of another country?
- Did the company, on or after 1990, transfer, alienate or dispose of any South African developed (or previously South African registered) intellectual property to any non-resident connected person or any foreign branch of a South African resident?

Note that the additional disclosures included in the income tax return will not form part of the information automatically exchanged with other competent authorities under the aforementioned multilateral CbCR instrument.

These reforms to the administrative provisions of the South African TP regime mark a significant shift in the compliance burden faced by taxpayers in South Africa, as discussed further in the sections that follow.

2.5.3. Compliance costs

The reporters are not aware of any South African specific studies estimating the compliance costs associated with the implementation of the BEPS Action 13 report recommendations. The cost of fully implementing the TP documentation reforms currently on the cards in South Africa could, however, be significant for some taxpayers, and the SARS.

Prior to the implementation of the OECD’s three-tiered approach and other South Africa specific requirements (set out above in sections 2.5.1 and 2.5.2), taxpayers would have been under no legal obligation to maintain and file TP specific documentation with the SARS.52 The reforms to the TP reporting framework

52 Many MNEs have, however, prepared and maintained TP policy documents in line with the OECD TP guidelines in order to ensure that their compliance with the arm’s length principle required under s. 31 could be defended.
in South Africa therefore mark a dramatic shift in the compliance requirements imposed on MNEs in South Africa.

The DTC, in its recommendations surrounding the implementation of the BEPS Action 13 report outcomes in South Africa, made specific reference to the OECD’s recommendation that a balance must be struck between the request for documentation and the administrative burden and costs this would impose on taxpayers. This sentiment is echoed by the SARS in Practice Note 7, in which it acknowledges that taxpayers should not be required to incur costs and effort disproportionate to the nature, scope and complexity of the underlying transactions.

Nevertheless, the scope of disclosure requirements currently on the cards in South Africa goes beyond those set out in the three-tiered approach recommended in the BEPS Action 13 report. Specifically, the requirements set out in the updated income tax returns and the additional document retention requirements set out in the draft notice (discussed in section 2.5.2) will impose additional compliance costs and administrative burden on South African taxpayers.

Although the influx of detailed TP information will add to the SARS arsenal in its fight against “transfer mispricing” (as it has come to be known), the increased disclosures and filings, along with the duty to exchange the information with other competent authorities, will also add significantly to the SARS’ administrative burden.

2.6. TP-related measures in other BEPS actions and other measures against BEPS

South Africa’s answer to BEPS Action 4, section 23M of the ITA, was introduced to limit the deduction available in respect of interest payments made to offshore parties not subject to tax in South Africa. This limitation takes the form of a formulaic cap calculated with reference to the EBITDA of the entity in question.

There is some uncertainty in practice as to how the section 23M cap interacts with the TP regime set out in section 31 of the ITA (specifically, in the context of thin capitalization). It would, however, appear as though the provisions of section 31 should be applied first to the relevant financing transaction (i.e. adherence to the arm’s length principle), with the result being further subject to the section 23M limitation.

As set out above, various measures have also been introduced that combat the erosion of the South African tax base via transfers of South African developed IP and related royalty or other payments to low tax jurisdictions (as dealt with in BEPS Actions 1 and 5). These measures include a robust CFC regime and a limitation placed on deductions associated with tainted intellectual property payments.

Beyond this, the corporate income tax return also requires taxpayers to disclose to the SARS if any South African developed intellectual property has been disposed of to a non-resident connected person, as well as the amount of any royalties or other fees paid to an offshore connected person.
2.7. Can BEPS work in favour of MNEs?

The heightened focus on value chain analysis and aligning profits (and taxable income) with substance and real economic activity has led many MNEs to critically evaluate their group-wide pricing policies anew. The updated and increased guidance provided by the BEPS Actions 8–10 report have in many ways assisted MNEs in performing this analysis and arriving at the arm’s length result. In some instances, this in-depth analysis of the various functions undertaken by the entities operating in the group might also hold other commercial benefits – for example, revealing duplicate functions or operational inefficiencies.

The uniform implementation of the three-tiered approach globally and the open exchange of CbCR between tax authorities might also hold some benefits for taxpayers in South Africa.

In terms of section 46 of the Tax Administration Act, the SARS may request the taxpayer to provide relevant materials held by an offshore connected person. If the taxpayer fails to provide this information, the material may not be produced by the taxpayer at a later stage during any subsequent proceedings. With the increased global transparency and uniform reporting of information, the information held by offshore parties might become more readily available, assisting South African taxpayers in responding to the SARS’ requests.

Across Africa, through the work of the Africa Tax Administrators Forum (ATAF), there is also a move towards increased cooperation among revenue authorities in tackling TP manipulation, as well as harmonizing the region’s approach to TP. Increased transparency and consistency in the application of TP legislation and practice among revenue authorities will go some way in providing taxpayers with some degree of certainty in their tax position. This could be further bolstered by the introduction of other measures, such as advanced pricing agreements (APAs) and mandatory binding mutual agreement procedure (MAP) processes. These measures are, however, not currently in place in South Africa.

3. What is the future of TP?

Based on the statements made by the SARS and the DTC in its interim report, it is accepted that South Africa will continue to look to the developments and recommendations put forward by both the OECD, and also the UN, for guidance. Further to this, South Africa has also reaffirmed its commitment to close cooperation with its BRICS partners in combating BEPS, including the exchanging of best practices and working towards common approaches to these issues.

Although the South African TP regime has been in place since 1995, the SARS has only truly begun to audit TP aggressively during the past few years. This could arguably be attributed to two key challenges faced by the SARS – first, a lack of...
ready access to TP specific taxpayer information, and secondly, a shortage of skills and resources.

As to the first point, arguably the most dramatic impact of the BEPS actions on the TP landscape in South Africa is the introduction of far-reaching TP documentation and disclosure requirements. These developments mark a significant shift in the compliance burden faced by taxpayers in South Africa who up to the introduction of these measures would have been under no legal obligation to prepare, maintain, or file TP documentation with the SARS (although many MNEs have opted to prepare and maintain TP policy documents in line with the OECD TP guidelines in order to defend their compliance with the section 31 arm’s length principle requirements).

Further to these disclosure requirements, certain other legislative amendments have also been enacted in recent years to bolster the SARS’ access to taxpayer information. This includes regulations surrounding the taxpayer’s ability to cite legal privilege as a basis for denying a request by the SARS for information, strengthening the SARS’ ability to gather information held by offshore parties, and the inclusion of certain other measures aimed at deterring taxpayers from withholding information from the SARS.

The increased information that will be at the SARS’ disposal with the implementation of the before mentioned disclosure requirements will be an invaluable addition to the revenue authority’s arsenal when it comes to auditing taxpayers’ TP compliance.

As to the skills and resource challenges faced by the SARS, this issue persists, with the SARS TP specialist team standing at 25 members as at May 2016 (although this number fluctuates over time). The capacity constraints represent a critical hindrance to the revenue authority’s ability to effectively enforce compliance with the South African TP regime. This is compounded by the complexity the OECD developed TP guidelines, and the absence of reliable domestic comparable data.

The SARS, however, remains resolute in its commitment to the enforcement of the arm’s length principle and is actively recruiting and training specialist staff to build capacity in its TP unit. The SARS also participates in the activities of organizations such as the UN and ATAF which focuses on the development of the TP knowledge base in developing countries.

As the SARS’ capacity increases, it is likely that the coming years will see a further increase in the SARS’ TP audit activities.

With the increased transparency on the part of the taxpayer in South Africa it is hoped that this will be met with increased certainty in their tax affairs – particularly in instances where there are discouraging TP adjustments proposed by the SARS and the other relevant competent authority.

To this point, although a number of South Africa’s double taxation treaties do make provision for an MAP, and the SARS has published guidelines as to how a taxpayer might go about approaching the SARS to initiate the MAP

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55 Refer to the May 2016 SARS presentation to the Standing Committee on Finance (a parliamentary committee), available from https://pmg.org.za.

process,57 South Africa has not committed itself to the mandatory binding MAP recommendations put forward in the BEPS Action 14 Report.58

In terms of APAs (and in the context of the resource constraints highlighted above), the SARS has stated that “it stands to reason that a country with little audit capacity should not be entering into APAs”.59

With the increased focus on TP internationally, the risk of double taxation is heightened in the absence of an effective dispute resolution mechanism. This remains a cause of concern for taxpayers.

Addendum

Subsequent to the submission of this branch report for publication, certain draft regulations and draft public notices referred to in the report were finalized and published by the SARS.

Specifically, the draft regulations setting out the CbCR obligations which would be required of South African multinational groups were finalized by the SARS during December 2016.60 These are virtually identical to the draft regulations referred to in the branch report and are closely aligned with the OECD’s recommendations in this regard. With the publication of the regulations, CbCR is now fully entrenched in South African tax law, and is effective for years of assessment beginning on or after 1 January 2016, with the first CbCR therefore being filed by December 2017.

Also, during October 2016, the draft notice setting out additional document retention requirements for TP purposes was finalized.61 Although broadly in line with the requirements set out in the previous version of the document, this does differ in some respects from the draft notice. Most notably, the relevant thresholds set out in the final notice now stipulate that taxpayers that engage in cross-border related-party transactions which in aggregate (without offsetting transactions), exceed or are reasonably expected to exceed ZAR100 million per annum will be required to “keep” the records specified in the notice. Further requirements are also imposed in respect of any potentially affected transaction that exceeds or is expected to exceed ZAR5 million. The final record keeping notice is effective for years of assessment beginning on or after 1 October 2016.

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58 Refer to the May 2016 National Treasury presentation to the Standing Committee on Finance (a parliamentary committee), available from <https://pmg.org.za>.
60 See SARS, Regulations specifying the country-by-country reporting standard for multinational enterprises, Government Gazette No. 40516 (23 December 2016).
61 See SARS, Duty to keep the records, books of account or documents in terms of section 29 of the Tax Administration Act No. 28 of 2011, Government Gazette 40375 (28 October 2016).
Summary and conclusions

Spain is among the countries that have adopted base erosion and profit shifting (BEPS) measures rapidly in their domestic tax legislation. The Spanish tax authorities took an active role in BEPS works and discussions and as a result of this, the domestic implementation in some areas was quickly and completely aligned with the BEPS recommendations.

The timing of the latest major corporate income tax (CIT) reform in Spain (2014) was ideal for anticipating the essential principles of the BEPS project and starting to implement a number of BEPS recommendations even before the final action plans were drafted. This was the case for transfer pricing (TP) country-by-country reporting (CbCR) obligations included in Action 13, which were implemented in detail, meeting all BEPS requirements in areas such as content, deadlines and penalties.

Additional TP amendments introduced include a new definition of related parties, revision of the valuation rules, comparability analysis and advance pricing agreement (APA) rules.

Other non-TP BEPS measures such as anti-hybrid measures or controlled foreign company (CFC) rules were also implemented in the Spanish domestic legislation taking advantage of the CIT reform.

The Spanish TP legislation has historically been drafted consistently with OECD “soft law” (OECD TP guidelines, Joint Transfer Pricing Forum works, OECD model and commentaries, etc.). Despite not having legal authority, OECD soft law enjoys a powerful status in Spain, being the main interpretative source for TP legislation, and as such, guiding taxpayers, the tax authorities and even the tax courts when they apply TP concepts. TP legislation expressly states the need for TP rules to be interpreted “in the light” of this soft law.

The TP outcomes included in BEPS Actions 8–10 have been addressed in the revised version of the OECD TP guidelines and BEPS measures are expected to enjoy the same powerful soft law status in Spain. It can therefore be affirmed that BEPS recommendations will become immediately applicable in Spain either by being directly implemented by the Spanish legislation, or as a result of their soft law status.

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As a consequence, it is uncertain whether additional implementation will take place for some of the TP measures not currently regulated under the Spanish CIT legislation. There is a common understanding that for some areas such as comparability analysis and the substance-over-form principle, clear and detailed legislative implementation will be needed, for the sake of legal certainty and to avoid increasing litigation. In other areas it may not be so clear whether additional legal implementation is expected.

From a practical perspective, during the last two or three years, the tax authorities in Spain have publicly welcomed BEPS and shared their favourable opinion on the BEPS discussions and works in progress. Additionally, members of the international tax office have commented in tax seminars and events on how the BEPS principles should be considered of application in tax audits even to years before the BEPS action plans were released. BEPS concepts in practice are already being discussed in tax audits, and there have already been tax court decisions by the Supreme Court directly referring to BEPS principles, and even going beyond BEPS recommendations.

As a conclusion, in practice BEPS is here to stay and taxpayers should conform to BEPS recommendations to ensure tax compliance.

1. Current TP regulation and practice in Spain

The TP rules in Spain are included in the CIT Law and regulations. The recent evolution of this set of rules as regards TP is as follows:

- Law 43/1995 on CIT established the essential CIT rules in Spain. Article 16 allowed the tax authorities to correct the prices of related transactions if they were not consistent with market value;
- Royal Decree 4/2004, the new amended text of the CIT Law, aimed to integrate all CIT rules in one legal body; there were no major changes in TP rules;
- Law 36/2006 (and implementing regulations, Royal Decree 1793/2008) significantly amended the Spanish TP rules. The main changes relate to the introduction of the arm’s length principle, new TP documentation obligations, additional TP valuation methods, the possibility for taxpayers to apply for APAs and finally establishing a penalty regime for TP;
- Law 27/2014 dated 27 November, on CIT and its implementing regulation, Royal Decree 634/2015 dated 10 July, are the result of a serious reform of this tax. For TP purposes, the legislative body has taken advantage of the BEPS draft action plans and has implemented a number of BEPS principles even before the BEPS final works were published, as will be subsequently explained.

On top of the Spanish domestic legislation, Spain has followed the OECD model, implementing the arm’s length principle in practice, by including article 9 in the tax treaties signed.

The OECD model and commentaries as well as the OECD TP guidelines and the works issued by the Joint EU Transfer Pricing Forum are considered soft law. The Spanish legislative body has expressly stated the need for Spanish TP rules to be interpreted “in the light” of this soft law. In practice, even when OECD soft law
does not have legal authority, it enjoys a powerful status, guiding taxpayers, the tax authorities and even the tax courts in interpreting the domestic TP legislation. The same soft law character applies to the BEPS project.

In conclusion, Spanish TP legislation explicitly endorses the application of the OECD TP guidelines and there is no wide deviation from such standards.

Finally, it is worth mentioning that in 2013 the Spanish government established the National Office for International Taxation (Oficina Nacional de Fiscalidad Internacional (ONFI)), a highly specialized unit focused on the monitoring of international tax topics, including TP and APA programmes, as well as tax audits related to cross-border transactions.

The creation of this body is a result of the increasing concern within the Spanish government: fighting against international tax fraud.

2. The impact of the BEPS project on TP

2.1. Introduction

Overall the BEPS project has been welcomed by Spanish tax authorities and the Spanish government.

Corporate Income Tax Law 27/2014 and Royal Decree 634/2015 approving the CIT regulations include significant amendments to the Spanish TP regime (article 18) with respect to previous legislation, mainly influenced by the BEPS project. The most relevant aspects are as follows:

• the tightening of the related parties definition, by restricting the related parties characterization between shareholder and entity to participation equal to or higher than 25 per cent (5 per cent under the old legislation);
• the elimination of the hierarchy of TP methods that the previous legislation included in order to determine the arm’s length value. Additionally, alternative methodologies and valuation techniques are admitted on a subsidiary basis, as long as they respect the arm’s length principle;
• specific valuation rules have been introduced for transactions between shareholders and professional entities, adjusted to the economic reality;
• the nature of the transaction and the conduct of the parties (substance-over-form principle);
• three-tiered TP documentation obligations: CbCR (new), master file and country file;
• the penalty regulations have been amended, becoming softer;
• the valuation for TP purposes becomes independent of any other valuation in other tax areas (customs, personal income tax, etc.). This principle was already included in the OECD TP guidelines;
• other amendments in APAs, secondary adjustments.

Spain is one of the countries that has implemented a number of measures included in the BEPS project even before the OECD released the final reports on 5 October 2015. The Spanish legislative body took advantage of the major tax reform of CIT that was taking place during 2013 and 2014 to introduce some of the BEPS principles that were already included in the BEPS draft works issued during 2014.
The statement of intent/general provisions of the new CIT Law include the increasing need to fight against tax fraud as one of the basic reasons for the CIT reform. As such, the need to step up anti-avoidance measures not just domestically but also in the international tax context is mentioned. Additionally, the preliminary OECD works on BEPS, as “implemented” in the different action plans against BEPS, are recognized as a key tool to analyse international tax fraud. In this context, the reform anticipates and implements a number of measures included in BEPS works, particularly related to TP, but also in other areas such as hybrids, CFC rules or harmful tax practices.

With regard to TP, again, the CIT Law statement of intent expressly states that the TP legislation included in the law must be interpreted consistently with the OECD TP guidelines and the EU Joint TP Forum recommendations, as long as they do not conflict with the literal wording of these TP rules.

This means in practice that:
- several principles and measures included in Actions 8–10 and 13 have been legally incorporated into domestic TP legislation;
- the measures or principles not included in the law will still be “implemented” in practice, due to the powerful interpretative character that soft law (OECD TP guidelines) has in Spain. Therefore, no significant additional changes in the regulations are necessarily expected.

It is worth highlighting that the Spanish tax authorities have confirmed, during public seminars and tax events, the applicability of BEPS principles, as soft law, to tax audits, not limiting their effects exclusively to tax years starting after BEPS.

The Spanish tax courts have also been inspired by BEPS, and there are already some tax court decisions that include some BEPS principles, in particular, the Dell Supreme Court decision, which goes beyond BEPS by applying a broader than Action 7 permanent establishment (PE) definition, anti-fragmentation rules and the recharacterization of transactions.

Overall, tax advisers, the academic community and multinational companies (MNEs) have closely followed the progress of the BEPS project, trying to anticipate the effects for taxpayers, assessing the importance of the action plans and trying to predict BEPS trends. The works of the OECD since the BEPS project started with the public announcement of the actions in 2013 to the publication of the final works in 2015, have been very present in the Spanish tax arena, and despite the criticism received, due to the expected increase in double taxation, increase in TP litigation and the high level of sophistication of the BEPS reports, BEPS is being perceived as the most significant change in the international tax field in recent decades.

2.2. Challenges of transactions with intangibles

2.2.1. Definition of intangibles

The significant increase of transactions related to intangibles as well as the complexities of applying valuation rules to these transactions and their future monitoring have led to a full review of the OECD TP guidelines in this respect. This is one of the areas that generates most controversy and which could lead to more profit shifting.
The Spanish TP legislation prior to the CIT reform in 2014 did not include a definition of intangible assets. The new CIT Law has not incorporated such a definition, even though by the time it was approved the intangibles definition of the BEPS project had already been included in the 2014 Action 8 report.

In practice, the Spanish TP rules have always followed the intangible asset definition as included in the OECD TP guidelines. This is also the expectation after the introduction of the new definition of intangibles in the amended chapter VI as a result of the BEPS project. An intangible asset for TP purposes is something

“which is not a physical or financial asset, which is capable of being owned or controlled for use in commercial activities, and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances.”

The purpose of providing a definition of intangibles is exclusively to provide clarity to the tax authorities and taxpayers on identifying intangibles for TP purposes. As such, a number of examples of types of intangibles that fall under the definition are also included in the redrafted guidelines: intellectual property, such as patents and trademarks, knowhow, trade secrets and contractual rights.

In Spain there are, of course, other definitions of intangibles in different fields, like the intangibles definition included in Spanish domestic accounting legislation (general accounting plan, RD 1514/2007), interpreted consistently with IFRS/IAS 38, intangible assets, patent legislation, etc. It is clear, however, for academics, that the tools used to value intangibles for financial or accounting purposes do not apply when dealing with TP intangibles (intangibles that may need to be remunerated according to TP rules).

As a consequence, there may be intangibles that are registered for accounting or legal purposes, with no TP implications, as well as non-registered intangibles for accounting or legal purposes that still need to be remunerated for TP purposes.

This said, a preliminary valuation by Spanish academics of the new intangible definition considers that it may be dangerous and ambitious to try to create a unique concept of intangible for purely TP purposes, disregarding any reference to the existing accounting, legal or tax definitions, which have already been analysed in a number of articles and court decisions and which in practice facilitate the interpretation of this concept.

When it comes to analysing TP intangibles, a preliminary step should be understanding the accounting and legal situation of such assets. If the intangible assets are booked for accounting purposes and enjoy legal protection, this will facilitate the TP analysis (it will be a fair starting point for the analysis and will help to determine who owns the asset). There is, in addition, a common understanding that if according to accounting and legal rules, an intangible asset exists, the chances are that it will exist for TP purposes as well.

With regard to the opposite situation, the BEPS report clearly states that the intangible character of an asset for TP purposes should not influence the characterization of the asset in other tax fields. This is important in Spain, where a Supreme Court decision (Coca Cola 2009 RJ210/1324) stated that the value of a good determined by the customs authorities for customs purposes could also be used by the entity for TP purposes. This approach has obviously changed as a result of BEPS.
The definition of intangibles for TP purposes is not intended to have any impact on other tax matters, such as the definition of royalties under article 12 of the model tax convention, or other tax matters relating to intangibles.

The detailed character of chapter VI leads experts to think that no future development in this area is expected in terms of changes in domestic regulations. The tax practice, however, will need to adapt to the redrafted guidelines on intangibles.

2.2.2. Transactions with intangibles

Prior to the 2014 CIT reform, the Spanish TP rules did not include any mention related to the recognition of transactions with intangibles. No amendments have been implemented in the CIT Law as a result of BEPS.

For accounting purposes, the local accounting rules include the main criteria for recognizing intangible assets: when it is probable that the future economic benefits will flow to the company, provided that the value of the asset can be reliably measured, and as long as the asset can be identified (either it is separable or arises from legal or contractual rights). These conditions, however, do not need to be complied with to determine the existence of an intangible for TP purposes.

For TP purposes, the OECD TP guidelines remain as the main rules for recognizing and valuing intangible assets. Tax authorities within the ONFI have publicly recognized in events and tax seminars the applicability in practice of the redrafted OECD TP guidelines to determine the appropriate TP valuation for intangibles.

2.2.3. “Substance-over-form” approach towards intangibles

The OECD has placed considerable emphasis on the “substance-over-form” principle in different areas. Under this principle, the tax authorities are allowed to ignore the legal form of an arrangement and to look to its actual substance in order to prevent artificial structures from being used for tax avoidance purposes.

With regard to TP intangibles, this means that the tax authorities are allowed to go beyond the legal ownership of an intangible and perform a “substance-over-form” analysis by considering the different functions, assets and risks contributing value to the intangible, in particular paying attention to which entities perform the important functions related to the development, enhancement, maintenance, protection and exploitation of the intangible (DEMPE). The analysis should also rely on the conduct of the parties and the economic principles that govern relationships between independent parties.

The Spanish TP rules do not include a “substance-over-form” provision particularly referring to intangibles, even though there is a new general provision included in the TP section of the CIT regulations referring to the need to take into account the nature of the transaction and the conduct of the parties when determining the arm’s length value of a related party transaction.

Whether this provision allows the tax authorities to disregard transactions or recharacterize them and under which conditions is unclear for taxpayers.

In practice, the tax authorities have publicly explained that the BEPS substance-over-form principle is to be followed when valuing TP intangibles, by initially considering the operations as legally structured by the parties, but also taking
into account the potential need to disregard the parties’ characterization of a transaction and recharacterize it if the economic substance of a transaction differs from its form, or, if the economic substance and form are consistent, the valuation is not found to be at arm’s length.

On a general basis, the general anti-avoidance rules provided for in the Spanish General Tax Law include the “conflict in the application of the tax law” provision, which allows the tax authorities to challenge the tax treatment of a given transaction where it is deemed artificial or inappropriate and it does not result in relevant legal or economic differences (if compared with a usual or appropriate transaction) other than obtaining tax savings.

As the level of aggressiveness of the tax authorities against international tax fraud increases, the likelihood of tax recharacterization is also higher. The taxpayer position in this regard is uncertain; therefore it is strongly recommended that detailed legislation is implemented in Spain to clearly define the situations under which the tax authorities can disregard or recharacterize a transaction for TP purposes.

The Spanish tax courts have followed the substance-over-form approach in a number of cases different from TP intangibles, such as in the context of MNE groups, challenging the interest deductibility of intercompany loans used to acquire related entities which have reduced the taxable base of the tax group. For the tax authorities, the lack of substance of a loan (no similar conditions would have been obtained from independent parties) permits the disregard of the whole transaction for tax purposes.

In practice, it is expected that the tax authorities and tax courts will follow the substance-over-form principle, as included by BEPS in the OECD guidelines, in future TP assessments on intangibles.

2.2.4. Comparability and group synergies

The OECD TP guidelines resulting from BEPS are clear in that group synergies are not themselves intangibles and it is recommended that they are treated as comparability factors to be taken into account when performing a TP analysis. The reason is that they cannot be possessed or controlled by any entity; however, as long as they may have an impact on the valuation of assets or business transferred between related parties, they are considered comparability factors. In this regard, the BEPS reports include provisions that explain how MNE group synergies should be treated for TP purposes. The main complexity is the impossibility of obtaining an independent objective valuation for group synergies.

Group synergies can be understood as the increased effectiveness that results when a group of entities work together. BEPS reports provide examples such as scale economies, integrated management, elimination of duplication, etc., and take the position that synergy benefits should be shared by the different related entities in proportion to the creation of such synergy (e.g. the entity purchasing more volume should be entitled to more benefit, in the case of advantages of economies of scale resulting from high volumes).

The Spanish TP legislation has recently been amended, by, among other things, including group synergies within a number of additional factors to be taken into account when determining the value of a related party transaction: loss-making
situations, decisions of public bodies, existence of savings related to location and group synergies. This is consistent with BEPS recommendations.

From the tax practice standpoint, TP implications with regard to group synergies are expected to be interpreted by the tax authorities consistently with the BEPS recommendations, as included in the OECD guidelines, which are soft law with significant interpretative power in Spain.

2.2.5. Hard-to-value intangibles

There is a concern about the arm’s length pricing of intangibles when valuation is highly uncertain at the time of the transaction or when the intangibles are hard to value. The revised OECD TP guidance explains the difficulties faced by the tax authorities in verifying the arm’s length basis on which taxpayers determined the pricing of certain intangibles, due to information asymmetry between the tax authorities and taxpayers, to lack of existing reliable comparables at the time of the transaction, or where the tax authorities cannot determine whether the differences between projected results used to set the TP (ex ante) and the actual results (ex post) were due to unforeseen developments or inappropriate TP.

This situation evidenced the need for measures, specific for hard-to-value intangibles, that could help tax administrations in determining whether the pricing arrangements agreed by taxpayers were at arm’s length and had considered an appropriate weighting of expected developments/events relevant for TP purposes or not.

As such, the OECD has included recommendations on hard-to-value intangibles in the final report on BEPS Actions 8–10. Initially the approach followed considered measures such as recharacterization of intangible transactions and the application of other anti-abuse provisions. Luckily, the OECD finally adopted an approach that is consistent with the arm’s length principle, and suggests including a price adjustment or other contingent pricing mechanisms in intangibles agreements, when the value of the intangible being transferred or the benefits of the intangible being created are highly uncertain.

Spanish TP legislation does not include any formal rules related to hard-to-value intangibles.

In practice, the Spanish tax authorities would normally challenge the TP for intangibles if the deviations between forecast information and actual outcome were significant. As a result of the BEPS reports, MNEs are now encouraged to include price adjustment clauses or other contingent pricing mechanisms, based on the fact that under arm’s length market conditions, independent parties would include such provisions to allow for a price adjustment if needed.

2.2.6. Cost contribution agreements (CCAs)

CCAs are often implemented with the objective of developing intangibles. The costs related to the development of a particular intangible, i.e. R&D activity, are shared among the parties that will be benefited by the results of the activity. Costs and risks are shared as well as the results or benefits of the activity.

CCAs can be a source of BEPS if contributions and benefits to the participant companies are not properly determined.
The main objective of the BEPS report in this area has been to align CCAs with the new provisions related to the control of risks and intangibles. Key aspects are the following:

- CCAs are commercial agreements whose main purpose is sharing contributions and risks associated with the common development, production or acquisition of intangibles, with the aim of obtaining a mutual profit by sharing resources and abilities;
- expectation of a future benefit is a must to participate in CCAs;
- control is a preliminary requirement to be a CCA participant. Each of the parties needs to be able to control the risks assumed in the CCA;
- the value of the contributions needs to be proportionate to an anticipated and reasonable expectation of obtaining a profit;
- the value of the participation of each participant party should be determined according to what independent parties would have agreed in comparable circumstances.

The Spanish TP legislation includes CCA provisions. These provisions have remained unchanged after the 2014 CIT reform.

According to Spanish TP legislation, CCAs need to include:

- identification of the participating parties;
- a description of the activities and projects covered by the agreement and their duration;
- the calculation method to determine the contribution split and allocation criteria for the benefits;
- each party’s tasks and liabilities;
- the consequences of adhering to or withdrawing from the agreement;
- any other mention covering a change in the circumstances.

Cost contribution payments are tax deductible provided they are at arm’s length (consistent with the OECD TP guidelines methods as implemented in the Spanish TP legislation) and the following requirements are met:

- the participating parties must be entitled to the ownership or other legal right that provides economic rights on the assets or rights that are developed, acquired or produced;
- each party contribution needs to be proportionate to the expected profitability according to rational criteria;
- the agreement must cover any potential change in the circumstances or parties and provide for appropriate price adjustments in such a case.

CCAs need to be documented in the master file and local files.

Finally, other aspects of general interpretation/understanding:

- CCAs need to be in writing;
- the activities do not necessarily need to be performed directly by the related parties – they can be subcontracted to a third party;
- CCAs are subject to withholding tax, even when a tax treaty in force can reduce it or even eliminate it (article 7).

The Spanish tax legislation already includes a number of statements to ensure the BEPS recommendations on CCAs are followed. Where BEPS recommendations are not expressly implemented in the Spanish CCA provisions, TP domestic legislation will be interpreted in the light of the OECD TP guidelines, so it is expected that the tax authorities will in practice follow the BEPS recommendations.
2.3. Risk and capital

The objective of Action 9 on risk and capital is avoiding BEPS by transferring risk or assigning excessive capital to some members of the group. Specific measures have been drafted to ensure that an entity will not be assigned excessive profits as a result of contractually assuming risks or providing capital, under the main principle of aligning TP outcomes to value creation.

The key aspects of this guidance include:

• the importance of accurately delineating the actual transactions between associated enterprises through analysing the contractual relations together with evidence of the actual conduct of the parties;
• detailed guidance on risk analysis as an integral part of the functional analysis, including a new six-step analytical framework. For TP purposes, the party assuming a risk should control the risk and have the financial capacity to assume the risk;
• capital-rich entities that do not perform any relevant economic activities and do not exercise control over the financial risk will not be allocated any excess profits and will just be entitled to a risk-free return;
• in exceptional situations showing lack of coherence and commercial rationality, the tax authorities can disregard the transaction.

Spanish TP rules do not include any provisions aimed at avoiding profit shifting caused by transferring risk or capital. The Spanish CIT reform has introduced a direct mention, under the TP rules, of the need to take into account the nature of the transactions and the conduct of the parties when comparing the conditions of related transactions.

In practice, the tax authorities have commented in seminars and tax events on the need to follow the six-step functional analysis on risks, as well as the importance of aligning TP outcomes to value creation in what refers to risk and capital, not rejecting the potential need to recharacterize or even disregard transactions if needed.

The tax courts are expected to follow the same principles.

2.4. High-risk transactions

2.4.1. Comparable uncontrolled price (CUP) and quoted prices for cross-border commodity transactions

Chapter II of the OECD TP guidelines has been amended to include new rules on commodity transactions, intended to provide guidance to cross-border commodity transactions, which have been identified as a potential source of base-eroding payments.

• “commodities” refers to physical products for which a quoted price is used as a reference by independent parties in the industry to set prices in uncontrolled transactions;
• a “quoted price” refers to the price of the commodity in the relevant period obtained in an international or domestic commodity exchange market, statistical agencies, etc.

The key aspect of the new guidance is the preference for the use of the CUP method for commodity transactions. The quoted price can be considered as a
CUP; however, whether the quoted price is appropriate or not will depend on a number of comparability factors:

(a) the physical features and quality of the commodity; and
(b) contractual terms of the controlled transaction, volumes, timing and terms of delivery, transportation, insurance and foreign currency terms.

An important factor to consider in using the quoted price is the “pricing date”, which needs to be set since commodity prices fluctuate over time, given the direct correlation between economic conditions and commodity prices. The pricing date needs to be consistent with the conduct of the parties.

Spain is not among the countries that rely heavily on commodity transactions as a significant source of economic activity.

The Spanish TP rules do not include any particular mention of how the arm’s length principle should be applied for commodities. CUP is expressly included as one of the valuation methods for TP transactions. The previous TP legislation stated the primacy of the CUP, cost plus or resale price methods over the indirect methods; however, under the current CIT Law, this hierarchy has disappeared, and what is key is to select the most appropriate method.

In practice, the improved framework for the analysis of commodity transactions included in the OECD TP guidelines will be applicable in Spain in the sense that tax authorities will expect taxpayers to apply the CUP method when determining the appropriate arm’s length price for commodity transactions, and to follow the guidance. The tax authorities are also expected to follow the BEPS recommendations in this regard when conducting TP audits related to commodities, and are expected to place emphasis on the actual conduct of the associated enterprises rather than only on their contractual arrangements.

The outcomes of BEPS in this regard improve consistency and provide clear guidelines, knowledge and tools to price commodity transactions.

2.4.2. Intra-group services

In the current context of MNEs, the headquarters often provides affiliates with a number of intercompany support activities (i.e. human resources, finance, IT, legal, marketing). Additionally, due to the increased competition between MNE groups and the increase in volume of intercompany cross-border transactions, there is a general trend to centralize intra-group services in a single location in order to bring efficiencies and economies of scale (i.e. shared service centres).

Despite being common transactions, the provision of intra-group services has opened BEPS opportunities to MNEs, through artificial and excessive management fees and head office allocations.

The existing guidelines prior to BEPS did not resolve this completely; taxpayers were requested to justify the benefit of the services, and in many cases, tax deductions were not allowed, and hence double taxation took place.

To tackle these issues, BEPS works have issued a revised chapter VII of the OECD TP guidelines on low value-added intra-group services. The four key areas follow:

• definition of low value-adding intra-group services: performed by one or more members of an MNE group, supportive in nature rather than being part of its core business, do not require the use of unique and valuable intangibles
and do not lead to the creation of such intangibles; and do not involve the assumption or control of significant risk by the service provider;

- an optional simplified approach to determine arm’s length price for low value-adding intra-group services: direct and indirect costs of delivering the service, appropriate part of operating expense before allocating to the members and applying a 5 per cent mark-up as a safe harbour not requiring a benchmarking analysis;
- documentation and reporting requirements by an MNE group electing to apply the simplified approach; and
- addressing issues with regard to the levying of withholding taxes on charges for low value-adding intra-group services.

Spanish TP rules do not include any specific mention of low value-adding intra-group services. There is, however, a mention of management fees, which are deductible if they are at arm’s length and the service yields a profit to the company receiving the service. The benefit together with the substance and reality of the services must be proved and documented.

Payments for services are subject to withholding, which will be reduced or normally eliminated under article 7, business profits, of the relevant tax treaty.

The revised guidance encourages tax administrations levying withholding tax to apply it only to the amount of the profit or mark-up. Spanish tax legislation already includes such a provision. Additionally, the wide Spanish treaty network will normally allow for services to not be subject to withholding.

It is worth mentioning the Supreme Court decision (STS 3054/2013) by which the tax deductibility of expenses for intra-group services received by companies resident in Spain from related non-resident entities was rejected. The reasons were the lack of evidence of the actual service supplied other than the contract and the invoices, which included a very high level description of the services.

Spain will probably be included among the countries that will adopt the simplified approach for 2018, since the Spanish tax authorities have played an active role in all the BEPS action plan debates and the Spanish government is keen on implementing BEPS recommendations in domestic law.

If taxpayers opt for the simplified approach to documenting low value-adding intra-group services, once implemented by tax administrations, it will probably reduce the burden taxpayers face in preparing the documentation for low value-adding intra-group services.

### 2.4.3. Profit splits in the context of value chains

The BEPS final report on Actions 8 and 10 published in 2015 includes the commitment to develop new guidance on the transactional profit split method. The main objective is clarifying, improving and strengthening the understanding on when it is appropriate to apply a profit split method and how to do it. The profit split method is useful for taxpayers; however, it is difficult to apply and to review (by tax authorities). The new guidance, which is expected to be finished during the first six months of 2017, will need to:

- determine the circumstances under which profit split methods are the most appropriate method as well as the factors needed to obtain a reliable profit split;
provide guidance on when the significant integration of a business may lead to the conclusion that a transactional method is the most appropriate method;
• align with other BEPS actions, in particular Action 1, Addressing the tax challenges of the digital economy;
• consider the work undertaken in situations where reliable comparable transactions are limited.

The Spanish TP rules include the profit split method among the recommended TP methods. Before the 2014 CIT reform, there was a priority of methods: the CUP method, the cost plus method and the resale price method were the preferred methods. Only when it proved difficult to apply those methods due to complexity or lack of available information were the profit split method and transactional net margin method (TNMM) also allowed. The TP legislation has been amended so that currently none of the five methods mentioned in the law (CUP, cost plus, resale price, profit split and TNMM) prevails on a general basis; rather, “electing the valuation method needs to take into account, among other circumstances, the nature of the related transaction, the availability of reliable documentation and the comparability between related and non-related transactions.”

Other than this general amendment in the application of the valuation methods, there has not been any reaction in the Spanish jurisdiction concerning the OECD’s work on profit splits.

Spanish TP legislation does not include any mention of how to apply TP rules to an MNE’s value chains.

The expectation is that once the OECD issues the final guidance, Spain will either implement it, or most probably, it will in practice be followed by the tax authorities and taxpayers, due to the powerful interpretative character of OECD soft law in Spain.

2.5. TP documentation

Spain was one of the first countries to implement Action 13 even before its latest version was drafted. In July 2015 Spain adopted the three-tiered TP documentation system – master file, local file and CbCR requirements – almost completely in line with the OECD’s recommendation included in Action 13.

Royal Decree 634/2015, the CIT regulation, dated 10 July, implemented and developed the provisions already included in the CIT Law, in force since 1 January 2015:

(a) the master file – aimed at providing tax authorities with high level information on the different transactions performed by MNEs, as well as their TP policies;
(b) the local file – aimed at providing tax authorities with intra-group transactions related to the local taxpayer, the amounts of the transactions as well as a TP analysis of these transactions;
(c) CbCR, including information related to MNE groups indicating the amount of revenue, pre-tax benefits, CIT paid and accrued on an annual basis in each of the jurisdictions, as well as number of employees, contributed capital, non-distributed benefits and tangible assets located in each of the jurisdictions in which the group operates, and finally, the identification of each of the entities
that performs activities in a particular country giving information about these activities.

2.5.1. CbCR

CbCR is a completely new obligation in Spain. It has been regulated and implemented and is fully aligned with Action 13 of the OECD’s BEPS project, and the Spanish rules meet all of the requirements imposed by the OECD in terms of deadlines, implementation and penalties resulting from non-compliance.

The purpose is to enhance transparency for the tax authorities.

In this regard, Order HFP/1978/2016, published on 30 December 2016, approves the new form to be used by the entities required to file the CbCR obligations (Form 231).

The entities required to file CbCR are:

- Spanish entities which are the ultimate parent entities of MNE groups whose revenue for the 12 months prior to the start of the tax year is at least €750 million;
- Spanish direct or indirect subsidiaries of MNE groups whose revenue for the 12 months prior to the start of the tax year is at least €750 million, provided that any of the following circumstances are met: (a) the ultimate parent entity is either not obliged to file the CbCR in its country of residence, or (b) the ultimate parent entity is tax resident in a country that has not signed the automatic exchange of tax information agreement;
- the Spanish subsidiary that has been designated by the group’s parent entity to prepare and file in the Spanish Tax Agency the CbCR for the group (“surrogate entity”).

As an exception, entities under the above circumstances are not required to file the CbCR when the group has designated a “surrogate entity” to prepare and file it in a country other than Spain.

Additionally, Spanish entities that form part of a group required to file the CbCR need to notify the Spanish tax authorities providing the name and country/territory of residence of the entity designated to prepare and file the CbCR. This communication needs to be electronically submitted on an annual basis before the end of the financial year.

Article 14 of the Spanish CIT regulations details the information that needs to be included in the CbCR per country on an aggregate basis:

- the group’s gross revenues, distinguishing between revenues obtained with related or unrelated parties;
- earnings before CIT (or identical or similar tax);
- CIT effectively paid, including withholding taxes;
- CIT accrued, including withholding taxes;
- capital stock and retained earnings at the end of the fiscal year;
- average number of employees;
- tangible fixed assets and real estate investments (other than cash and credit rights);
- list of resident entities, including PEs, and the main activities carried out by each of them;
• any additional information deemed relevant, and if necessary, an explanation on the report information.

The CbCR information is required in Spain for tax years starting as of 1 January 2016, and must be submitted no later than 12 months following the end of the fiscal year to which it refers. The CbCR must be filed electronically.

No specific penalty regime has been included for not filing the CbCR.

Both the Spanish CIT regulations and the order implementing the CbCR obligation state that the purpose of the CbCR is to provide tax authorities with an instrument to evaluate potential risks in the TP policies of MNEs, but that in no case can it serve as a basis for the tax authorities to make pricing adjustments.

The Convention on Mutual Administrative Assistance in Tax Matters has been in force in Spain since 1 January 2013. Spain is also a signatory of the Multilateral Competent Authority Agreement to exchange financial account information.

2.5.2. Master and local files

The Spanish documentation requirements, established by Royal Decree 1793/2008, are aligned with the EU Transfer Pricing Forum’s Code of Conduct concepts, the master file and the local file.

The information requested must be available for the Spanish tax authorities at the conclusion of the voluntary period for filing the annual CIT return (for fiscal year ending 31 December 2016, the due date is 25 July 2017). The tax authorities may request documentation anytime after the taxpayer files the annual CIT return.

Additional comments with regard to TP documentation obligations:
• the CIT Law includes a general reference to proportionality and sufficiency principles in relation to the obligation to maintain TP documentation;
• the option to prepare simplified documentation for persons or entities with turnover below €45 million (not applicable under certain circumstances, i.e. intangibles);
• exceptions to TP documentation obligations (tax consolidated group, etc.).

In addition to TP documentation obligations, taxpayers in Spain must provide information on related party transactions by filing the CIT return (Form 200) which includes a section meant to report intra-group relationships and transactions.

2.5.3. Compliance costs

As a result of BEPS Action 13 a brand new documentation obligation has been introduced in Spain, the CbCR information.

There is no public information on the compliance costs that such documentation will entail for the MNEs. Preparing the CbCR for the first time requires not only IT tools to extract the accounting/financial information in a particular format, but also resources to set up the appropriate processes, interlock with the necessary functions to obtain the information requested, analyse the country-by-country information obtained, etc.

Compliance costs will probably be reduced for the following years, as long as CbCR becomes an ongoing process.
2.6. TP-related measures in other BEPS actions and other measures against BEPS

There have not been TP developments in Spain driven by any of the non-TP BEPS actions. There is, however, a strong linkage between TP actions and other actions such as Action 7 on artificial avoidance of PE status, Action 3 on CFCs, Action 2 on neutralizing the effects of hybrid mismatch arrangements, or even Action 14 on dispute resolution (which will be significantly affected by Actions 8–10 as well).

Spanish TP legislation has been inspired by the EU Joint Transfer Pricing Forum’s works as well as the OECD TP guidelines. There are no local TP measures that may be adopted multilaterally in the context of the BEPS project.

2.7. Can BEPS work in favour of MNEs?

As described by the name of the project, BEPS, the main purpose of the reports has been avoiding BEPS, meaning avoiding the tax authorities losing tax income as a result of a reduction in the tax collection caused by taxpayers artificially shifting their tax basis to other (low tax) jurisdictions.

In order to avoid BEPS, one course of action is increasing transparency, in favour of tax authorities, so that the tax authorities can ensure that no tax bases are being shifted.

In Spain, no measures have been adopted that are directly aimed at improving the tax transparency for the benefit of taxpayers.

Whether exchange of information mechanisms can be used in practice for the benefit of taxpayers is still to be determined. Some ways in which exchange mechanisms can potentially benefit taxpayers are:

- the tax authorities could obtain from foreign tax authorities information on intercompany transactions that simplify taxpayers’ obligations, during the course of an audit of TP documentation;
- the tax authorities may get the outcome of foreign APAs agreed by foreign tax authorities, in foreign jurisdictions, simplifying the TP discussion in a local APA or tax audit.

However, even if these actions were possible in practice, it is not clear whether they would mean a real benefit or advantage for taxpayers, which can always request such information from their related entities, probably in a less cumbersome way.

3. What is the future of BEPS?

BEPS has received a strong political support aimed at fighting against tax fraud. This political impetus has been key for the OECD achieving the BEPS works in a relatively limited period of time; hence the potential for BEPS to reshape TP rules is strong. It is expected that the final TP action plans will be implemented in the domestic law of many countries, either because their legislation already incorporates the OECD TP guidelines by reference or because they will implement the
final text and principles into domestic law by way of separate decrees, laws or circulars.

The future of TP in Spain overall is consistent with the BEPS project.

However, TP in Spain can go beyond BEPS, becoming a more challenging topic for the domestic tax authorities. There is an increasing focus on tax fraud and on TP, as the ONFI has published in its tax and control plan, issued annually and focused on areas pertaining to fraud control and prevention. In a number of tax audits, tax abuse and anti-avoidance rules are brought up by tax auditors early in the audit process. The tax authorities have publicly defended the need to disregard or recharacterize a transaction where the economic substance differs from its form or when the arrangements made differ from those which would have been adopted by independent parties, even when this is not clearly implemented in the domestic legislation.

Tax authorities and court decisions are starting to apply BEPS principles even to transactions that occurred before BEPS, and in some areas like PE, the tax authorities and tax courts interpret BEPS rules even more strictly than BEPS. This is triggering concern about the need for more legal certainty in the Spanish tax system.

Fortunately, the penalty regime for TP documentation that was implemented under the prior legislation has now been reviewed to make it softer.

As commented in the report, no significant changes in TP regulations are expected in the future that deviate from BEPS. Domestic TP legislation is expected to be interpreted consistently with the BEPS reports, which are soft law; however, in some areas we may expect legislation aimed at helping to implement some of the measures, probably consistent with BEPS and reducing uncertainty in certain areas.

Tax practice is expected to progressively adapt to the new BEPS recommendations and guidance in the different areas.
Summary and conclusions

The arm’s length principle was originally incorporated into the Swedish tax code in 1929 and has been amended several times. Its present wording in chapter 14 section 19 of the Swedish Income Tax Act (SITA) has been generally the same since 1965.

Swedish preparatory work and court cases from the Supreme Administrative Court refer to the OECD transfer pricing (TP) guidelines as a fair and well-balanced guidance without, however, giving them binding effect. These guidelines are thus normally applied in Sweden for interpreting the arm’s length principle in chapter 14 section 19 SITA.

With respect to the BEPS Action 13 report, Sweden has agreed to implement the new standard for TP documentation. Since the current Swedish legislation on TP documentation differs from Chapter V in the BEPS Action 13 report, the legislation must be amended before the changes to TP documentation can be implemented in Sweden. The Swedish government referred a proposal to the Council on Legislation on 19 October 2016 and the final government bill is expected to be presented at year end 2016 or early 2017.

The reception of stakeholders in Sweden of the TP outcomes of the BEPS project is varied. The legislator1 is of the view that the BEPS Actions 8–10 report represents a well-balanced compromise but that it is very important to monitor the outcomes and the work on arbitration that is carried out.

The Swedish Tax Agency (STA) is of the view that the BEPS Actions 8–10 report provides clearer guidance and a better methodology on how to apply the arm’s length principle and is implying that the BEPS Actions 8–10 report may be retroactively applied.

The academic community2 also states that it should be considered whether the Swedish domestic provisions should be amended in order to be able to fully imple-
ment the BEPS Actions 8–10 report since this stipulates principles that may not necessarily be acceptable under Swedish domestic law. The academic community also considers that the retroactive approach stated by the STA cannot be supported without demonstrating that the BEPS Actions 8–10 report interprets the arm’s length principle in a manner that is consistent with the previous version of the OECD TP guidelines.

The main concerns of the Swedish TP network (the views of about ten of the larger Swedish multinational companies (MNEs)) with the BEPS project can be grouped around five themes. The first theme is the business model complexity in the modern economy. A value chain can appear in many forms, as business models have evolved as a result of globalization and digitalization, which may be difficult for tax administrations to fully understand and their efforts to delineate a transaction and perform a risk allocation may be open to subjectivity and widespread interpretation. The second theme is that the administrative workload, at least initially, would be quite burdensome both in terms of time and money. The third concern is that a retroactive application of the BEPS Actions 8–10 report may clear the way for the arbitrary use of hindsight, with increased uncertainty and risk for taxpayers. The fourth theme is that a shift in principles will effectively move profit potential out of the country of the entrepreneur as risks and costs historically assumed by the entrepreneur may not be appropriately acknowledged “post BEPS”, as foreign tax administrations may potentially argue that the control of risk and important functions are performed elsewhere and that the benefits of the centralized model formerly in place may have shifted, without the legal entity in the other country having borne the corresponding costs related to those risks. The fifth concern is consequently that the BEPS project may lead to more disputes given the focus on substance and important functions performed, as tax administrations in different jurisdictions could interpret the commercial reality underpinning TP policies differently.

There are no specific rules in Swedish tax legislation regarding challenges of transactions with intangibles. Instead, the OECD TP guidelines in relevant parts are used for the interpretation of the Swedish arm’s length principle. However, an increased focus on the BEPS Actions 8–10 report with respect to the level of details surrounding how functions relate to the development, enhancement, maintenance, protection, and exploitation (DEMPE) of intangibles within the MNE group will in the reporters’ view create challenges for both the Swedish MNEs and the STA in terms of explaining where and how important business decisions are made in connection with the DEMPE functions and determining which part/parts of the DEMPE functions create the most value.

As regards hard-to-value intangibles (HTVI) the reporters have for almost a decade experienced some interesting developments, in that adjustment clauses have been applied in a number of situations by Swedish MNEs. The intention of an adjustment clause may have merits, as it is meant to provide comfort to the tax administration that the value is fair, as financial projections are often highly uncertain at the time of the transfer, but such clauses have proved difficult to apply in reality.

There are mixed reactions among Swedish stakeholders regarding the OECD’s work on profit splits in the context of value chains as part of the BEPS project. A common concern is that the transactional profit split, as formulated in the discus-
sion draft with the use of actual or anticipated profits, might be problematic to implement in practice.

In the reporters’ view it is very important that tax administrations and MNEs commonly act to promote an environment of cooperation and trust in order for the BEPS project to accomplish its objectives without jeopardizing international trade and growth. Also, for the BEPS project to reshape TP rules and practices around the globe, tax administrations must communicate and interact in a conclusive manner with other tax administrations and focus on jointly agreed principles. Both Swedish MNEs and the STA have positive experiences of multilateral controls where two (or more) tax administrations, together with the MNE, discuss TP issues during the audit. Many issues could be resolved during the audit in this way instead of by complicated and time-consuming mutual agreement procedure (MAP) processes.

1. Current TP regulation and practice in Sweden

The arm’s length principle was originally incorporated in the Swedish Tax Code in 1929 and has been amended several times, but its present wording has mainly been the same since 1965. The present wording is included in chapter 14 section 19 of the SITA and authorizes an increase in the taxable income of a Swedish associated company equal to the reduction of income resulting from cross-border transactions that are not at arm’s length. Chapter 14 section 20 defines when companies are associated. The sections have been drafted to reflect the arm’s length principle in article 9 in the OECD model.

The arm’s length principle has superiority (lex specialis) over the general rules in the SITA. According to case law (e.g. the Shell case from 1991) the STA bears the full burden of proof in TP cases. There are no specific TP penalties in Sweden; however, general penalty rules apply, with penalties ranging from 10 per cent to 40 per cent of the additional tax imposed. In TP cases, penalties at a rate of 40 per cent are generally imposed. A company may avoid penalties by providing a full open disclosure in its tax return. The statute of limitations on assessment of TP adjustment, as with any other tax adjustment, is six years from the end of the relevant financial year.

Swedish preparatory work and also the Shell cases from the Supreme Administrative Court, refer to the OECD TP guidelines as fair and well-balanced guidance without, however, giving them binding effect. It should be noted that the OECD TP guidelines are not statutory law, since tax legislation under the Constitution must be adopted by the Swedish Parliament. The Supreme Administrative Court also referred to these guidelines in a recent case on 7 June 2016. The OECD TP guidelines are thus normally applied in Sweden for interpreting the arm’s length principle in chapter 14 section 19 SITA.

3 Supreme Administrative Court, RÅ 2004 ref. 13 and RÅ 2006 ref. 37.
4 Supreme Administrative Court, RÅ 1991 ref. 107.
5 Government bill 2005/06:169 p. 89.
6 Supreme Administrative Court, RÅ 1991 ref. 107.
7 Supreme Administrative Court, HFD 2016 ref. 45.
On 1 January 2007 TP documentation requirements were adopted (chapter 39 section 15 and 16 of the Tax Procedure Act and chapter 9 section 9 of the Tax Procedure Ordinance Act). According to the government bill it was important that the Swedish documentation rules were drafted in accordance with international standards, i.e. the OECD TP guidelines. The documentation requirements are applicable for all companies registered in Sweden that conduct cross-border transactions with associated companies. However, the legislation does not include partnerships or permanent establishments (PEs). Also, companies entering into intra-group transactions of limited value can benefit from simplified documentation requirements. Transactions of limited value are defined as intra-group transactions of goods for a value of less than approximately 25 MSEK (630 “basic amounts”) per company within the group, and for other transactions, a value of less than approximately 5 MSEK (125 “basic amounts”) per company within the group. The simplified documentation requirements are, however, not applicable to the intra-group transfer of an intangible asset.

The Swedish legislation regarding what the documentation should contain only consists of five bullet points (chapter 9 section 9 in the Tax Procedure Ordinance Act) but states that further guidance could be issued by the STA. Thus, in connection with the introduction of the documentation requirements, a regulation was issued by the STA on 14 February 2007 and administrative guidelines were issued by the STA on 15 November 2007. TP documentation prepared in accordance with the EU code of conduct on transfer pricing documentation (EU TPD) fulfils the requirements in the regulation issued by the STA. There is no penalty charge for non-compliance with the TP documentation requirements in Sweden and the TP documentation only needs to be filed with the STA upon request during an audit or as part of a review. There is also no requirement to disclose any TP information with e.g. the annual corporate income tax return.

2. The impact of the BEPS project on TP

2.1. Introduction

2.1.1. STA

The overall reception, from the STA’s point of view, of the TP outcomes of the BEPS project is positive. The BEPS Actions 8–10 report provides clearer guidance and a better methodology on how to apply the arm’s length principle. The clearer guidance should lead to improved TP reviews and an outcome that better aligns with value creation. The burden of proof lies with the STA, although companies are liable to assist in the review. Clearer guidance and a better methodology provide Swedish companies, the STA and the Swedish Courts with a better framework in their respective tasks.

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8 Government bill 2005/06:169 p. 103.
9 SKVFS 2007:1.
10 SKV M 2007:25.
Chapter 14 section 19 SITA aims at incorporating the arm’s length principle into Swedish law and, as mentioned above, case law from the Supreme Administrative Court\textsuperscript{11} states that the OECD TP guidelines provide a good framework for the interpretation of the Swedish legislation.

As stated by the OECD, the BEPS project concluded that the arm’s length principle is still relevant and appropriate. However, the arm’s length principle has proved vulnerable to manipulation due to its perceived emphasis on the contractual allocation of functions, risks and assets. Since this manipulation of the arm’s length principle could lead to an outcome which did not correspond to value created in the underlying economic activities, the BEPS Actions 8–10 report included a revision of certain chapters of the OECD TP guidelines. The goal was to create a clearer framework with respect to what the arm’s length principle entails.

According to the OECD, the content of the BEPS Actions 8–10 report is consistent with the arm’s length principle. Therefore, the STA is of the view that the BEPS Actions 8–10 report can also be used for the interpretation of the Swedish legislation. In a recent court case from the Swedish Administrative Court of Appeal\textsuperscript{12} it was also stated that it is possible to use the BEPS Actions 8–10 report for the interpretation of the Swedish arm’s length principle also for previous years, as long as the BEPS Actions 8–10 report is consistent with the Swedish rule in chapter 14 section 19 SITA. To conclude, the STA is of the opinion that the BEPS Actions 8–10 report does not deviate from the arm’s length principle in chapter 14 section 19 SITA, implying that the report may be retrospectively applied.

With respect to the BEPS Action 13 report, Sweden has agreed to implement the new standard for TP documentation. Since the current Swedish legislation on TP documentation differs from chapter V in the BEPS Action 13 report, the legislation must be amended before the changes can be implemented in Sweden. Legislative work is under way.

\subsection*{2.1.2. Swedish TP network}

About ten of the larger Swedish MNEs active within different industries (transportation, banking, communication, consumer products, etc.) frequently meet to share experiences and to discuss various TP issues and best practice (hereafter referred to as the Swedish TP network).

A brief survey performed within this group in order to gather input for this report reveals that BEPS is considered a “double edged sword”. While the intention of the project, to create a clearer framework for international trade and to prevent aggressive tax planning and tax avoidance practices, is welcome, the new guidance may require further administrative tasks and increase the risk of double taxation, especially in relation to how to value and allocate intangibles and risks for TP purposes.

The main concerns discussed within the Swedish TP network may be grouped around five themes.

\footnotesize{\textsuperscript{11} Supreme Administrative Court, RÅ 1991 ref. 107 and HFD 2016 ref. 45.}

\footnotesize{\textsuperscript{12} Administrative Court of Appeal of Stockholm, 8 March 2016, case no. 9210-9214-14.}
2.1.2.1. Business model complexity in the modern economy

The modern economy is dynamic as a result of globalization, digitalization and the evolution of complex capital markets. Business models and value creation have accordingly evolved in unforeseen ways, which may be difficult for business people to grasp and most probably even more difficult for tax administrations to understand.

Even though the BEPS Actions 8–10 report is meant to provide clarification, a value chain can appear in many forms and genuine efforts to accurately delineate the transaction and to provide reliable evidence of arm’s length behaviour may be subjective in nature and be open to wide interpretation. Furthermore, risk allocation under the new rules will probably become a cumbersome task. Taxpayers are requested to identify and judge the impact of all economically significant risks and to determine which legal entity (in an operational structure without functions assigned to legal entities but to operational bodies) has the most control over a certain risk. There will most probably be elements of subjectivity in both steps.

The Swedish TP network hopes that tax administrations will appreciate that profitability and volatility may differ depending on the industry, time period and whether a centralized or decentralized TP policy has been implemented.

2.1.2.2. Administrative burden

The BEPS project will for most MNEs surveyed not result in material changes in how their global operations are structured but the administrative requirements may, at least initially, be quite burdensome both in terms of time and money.

Tax administrations should appreciate the efforts an MNE invests in describing its intra-group activities and understand that a global business is not only complex to operate, but sometimes also difficult to describe in the prescribed TP documentation format.

2.1.2.3. Use of hindsight

The STA’s opinion that the BEPS Actions 8–10 report is applicable with retroactive effect is surprising, even though this statement has been made by tax administrations in other countries as well. The Swedish TP network believes that the reference to the BEPS Actions 8–10 report for past periods may clear the way for the arbitrary use of hindsight with increased uncertainty and risk for taxpayers.

The perception of the Swedish TP network is that the STA’s interpretation does not coincide with the principle of legality, as non-retroactivity is virtually a worldwide standard that essentially means that criminal liability and punishment should be based only upon a prior enactment of a prohibition that is expressed with adequate precision and clarity, even though the BEPS Actions 8–10 report is not incorporated in tax law.

2.1.2.4. Shift in principles

While the BEPS Actions 8–10 report states that the contractual arrangements remain the starting point for a TP analysis, a more function-based allocation
mechanism may effectively move profit potential out of the country of the entrepreneur. Shifting focus to transaction related circumstances (as required to achieve proper risk allocation under the new rules), as opposed to evaluating the overall strategic structure and the importance of intangibles, is not expected to be beneficial for entrepreneurs based in Sweden in terms of more income being allocated to Sweden.

Tax systems were originally designed to tax assets based on their legal ownership and physical location, and funding and control have been key elements when determining the intra-group allocation of proceeds from intangibles and associated risk taking. Hence, the party that has funded the investment, controlled the activity and taken the financial risk has been the rightful legal and economic owner of the intangibles. This funding of contract research and marketing and distribution activities, often for decades, leading to the development of valuable intangible assets, has been based on the premise that these assets will generate profits in the country of the legal owner and funder over time.

With the approach described in the BEPS Actions 8–10 report on value creating functions, the question arises to what extent centralized TP models will be respected and whether risks and costs historically assumed by the entrepreneur will be appropriately acknowledged. If not, the legal entity that is now — “post BEPS” — identified as controlling the risk and performing important functions may reap the benefits of the centralized model formerly in place, without having borne the corresponding costs related to those risks.

2.1.2.5. More disputes

The BEPS project is likely to result in complex disputes given the focus on substance and important functions performed, as tax administrations in different jurisdictions could interpret the commercial reality underpinning TP policies differently. The Swedish TP network is already facing these challenges, as questions raised during current audits are clearly influenced by the BEPS project. Further, taxpayers face requests to provide answers and documentation prepared in line with the new guidance in the BEPS Actions 8–10 report within a short period of time.

Given the political focus on BEPS and governments’ expectations of increased taxes due to the BEPS project, the Swedish TP network fears that tax administrations may even potentially misuse the project as an opportunity to increase the local tax base. The impression is that sometimes the tax administrations’ approach during audits and in bilateral disputes is not primarily about ensuring that taxes paid are fair and reasonably distributed between the related parties, i.e. at arm’s length, but rather about expanding the tax base and improving the (fiscal) statistics in the tax administration’s jurisdiction. The Swedish TP network experience is that such an approach increases both the number of disputes and the difficulty of reaching a bilateral agreement to avoid double taxation.

2.1.3. Academic community

The view of the academic community is that any TP analysis should start by considering whether the guidance provided by the OECD is applicable under Swedish
domestic law, given the usefulness of the OECD TP guidelines and, at the same
time, the need to enforce the principle of legality. Therefore, it seems appropriate
to consider whether the Swedish domestic provisions should be amended in order
to be able to fully implement the BEPS Actions 8–10 report. In the lack of amend-
ment to the domestic arm’s length rule, the academic community expresses doubts
on the possibility of applying the BEPS Actions 8–10 report retroactively, given
that the report stipulates principles that may not necessarily be acceptable under
Swedish domestic law.

The academic community also considers, apart from the Swedish domestic pro-
visions, that the retroactive approach cannot be supported without demonstrating
that the BEPS Actions 8–10 report interprets the arm’s length principle in a manner
that is consistent with the previous version of the OECD TP guidelines. This may
be challenging to prove, as the BEPS report introduces certain new principles, for
example when it comes to the ex post valuation of HTVI at paragraph 6.192 in the
report. Also, the revised guidance on chapter I created some inconsistencies with
the former chapter IX, something that argues against a general retroactive applica-
tion of the BEPS Actions 8–10 report.

The academic community is critical of the combination of increased subjectiv-
ity in the report with the lack of commitment to broadly implement binding manda-
tory arbitration. The trend observed in recent Swedish treaties to implement
arbitration (in the treaties with Japan, Switzerland, the UK, and Armenia) is found
to be positive and it is hoped that future treaties will continue to implement arbitra-
tion provisions.

2.1.4. Legislators

The BEPS project has a major impact on the area of TP and is therefore very
important for a country like Sweden with many MNEs. Sweden has therefore
devoted a lot of resources to the work on the BEPS Actions 8–10 report. The new
approach represents a well-balanced compromise, taking into consideration the
situation of small open economies, and is a response to unilateral measures that
have created double taxation. The outcomes of the report give new instruments
to tackle BEPS, for example in relation to cash boxes, which is very positive. It
is essential that the arm’s length principle has been preserved and that clearer
guidance on the application of that principle has been elaborated. It will, how-
ever, be very important to monitor the outcomes to ensure that the new guidance is
applied appropriately. Further, it will be crucial that the work on arbitration is
carried on.

2.2. Challenges of transactions with intangibles

2.2.1. Definition of intangibles

There is no definition of intangibles for TP purposes in Swedish tax legislation
since Sweden uses the OECD TP guidelines in relevant parts as guidance on how
to interpret the Swedish arm’s length rule.
2.2.2. Transactions with intangibles

There are no specific rules for the recognition of transactions involving intangible assets in Swedish tax legislation since Sweden uses the OECD TP guidelines in relevant parts as guidance on how to interpret the Swedish arm’s length rule.

2.2.3. “Substance-over-form” approach towards intangibles

In Sweden, TP analyses by the STA of transactions involving intangibles are based on a substance-oriented analysis. This ensures that the TP outcome is in line with value creation and that income is not improperly shifted to other locations by intra-group contractual arrangements alone. The substance-oriented analysis also embodies the concepts of “economic substance” and “control over risk” already incorporated in the OECD TP guidelines (see paragraphs 1.48, 1.65 and 9.22).

The Swedish courts have historically been inclined to take a formalistic, or legalistic, approach to TP cases. There are multiple cases where the courts have taken such an approach (e.g. the Michelin case).¹³ In the BEPS Actions 8–10 report, however, it is very clear that the contract is the starting point but that the conduct is the most important, i.e. conduct over contract. Accordingly, it remains to be seen whether and how the Swedish courts will adjust their approach and apply a less formalistic view in future TP cases to ensure alignment with the BEPS report.

In the reporters’ view, an increased focus on the BEPS Actions 8–10 report with respect to the level of detail surrounding how functions relate to the DEMPE within the MNE group will create challenges for both Swedish MNEs and the STA. MNEs are expected to produce a detailed description of where and how important business decisions are made to elucidate how group entities handle risk. Furthermore, a description of the intangible assets and value-creating functions within an MNE and their impact on profit/loss allocation among the group entities shall be part of the new TP documentation standard. For the STA the challenge would be, based on the MNE’s documentation, to draw its own independent conclusion about the relative importance between the DEMPE function(s) in each specific case.

Even though the OECD has expressed the view that arrangements should not be disregarded by a tax administration when internal agreements mirror the actual behaviour and functional profile of the parties, the Swedish TP network is concerned about the anticipated level of detail required and potential undesired consequences in the practical application and analysis.

One topic discussed within the Swedish TP network is therefore whether efforts should be made to amend existing pre-BEPS documentation describing how intangibles are exploited and assigned within the group to abide by the new guidance in the BEPS Actions 8–10 report on DEMPE functions. This would be done as a preemptive measure in case of future TP audits or reviews based on the BEPS report.

Even though the approach by business should naturally be to behave “as if independent” the Swedish TP network is concerned about how tax administrations

¹³ Administrative Court of Appeal of Stockholm, case no. 2400-2404-11.
evaluate the notion that the intra-group arrangement of a transaction involving intangibles may not completely mirror the relationship between two independent parties. Two (or more) entities that are part of a group usually have an element of “internal trust” built into the relationship which differs from that between external parties and rather than regulating their interactions by way of legal agreements and similar contractual arrangements, the cooperation is guided by internal policies and governance structures as well as operational hierarchies and ownership structures. Decisions are typically aligned with this framework, but may not be documented on a decision-by-decision basis.

The centralized model, which naturally leads to surpluses and deficits arising in the entrepreneurial entity in light of intangible property (IP) ownership and risk, is quite common among larger Swedish MNE groups and was already being implemented by some in the 1990s.

An MNE group, whether based in Sweden or elsewhere, can have very complex value chains, naturally depending on the type of business activity and whether the group has expanded through organic growth or acquisitions. It may not always be feasible to identify an arm’s length price at the transactional level or to separate risk and IP into specific types of groups and benchmark with sufficient comparability. Parts, components, services, IP rights, etc. are sourced on a global market and transactions occur both with internal and external parties, but are often not sufficiently comparable.

Strategic decisions, funding, governance and control have historically been decisive when establishing the allocation of proceeds throughout the value chain and deciding who should be the rightful owner of the intangibles from a tax perspective. Swedish companies have in some cases taken the consequences of their centralized models in the form of large losses in Sweden, especially during the 2008/2009 financial crisis, assuming that this over time would generate benefits and income.

Since the BEPS Actions 8–10 report provides tax administrations with more tools to make a detailed TP analysis, which may lead to income adjustments, the Swedish TP network would appreciate it if practical guidance could be provided on self-rectification and documentation issues as the BEPS Actions 8–10 report in Sweden will, according to the STA, have both retroactive and prospective effect.

2.2.4. Comparability and group synergies

There are no specific rules in Swedish legislation that provide a mechanism to identify group synergies in the application of the TP rules since the OECD TP guidelines in relevant parts are used as guidance on how to interpret the Swedish arm’s length rule.

2.2.5. HTVI

No specific measures to improve the valuation of HTVI have been adopted in Sweden since the OECD TP guidelines in relevant parts are used as guidance on how to interpret the Swedish arm’s length rule.

The BEPS Actions 8–10 report with specific guidance on HTVI enables tax administrations to use ex post evidence of financial outcomes of an intangible
transaction as presumptive evidence of the appropriateness of the arrangement. In practice, however, while not a consequence of the report per se, the reporters have for almost a decade experienced some interesting developments in that adjustment clauses have been applied in a number of situations by Swedish MNEs when transferring intangible assets or important functions or risks to Sweden as part of a restructuring. The intention with the adjustment clause in these cases has been to mitigate the negative effects of information asymmetry between tax administrations and the taxpayer due to the fact that financial projections are often highly uncertain at the time of the transfer and reliable comparisons are not available.

Any reorganization is, of course, unique in itself and a complex process that often involves a number of changes that occur over a period of time. When a company becomes part of a new group it may be stripped of strategic decision making processes, functions, risks and assets and is perhaps also ultimately converted into a contract service provider. It is further often concluded that comparable uncontrolled transactions that can be used to determine the arm’s length compensation for the restructuring itself cannot be identified.\(^{14}\)

Hence, when defining arm’s length compensation for a restructuring it is important to take into account the options realistically available, and the particular facts and circumstances of the case. Similar to external acquisitions, the compensation of the restructuring is often determined by using a discounted cash flow valuation technique, in which the net present value of future expected cash flows is calculated.

The mechanism should take both the perspective of the seller (that expects to be paid a minimum payment to compensate for the loss or reduction of profits due to the transfer and any closure and restructuring costs) and the buyer (that would expect to make a maximum payment that is equivalent to the increase in profit potential due to the transfer) into consideration.

In this respect, no restructured entity, from a quantitative viewpoint, would agree to participate in the restructuring if the “to be” scenario would have a net present value lower than the “as is” state, and the value of the restructuring must at least compensate for the loss of future expected earnings to ensure that the restructured entity is not financially worse off than under its next best option.

However, the only thing certain about a forecast is that it is uncertain and that it often deviates from actual figures. To mitigate this risk, and in case of such a deviation in reality, the adjustment clause therefore determines (a) that a new valuation is to be performed after a pre-defined period of time (often five years) based on actual results and (b) that the restructuring compensation (the stipulated value) is to be adjusted accordingly (upward or downward) if the new value is outside a pre-defined range to safeguard the parties against the uncertainty in the original forecast. Typically, the adjustment clause further provides that if the actual value is within a certain percentage (often 5 per cent to 20 per cent up or down) from

\(^{14}\) The OECD TP guidelines stipulate that a business restructuring may involve “cross-border transfers of something of value, e.g. of valuable intangibles, although this is not always the case. It may also or alternatively involve the termination or substantial renegotiation of existing arrangements, e.g. manufacturing arrangements, distribution arrangements, licenses, service agreements, etc.” and that such transfers or contractual changes must be compensated on an arm’s length basis.
the stipulated value, applying the same valuation methodology, no adjustment is required.

In the reporters’ view, while the intention of an adjustment clause may have merits in that it is meant to provide comfort to the respective tax administration that the value will (in the end) be fair, the approach merely delays the decision regarding appropriate value and it has proved difficult to apply in reality as it adds an additional layer of uncertainty and documentation requirements for the taxpayer. Even though an adjustment clause could be difficult to apply in reality, the STA is of the view that since adjustment clauses in various forms can be seen in practice in agreements between independent companies it could also be a valuable tool in order to achieve an arm’s length price for associated companies.

2.2.6. Cost contribution agreements (CCAs)

Sweden uses the OECD TP guidelines in relevant parts as guidance on how to interpret the Swedish arm’s length rule, which is why no regulations as regards to CCAs, to the reporters’ knowledge, will be implemented. The BEPS Actions 8–10 report has provided the STA and Swedish companies with further directions on how to analyse and deal with CCAs.

The concept of mutual benefit is fundamental to a CCA and a party must have a reasonable expectation of benefit from the CCA activity to qualify as a participant. Accordingly, the analysis must consider not only the contractual terms of the CCA but also the parties’ actual business circumstances to determine the true CCA participants. As a result of the BEPS report, it is the reporters’ view that the STA will probably examine the parties’ actual conduct and circumstances in even more detail going forward, especially regarding control over risk.

The OECD TP guidelines, paragraph 8.15, noted that “countries have experience both with the use of costs and with the use of market prices for the purposes of measuring the value of contributions to arm’s length CCAs”. The section also mentioned that “the questions must be resolved on a case-by-case basis”. In the reporters’ view, the STA has in a similar spirit historically not demonstrated a clear preference for the use of costs or the use of market prices and has generally evaluated the arm’s length nature of CCAs based on the circumstances of each specific case. In the BEPS Actions 8–10 report, the OECD clarified that contributions should generally be assessed at value (i.e. based on arm’s length prices) rather than at cost and should be properly related to the relative benefit for the participants. In the STA’s view, costs may only be accepted when all contributions are low-value services since the outcome will be broadly similar (as illustrated mathematically by one of the examples provided by the OECD in BEPS Actions 8–10 report chapter VIII).

2.3. Risk and capital

Sweden uses the OECD TP guidelines in relevant parts as guidance on how to interpret the Swedish arm’s length rule, which is why Sweden will not adopt any TP regulations aligned with the BEPS Actions 8–10 report to control the return on capital or the compensation for the assumption of risk.
2.4. High-risk transactions

2.4.1. Comparable uncontrolled price (CUP) and quoted prices for cross-border commodity transactions

Swedish companies within the commodity industry, mainly companies within the forestry industry and iron ore industry, have according to the reporters’ experience normally used the CUP method and referred to a quoted price on the transaction date. The BEPS Actions 8–10 report states that when the taxpayer can provide “reliable evidence” of the actual pricing date agreed between the associated parties, then tax administrations should take that date as reference; if not, the tax administration may set the pricing date for the commodity transaction on the basis of other evidence available to them.

Since, in the reporters’ experience, Swedish companies usually provide well-prepared documentation of the pricing date for commodity transactions, the BEPS Actions 8–10 report does in not in their view change the approach towards commodity transactions in Sweden and they believe that the “deemed pricing date” will not be used that often by the STA. However, additional clarification as to the meaning of “reliable evidence” would be welcomed.

2.4.2. Intra-group services

In the reporters’ opinion the general view on intra-group service charges is not expected to change in Sweden as a result of the BEPS project since the BEPS Actions 8–10 report on intra-group services is based on the same concepts as the OECD TP guidelines. For example, key issues to consider are whether a service has been rendered and, if so, what is an arm’s length charge. Scrutiny of intra-group service charges is likely to persist, but with increased clarity and consistency based on the enhanced guidance prepared by the OECD as part of the BEPS project.

It is, however, important to note that in the BEPS Actions 8–10 report, the OECD introduces an elective, simplified approach for low value-adding services. This approach involves a moderated benefits test and a “safe harbour” mark-up of 5 per cent that does not need to be justified by a benchmarking study. The OECD encourages countries to endorse the applicability of the simplified approach before 2018. Sweden is expected to endorse the simplified approach right away since Sweden applies the OECD TP guidelines in relevant parts as guidance for Swedish statutory legislation. Furthermore, countries are able to include a threshold. Where the threshold is exceeded the tax administration would not be obliged to accept the simplified approach, but instead could require a full functional and comparability analysis. The reporters do not expect that such a threshold will be implemented in Sweden.

The simplified approach is expected to somewhat reduce the administrative burden for MNEs on providing sufficient documentation on intra-group services. For example, MNEs may apply and refer to the safe harbour mark-up instead of preparing a benchmarking study. According to OECD, the simplified approach also
allows tax administrations to free up resources. In this way, they may focus their efforts on identifying and examining TP cases where the risk of encountering BEPS issues is more substantial. In the reporters’ experience, the simplified approach somewhat resembles the conduct already demonstrated by the STA. Swedish companies have occasionally referred to the EU JTPF document on low value-adding services from 2010 as indicative support for their mark-up percentage. The STA has usually accepted this reference where the service fees have been limited and it has been obvious that a benchmarking study would not have yielded a different result.

As noted by the OECD, nearly every MNE group must arrange for a wide scope of services to be available to its members. Since intra-group services occur in most MNE groups it is not surprising that the pricing of such services often comes under scrutiny in TP audits. This has been the case in the past and this will probably continue in the future. A glance at recent Swedish court cases reveals that the various aspects of MNE groups’ service charges, e.g. the mark-up, have been questioned. In one court case\textsuperscript{15} a Swedish taxpayer had charged services at cost. The STA reasoned that a mark-up should have been applied to grant the companies a profit incentive for their activities. In another court case,\textsuperscript{16} the taxpayer had applied a mark-up but the STA argued that the mark-up was too low considering the high value-adding of the services.

2.4.3. Profit splits in the context of value chains

Sweden uses the OECD TP guidelines in relevant parts as guidance on how to interpret the Swedish arm’s length rule and will thus not adopt any special rules or any sort of profit split mechanism in Swedish legislation.

There are mixed reactions among Swedish stakeholders regarding the OECD’s work on profit splits in the context of value chains as part of the BEPS project. A common concern is that the transactional profit split, as formulated in the discussion draft (published 4 July 2016), with the use of actual or anticipated profits, might be problematic to implement in practice.

The appropriate use of a profit split requires the existence of a specific commercial relationship between the parties, and the absence of comparables alone should not justify the decision for selecting the profit split method. Hence, the difficulties in applying the profit split method in practice should not be underestimated, in particular since businesses’ operating models tend to increase in complexity and with a degree of integration at many levels that does not exist between unrelated parties, while not necessarily affecting the intra-group pricing.

Both the Swedish TP network and the STA see a challenge in the practical and uniform implementation and interpretation at a worldwide level of profit (or loss) splits by tax administrations and companies, where different approaches would lead to an increased risk of disputes and double taxation.

\textsuperscript{15} Administrative Court of Appeal of Gothenburg, case no. 1737-1738-11.

\textsuperscript{16} Administrative Court of Appeal of Gothenburg, case no. 1168-14.
2.5. TP documentation

2.5.1. Introduction

Upon request from the Swedish government, the STA prepared and presented a proposal on 25 April 2016 on a new TP documentation standard. Since consistent implementation is essential according to the OECD, the proposal is based on the BEPS Action 13 report but also considers the amended EU Directive (2011/16/EU) regarding the implementation of the OECD standard for country-by-country reporting (CbCR) in EU law (DAC 4).

The proposal consists of both new legislation and new chapters and amended sections in existing legislation. On 19 October 2016 the Swedish government referred a proposal to the Council on Legislation (the proposal). The government bill is expected to be presented at year end 2016 or early 2017.

The proposal from the Swedish government is very similar to the STA’s proposal with the main difference being that the STA suggested that the new documentation standard should enter into force on 1 January 2017 while it is stated in the proposal from the Swedish government that the new documentation standard should enter into force on 1 April 2017.

2.5.2. CbCR

Even though the new documentation standard is proposed to enter into force on 1 April 2017, CbCR is proposed to be filed for the first time for financial (“reporting”) years starting after 31 December 2015. The report is to be filed with the STA within 12 months after year end of the reporting year. No late filing penalties or other penalties to encourage compliance have been proposed. However, the existing Swedish regulation\(^\text{17}\) that allows the STA to enforce filing should be applicable. In exceptional cases penalties could be levied under these rules.

One of the main purposes with CbCR according to BEPS Action 13 report is to provide helpful information for high-level TP risk assessment. CbCR should not be used as a substitute for a detailed TP analysis of individual transactions. Consequently, in the proposal it is stated that it should be included in the Swedish legislation that CbCR on its own should not constitute conclusive evidence that transfer prices are or are not appropriate.

In line with the BEPS Action 13 report only MNEs with annual consolidated group revenue equal to or exceeding 7 billion SEK (approximately €750 million) in the financial year prior to the reporting year is obliged to file a CbCR.

The STA has estimated that up to 100 Swedish parent companies and surrogate parent companies are obliged to file CbCR and that approximately 3000 to 4000 Swedish subsidiaries belong to a group where the ultimate parent company is obliged to file a CbCR in its country of residence, which is to be exchanged via the automatic exchange system.

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\(^{17}\) The Penalty of Fine Act 1985:206
The Convention on Mutual Administrative Assistance in Tax Matters had entered into force in 1995 and the Multilateral Competent Authority Agreement on the Exchange of CbCR was signed on 27 January 2016. New legislation and a regulation have been proposed that refer to the competent authority agreement and the amended EU Directive 2011/16/EU and the Swedish competent authority, i.e. the STA, will exchange CbCR accordingly. It is also stated in the proposal for legislation regarding automatic exchange of CbCR that the legislation will also be applicable to any future bilateral agreements between the Swedish competent authority and other competent authorities regarding exchange of CbCR.

All Swedish companies within an MNE group obliged to file CbCR should inform the STA if they are an ultimate parent company, a surrogate parent company or otherwise which company, including residence of the company, within the group is obliged to file the CbCR. The information about filing should be received by the STA prior to the end of the reporting year except for reporting year 2016 where the information should be received on 31 March 2017 at the latest. If there is a systemic failure regarding the exchange of CbCR the STA is allowed to request CbCR from the Swedish subsidiary if the STA informs the Swedish subsidiary about the systemic failure in advance. There is no further information in the proposal on how far in advance the STA should inform the Swedish subsidiary.

The information to be included in CbCR is proposed to be listed in chapter 33a section 9 in the Tax Procedure Act and corresponds to the information listed in Tables 1 and 2 of annex III to chapter V in the BEPS Action 13 report. It is stated in the proposal that since CbCR should be exchanged between different countries it is important that it has a similar format. Accordingly, it is proposed that chapter 38 section 1 in the Tax Procedure Act stipulates that CbCR should be filed on a specific form. The specific form will be completed by the STA during 2017. It is expected, however, that the specific form will be similar to annex III to chapter V in the BEPS Action 13 report.

The proposal gives short explanations regarding some of the information listed but it is stated that since the information to be included in the CbCR should be the same worldwide there is no need to include additional information in the Swedish legislation in addition to the comments made by the OECD in the BEPS Action 13 report. It is further stated in the Swedish proposal that if the definition of any of the information to be included in the CbCR seems to be unclear, any lack of clarity will be analysed by the OECD in connection with the review of the new TP documentation standard 2020.

The proposal states that it is possible to include the CbCR in the existing Swedish legislation regarding confidentiality.

2.5.3. Master and local files

As mentioned above, the master file and local file concept is proposed to be applicable on financial (“reporting”) years beginning on or after 1 April 2017. This means that Swedish companies with the calendar year as their financial year will remain under the current Swedish TP documentation rules for 2017. The local file is proposed to be completed no later than the deadline for filing the Swedish corporate income tax return (which, according to the main rule, is six months after the end of the financial year). The master file is proposed to be com-
pleted at the latest when the parent company in the group files its corporate income tax return. The master file and local file should according to the proposal be filed with the STA upon request, i.e. in connection with a review or an audit. No penalty regime to encourage compliance has been proposed.

The master file and the local file could according to the proposal be prepared in Swedish, Danish, Norwegian or English.

According to the proposed chapter 39 section 16 in the Tax Procedure Act companies that are requested to prepare a master file and a local file are: Swedish companies, Swedish companies with a foreign PE, Swedish partnerships, Swedish partnerships with a foreign PE and foreign companies with a PE in Sweden. Neither Swedish partnerships nor PEs have been obliged to prepare any TP documentation under the current Swedish rules and if the date of enforcement of the new legislation will be 1 April 2017, these companies (if they have calendar year as financial year) are obliged to prepare a master file and local file according to the Swedish legislation for the first time as regards to financial year 2018.

As recommended in the BEPS Action 13 report it is proposed that small- and medium-sized enterprises (SMEs) are exempt from the TP documentation requirements. The Swedish SME definition is in line with the EU recommendation 2003/361. Accordingly, if a group of companies has fewer than 250 employees and either less than 450 MSEK (€50 million) in turnover or less than 400 MSEK (€43 million) in balance sheet total the year prior to the reporting year, the group is exempt from the Swedish documentation requirements.

In line with the BEPS Action 13 report it is also proposed that intra-group transactions that are immaterial do not need to be included in the local file. Immaterial always means intra-group transactions with one associated company not exceeding 5 MSEK in market value during the reporting year. The materiality threshold is, however, not applicable if the intra-group transaction involves IP, unless the IP is immaterial for the company’s whole business as such.

The content of the master file and local file is in line with the BEPS Action 13 report. Consequently, annexes I and II to chapter V regarding what information the master file and local file should contain have been translated into Swedish and are proposed to be included in chapter 9 in the Tax Procedure Ordinance Act.

2.5.4. Compliance costs

In the proposal regarding TP documentation, the impact on compliance and its cost for MNEs in Sweden has been considered but not analysed in detail. For Swedish SMEs the compliance burden will, however, decrease significantly since the current Swedish TP documentation legislation has no exception for SMEs. It is stated in the proposal that the reason for the proposed exception is that the benefit for the STA in receiving TP documentation in connection with a review or an audit of an SME is less than the burden for an SME to prepare TP documentation and to keep it updated every year. However, since the TP documentation legislation is proposed to apply to financial years beginning on or after 1 April 2017 an SME with calendar year as financial year is obliged to prepare TP documentation under the current Swedish TP documentation rules for 2017.

As regards the master file and the local file concept it is stated in the proposal that at first glance it seems that the compliance burden will increase since the guidance
in the BEPS Action 13 report regarding what the master file and local file should contain is much more detailed than the previous guidance. The Swedish government is, however, of the view that the compliance burden will not increase since the guidance is clearer than the existing Swedish TP documentation legislation.

It is further stated that since the master file should be the same for the whole group of companies it is one company (normally the parent company) that prepares the master file which means that the compliance burden for other companies within the group should decrease.

The compliance burden for preparing the local file will decrease since intra-group transactions that are immaterial for the specific business do not need to be included in the documentation. In addition, it is stated in the proposal that similar documentation rules already exist worldwide and therefore the preparation of the local file should not increase the compliance costs over what they are today.

The Swedish government recognizes, however, that the proposed Swedish TP documentation legislation will increase the compliance burden for Swedish partnerships, Swedish companies and partnerships with a PE abroad and foreign companies with a PE in Sweden, since the existing TP documentation requirements currently exclude such entities.

Please note, however, that since the new legislation regarding the master file and local file concept is proposed to apply to financial years starting on 1 April 2017 or later, companies with the calendar year as their financial year are not obliged to prepare a master file and local file in Sweden until financial year 2018. This would mean that e.g. Swedish partnerships and foreign companies with a PE in Sweden are not obliged to prepare any TP documentation at all in Sweden until 2018.

The Swedish government estimated the total compliance costs in Sweden when the current Swedish TP documentation legislation entered into force 2007. It was at that time estimated that the preparation of the TP documentation would take approximately 32 hours at a salary cost of 477 SEK/h. Since it was estimated that 20,000 Swedish companies would be obliged to prepare TP documentation the total compliance cost was estimated to approximately 305 MSEK. It is stated in the proposal that the preparation time for the master file and local file should be estimated at approximately 32–40 hours as well. In order to be able to compare the compliance cost with the current Swedish TP documentation the salary cost of 477 SEK/h was kept. It is estimated that approximately 3,820 Swedish companies will be obliged to prepare a master file and local file in Sweden and that the total compliance cost should thus be between 58 and 73 MSEK. In the reporters’ experience both the preparation time and the hourly costs appear to be significantly underestimated in the proposal.

The preparation of CbCR will naturally increase the compliance burden for Swedish MNEs, since this is a new concept. However, it is stated in the proposal that the information to be included in CbCR is most probably already collected by the parent company for other purposes. The Swedish government states in the proposal that the Swedish legislation regarding CbCR is proposed to be as similar to the agreed legislation in the BEPS Action 13 report as possible. It is also stated in the proposal that the compliance burden will differ between Swedish MNEs depending on e.g. IT systems and whether the information is already collected or not.
In order to estimate the compliance costs for the preparation of CbCR it is stated in the proposal that if the preparation time and the salary cost per hour is approximately the same as for a master file and local file (i.e. 32 hours at 477 SEK/h) and approximately 75 Swedish parent companies will prepare the report, the total compliance cost would be approximately 1 MSEK, which the Swedish government considers to be relatively negligible. In the reporters’ view the estimated compliance costs for CbCR will also be significantly higher than in the proposal, especially in the initial year of implementation.

CbCR is intended to be a standardized risk assessment tool designed to give tax administrations unprecedented insight and information into an organization’s global tax footprint, but it will not present relevant information if read separately from a master file and a local file. Accordingly, the Swedish TP network is concerned that tax administrations equipped with the CbCR will feel empowered to challenge an organization’s tax arrangements, based only on assumptions gathered from the CbCR itself. As stated in the BEPS Action 13 report and also in the Swedish proposal for legislation, the Swedish TP network emphasizes that it is important that tax administrations use the information prudently and put it in the right context and that the CbCR is not foremost used as the main source of information when contemplating a TP adjustment.

The Swedish TP network’s main concern is therefore not only that the new reporting requirements will lead to a significant increase in the compliance burden and the related costs, but also to increased costs for explaining and defending applied TP models and internal pricing in future audits due to the new documentation standard. Further, as some countries still demand that the documentation is filed in the local language with short deadlines, it will be a cumbersome task to meet these requirements and there is a risk that the documentation will be incomplete, with documentation penalties and arbitrary adjustments as a consequence.

2.6. TP-related measures in other BEPS actions and other measures against BEPS

One of the other BEPS actions that could have the most effect on MNEs’ tax models, including TP, is the BEPS Action 7 report regarding PEs. In the reporters’ view the lowered PE threshold in the OECD model will increase the number of situations where a PE is created, while few or no additional taxable profits should be allocated to the PE, because no significant people functions are performed by the PE. However, the increased number of deemed PEs will increase the compliance burden for both MNEs and tax administrations worldwide.

The Swedish PE definition is stated in chapter 2 section 29 SITA. The Swedish definition is based on article 5 in the OECD model but does not contain the exemptions listed in article 5.4 in the OECD model. Since Sweden has a dual system for international treaties (the tax treaty needs to be implemented into domestic law) the Swedish legislation needs to be amended in order for the BEPS Action 7 report to have effect in Sweden. The reporters do not expect that the Swedish PE definition will be amended within the near future. The discussion in Sweden has been that there is no need to create additional PEs in Sweden to which few or no additional taxable profits could be allocated anyway.
Furthermore, the reporters expect that the Swedish government is currently analysing whether Sweden should introduce mandatory disclosure rules for tax advisers (i.e. similar to the BEPS Action 12 report) on tax planning strategies. Such mandatory disclosure rules would increase the transparency of the MNEs’ tax models, including TP, towards the STA.

In addition, the EU’s Anti-Tax Avoidance Directive was adopted on 21 June and three out of five action points are similar to the BEPS action points. These three action points in the EU directive reflect BEPS Action 2 (hybrid entities), Action 3 (controlled foreign companies (CFCs)) and Action 4 (interest deduction limitation rules). The EU Member States are obliged to implement domestic legislation that is consistent with the EU directive if their existing domestic legislation is not already in line with the directive.

Sweden introduced CFC legislation in 1990 (amended 2004 and 2008 in accordance with the EU case Cadbury Schweppes) and interest deduction limitation rules between affiliated companies in 2009 (amended 2013). According to the interest deduction limitation rules a deduction will be denied if the interest is taxed below 10 per cent in the hands of the receiver, and if the payer or its affiliated group does not have sufficient business reasons to take up the loan. The existence of hybrid mismatch arrangements is included in the many facts to be considered when deciding on granting or disallowing a deduction. Sweden has also incorporated the hybrid rule in the EU Parent–Subsidiary Directive into Swedish legislation with effect from 1 January 2016. According to chapter 24 section 19 SITA dividends received from foreign companies are exempt only if the payment is not deducted by the distributing foreign company. Aside from this, Sweden does not have any specific rules targeting hybrid situations.

It is not expected that the Swedish government will amend the existing Swedish CFC legislation, since it is similar to the rules explained in the EU’s Anti-Tax Avoidance Directive. The reporters do, however, expect the Swedish government to introduce legislation for hybrid mismatch arrangements and amend the existing interest deduction limitation rules, in accordance with the EU directive and probably influenced by the BEPS recommendations, which would have an effect on MNEs’ tax models and TP structure.

2.7. Can BEPS work in favour of MNEs?

As far as the reporters know, there has been no initiative in Sweden to use the BEPS platform to provide MNEs with information that is in the possession of other countries that are necessary for MNEs’ domestic compliance.

That said, the EU has proposed a mandatory public CbCR (amending EU Accounting Directive (Directive 2013/34/EU)) which in the reporters’ view can be seen as an initiative to make information that is in the possession of MNEs and other countries public.

The EU Commission states\(^\text{18}\) that MNE groups should annually publish a report disclosing the profit and the tax accrued and paid in each Member State on

\(^{18}\) European Commission, Commission Staff Working Document assessing the potential for further transparency on income tax information accompanying the document Proposal for a Directive
a country-by-country basis. Information such as turnover, number of employees and nature of activities will have to be disclosed for every EU country in which a company is active, as well as for those tax jurisdictions that do not abide by tax good governance standards (i.e. tax havens). Aggregate figures will also have to be provided for operations in other tax jurisdictions in the rest of the world. The report should be filed with the relevant business register and made available on the company’s website for five years.

3. What is the future of TP?

In the reporters’ view it is very important that tax administrations and MNEs commonly act to promote an environment of cooperation and trust in order for the BEPS project to accomplish its objectives without jeopardizing international trade and growth. Also, for the BEPS project to reshape TP rules and practices around the globe, tax administrations must communicate and interact in a conclusive manner with other tax administrations and focus on jointly agreed principles.

The reporters see a risk of additional disputes if different tax administrations prepare different local guidance both with regard to the BEPS Actions 8–10 report and the BEPS Action 13 report. With regard to the BEPS Action 13 report it is important that any lack of clarity is highlighted and analysed by the OECD in connection with the review of the new TP documentation standard 2020. It is important that companies and tax administrations focus on jointly agreed principles and devote sufficient and appropriate resources to attempt to resolve cross-border TP disputes within a reasonable amount of time.

There is an EU-financed project within the European Union called Fiscalis 2020 with the aim of promoting cooperation (e.g. joint audits, multilateral controls (MLCs), seminars, workshops and working visits, etc.) between tax administrations within the EU Member States. A formal joint audit is not possible according to current Swedish law but both the STA and Swedish MNEs have positive experiences from MLCs where two (or more) tax administrations, together with the MNE, discuss TP issues already during the audit of the MNE. The main difference between a joint audit and an MLC is that the foreign auditors have the right to perform audit activities in a domestic context during a joint audit, whereas foreign auditors only have the right to observe and ask questions through the domestic auditors during an MLC. Many issues could normally be resolved during the audit, avoiding the need for complicated and time-consuming MAP processes. A similar programme could, for example, be introduced within the OECD.

The future of TP in Sweden is connected to the BEPS project’s outcome since Sweden applies the OECD TP guidelines in relevant parts as guidance to our domestic arm’s length principle in chapter 14 section 19 SITA. However, since Sweden is an EU Member State, the work carried out by the EU is also of great importance for Sweden. Not only does the EU Anti-Tax Avoidance Directive have cont. of the European Parliament and of the Council amending Directive 2013/34/EU as regards disclosure of income tax information by certain undertakings and branches, 12 April 2016.
an impact on the application of BEPS guidance on the TP practice in Sweden, but
so also does the guidance provided within the EU Joint Transfer Pricing Forum
and the proposal regarding the common (consolidated) corporate tax base (if and
when implemented), which will have an effect on TP practice in Sweden in the
future. Also the application of state aid prohibitions may be affected by BEPS
since the application of TP rules and substance plays an important role in the Euro-
pean Commission’s current investigations about state aid.

Since Sweden applies the OECD TP guidelines in relevant parts to interpret the
domestic arm’s length principle in chapter 14 section 19 SITA, there will, as far as
is known, be no changes in Swedish TP regulations to implement the guidance in
the BEPS Actions 8–10 report. However, since the Swedish legislation on TP doc-
umentation differs from chapter V in the BEPS Action 13 report, Swedish legisla-
tion must be amended before the changes to the TP documentation rules can be
implemented in Sweden. It is proposed that the CbCR should be filed for the first
time for financial years starting after 31 December 2015 and that the master and
local files concept will enter into force for financial years beginning on 1 April
2017 or later. The legislation regarding TP documentation is currently in prepara-
tion.
Summary and conclusions

Having stable, foreseeable, well-balanced and internationally accepted transfer pricing (TP) rules is vital for Switzerland to remain an attractive place for international investment. Switzerland has closely cooperated with international policymakers, mainly with the OECD, to ensure a balanced international framework in the area of transfer prices. Switzerland has continuously applied the arm’s length principle for a long time and is committed to following the OECD TP guidelines, economic literature and industry practice for all cross-border transactions. The Swiss Federal Tax Administration has published a few circular letters providing particular guidance for arm’s length pricing (e.g. in the case of high-value adding services) and safe harbour rules (e.g. in the case of intra-group interest rates). Under general administrative procedural rules, there is the possibility of seeking unilateral or bilateral advance rulings on TP matters. As a countermeasure against potential base erosion and profit shifting (BEPS) behaviour, the Swiss authorities use anti-tax avoidance rules based on long-standing court practice.

Switzerland has contributed actively to the work of the G20/OECD actions. The Federal Council, Switzerland’s government, has instructed the Federal Department of Finance to deliver analysis and proposals for implementing the BEPS outcome. The administration is currently working on the implementation of the BEPS minimum standard (i.e. prevention of treaty shopping, country-by-country reporting (CbCR), fighting harmful tax practices and improving dispute resolution). It is understood that Switzerland intends to implement the minimum standard only but continuously reviews all other recommendations. Separate law to implement CbCR has already been presented for public consultation (the first exchange with partner states expected in the first half of 2020 for the year 2018; the mechanism foreseen allows for earlier voluntary filing). Swiss tax authorities and taxpayers generally apply the latest version of the OECD TP guidelines and therefore it can be assumed that the revised guidance will be applied with immediate effect. The Swiss tax administrations favour one-sided TP methods and there is still a preference for the OECD’s original strict hierarchy of methods. Further, there are provisions in the revised guidelines that

* Roche, Head of Group Tax & Insurance
** Roche, Area Tax Director
are in conflict with Swiss tax laws (e.g. claw-back rules with regard to hard-to-value intangible (HTVI)) or practice.

Switzerland dynamically follows international developments as long as the arm’s length standard is respected. There is also no intention to further formalize the existing documentation rules. As a small open economy, Switzerland cannot cover all possible business relationships and transactions in a static TP law. Moreover, in order to be able to cope with the continuous changes in different industries and businesses, Switzerland’s TP framework has to be kept dynamic, with the arm’s length standard serving as the overarching principle. Potential uncertainties in the application of the TP rules can be reduced with safe harbour rules and advance rulings. In the case of safe harbour rules, the taxpayer has the right to deviate if the arm’s length nature of a transaction can be demonstrated. The anti-tax avoidance rules developed by the Swiss courts remain a strong instrument to counteract the potential BEPS behaviour of multinational enterprises (MNEs).

1. Current TP regulation and practice in Switzerland

As Switzerland is a small and open economy with strong exporting industries,1 TP rules have always been an important part of its international tax law.2 Having stable, foreseeable, well-balanced and internationally accepted TP rules is vital for Switzerland to remain an attractive place for international investments. Double tax treaties have been relevant for a long time3 and remain important. Switzerland closely cooperates with international policymakers to ensure a balanced international framework in the area of transfer prices.4

This report deals with the G20/OECD BEPS initiative. A summary of the main principles of the TP environment in Switzerland is provided first.5 The framework in Figure 1 gives an overview, focusing on the main steps in a transaction between related parties until their final assessment by the tax authorities.

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3 Two of Switzerland’s tax treaties still in force were concluded before World War II: Germany (1931) and France (1937). For further information see C. Schelling, “Swiss Tax Treaty Policy”, Bulletin for International Taxation 2015, p. 216 et seq.
4 Switzerland participates in the work of the OECD and its predecessor organization as well as the work of the United Nations.
Switzerland is a federal state consisting of 26 cantons. The cantons have a high degree of autonomy unless a power is reserved by the Federal Constitution. The Confederation and the cantons each levy different types of taxes based on the allocation laid out in the federal Constitution. One of the main principles is the EISERNG, REGLI

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**Figure 1 Overview of TP assessment by the Swiss authorities**

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6 State powers are divided between the Confederation, the cantons and the communes. The cantons and communes have extensive powers and have their own sources of income. The federal Constitution divides the power to tax between the Confederation and the cantons. Within each canton the power to tax is again divided between the canton and its communes.

7 Art. 3 of the federal Constitution of the Swiss Confederation (18 April 1999), SR 101.

8 For details see Oberson and Hull, op. cit., p. 3 et seq. and p. 246 et seq.
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avoidance of double taxation of income. This is achieved by consistently applying the exemption method in domestic situations together with the possibility of seeking judicial review in cases of double taxation.

With regard to TP the corporate income taxes levied by the Confederation and the cantons are of most interest and are thus in the central focus of this branch report. Federal and cantonal corporate income taxes are assessed and collected by the canton in which the company is resident. The Federal Tax Administration oversees the assessment of the federal tax, issues guidance in the form of circular letters and reviews of tax assessments by cantonal authorities. The federal authorities are not allowed to intervene in ongoing tax assessment procedures but have the right to appeal against assessments for federal taxes issued by cantonal authorities. Foreign tax policy matters are dealt with by the State Secretariat for International Tax Matters (SIF), a department of the federal Finance Ministry. The SIF is responsible for negotiations of double tax treaties and is also Switzerland’s competent authority for mutual assistance procedures and advance pricing arrangements.

One of the key principles of corporate income tax at federal and cantonal level is the application of the Swiss generally accepted accounting practice (GAAP, Massgeblichkeitsprinzip). The company’s profit and loss statements prepared in accordance with Swiss GAAP defines in principle the taxable profit. Some provisions exist to adjust the profit determined by Swiss GAAP. In particular, for TP purposes an adjustment will be made in the case of the transfer of benefits to related parties in the form of hidden profit distributions or earnings not credited in the profit and loss statement. Even though the domestic tax laws do not directly use the term “arm’s length principle”, the Swiss tax courts have consistently confirmed the application of this internationally accepted principle when applying Swiss corporate income tax law in cross-border transactions, even those independent of the application of a double tax treaty.

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9 Certain transactions might be subject to Swiss withholding tax levied by the Confederation, which will be covered where appropriate. Value added tax and customs duties levied by the Confederation and special taxes such as real estate gains tax or property transfer taxes levied by certain cantons will only be mentioned where appropriate.

10 Art. 128(4) of the federal Constitution.

11 Art. 7(2)(d) of the Ordinance on the organization of the Federal Department of Finance (FDF) (17 February 2010), SR 172.215.1.

12 Swiss GAAP is also relevant for other taxes (e.g. distribution amount subject to Swiss withholding tax).


14 Art. 58(1)(b) DTL and art. 24(1)(a) THL.

15 Art. 58(1)(c) DTL and art. 24(1)(b) THL. With the corporate income tax reform these articles may be replaced with an amended wording with art. 61b DTL and art. 24c(1)(b) THL. Swiss tax practice has developed its own interpretation regarding the existence of a controlled transaction with a shareholder or an affiliate, the existence of an apparent and material difference between the benefit granted and the consideration received. Special rules exist e.g. regarding the maximum amount of tax deductible interest (art. 65 DTL and art. 24(1)(c) THL). For details see O. Untersander, Branch Report Switzerland on New Tendencies in Tax Treatment of Cross-Border Interest of Corporations, vol. 93b, Cahiers de droit fiscal international, p. 713 et seq.

16 This has been confirmed in a very high number of cases. Cf. the recent Supreme Court judgment of 20 February 2015, 2C-508/2014 and 2C-509/2014 E.5, with additional references.
Concerning the implementation of the arm’s length principle in Switzerland, the Federal Tax Administration has issued a circular letter emphasizing that the cantonal tax administrations (generally) have to take into account the OECD TP guidelines when assessing MNEs. Further, the Swiss Federal Tax Administration has issued a few circular letters providing particular guidance for arm’s length pricing and safe harbour rules (e.g. in the case of intra-group interest rates).

Although the Federal Tax Authorities provided guidance in 2004 to follow the OECD TP guidelines, the following should be considered:

- the Federal Tax Administration can only provide binding guidance to the cantonal tax administrations with regard to the assessment and collection of federal income taxes and not cantonal taxes;
- the guidelines can only be directly applied to the extent detailed guidance is provided therein; and
- it is not clear which edition of the OECD TP guidelines is covered by the circular letter issued by the Swiss Federal Tax Administration in 2004.

Therefore, the question arises whether the Federal Tax Administration supports a flexible linkage or whether the wording of the guidelines from 2004 (or even 1995) should be followed and whether Switzerland has to apply the OECD TP guidelines to transactions with counterparties in treaty partner states only or to all cross-border transactions.

Tax administrations in Switzerland generally follow the OECD guidelines and consider the economic literature and industry practice for all cross-border transactions. It is acknowledged that due to their wide international acceptance the guidelines are of particular importance. Taxpayers and tax administrations generally apply the latest version approved by the Committee on Fiscal Affairs. The Swiss tax administrations favour one-sided TP methods and there is still a preference for the OECD’s original strict hierarchy of methods.

There are only a few TP specific procedural provisions in Swiss tax law. The most important provision is that an agreement reached under a mutual assistance procedure is a valid reason for a revision of a tax assessment that has become binding. A tax assessment issued by the cantonal tax administration for cantonal and federal taxes becomes binding if neither the taxpayer nor the Federal Tax Administration (for federal taxes only) raises objections within the period of appeal. The tax administration is obliged to issue a tax assessment for corporate income tax purposes within five years after expiry of the end of the taxable period, unless there

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17 Federal Tax Administration Circular Letter no. 4, Taxation of Service Companies (19 March 2004). The circular letter is also available in English at https://www.estv.admin.ch/estv/de/home/direkte-bundessteuer/direkte-bundessteuer/fachinformationen/kreisschreiben.html (last visited September 2016). The circular refers to a letter from the Director of the Federal Tax Administration to the cantonal tax administration with the request to follow the OECD TP guidelines. A copy of this letter can be found in ASA 66 (1997/98), p. 45.

18 For a summary see Eisenring, op. cit., art. 9 point 61 et seq.; Stocker and Raab, op. cit., p. 2341 et seq. or Stocker and Studer, op. cit., p. 387.

19 In mutual assistance procedures, the competent authority is in charge of the application of Swiss international tax law. The State Secretariat for International Financial Matters has acknowledged the OECD TP guidelines.

20 Art. 130 et seq. DTL and art. 46 et seq. THL.
is a special reason (e.g. pending audit), but in any case 15 years after the taxable period has ended.\textsuperscript{21}

The federal and cantonal income tax laws require the taxpayer to file a tax return together with all supplementing documents required by law.\textsuperscript{22} Taxpayers have to provide duly signed annual financial statements showing taxable equity at the beginning and the end of the taxable period.\textsuperscript{23} Further, the taxpayer is required to fully cooperate with the tax administration to ensure a complete and accurate assessment. For this purpose the taxpayer has to provide – upon request by the administration – verbal and/or written information, disclose the company’s accounts, records and certifications and documents concerning the business of the taxpayer.\textsuperscript{24}

According to Swiss court practice, additional documentation is required if a Swiss taxpayer wants to deduct payments to counterparties abroad.\textsuperscript{25} The Supreme Court accepts this additional requirement as the Swiss tax administration has limited possibilities of verifying whether such a payment is economically justified. Documentation in general has to be available depending on the nature of transactions. Insufficient documentation shifts the burden of proof to the taxpayer.

2. The impact of the BEPS project on TP

2.1. Introduction

As a member of the OECD, Switzerland has contributed actively to the work of the G20/OECD on BEPS. After publication of the final reports in 2015 the Federal Council, Switzerland’s government, has instructed the Federal Department of Finance to deliver analyses and proposals for implementing the outcomes.\textsuperscript{26} The SIF works in close collaboration with the Federal Tax Administration on proposals for the implementation of the BEPS minimum standards (i.e. prevention of treaty shopping, CbCR, fighting harmful tax practices and improving dispute resolution).\textsuperscript{27}

It is understood that Switzerland intends to implement the minimum standard of the G20/OECD actions and continuously reviews all other recommendations considering international developments.\textsuperscript{28} The Swiss government has proposed a separate law to implement CbCR (see below section 2.5.1) and the spontaneous exchange of rulings (see below section 2.6). The OECD work on the patent box has

\textsuperscript{21} Art. 120 DTL and art. 47(1) THL.
\textsuperscript{22} Art. 124(1) DTL and art. 42(1) THL.
\textsuperscript{23} Art. 125(2) \textit{et seq}. DTL and art. 42(3) THL.
\textsuperscript{24} Art. 126(2) \textit{et seq}. DTL and art. 42(2) THL.
\textsuperscript{25} See for example BGer 31 July 2013, 2C-797/2012, E2.2.2, with additional references.
\textsuperscript{26} See the press release of the State Secretariat for International Financial Matters SIF published after the BEPS reports were published in October 2015: https://www.sif.admin.ch/sif/en/home/dokumentation/medienmitteilungen/medienmitteilungen.msg-id-58972.html; last visited September 2016.
\textsuperscript{28} See the State Secretariat for International Financial Matters SIF press release cited under note 26.
been considered in the current revision of Switzerland corporate income tax law.\textsuperscript{29} Looking at the first proposals made public for consultation it is noted that the proposed implementation occasionally goes beyond what is required under the BEPS minimum standard in order to establish a level playing field between Swiss and foreign companies. With regard to the changes included in the OECD TP guidelines, the Swiss authorities have not published additional guidance. Therefore it can be assumed that they will be applied with immediate effect to the extent they do not contradict applicable laws and the arm’s length principle. This is the case where the guidelines are too specific when trying to counteract potential tax avoidance behaviour of taxpayers (e.g. retroactive adjustments for hard-to-value intangibles).

Switzerland already has a robust toolbox of rules and legal concepts in place to counteract potential tax avoidance behaviour and to address BEPS issues. In sections 2.2 to 2.5, the current discussion on TP matters in Switzerland will be described following the instruction of the general reporter as deemed appropriate. Further the report will address in section 2.6 other areas closely related to TP.

2.2. Challenges of transactions with intangibles

2.2.1. Definition of intangibles

Since the last branch report on TP and intangibles for the IFA congress in Kyoto almost 10 years ago, little has changed in relation to the definition of intangibles in Switzerland.\textsuperscript{30} There is no distinct definition of intangibles in the Swiss corporate income tax law. The definitions used for accounting purposes are also applicable for tax purposes (Swiss GAAP principle). There is generally no distinction made between legal ownership in the strict sense (i.e. “registration”) and economic ownership.\textsuperscript{31} The following categories are mentioned in the Swiss audit manual:\textsuperscript{32} patents, trademarks, trade names, brand names, knowhow, customer lists or technical data.\textsuperscript{33}

Contracts and corporate transactions and their treatment for accounting purposes are the basis for identifying intangible assets. Practical challenges may arise in cases where intellectual property is not recorded in the company’s statutory books.\textsuperscript{34} Further examination considering the guidance provided by the OECD TP

\textsuperscript{29} Swiss corporate income tax law currently undergoing its third major reform since the cantonal tax laws were harmonized in 1995. After several years of intensive discussions, the European Union and Switzerland have settled their dispute over corporate income tax issues. Switzerland has agreed to abolish certain tax regimes that were considered harmful by the European Union. At this occasion several aspects included in the BEPS packages have been implemented in the current legislation that will be decided in a referendum on 12 February 2017. Regarding anti-abuse provisions in Switzerland’s vote on double tax treaties, the OECD’s work will be taken into account before a decision will be made whether the necessary adjustments will be made multilaterally or bilaterally. See the State Secretariat for International Financial Matters SIF press release cited under note 26.

\textsuperscript{30} J.-F. Mariaia, Branch Report Switzerland, Transfer Pricing and Intangibles, vol. 92a, Cahiers de droit fiscal international, p. 583 et seq.

\textsuperscript{31} This is in contrast to Swiss intellectual property law where numerous strict clauses exist.


\textsuperscript{33} Some intangibles such as patents and trademarks are legally protected, others are not.

\textsuperscript{34} Cf. for example s. 6.7 of the revised OECD TP guidelines.
guidelines might be appropriate to identify additional intellectual property in case of conflicting definitions in the two jurisdictions. In line with the OECD guidance, it should be kept in mind that “care should be taken in determining whether or when an intangible exists and whether an intangible has been used or transferred”.

In the planned revision of the corporate income tax law, to be confirmed on 12 February 2017 by popular vote, Switzerland anticipates introducing a patent box and an update of its rules for cross-border business restructurings. The Federal Tax Administration is currently working on implementation rules that will define the term “patents and similar intellectual property rights”. It is generally expected that the new rules will follow existing categories and will not create new categories of intellectual property rights that will deviate from categories currently accepted for Swiss statutory purposes. The rules governing cross-border business restructuring do not introduce a new category of intellectual property but will have an impact on the applicable valuation scope and methods in certain cases.

### 2.2.2. Transactions with intangibles

There are no special rules for the TP of intangibles in Swiss tax law. It is one of the main pillars of Swiss corporate taxation that the qualifications made under civil law are followed and respected unless the conduct of parties proves different from the legal form of the transaction or in case transactions fail the tax avoidance test. In practice this leads to the question of whether a transaction or a business relationship has the appropriate legal form or, if not, has to be reclassified with regard to its legal form, as it does not accord with the actual behaviour and intention of the parties (see below section 2.2.3). Transactions have to stand the tax avoidance test that has been developed by the Supreme Court. A transaction may be reclassified or disregarded if (a) the taxpayer’s chosen legal structure is unusual, inappropriate or inadequate to its economic purpose, (b) the tax considerations are the only reason for the transaction, and (c) the transaction leads to tax savings.

Following general procedural rules, the party has to provide sufficient proof to substantiate its demand. If the tax administration claims that a piece of intellectual property was not recorded in the statutory books and that the asset has

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35 Cf. OECD TP guidelines, s. 6.8 et seq.
36 OECD TP guidelines, s. 6.11. “For example, not all research and development expenditures produce or enhance an intangible and not all marketing activities result in the creation or enhancement of an intangible.”
37 See for further information section 2.6.
38 “Patents and similar intellectual property rights” should qualify the patent box (art. 24a Abs. 1 Draft-THL).
40 Art. 61b(2) draft DTL and art. 24c(2) draft THL.
42 Cf. for example F. Regli, Grundlagen für die Konzernbesteuerung im schweizerischen Steuerrecht, 2013, p. 228. Civil law provides for example the basis for the transfer of ownership between legal persons which is a requirement for concluding the transaction.
43 Cf. BGE 138 II 239 E4.
been transferred abroad, it is up to the administration to provide sufficient proof.\footnote{In practice, it may yet happen that the administration tries to shift the burden of proof by pretending the existence of an intellectual property right.} However, from a practical perspective the focus of the tax administration is more on the concepts applicable for the valuation of intangibles and the question of what affiliates contributed to the building up of the intangible value (see for valuation related topics in the context of hard-to-value intangibles section 2.2.5 and cost contribution agreements (CCAs) in section 2.2.6).

### 2.2.3. “Substance-over-form” approach towards intangibles

Tax law in Switzerland has always been understood to be interdisciplinary. Hence, several concepts use an economic approach with the aim of ensuring that tax collection is based on the taxpayer’s economic capacity\footnote{Cf. Regli, op. cit., p. 65 et seq.} or – going a step further – preventing tax avoidance.\footnote{Cf. for detailed discussion section 2.2.2.} Several tools exist to ensure that the actual transaction is subject to tax and not an “artificial reality” constructed through legal means. It goes almost without saying that not all these tools are specifically targeted towards intangibles; they cover all aspects of taxation in Switzerland, including intangibles.

Tax administrations can reclassify the nature of transactions. They use the criteria from former court cases against tax avoidance as described in section 2.2.2 above, or in a rather old court case where a foreign entity of a Swiss group bought and resold a minority stake in another listed company after a bidder fight realizing a substantial capital gain, the courts agreed on the tax administration’s construction of an (assumed) commissionaire agreement between the foreign affiliate and its Swiss headquarters.\footnote{StE 1995 B 72.11 No. 3 (dBSt).} Consequently, the court decided that the capital gain had to be allocated to the Swiss head office and was taxable in Switzerland. From a TP perspective it is interesting to see that already in 1995 the Swiss tax administration was reviewing the functions performed, assets used and risked assumed on a rather broad scale, considering the whole transaction including the building up of the minority stake, the merger negotiations and the subsequent sale to a third party making a competing offer.

From a conceptual point of view the Swiss approach is similar to what the revised OECD TP guidelines propose under the new DEMPE\footnote{Development – Enhancement – Maintenance – Protection – Exploitation.} concept, which considers all the economic aspects of the transaction and the actual conduct of the parties and does not rely only on contractual risk allocation. Such a dynamic approach can also be observed in other areas of Swiss domestic tax law; tax residency, for example, is an area where management acts on a day-to-day basis.\footnote{Art. 50 DTL and art. 24(1) THL.}

### 2.2.4. Comparability and group synergies

In line with its general policy, Switzerland follows the OECD TP guidelines regarding comparability and group synergies.\footnote{Cf. OECD TP guidelines, s. 1.157 et seq.} In Swiss tax practice this is mostly
2.2.5. HTVI

On the one hand the revised OECD guidelines foresee a careful *ex ante* review and documentation of the facts and circumstances of the transfer of HTVI, including financial projections and how reasonable foreseeable events and other risks were accounted for,\(^{51}\) as well as the contractual provisions including payment arrangement.\(^ {52}\) On the other hand the guidelines allow an *ex post* adjustment of the remuneration five years after the transaction if the *ex post* outcome significantly deviates more than 20 per cent from the original valuation unless the difference is caused by unforeseeable developments within the applied risk framework and was included in the underlying probabilities of occurrence or covered by a bilateral or multilateral advance pricing agreement.\(^ {53}\)

Swiss procedural tax rules allow retroactive changes of a final tax assessment only in the case of new information not known at the time of assessment and only if the absolute statute of limitation has not yet been reached.\(^ {54}\) Therefore, any adjustment needs to be made while the taxable year is still open for assessment and the tax administration is allowed to scrutinize the transaction. In an older case related to a real estate transaction the competent court ruled that with a deviation of more than 25 per cent the transactions apparently lacked congruence between the benefit granted and the consideration received.\(^ {55}\) Although the accepted deviation should be based on the nature of the transaction and the characteristic of the underlying transaction, the 20 per cent requirement for HTVI does not seem unreasonable considering Swiss court practice.

It remains the question whether a retroactive adjustment is even necessary under Swiss law. If an intangible is indeed “hard to value”, third parties might agree on risk-balancing contractual provisions such as price adjustment clauses. Therefore, the tax administration could reclassify a straight sale agreement under an economic approach as an agreement comprising certain contingent obligations in the year of assessment. Eventually this would lead to an adjustment of the value of the intangible as it would be contractually agreed by independent parties in case of an HTVI.

2.2.6. CCAs

There are no specific regulations regarding CCAs. The general rules for transactions between related parties apply. It is acknowledged that different kinds of CCA may exist, provided the conditions established for the related party transactions are consistent with the arm’s length principle. In line with the OECD TP guidelines a CCA can be concluded for R&D activities or services.

\(^{51}\) HTVI are defined in s. 6.189 of the OECD TP guidelines.
\(^{52}\) Cf. OECD TP guidelines, s. 6.193(i) and s. 6.194.
\(^{53}\) Cf. OECD TP guidelines, s. 6.19.
\(^{54}\) See regarding the statute of limitation in Swiss law s. 1.
With regard to the ownership of intangibles developed under a CCA the contractual agreement, including its financial terms, is the starting point of the review that the relative input and the related output for each party are balanced.\footnote{If necessary, buy-in and balancing payments have to be made.} The main questions are which parties contribute what at the beginning of the cost contribution period, what assets are provided, functions performed and risks assumed by each party during the cost contribution period and who obtains the benefits.

In order to document the existence of CCAs written agreements should be signed by the parties. Payments made under a CCA are tax deductible if and to the extent they are commercially justified.\footnote{Art. 58 s. 1 in conjunction with art. 59 DTL and art. 24(1) in conjunction with 25 THL.} In addition, the Swiss tax administration may ask for enhanced documentation in case of cross-border payments.\footnote{Cf. for details above s. 2.2.2.} As the participants acquire direct ownership of the intellectual property through the CCA, the contributions are not royalty payments. Since Switzerland does not levy withholding taxes on royalty payments, the question of whether CCAs could be considered licence agreements is not relevant.

### 2.3. Risk and capital

There is already a robust framework in Switzerland in place to ensure that profits are taxed where value is created. The principles described above in section 2.2.3 are not only applicable in the case of intangibles but are also generally applicable to all kinds of transaction. Especially with regard to substance, Switzerland applies a functional approach also requiring the exercise of control in addition to sufficient financial capacity. Moreover, in practice management needs to have the required skills in addition to the competencies assigned.

### 2.4. High-risk transactions

#### 2.4.1. Comparable uncontrolled price (CUP) and quoted prices for cross-border commodity transactions

Although the OECD TP guidelines do not foresee an explicit hierarchy between the different methods to determine and test transfer prices between related parties,\footnote{Moreover, with the 2010 revision the hierarchy between the traditional transaction methods and the transactional profit methods was abandoned.} Switzerland applies the CUP method as the primary method where comparable transactions are available and such comparables are reasonably applicable to the tested transaction. In practice, the CUP method is preferred in the case of commodities with quoted prices as is the case for customs purposes. The CUP serves as the primary proof of the arm’s length nature of the transaction value, i.e. the value is not influenced by the relationship of the parties.\footnote{Cf. art. 1(2)(a) and (b) of the Agreement on Implementation Article VII of the General Agreement on Tariffs and Trade (12 April 1979) SR 0.632.231.3.}
2.4.2. Intra-group services

In accordance with the OECD TP guidelines Switzerland allows the determining and testing of transfer prices for intra-group services with the cost-plus method. In practice, some cantonal tax administrations follow the proposal made by the EU Joint Transfer Pricing Forum in its guidance on low value-adding intra-group services.  

In a circular letter dated 19 March 2004, the Federal Tax Administration issued the guidance that for financial services or management functions the cost plus is not the appropriate method (or only in exceptional cases). The guidance has been issued in the course of the discussion on the attribution of profits to permanent establishments, and refers to high value adding activities only. Certainly, for so-called “low value-adding” services the cost plus method remains the appropriate TP method.

2.4.3. Profit splits in the context of value chains

Swiss TP practice has a preference for one-sided methods. Such methods are easier to apply and to document. However, for global trading with financial instruments profit splits are considered more appropriate. In practice, it can be seen that independent parties may agree on profit splits or similar schemes in the case of joint development of a product or market. The common characteristic of such collaborations is usually that the parties stand on an equal footing with regard to their unique and valuable contributions and/or the close integration of their operations.

2.5. TP documentation

2.5.1. CbCR

Under the lead of the SIF, the Swiss authorities are working on the implementation of the minimal standard set forth by the report dealing with BEPS Action 13 to meet the G20/OECD deadlines. The Swiss delegation to the OECD has always emphasized that the law setting process in Switzerland does not allow for immediate implementation. After a public consultation procedure held in the first half of 2016, the authorities are finalizing the legislative proposal to be presented to the two chambers of Parliament.

It is expected that the new law will enter into force effective for fiscal years beginning in 2018 so that the first reports have to be filed with the Swiss tax authorities.

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63 The OECD published the final report in 2010.
64 The new tax reporting requirement has to be introduced with a federal law that is subject to parliamentary approval and – if a referendum is called – a popular vote.
by the end of 2020. Consequently, the first exchange of CbCR with partner states is expected to take place during the first half of 2020 covering information related to fiscal year 2018. In addition, there is a mechanism foreseen that allows for voluntary filing and exchange of information covering the fiscal years 2016 and 2017.

The draft legislation follows the recommendations of the G20/OECD under Action 13 (TP documentation and CbCR) and complies with the minimum standard agreed. Under the existing legal framework for exchange of information, CbCR should be automatically exchanged with the jurisdictions in which the Swiss group maintains constituent entities and where at the same time a mutual agreement is applicable. The information is provided exclusively to foreign tax authorities and will not be made publicly available.

The report can be prepared and filed in English or in a Swiss official language (German, French or Italian) and can be presented in Swiss francs or in the group’s functional currency. The draft legislation includes a secondary filing mechanism which allows the Swiss tax authorities to require a Swiss based constituent entity of a foreign group to file the group’s CbCR in Switzerland if the ultimate parent entity is resident in a foreign country that is not a partner state or if there is a systemic failure in the foreign headquarters jurisdiction. However, Switzerland clearly understands that CbCR is used for risk assessment purposes only.

According to the draft law the reports have to be filed within 12 months after the end of the reporting period (art. 11(1) draft Federal Act on the International Automatic Exchange of Country-by-Country Reports of Multinational Entities (draft ALBA)). According to the available draft law such reports should have been exchanged under existing double tax treaties or other bilateral or multilateral agreements allowing for an exchange of (tax) information (art. 29 draft ALBA). However, it is expected that in the final draft to Parliament early exchange will only be possible through an early adoption of the ordinary mechanism for the exchange of CbCR (cf. note 68).

The exchange of CbCR is partly based on the following existing legal framework for the exchange of information but requires also new legal basis: the OECD/Council of Europe Convention on Mutual Administrative Assistance in Tax Matters (adopted by Swiss Parliament on 18 December 2015, to be ratified), the Multilateral Competent Authority Agreement on the Exchange of Country-by-Country Reports (MCAA; signed on 27 January 2016, to be submitted to and approved by the Swiss Parliament) and the Federal Act on the International Automatic Exchange of Country-by-Country Reports of Multinational Enterprises (draft under consultation process, final draft to be submitted to and approved by the Swiss Parliament).

Consultation report on the multilateral agreement on the exchange of CbCR and the federal Act (13 April 2016), p. 6). This has been confirmed by the Swiss government in a response to a request by a member of parliament in August 2016 (Motion Béglé, Préserver la “sphère privée” de nos multinationales. La Suisse doit s’engager à ne pas publier les données recueillies dans le cadre du BEPS (15 June 2016) 16.3468).

Art. 4 et seq. draft ALBA.

Art. 8 draft ALBA. In line with the G20/OECD proposal also the possibility of surrogate filing in Switzerland is included in the current draft (art. 9 draft ALBA). Although secondary and surrogate filing are not considered to be a minimum standard under BEPS 13, Switzerland aims for a level playing field by including both mechanisms in its domestic law.
2.5.2. Master and local files

No requirement to request a master and/or local file will be introduced for the time being. This is in line with the Swiss policy of implementing the minimum standard only. The Swiss tax authorities will continue their practice of asking for additional information in the assessment process as needed. Swiss and foreign MNEs may voluntarily provide the tax administration with additional information such as a master and/or local file as defined by the OECD in the report for BEPS Action 13. It also helps in cases where the burden of proof lies with the taxpayer.

2.5.3. Compliance costs

Compliance costs for Swiss and foreign MNEs operating in Switzerland are low in general as Swiss tax authorities are trying to keep formal requirements low and focus on the economics of transactions. Most tax authorities in Switzerland accept documents in English; translation work and duplication in the preparation of documents can be largely avoided.

2.6. TP-related measures in other BEPS actions and other measures against BEPS

Switzerland contributed actively in the global discussion on tax, especially in the G20/OECD BEPS discussion. At the same time it has been made clear that only the agreed minimum standards will be implemented immediately and all other output will be carefully reviewed and only transposed into Switzerland’s domestic and/or international law to the extent it is value adding from a Swiss perspective. There are three additional subjects which are worth mentioning in the current G20/OECD BEPS discussion when discussing TP: (a) ruling exchange (BEPS Action 5), (b) interest deductions (BEPS Action 4), and (c) dispute resolution (BEPS Action 14). The outcome of BEPS Action 5 regarding the exchange of rulings is considered a minimum standard and therefore Switzerland is currently implementing the required legal basis. With the recent change of its policy on the international exchange of information, Switzerland has incorporated the OECD standard on the exchange of information in its double tax treaties with 53 states (47 currently in force), concluded 10 tax information exchange agreements (TIEAs, 7 currently in force) and signed the OECD/Council of Europe Convention on Mutual Administrative Assistance in Tax Matters which serves as the basis for the exchange of CbCR. By joining this multilateral convention, Switzerland will be able to

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72 This information would need to be filed with the cantonal tax administration responsible for the tax assessment. Information provided to the tax administration is to be delivered in the official language of the canton concerned (German, French or Italian). However, most tax administrations accept documentation in English.

73 In March 2009 Switzerland withdrew its reservation to art. 26 of the model tax convention on income and on capital. Whereas Switzerland in the past only granted information for the proper application of its tax treaties, it has now started to include the OECD standard on information exchange in its tax treaties.


75 Regarding its current status see footnote 68.
exchange information spontaneously insofar as the criteria set forth in the convention are met. In order to implement the requirements into Swiss law, the competent authorities will issue an ordinance that already has been published in a draft version for consultation earlier this year.\textsuperscript{76} Although the information, which could potentially be exchanged, is quite broad in theory, Switzerland confirmed its practice that it will follow the international consensus on which information will be exchanged spontaneously.\textsuperscript{77}

BEPS Action 4 recommends certain measures in relation to the limitation of the deduction of interest. Although not considered a minimum standard, the implementation of the current proposal made by the G20/OECD conflicts with existing Swiss domestic law in several respects such as the Swiss GAAP principle (Massgeblichkeitsprinzip) and the Swiss rules and practice regarding benefits in kind including the circular letters regarding interest payments and hidden equity.\textsuperscript{78} For the purposes of interest deduction Switzerland provides safe harbour rules considering to what extent a Swiss based entity can be leveraged as well as the interest rate. In addition, Swiss practice consistently applies the arm’s length principle by allowing the taxpayer to substantiate the interest rate and debt/equity ratio on a case by case basis.\textsuperscript{79}

With regard to BEPS Action 14 Switzerland expressed its intention of implementing the elements that are considered a minimum standard and not yet included in its tax treaties. It is understood that the comprehensive review is still ongoing and the administration is still analysing whether such changes can be implemented with the multilateral instrument currently being developed. The Swiss competent authorities have hired additional staff over the last years to meet future needs in mutual assistance procedures. It remains Switzerland’s goal to introduce binding arbitration clauses with all treaty countries. In order to prevent double taxation Switzerland was one of the first countries to introduce binding arbitration in its tax treaties.

2.7. Can BEPS work in favour of MNEs?

It has been emphasized that the additional information available through CbCR should only be used for risk assessment purposes, e.g. allocation of resources within the tax administration or audit plans. From a practical perspective tax administrations may be under pressure to use this new source of information simply because it is available. It might be used to compare different taxpayers even though CbCR information does not relate to third party transactions. Or, alternatively, the profits of the same taxpayer in different countries are compared.


\textsuperscript{78} Cf. also R. Stocker, “Potential Effects of the OECD Base Erosion and Profit Shifting Initiative on Swiss Transfer Pricing Rules and Swiss Companies”, Bulletin for International Taxation, April/May 2015, p. 209 et seq., p. 213.

\textsuperscript{79} Federal Tax Administration Circular Letter no. 6, Hidden Equity (6 June 1997) and Federal Tax Administration circular, Interest Payment between related parties (23/24 February 2016; updated annually).
CbCR may also be used as a plausibility check in favour of the taxpayer. There will be additional transparency with CbCR regarding revenues and profits but also with regard to profit margins and tax payments in other countries. Of course, there might still be differences in the individual functional profiles or the methods applied to determine and/or test specific transfer prices. The new reporting requirement might be supportive of MNEs in their defence of the arm’s length nature of the consideration paid for certain activities as it is transparent what other profit levels have been accepted in other countries with comparable activities. This reveals once more that the new reporting requirement puts more emphasis on transactional profit methods. At the same time this increases the tensions with the customs regulations, which have a strong preference for the traditional transaction methods. A lower cost of compliance and a lower risk of double taxation are reasons why traditional transaction methods are favoured in practice for TP purposes.

Looking at the reports issued by the G20/OECD it seems to be presumed that many MNEs have substantially shifted profits to low-tax jurisdictions without sufficient economic effect. This may have created some unjustified benefits for some companies compared to their competitors. From a competition point of view unjustified benefits (e.g. through non-taxation) or unjustified disadvantages (e.g. through double taxation) are not favourable to the business of MNEs. The future contribution of CbCR to reducing unjustified competitive advantage will have to be compared with the additional administrative cost within tax administrations and companies related to the CbCR process.

Competition should be limited to tax rate competition between countries and the effectiveness of their administrations. The latter is probably easier to achieve in environments and with measures that favour trust and predictability. Advance rulings (including APAs) and speedy tax assessment processes avoid potential conflict.

3. What is the future of TP?

3.1. The taxpayer’s situation

The arm’s length principle is applicable in Switzerland for cross-border and internal transactions. The avoidance of double taxation for transactions within Switzerland is guaranteed by the federal Constitution (e.g. for cantonal taxes). The corresponding instruments for cross-border transactions are arbitration clauses with all treaty partners. For this reason, Switzerland seeks to insert arbitration clauses in its treaties.

The Swiss tax authorities have issued some safe harbour rules (e.g. for interest rates) to simplify the assessment process. Taxpayers, however, can deviate from these instructions by documenting the arm’s length nature of their transactions. For all transactions without specific guidance, the minimum requirement is to have the documentation available as per Swiss commercial law that includes Swiss GAAP provisions. The required minimum documentation (burden of proof) consists of what can be reasonably expected considering the nature of the transactions and business practice.
3.2. The position of the Swiss tax authorities

There is no intention to further formalize the existing documentation rules. Switzerland dynamically follows international developments as long as the arm’s length standard is respected. This approach has the advantage that there is no additional formal work burden either for the taxpayer or for the tax authorities. The Swiss authorities try to keep the assessment process simple but adjust transactions that (materially) deviate from arm’s length behaviour or do not fulfil the minimum documentation requirements. Documentation with a high complexity level and missing transparency and traceability may be rejected by the Swiss tax authorities if the result cannot be confirmed by a plausibility check. As a countermeasure against potential BEPS behaviour, the Swiss authorities use anti-tax avoidance rules based on long-standing court practice.

3.3. The role of the OECD TP guidelines in Switzerland

Before the last revision of the current OECD TP guidelines which were approved by the council on 22 July 2010 the traditional transaction methods were “preferable to other methods” and considered “the most direct means of establishing whether conditions in commercial and financial relations between associated enterprises are at arm’s length” 80 For practical reasons the Swiss tax authorities still favour the one-sided method but also accept “the most appropriate method for a particular case”. 81

In mutual agreement procedures, Switzerland follows the OECD guidelines by considering functions, assets and risks. As Switzerland is a highly developed country with substantial innovation activities, the consideration of intangible assets and the related risk in building them up, are of importance. Formulary apportionment methods do not consider intangible assets and are therefore not appropriate for the cross-border profit allocation based on arm’s length considerations. Within Switzerland, there is an administrative and court practice for the allocation of profits to the different cantons based on formulary apportionments (indirect allocation). This is the standard method comparable to safe harbour rules. However a direct profit allocation based on arm’s length principles and corresponding documentation (e.g. branch accounting) is accepted.

3.4. Relationship between transfer price and customs value

One-sided TP methods (e.g. resale price method, cost plus, TNMM, CUP) can be reconciled with customs law as customs and one-sided methods are transaction oriented. From a practicability and efficiency point of view income tax, indirect tax (VAT) and customs authorities should be interested in seeking the further alignment of the valuation of cross-border transactions rather than creating more differences with profit split approaches.

80 Cf. OECD TP guidelines 2009, s. 2.4.9.
81 Ibid., s. 2.2.
3.5. Efficient tax assessments without new TP laws

The equal treatment of taxpayers and the efficient levy of tax revenue are two important goals for the Swiss tax authorities. In Switzerland, all tax returns are reviewed. Unlike some other countries Switzerland did not take unilateral action by establishing domestic TP laws. Critical transactions can be presented proactively to the competent tax administrations by taxpayers in advance of their execution. A ruling issued by the authorities responsible for assessment provides certainty and avoids surprises in the assessment process. Switzerland has been successful with efficient ruling procedures and timely discussions between the competent tax administrations and taxpayers.

The process of changing laws in Switzerland takes a lot of time. TP is a dynamic discipline as it follows or should follow business developments. Therefore, there is no activity in Switzerland to establish TP laws or regulations other than updating safe harbour rules. The Swiss practice and courts follow TP and business developments dynamically and have developed rules against tax avoidance.
Summary and conclusions

BEPS action plans related to transfer pricing (TP) were put in place in Turkey with the draft entitled general communiqué serial no. 3 on disguised profit distribution through TP. The draft communiqué has not entered into force and studies on it continue.

The subparagraph added to the Corporate Income Tax law via article 59 of Law No. 6728, dated 17 July 2016, brought some changes to the implementation of the arm’s length principle. In addition to the existing methods for determining arm’s length, the law, which came into force on 9 August 2016, added the “transactional net margin” and “profit split” methods to TP legislation.

The definition of an intangible asset is in the secondary regulation, but many respected experts think that this definition does not meet the OECD’s expectations.

Article 3 of the draft transfer pricing communiqué serial no. 3 states that new additions must be applied to the comparability section of the effective TP communiqué. The purpose is to take into account local market qualities, the experienced work force, and group synergies in the benchmark analysis. This article aims to bring TP documentation in Turkey into conformity with the BEPS Action 13, and foresees reporting in three phases. The Convention on Mutual Administrative Assistance in Tax Matters was signed on 3 November 2011 and is now awaiting a vote in Parliament.

1. Introduction

Operations of multinational companies (MNEs) in the same or similar business lines in more than one sovereign country and/or as partnerships on the same or different continents raise questions regarding the “intra-group services” of these companies in international literature and practice. These activities, which are especially relevant to the free circulation of “labour, capital, and services” and profit maximization related to globalization, have accelerated to become some of the most important topics related to tax policies and legal jurisprudence. Turkish jurisprudence is following this global trend. The new Corporate Tax Law, which

* PwC, Tax Partner/Dispute Resolution Services
came into force in 2006, is an important milestone in the implementation of the OECD and EU approaches in Turkish law.1

According to World Bank data, the amount of total global foreign direct investments was US$331.8 billion between 2011 and 2015. Turkey had received US$12.765 billion in foreign direct investment (FDI) as of 2014.2 The number of foreign companies at the time this report was written was 41,397, according to official data, and 612 companies have regional operation centres in Turkey according to data from 16 global companies in Turkey.3

In terms of legal issues, the above figures indicate a high number of agreements in private law and related rights and responsibilities or state private law issues, and unavoidably tax law matters in public law. Income subject to tax or, in other words, the tax base, changes depending on certain private law practices, which are basically related to the code of private obligations. Differences of opinion on the definition, scope, and content of actions arising from an agreement cause large numbers of material tax disputes between the tax authorities and taxpayers.

A significant number of tax disputes arise from TP, which can be defined as “the price charged by the parent company to its subsidiaries or other related companies [or persons] for the goods, services or intangible assets that it sells”.4 TP, by its nature, refers to cross-border transactions and, generally, to international legal transactions. It is not simply an aspect of international taxation but is the most important tax problem that the business world faces today, and it will continue to face this same challenge in the future.5 There is no doubt that this view is applicable to the legal system in Turkey, which has for a long time been a member of the OECD.

BEPS reports on TP led to work on a draft communiqué on domestic law which will be implemented in Turkey. This draft communiqué entitled general communiqué serial no. 3 on disguised profit distribution through TP has not yet come into effect. In addition, new methods were added for determining the arm’s length principle with the change to the relevant article of the Corporate Tax Law.

This report reviews the basis of the arm’s length principle, which is the cornerstone of TP, in terms of Turkish positive law, and its implementation considering the impact of relevant BEPS action plans.

2. Arm’s length principle present and future

The disguised capital, disguised earnings and arm’s length principles stated in Corporate Tax Law6 No. 5422 are to a certain extent revised in Corporate Tax Law

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5 Official Gazette, 10 June 1949, No. 7229.
No. 5520, which became effective in 2007, in line with international standards and OECD norms to determine clearer and more tangible standards. It should be noted that the expression “as compared to arm’s length” is used for disguised capital and earnings in Law No. 5422. However, there is no reference in the same law to methods or conditions for determining the arm’s length nature. With the enactment of Corporate Tax Law\(^7\) No. 5520 in 2006, the “arm’s length” principle was included in the law. The TP legal regulation was amended a couple times after it was first enacted.

The sub-title of article 13 of Corporate Income Tax Law No. 5520 is “disguised profit distribution through transfer pricing”. The first version of the article, which came into force and is related to this report, is as follows:

“The article 13-(1) If companies perform goods and services purchase or sale transactions with related parties in a manner contrary to the arm’s length principle, the earnings are deemed to be completely or partially distributed through transfer pricing in a disguised manner. Purchase, sales, production and construction work, rental and lease transactions, borrowing and lending, transactions requiring bonuses, and salaries and similar payments are under any conditions considered the purchase or sale of goods or services.

(3) The ‘arm’s length principle’ is defined as the compliance of the price and cost applied to buying and selling goods and services from/to related parties with the price and cost that occurs when no such relation exists between them. It is obligatory to keep the records, tables and documents related to the calculations of prices or fees determined according to the arm’s length principle as proof.

(4) The Law states that the prices or fees applied by enterprises for transactions performed with related parties can be defined using the most appropriate method from the list below:

(a) Comparable price method: the comparable uncontrolled price method compares the price applied between related parties to the price applied in transactions between real or legal entities engaged in the purchase or sale of comparable goods or services and not related to one another in any way.

(b) Cost plus method: the cost plus method is defined as the calculation of arm’s length prices by adding a reasonable gross profit margin to the costs of goods or services.

(c) Resale price method: RPM is defined as the calculation of the arm’s length price by subtracting a reasonable gross sale profit from the price that will be applied upon resale of the goods or services to real or legal persons that are not related to one another.

(d) If arm’s length prices cannot be identified using any of the above-mentioned methods, the taxpayer is free to employ another method suited to the nature of the transactions.”

The implementation of and conditions for the arm’s length principle which are required by the law are regulated by a secondary regulation. Council of Ministers Decree\textsuperscript{8} No. 2007/12888 and general communiqué serial no. 1 on the distribution of disguised profit through TP\textsuperscript{9} which detail the arm’s length principle and methods to be used.

The subparagraph added to article 59 of Law No. 6728 dated 17 July 2016 brought some changes to the implementation of the arm’s length principle. In addition to the above-mentioned methods for determining the arm’s length price, the law, which came into force on 9 August 2016, added the “transactional net margin” and “profit split” methods to TP legislation:

“(c) Transactional profit methods: Transactional profit methods take the profit arising from related parties as the basis for determining price and fee. This category of method includes the transactional net margin method and the profit split method. The transactional net margin method relies on the examination of the net profit margin identified by the taxpayer relative to an appropriate base such as costs, sales, or assets. The profit split method is based on the allocation of total operating profit or loss attributable to one or more controlled transactions of related parties at arm’s length rates depending upon the functions performed and risks undertaken.

(d) If arm’s length prices cannot be identified using any of the above-mentioned methods, the taxpayer is free to employ another method suited to the nature of the transactions.”

With these changes, Turkey’s TP regulation was brought into full compliance with the OECD TP guidelines (2010) in terms of methods used to determine arm’s length fees and prices. These changes in the legislation highlight transparency and increase clarity and predictability for the taxpayer. In this regard, it can be said that the increase in the number of methods for determining the arm’s length price is the result of BEPS action plans.

3. Challenges of transactions with intangibles

Using intangible rights and transferring them within MNE groups have been controversial subjects legally for most countries, including Turkey. Disputes are generally related to the definition of intangible rights outside the digital economy.

3.1. Definition of intangibles

The definition of intangible rights in Turkish tax law is included in the secondary legislation (TP general communiqué serial no. 1). Subtitle 10(1) (definition of intangible rights) of the communiqué is as follows:

\textsuperscript{8} Official Gazette, 6 December 2007, No. 26722.
\textsuperscript{9} Official Gazette, 18 November 2007, No. 26704.
“The right to use the copyright of any literary, artistic, or scientific work, including cinematograph films and recordings for radio or television, any patent, trade mark, design, model, plan, secret formula or process, or of information concerning industrial, commercial, or scientific experience, or for the use of or right to use industrial, commercial, or scientific equipment…”

In other words, intangible rights include the right to use industrial assets such as patents, trademarks, trade titles, designs, models, ownership rights of literary and artistic works, commercial knowhow, and intellectual rights such as trade secrets.

In the communiqué, intangible rights are divided into commercial intangible rights and intangible rights for marketing based on their features. Commercial intangible rights are defined as patents, knowhow, designs and models used in the production of goods, and intangible rights in the nature of commercial assets transferred to customers or used in commercial activity (such as computer software). Intangible rights for marketing are defined as trademarks and trade titles supporting the commercial use of a product or service, customer lists, distribution channels, and idiosyncratic names, symbols, or pictures which have an important promotional value in terms of the product.

A survey was conducted by the tax administration to measure whether this definition meets the expectations of the executors. Participants in the survey were asked to what extent they were satisfied with the new definition of intangible assets in defining transactions including intangible assets and determining the correct arm’s length. Whereas 27 per cent of company executives and 32 per cent of tax inspectors stated that the new definition met their expectations (at a high or very high level), the rates were much lower for bureaucrats (0 per cent very high and 15 per cent high). As the results show clearly, the definition of the intangible asset in the communiqué did not meet the level of expectations in practice which is required by OECD.

According to unofficial statements, the Ministry of Science, Industry and Technology and the Ministry of Finance are carrying out joint work to define intangible assets. It is commonly believed that a common and comprehensive definition will be used in Turkish law to meet the expectations of the OECD when the work of the ministries is concluded.

10 An on-line survey was conducted by the tax administration between July 2015 and September 2015 of Turkish company executives, tax inspectors, and senior officials (also referred to here as survey participants or participants). Following an in-depth investigation to identify the relevant people for each participant group, a total of 542 people from a pool of 8,226 people was identified as being potentially eligible to participate. However, in an in-depth investigation, 339 people were eliminated for a variety of reasons (e.g. invalid email addresses, job changes, no longer being eligible, their company not having TP transactions). Ultimately, invitations to participate in the on-line survey were emailed to the remaining 203 eligible participants. Valid responses were collected from 44 company executives, 20 senior officials, and 46 tax inspectors. For detailed explanations see Erdal Aydin, “Transfer Pricing Actions under the OECD BEPS Project: Impact on Turkey and Attitude Toward the Project Outcomes”, International Transfer Pricing Journal, January/February 2016, IBFD, p. 86.

11 Ibid., p. 90.
3.2. Transactions with intangibles

In Turkish law, there is no specific regulation about the transfer of intangible rights within MNEs. General principles and the rules of TP apply to specific events. In the transactions related to intangible rights, there is no explanation or authority’s approach that provides guidance for TP practices.

3.3. Substance-over-form approach towards intangibles

Turkish law does not contain a specific substance-over-form practice for determining the ownership of intangible rights (legal/financial). In addition, the general anti-avoidance rule in the Tax Procedural Law can apply to intangible rights and the reporter believes that the authority’s approach will be the same. Article 3 of Tax Procedural Law states the following:12

“(A) Implementation of tax laws ….Tax laws make a statement with the letter and spirit. In cases where the wording is not clear, the provisions of the tax laws are implemented considering the purpose of enactment, place and context of the wording in the law, and its connection with other provisions.

(B) Justification: In taxation, the true nature of the taxable event and of any related transactions shall be fundamental… The true nature of the taxable event and of any related transactions may be justified by all types of evidence except oath. Statement of witnesses whose connection to the taxable event are not certain and explicit may not be used as a tool of proof …if a claim is made that does not comply with financial, commercial and technical requirements, or which is not normal and customary under the conditions of the incident, then the justification of expenses lies with the claiming party.”

Accordingly, it can be foreseen that the tax authority will handle the transactions related to intangible rights within the group in line with article 3 of the Tax Procedural Law. Even if article 3 is used, it is not certain which test standard will be used for the true nature of the transaction. For such matters, there is no legislation study related to implementation of a general anti-abuse rule (GAAR).

In addition, sections 10.2 and 10.3 of the effective communiqué serial no. 1 regulate the methods to be used for determination of arm’s length price and arm’s length principle for intangible rights. Accordingly, the price in product or service purchase or sales transactions between related parties where intangibles are involved will be determined according to the arm’s length principle.

As per the communiqué, first of all the transferor and the transferee of the intangible right must be evaluated separately when determining the arm’s length price of intangibles. From the perspective of the transferor, the arm’s length price of the intangible right should be the price at which the owner of the intangible right would be willing to transfer the right in a comparable and uncontrolled transaction.

12 Official Gazette, 10 January 1961, No. 10703.
From the perspective of the transferee, the arm’s length price is the amount a comparable unrelated enterprise would accept paying for an intangible right it planned to use in its business.

The communiqué advises the following approach regarding the methods to be used to determine the arm’s length price of an intangible right. In cases when intangible rights are involved in related party transactions, a benchmark analysis must be carried out between controlled and uncontrolled transactions in order to apply the arm’s length principle. The best TP method will then be determined for purchase or sale transaction of the intangible right.

The comparable uncontrolled price (CUP) method may be used to determine the arm’s length price for the sale or licensing of an intangible right. As per this method, if the owner of the same intangible right can determine the price based on which a similar intangible right is transferred or the licence right is granted to unrelated parties under comparable conditions, this price will be used as the arm’s length price/value.

A CUP may be used in the sale of products involving intangible rights. If intangible rights are to be marketed (for instance a commercial brand), acceptability by customer, geographical importance, market share, and other relevant criteria must be taken into account in the benchmark analysis to be carried out. When commercial intangible rights are involved, the importance of the relevant intangible rights (protected patent or other types of exclusive intangible rights) and R&D functions must be taken into account in the benchmark analysis.

However, in transactions where highly valuable intangible rights are involved and comparable uncontrolled transactions cannot be found, methods other than the CUP may be used to determine arm’s length price.

3.4. Comparability and group synergies

Article 3 of the draft transfer pricing communiqué serial no. 3, which was prepared after the BEPS action plan, states that new additions must be applied to the comparability section of the effective TP communiqué. The purpose is to take into account the local market qualities, experienced workforce and group synergies in the benchmark analysis. Article 3 of the draft communiqué underlines that the qualities of the geographical market where operations are carried out may affect comparability and the arm’s length price within the scope of benchmark analysis. Within this context, some obstacles may arise in the evaluation of differences between geographical markets and the determination of proper comparability adjustments. In some cases, the differences may stem from cost advantages in the market that carries out operations. According to the communiqué, such advantages are called location advantages.

In cases when it is possible through functional analysis that comparable companies and transactions are available in the local market, and location advantage can be established within the group, comparables in the local market are the most reliable indicators to determine how to distribute location advantage between two or more related parties. In such cases, if reliable local market comparables can be used to determine the arm’s length price, there is no need to make comparability adjustments related to location advantage.
On the other hand, when making an adjustment related to location advantage, all conditions, functions performed, risks assumed, and assets used must be taken into account.

In addition, in TP analyses it is important to differentiate between knowhow, licences, or contractual rights that are regarded as intangibles and must be used in the relevant market. Also, the local market qualities which cannot be regarded as intangible rights must be recognized. For instance, in some cases, contractual rights and licences may limit the entrance of competitors (i.e. comparable companies) into the relevant market and as a result have an impact on the sharing of differences resulting from local market qualities between related parties. That is why such issues must be taken into account in benchmark analyses.

According to the draft communiqué, some enterprises are very successful at combining experienced and high quality workforce groups. The services performed among related parties by such workforce groups must be taken into account in benchmark analysis if necessary. The transfer of experienced members of the workforce between the parties of the transaction will provide time and cost savings for the transferee who will receive experienced and high quality employees when new hiring and training expenses are taken into account. In this case, the transferee may need to pay an arm’s length price for the services of the employee when a temporary assignment is in place between related parties. The transfer or temporary assignment of one or more members of the workforce, under certain conditions and assumptions, may result in the transfer of valuable knowhow or other intangible rights between related parties. In this case, transactions must be analysed separately. Therefore, TP analyses for the usage of intangible rights must be carried out separately.

In addition, the requirement for comparability adjustments may arise due to the synergies of the MNE group. In some cases, related parties in the group and MNE groups benefit from the relationship and synergies between group members, which generally cannot be found among third parties, such as shared management, shared purchasing power, shared computer and communication systems, higher borrowing power, etc. Such group synergies will be beneficial for the group as a whole. As a result, the group’s total profitability will increase based on cost advantage and competitive conditions. If a group synergy exists and group members have a common attitude to benefiting from such synergy, the benefits may be shared among group members pro rata to their contributions. In such cases, it is accepted that comparability adjustments may be necessary to explain group synergies.

The provisions of the draft communiqué are proper in terms of making an accurate and effective comparison. The reporter believes that after the draft is accepted, domestic legislation will be fully compatible with OECD methods and approaches in terms of understanding and foundations.

### 3.5. Hard-to-value intangibles

Turkish tax legislation does not include a specific provision regarding the procedures for testing the pricing of intangibles for which a comparable is almost impossible to find and valuation is hard, such as brand and royalties.
3.6. Cost contribution agreements (CCAs)

The effective TP legislation does not regulate CCAs. In addition, the draft TP communiqué regulates the matter in detail, after the intra-group services section of the effective communiqué serial no. 1. According to the communiqué, CCAs are defined as follows:

“Cost contribution agreements are contractual arrangements between related parties with the aim of sharing contributions and risks for acquisition; production; or shared development of intangibles, tangible assets, or services. Each contributor is expected to create benefits for the said intangibles, tangible assets, or services.”

As stated in the draft, CCAs have the nature of a contractual agreement rather than a legal entity or permanent establishment created by a combination of all contributors. Accordingly, the parties to the agreement are not expected to combine their activities in order to benefit from CCAs. Instead, a system is formed where contributors can benefit from the results of this agreement with their individual activities.

In the format planned to be included in TP legislation, CCAs are models with the fundamental element of sharing contributions. Parties who have similar economic qualities and who act within the scope of a contract expect to derive similar revenue regardless of whether the contract is called a CCA or not.

CCAs are divided into two in the draft: development CCAs and service CCAs. Development CCAs are entered into with the aim of acquisition, production, or shared development of intangibles or tangible assets. Service CCAs are entered into for the acquisition of services are evaluated within the unique conditions and terms of each agreement. The basic difference between the two agreements is that development CCAs are expected to create continuous and prospective benefits for contributors, whereas service CCAs are expected to create only current benefits.

In service CCAs, contributions basically involve the development of services, whereas, contributions in development CCAs mostly involve the performance of development activities (e.g. R&D, marketing) and, in general, additional contributions such as tangible assets and intangibles related to this agreement which existed previously.

Regardless of the type of CCA, the value of all current or currently available contributions must be determined and calculated according to the arm’s length principle.

Section 13.2 of the draft communiqué regulates the implementation of the arm’s length principle in CCAs. Accordingly, in order to apply the arm’s length principle to a CCA, the contributions of a contributor must be consistent with the contributions an independent enterprise would accept to provide within the scope of the benefit to be derived reasonably from any agreement of such a type under comparable conditions.

In order to determine whether a CCA fulfils the requirements of the arm’s length principle (for example, determining whether the share of each contributor of the total amount of contribution made to the relevant agreement is consistent with the share the contributor is expecting to obtain from the whole benefit), the value
(amount) of each contributor’s contribution to the agreement needs to be defined. To ensure consistency with the arm’s length principle, the value of the contributions should be calculated on the value emerging at the time of providing the contribution. This should be done by taking into account the investors’ mutual risk sharing in addition to the scope and quality of the benefit expected from a CCA.

While determining the value of the contributions, the differences between the value of the already existing contributions and the value of the contributions made in the current period need to be detected. All contributions are defined according to value. However, in some cases it might be appropriate to determine the value of contributions according to the cost. In cases where the difference between contribution value and cost is relatively insignificant due to practical reasons, current contributions for service CCAs can be measured with cost. However, in some other cases (for instance, contributions provided by the contributors may consist of various service types and/or intangible assets or other assets) it is impossible to measure the cost of the current contributions and determine the respective contributions of the contributors and this could lead to results that are not at arm’s length. For development CCAs, the measurement of the current contributions based on cost generally does not lead to reliable results for the implementation of the arm’s length principle.

Since the mutual benefit concept is of great significance in the context of a CCA, in cases where one of the parties is not expected to gain a reasonable benefit from the agreement, that party is not accepted as a contributor.

The communiqué covers balancing payments with regard to the adjustment of contributions at different rates. According to this, balancing payments should fulfil the conditions of the arm’s length principle which requires that each contributor’s contribution that is determined in proportion to the total contributions is consistent with the benefits defined in proportion to the total benefits expected to be gained as per the agreement. If the determined contribution for each contributor is consistent with the share the contributors will gain from the total benefit expectations from the same agreement, also taking the balancing payments into account, the CCA is accepted to be at arm’s length. If this consistency cannot be ensured, the return provided to at least one of the contributors for its contributions will be insufficient. The return at least one contributor will gain for its contributions will be higher than the return an independent company would gain under comparable conditions. In such a case, an adjustment is required according to the arm’s length principle. The quality of the adjustment might change in accordance with the current conditions and nature of the transaction in question. However, the adjustment generally consists of making a balancing payment.

Contributions made to a CCA, including the balancing payments, should be evaluated within the framework of the provisions that would be applicable if the contributions were made outside the scope of a CCA in order to continue the relevant activity from a tax perspective.

On the other hand, a party involved in a CCA in force might gain benefits from the results of the activities started before its own involvement in the agreement. In such a case, the payment of the amount corresponding to the arm’s length value of the benefit transferred during the transfer of the existing rights from the existing contributors to the new joiners as per the arm’s length principle is called an entrance payment.
It is also possible for a contributor to withdraw from a CCA. The party withdrawing from the agreement can transfer the benefits emerging from the past activities carried out within the scope of the agreement (also including the ongoing activities) to other contributors. This transfer transaction should be priced in accordance with the arm’s length principle. The payment made for this transaction is called an exit payment. All these payments are evaluated according to the nature of the transaction and in line with the relevant provisions of the Corporate Income Tax Law and the provisions of the relevant double taxation treaty.

Some of the information and documents should be included in the annual TP report for the period when the CCA was made and the period during which the agreement was in force.

4. Risk and capital

Action 9 of the BEPS action plan sets forth the development of rules among the group members to prevent BEPS through the transfer of risk or allocation of idle capital. The aim is to introduce special rules to enable the adoption of the relevant TP rules or to prevent the accrual of inappropriate profits due to reasons such as investing capital or assuming risks only on paper. Turkish TP legislation does not include any provisions regarding this issue. There is also no provision regarding this topic in draft TP communiqué serial no. 3. Turkey has not yet taken any precautions with regard to Action 9.

5. High-risk transactions

5.1. Commodity transactions

Turkish TP legislation does not include any regulations related to commodity transfers. There is also no regulation regarding this topic in the draft TP communiqué. It is possible that this approach results from article 3 of the Tax Procedural Law in force (GAAR). Moreover, we see that article 5(3) of the draft Tax Procedural Law gives extensive discretion to the tax authority with regard to such transfers. The article states the following:

“(3) The impact of the actions on the tax liability that aims to hide or change the real nature of the taxable event or transactions related to said event by, for example, abstaining from provisions of tax laws, staying out of the necessary tax liability, or planning the tax liability in a way to create an advantageous effect is not taken into consideration. This action’s being legally valid, registered, or subject to an official form does not change the consequence.”
5.2. Intra-group services

The topic of intra-group services is covered in article 11 of TP communiqué serial no. 1. The definition and scope of the intra-group services are as follows: intra-group services are services rendered between related companies, and mainly by services provided by the parent company to its affiliate or services provided by one group company to another. These services also include the provision of management, coordination, and control functions for the entire group. The cost of rendering such services might be undertaken by the parent company, a group company assigned for this purpose, or another group company (group service centre).

The communiqué states that the following should be determined with regard to intra-group services:
• whether the service has actually been provided;
• whether the recipient company/companies actually needs/need the relevant service;
• if the service is actually received, whether the service fee is in compliance with the arm’s length principle.

It is obligatory to determine whether the intra-group service is actually provided as per the arm’s length principle. Accordingly, when applying the principle, it should be considered whether the service provides a commercial or financial value which will strengthen the receiving group company’s commercial position.

5.2.1. Determining the arm’s length fee for intra-group services

In addition to determining whether the intra-group services are actually provided, it is also necessary to separately evaluate the arm’s length nature of the service fee from the perspectives of both the service receiver and service provider.

The arm’s length fee for the services provided to one or several of the group companies will be determined within the framework of the methods defined in the communiqué. As a result, the service fee needs to be the arm’s length fee in intra-group services.

5.2.2. Methods that can be used to determine the arm’s length fee for intra-group services

According to the communiqué, the methods used for determining the arm’s length price for intra-group services are selected in accordance with the relevant sections of the communiqué. However, the CUP method or cost plus method might be preferred over other methods for the pricing of intra-group services.

The CUP method can be applied when a comparable service exists between unrelated companies operating in the same market as the party receiving the service. For instance, this method can be applied to the services provided in the fields of accounting, law, or computers. However, in cases where a comparable price cannot be found, it would be more appropriate to use the cost plus method. For the application of this method, the cost base of related (controlled) and unrelated (uncontrolled) transactions must be the same.

On the other hand, in cases where it is not possible to apply the CUP method or cost plus method, it is possible to use the other methods stated in this communiqué.
to make sure that the arm’s length price is correctly determined. For using these methods, a functional analysis needs to be carried out among the group companies.

As can be seen in the legislation in force mentioned above, there is no differentiation of low value-added or high value-added in terms of intra-group services in Turkish law. The tax authority’s approach to intra-group services is to check whether goods or services are actually received, benefited from, or at arm’s length. Low value-added and high value-added differentiations did not exist before the BEPS actions and were not covered in the draft communiqué either.

5.3. Profit splits in the context of value chains

No regulation related to this topic exists in the domestic legislation. The tax authority’s approach to this matter is to act on the basis of traditional methods.

6. TP documentation

As mentioned in the previous sections of the report, TP legislation at OECD standards was introduced into domestic law through Corporate Income Tax Law 5520. The principles of TP documentation are covered in general communiqué serial no. 1 on disguised profit distribution through TP. The communiqué introduced two different types of documentation liability for the taxpayers. Accordingly, taxpayers need to fill out the form in the appendix of the corporate income tax return with regard to the goods or services purchased or sales transactions they perform with their related parties in an accounting period. Furthermore, taxpayers registered with the Directorate of Major Taxpayers Tax Office are obliged to prepare an annual TP report including the information and documents stipulated by the communiqué and in the format defined there. These reports are made with regard to the domestic and overseas transactions they carry out with their related parties in an accounting period and overseas transactions carried out in a given accounting period by other corporate income tax payers and their related parties. They need to be completed by the submission date of the corporate income tax return and to submit this report to the authority or the officials authorized to carry out tax inspections after the end of this period, upon demand.

6.1. Country-by-country reporting (CbCR)

Within the scope of the BEPS Action Plan 13, draft TP communiqué no. 3 aims to bring TP documentation in Turkey into conformity with the action plan. Article 6 of the draft communiqué examines the trio documentation system in detail and completely in line with the OECD approach.

The communiqué states the following about CbCR:

“the previous accounting period should be submitted online by the end of the 12th month after the accounting period reported by the ultimate parent company, located in Turkey, of a multinational enterprise group, whose total consolidated
group income is two billion, thirty-seven million TRY or more based on their consolidated financial statement.”

The report should include the following:

“a) income amount, profit/loss before tax, income tax/corporate income tax paid, accrued income tax/corporate income tax, authorized capital, previous year’s profits (retained earnings), number of personnel, non-cash and non-cash equivalents tangible fixed assets related to each country where the multinational enterprise group operates;

b) for each establishment of the multinational enterprise group, the name/title, location (the place it operates should also be included if the establishment location is different from the operating location) and the nature of the main business operations.”

As per the draft communiqué, CbCR is made by the end of the 12th month after the accounting period and is reported by one of the MNE group’s companies on behalf of itself and all the other companies, if there is more than one company, in the event there is no agreement related to automatic sharing of CbCR information between the authority and the country authority where the ultimate parent enterprise is located, or in the event that the country authority where the ultimate parent enterprise resides has not put into force the legal regulations related to CbCR.

The first CbCR must be made for the 2016 accounting period by 31 December 2017. The ultimate parent enterprise, which is located in Turkey and subject to the special accounting period, will complete the first CbCR for the accounting period starting after 1 January 2016.

The above-mentioned amount, which is related to total consolidated group income based on the MNE group’s consolidated financial statements, is stated in TRY and is equal to €750 million using last year’s January average buying rate of exchange announced by the Central Bank of the Republic of Turkey for the 2017 accounting period and later.

Forms in Appendix 5, which are based on CbCR, will be filled out in line with the explanations included. CbCR information could be mutually shared with other countries’ tax offices as per the bilateral and/or multilateral international agreements which Turkey is also a party to. The authority will announce the list of the countries which are party to the agreements.

Turkey made its first tax information exchange agreement with Jersey on 23 November 2010, and the agreement entered into force in 2013. In line with developments in international law, this agreement, which preceded the BEPS plan, was followed by Bermuda (2012), Guernsey (2012), the Isle of Man (2012), Gibraltar (2012) after the issuance of action plans. Additionally, Turkey signed the FATCA with the USA (2015), and the agreement was ratified by Parliament.

14 Official Gazette, 27 April 2013, p. 28630.
15 Not yet in force.
16 Not yet in force.
17 Not yet in force.
18 Official Gazette, 5 October 2016, p. 29848.
Following the signing of the tax information exchange agreement, a “competent authority arrangement” was signed with the USA only (2016).19

Also, some double tax treaties were amended. Not only was article 26 of the double taxation treaty between Turkey and Luxembourg on information exchange revised, but the whole agreement (2009) was revised.20 Article 26 of the double taxation treaty between Turkey and Singapore related to information exchange was amended by an additional protocol (2012), and the protocol entered into force.21 Article 25 of the double taxation treaty between Turkey and Malaysia related to information exchange was amended with the addition of additional protocols (2010) and the protocol entered into force.22

The Convention on Mutual Administrative Assistance in Tax Matters was signed on 3 November 2011 and is up for a vote in Parliament.

An article with these amendments was added to the current Tax Procedural Law. This article is as follows:

“Information exchange as per international agreements
Article 152/A
The Ministry of Finance Revenue Administration, or those authorized to do tax inspections, may collect information, without limitations, to the extent specified in Article 1 of this law, within the framework of information exchange provisions of international agreements which are duly entered into force and according to procedures determined by the Ministry of Finance.”

6.2. Master and local files

The parts of the draft communiqué related to definitions, master file, country file, and CbCR, were examined in detail. Accordingly, taxpayers who meet the following conditions must submit “the master file”, which is the first part of trio documentation.

“Corporate income taxpayers who fall within the scope of multinational enterprise groups and whose assets in the previous accounting period end balance sheet and net sales revenue on income statements are 250 million TRY or more, must prepare a ‘master file’ which includes the following information and documents by end of the second month following the corporate income tax return submission date, and must submit it to the administration or those authorised to perform tax inspections upon demand after the submission date expires.”

A “country file”, which is another part of trio documentation, mentions transactions and taxpayers which meet the following conditions:

“If the amount of the goods or service purchases or sales transactions the corporate taxpayer carries out with related parties in the accounting period is thirty

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19  See agreement www.gib.gov.tr.
20  Official Gazette, 4 July 2011.
21  Official Gazette, 6 June 2013, p. 28668 (duplicate).
thousand TRY or more, for these transactions the taxpayers must fill out ‘the form on transfer pricing, controlled foreign companies, and thin capitalization’ in Appendix 2 and submit it to the tax office mentioned in the corporate income tax return. No transaction related to goods or service purchase or sales in the relevant accounting period with a net amount less than thirty thousand TRY shall appear on this form.

A taxpayer with assets on the previous accounting period end balance sheet and net sales revenue on income statement of 100 million TRY or more must submit a ‘transfer pricing form for transactions made with related parties’ online, in Appendix 4, for transactions exceeding thirty million TRY with related parties in a single accounting period by the end of the second month following the corporate income tax return submission date. When the transaction amount is equal to or greater than thirty thousand TRY, the total net of purchase-sale transactions carried out with each related party in the relevant accounting period are considered.”

6.3. Compliance costs

The trio documentation system, which is mentioned above and is considered to be new under Turkish legislation, worries stakeholders due to the costs incurred in order to be compliant, and issues raised during implementation. A survey carried out by the tax office asked Turkish company directors if they were concerned about TP compliance and documentation costs, which are expected to increase. The survey showed that Turkish company directors expect an 87 per cent increase in costs due to the increasing amount of information and reporting which will be requested by companies within the scope of Action 13. Nothing has been done to meet their concerns.23

Compliance costs cover documentation, employing personnel, fees paid to consulting firms assigned to a joint study, and the fines incurred if compliance falls short. Fines applied to the taxpayers who do not meet the documentation obligation were amended in Article 278 of the draft Tax Procedural Law entitled “Special irregularity acts and fines”:

“The expected fine for those who do not prepare the transfer pricing reports or forms which the Ministry of Finance requires, or who omit information, or provide incorrect information, is expected to be 50,000TRY for each report or form.”

In addition to the extra costs new regulations bring to taxpayers, a set of benefits are planned for taxpayers who do the documentation correctly and on time.

Law No. 6726 which entered into force on 9 August 2016 resulted in many changes to Turkish tax legislation. One amendment rewards firms which meet the documentation obligation for TP. Accordingly, subparagraph m.13/8 of the Corporate Income Tax law was amended as follows: “a 50% discount is applied on the

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23 Aydin, op. cit., p. 93.
penalty due to loss of tax for taxes which are missing or not accrued because of thin capitalization”.

7. TP-related measures in other BEPS actions

There are no developments in Turkish legislation related to this topic.

8. Other measures against BEPS

In parallel with developments globally and with the BEPS project, levying tax on digital economies is a subject about which the Turkish tax office shows interest. The power to raise taxes is a sovereign power, but it extends only to the limits of sovereignty, and this power is limited to the time and place in which sovereignty exists. Countries base their tax-raising power on two legal concepts: territorial sovereignty and individual sovereignty. Territorial sovereignty is defined as the sovereignty a state has over its country, while individual sovereignty is defined as the sovereignty a country has over its citizens. Currently, countries’ tax-raising powers are based on the source principle which is based on territorial sovereignty law and on the principle of residency which follows from individual sovereignty law.\(^{24}\) In tax law, a problem is created in that there is a question related to ownership of a specific possession, and the outcome depends on political preferences.\(^{25}\)

Taxation problems resulting from non-fixed workplaces in the digital sector triggered the Turkish financial authority to redefine workplace. The first studies on this subject are included in the draft Tax Procedural Law. Article 129 of the draft defines the workplace as follows:

“A workplace is a place designated for and used in carrying out commercial, industrial, agricultural, and professional activities in the following kinds of sales office, atelier, warehouse, laboratory, exhibition hall, training sites, home office, auction hall, hotel, coffee shop, entertainment and sport centre, field, vineyard, orchard, farm, livestock raising facilities, weir and cast location, salt pan, quarry, mine, construction area, vehicle transporting freight or passengers, kiosk at a ferry, mobile vehicle, electronic environment.”

In addition, a workplace at an electronic environment was defined in article 130 as follows:

“(1) A workplace is created in an electronic environment when internet, extranet, intranet or a similar telecommunication media or device is assigned to a commercial, industrial or professional activity.

(2) The Ministry of Finance is authorized to do the following:


determine matters related to the scope of workplaces emerging in the electronic environment and related to fulfilling liability obligations;

• hold those who are intermediaries providing goods or service via workplaces which have emerged in the electronic environment and goods/service recipients, responsible for paying service fees and relevant taxes;

• determine the procedures and principles for implementation.”

As per the draft articles mentioned above, the Turkish Financial Authority tends to recognize the electronic environment as a workplace. In addition, there is an arrangement related to creating a workplace in the electronic environment by carrying out a commercial or professional activity through the internet.

Using the provisions in the draft, the Turkish Tax Office has shown the intention and taken the first steps in levying taxes on electronic commerce using the source principle under the framework of BEPS Action 1 on taxing the digital economy.

9. Can BEPS work in favour of MNEs?

There is no initiative regarding this in Turkish law.
Summary and conclusions

Historically, Ukrainian transfer pricing (TP) regulations at the level of laws have existed for a long time; however, the provisions were rather basic. In September 2013, a tax reform was launched, which introduced more detailed and full-fledged TP regulations which are generally based on OECD TP guidelines.

According to Ukrainian TP regulations, only cross-border transactions of Ukrainian taxpayers can be potentially qualified as controlled transactions falling under the scope of TP control, while intra-Ukrainian transactions between Ukrainian taxpayers are outside the scope of the regulations. Importantly, not only cross-border transactions with related non-residents can fall within the scope of TP control, but also transactions of Ukrainian taxpayers with non-related non-residents from “low-tax” jurisdictions and some others.

If a Ukrainian taxpayer was involved in controlled transactions during a reporting period then it has to (a) submit a report on controlled transactions and (b) provide TP documentation (i.e. local file) upon separate request of tax authorities. As of now, there is no requirement for the preparation and provision of master files or country-by-country reports (CbCR); however, it is expected that such requirement may be introduced into Ukrainian TP regulations soon.

Although the full-fledged TP regulations have been already amended several times after they were implemented in Ukraine in 2013, there are still many gaps and issues which are not addressed. In particular, Ukrainian TP regulations in their current state do not contain a separate definition of intangibles for TP purposes; special rules for recognition of transactions with intangibles; special rules on DEMPE functions in relation to intangibles; rules for identification of group synergies; rules on the valuation of hard-to-value intangibles (HTVI), rules on cost contribution agreements (CCAs), rules regarding control of the return on capital or compensation for the assumption of risk; and special rules on the application of the profit split method in the context of value chains. There is no information about whether any of these issues will be addressed with the next round of amendments into Ukrainian TP regulations.
That said, the Ukrainian TP regulations contain special rules in relation to controlled transactions on the import/export of certain commodity goods (i.e. the so-called sixth method). Particularly, there is a separate list of commodity goods in relation to which prices should be verified with the comparable uncontrolled price (CUP) method based on prices from international commodity exchanges.

The next round of amendments to Ukrainian TP rules and the next leap forward is expected with the implementation of the concept of the “deoffshorization” tax reform. The reform is heavily influenced by the base erosion and profit shifting (BEPS) project and it was announced by Ukrainian government in May 2016 in the form of a presentation. It is expected that the draft law for its implementation will be made public by the end of 2016.

This may introduce a number of TP changes in the Ukrainian TP regulations which are mostly driven by TP actions of the BEPS project, particularly Actions 8–10 and 13. Among the most important changes will probably be the introduction of master files and CbCR, further detail and clarification of the rules applicable to export/import transactions with commodities and the introduction of special rules for intra-group low value-adding services (the list of expected changes is not exhaustive). The issue of automatic exchange of tax information with the tax authorities of other countries is also raised by the reform and may be implemented.

It should be noted that besides TP related changes driven by TP actions of the BEPS project, the reform should also introduce other non-TP related changes which, however, are also driven by the BEPS project. The most significant of them are introduction of controlled foreign corporation (CFC) rules, rules introducing limitations on deduction of interest and other financial payments with related non-resident companies, measures on preventing the granting of double tax treaty benefits in inappropriate circumstances and measures on preventing the artificial avoidance of permanent establishment status.

Summarizing, it should be noted that there has been no actual effect of the BEPS project as of the date of this report either on Ukrainian tax legislation in general, or on its TP regulations in particular. However, it is expected that the BEPS driven changes may be introduced in Ukrainian legislation by the end of 2016 with the implementation of the tax reform.

1. Current TP regulation and practice in Ukraine

Historically, Ukrainian TP regulations at the level of laws have existed for a long time; however, the provisions were rather basic. In September 2013, a tax reform was launched, which introduced more detailed and full-fledged TP regulations. Ukrainian TP regulations are generally in line with OECD TP guidelines.

As of now, the major TP source in Ukraine is article 39 of the Tax Code of Ukraine (TCU). Article 39 became effective on 1 September 2013 and underwent a number of amendments afterwards. The latest major amendment was introduced in August 2015. Along with that, a set of TP matters are addressed in various by-laws adopted pursuant to article 39 of the TCU and with the purpose of detailing of its provisions. The list of the most important by-laws is provided in the annex.
As of the date of this report the following types of cross-border transactions may be qualified as controlled for the purposes of the TP regulations:

- between residents and related non-residents;
- between residents and non-residents registered in “low-tax” jurisdictions (the list of such jurisdictions is adopted by the Cabinet of Ministers of Ukraine);
- on sales of goods through non-resident commissionaires;
- with related non-residents or non-residents registered in “low-tax” jurisdictions involving non-related intermediaries which do not perform essential functions, do not use essential assets and do not bear essential risks.

These types of transaction can be qualified as controlled only if the following thresholds are simultaneously exceeded:

- the annual income of the Ukrainian taxpayer from any activity exceeds UAH 50 million/approximately €1.7 million; and
- the annual amount of transactions of the Ukrainian taxpayer with qualified counterparties exceeds UAH 5 million/approximately €179,000.

Once these thresholds are exceeded and a transaction is qualified as a controlled one for TP purposes, a Ukrainian taxpayer is required to comply with the following requirements:

(a) to submit a report on controlled transactions before 1 May of the year following the reporting year;

(b) upon the request of the tax authorities to provide TP documentation in relation to controlled transactions for the reporting year within one month from the date of receipt of the request.

Ukrainian legislation provides for the following methods of evaluation of transfer prices within the controlled transactions:

- the comparable uncontrolled price (CUP) method;
- the resale price method (RPM);
- the cost plus method (CPM);
- the transactional net margin method (TNMM);
- the profit split method (PSM).

After the introduction of the Ukrainian TP rules in 2013, the transactions of Ukrainian residents with other Ukrainian residents, which satisfy certain criteria, were also within the scope of TP control and could potentially be qualified as controlled transactions. However, these provisions were later amended and transactions between Ukrainian residents were excluded from the scope of TP control.

Even if a Ukrainian resident and a non-resident are not related parties.

Currently, the criteria for the Cabinet of Ministers of Ukraine to include jurisdictions into the list are as follows: (a) the general corporate profit tax rate in jurisdiction is 5 per cent lower than in Ukraine (i.e. 18 per cent); (b) there are no international agreements concluded between this jurisdiction and Ukraine on the exchange of information.

As of now, there is a draft law No. 5368, On amending the Tax Code of Ukraine (regarding improving the investment climate in Ukraine) dated 7 November 2016 which, if adopted, will include within the scope of TP control the following: transactions on the purchase of goods through non-resident commissionaires and transactions with non-residents (i.e. including those non-related) which do not pay corporate profit tax or are exempt from it.

As of now there is a draft law No. 5368, On amending the Tax Code of Ukraine (regarding improving the investment climate in Ukraine) dated 7 November 2016 which, if adopted, may increase thresholds to UAH 150 million (approximately €5.3 million) and UAH 10 million (approximately €359,000) respectively.
A taxpayer may select any method that it considers on a reasonable basis to be the most appropriate one (a combination of two and more methods is allowed). However, the method hierarchy is as follows:

- if it is possible to apply the CUP method and any other method, the CUP method is preferable;
- if it is possible to apply RPM/CPM and TNMM/PSM, RPM/CPM is preferable.

There are also special rules in relation to controlled transactions on the import/export of certain commodity goods (i.e. the so-called sixth method). A detailed description of those rules is provided in section 2.4.1 of this report.

According to recent statistics provided by the State Fiscal Services of Ukraine in relation to the 2015 fiscal year,7 the tax authorities have reviewed more than 1,900 reports on controlled transactions, have requested 41 taxpayers to provide TP documentation and have conducted three TP audits. It is expected that the number of TP audits will increase by the end of 2016 and in the following years.

The court practice on TP matters is currently not large and is under development. This is explained by the relatively recent introduction of full-fledged TP regulations and by the relatively low number of TP audits conducted. Given that the majority of court cases on TP matters which are now available mostly relate to basic technical issues such as identification of controlled transactions and the necessity to submit reports on them.

As of the date of this report, no recommendations of the BEPS project have been introduced in Ukrainian legislation. However, in May 2016 the Ukrainian government announced the concept of the “deoffshorization” tax reform, which is highly influenced by the BEPS project. The reform was announced in the form of a presentation prepared by the working group within the government and contains the list of expected changes and their main points. It is expected that the draft law for implementation of the reform will soon be made public.

2. The impact of the BEPS project on TP

2.1. Introduction

Although Ukraine is not a member of the OECD, the development of the BEPS project was closely monitored by the Ukrainian tax professional community since its very beginning in 2012.

One of the first attempts to introduce BEPS driven changes in Ukrainian TP legislation was proposed in 2015 in the draft law on the tax reform8 prepared by the Ministry of Finance. Among a number of changes proposed by the 2015 Reform Draft Law, the following were related to TP:

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8 Draft law No. 3630, On the creation of competitive terms for the taxation and enhancement of business activity in Ukraine, dated 11 December 2015.
the introduction of a three-tier system of reporting (i.e. in addition to local documentation, qualifying taxpayers were required to prepare and provide the master file and CbCR; and

- the introduction of special rules for low value-adding services.

However, the 2015 Reform Draft Law was not adopted by the Ukrainian Parliament.

On 21 March 2016, the National Bank of Ukraine, the State Fiscal Service of Ukraine and the Anti-Monopoly Committee of Ukraine discussed a combined strategy on TP and deoffshorization initiatives and mentioned the BEPS project in this regard. In particular, the Head of the National Bank of Ukraine commented that it was very important to discuss the deoffshorization model which would result in an increase of transparency and identification of beneficial owners, and that this direction had already been chosen by EU countries in accordance with the BEPS project developed by OECD.

The next step of discussion of the BEPS project by Ukrainian society was triggered by the “Panama Papers” leak which happened in April 2016 and caused huge anti-offshore discussion in Ukraine.

Subsequently, few draft laws suggesting various deoffshorization initiatives, which included some BEPS-driven recommendations, were registered in the Ukrainian Parliament during April and May of 2016. None of them was approved by the Ukrainian Parliament.

On 28 April 2016, the President of Ukraine signed the Decree, On actions concerning countering BEPS, calling for the creation of a special working group with a mission to draft laws embodying a comprehensive reform by mid-June 2016. As a result, the Ukrainian government announced the concept of the “deoffshorization” tax reform in May 2016.

This was announced in the form of a presentation prepared by the working group within the government and contained the list of expected changes and their main points. Besides a number of changes which did not relate to TP, a number of changes were suggested in the Ukrainian TP regulations, particularly:

- the recognition of transactions between non-residents and their Ukrainian-based permanent establishments as controlled subject to TP control (if certain thresholds were exceeded);
- the introduction of the requirement for Ukrainian-based permanent establishments of non-residents to submit reports on controlled transactions and TP documentation (once TP control is applicable);
- the introduction of the requirement to submit CbCR once certain conditions are met;
- the introduction of the requirement to submit the master file once certain conditions are met;
- further detail and clarification of rules applicable to export/import transactions with commodities;
- the introduction of the requirement to disclose in TP documentation (i.e. local file) (a) information on transactions with intangibles and (b) information on

9 https://www.bank.gov.ua/control/uk/publish/printable_article?art_id=28946015&showTitle=true.

10 Particularly, draft laws No. 4380 as of 12 April 2016, No. 4381 as of 12 April 2016 and No. 4636 as of 11 May 2016.
the calculation and allocation of income/expenses which are influenced by transactions with controlled parties if such income/expenses are taken into account upon calculation of the profit level indicator in the controlled transaction analysed;
• the introduction of special rules for intra-group low value-adding services which are supplied and received within a group;
• an increase of fines for failure to report controlled transactions in the TP report and for failure to submit TP documentation.

As of October 2016, no draft law implementing the provisions of the reform had been registered in the Ukrainian Parliament. However, it is generally expected that this draft law will be announced by the end of 2016.

In October 2016, the Head of the National Bank of Ukraine commented that she considers the BEPS project to be one of the most important conditions for currency liberalization in Ukraine and confirmed that the government intended to implement 10 of the 15 BEPS measures.\(^{11}\)

Summarizing, it should be noted that as of the date of this report there has been no actual effect of the BEPS project either on Ukrainian tax legislation in general, or on its TP regulations in particular. However, it is expected that BEPS driven changes may be introduced in Ukrainian legislation by the reform, which is expected to be adopted by the end of 2016.

### 2.2. Challenges of transactions with intangibles

#### 2.2.1. Definition of intangibles

Currently there is no special definition of intangibles for TP purposes in Ukrainian legislation, and the general tax definition of intangibles provided in the TCU should be used also for TP purposes.

The definition is provided in the TCU and is as follows:\(^{12}\)

> “intangibles are ownership of the results of intellectual activity including industrial ownership and other similar rights recognized as objects of property rights (intellectual property), the right to use taxpayer’s property and property rights according to the law including the rights to use natural resources, property and property rights acquired according to the law…”

Separately, the TCU also identifies goodwill as a specific intangible asset which is subject to special tax treatment.

The definition of intangibles provided in the TCU also refers to and includes the definition of objects of intellectual property provided in the Civil Code of Ukraine including the following:\(^{13}\)

- literary and art works;
- software;
- compilations of data (databases);


\(^{12}\) Para. 14.1.120 of the TCU.

\(^{13}\) Art. 420 of the Civil Code of Ukraine.
performances;
phonograms, films, sound recordings and broadcasts;
scientific discoveries;
 inventions, utility models, industrial designs;
topographies of integrated circuits;
rationalization proposal;
 plant varieties, animal breeds;
 trade names, trademarks, geographical indications;
 commercial secrets.

It can be concluded that the definitions of intangibles provided in Ukrainian tax law and in Ukrainian civil law are too narrow for TP since they do not capture/recognize specific intangibles which may be important from a TP perspective.

Given that, Ukrainian legislation provides for a different definition of intangibles for accounting purposes. This definition is provided in the Ukrainian Accounting Regulation (standard) no. 8, Intangibles and is as follows: “An intangible is a non-monetary asset which does not have a material form and can be identified.”

Obviously, the accounting definition of intangibles is too broad for its proper application for TP purposes.

Therefore, Ukrainian TP regulations do not contain any special definition of intangibles for TP purposes. Instead, the general tax definition (which also refers to civil law definition) should be used, though it does not capture/recognize some specific intangibles which may be relevant for TP purposes.

As of now, there is no information about whether any separate definition of intangibles for TP purposes or any changes in present tax definition of intangibles aligned with Actions 8–10 of the report will be introduced in the Ukrainian legislation with the implementation of the reform.

2.2.2. Transactions with intangibles

There are no special rules on the identification of transactions with intangibles in Ukrainian TP regulations.

That said, transactions with intangibles are covered by general TP rules which provide that, among other things, the following business transactions should be recognized for TP purposes:

- transactions with goods, such as raw materials, finished products, etc.;
- transactions on the provision of services;
- transactions with intangibles, such as royalties, licences, payment for use of patents, trademarks, knowhow, and any other intellectual property objects;
- financial transactions, including leasing, participation in investment, credits, commission and guarantee, etc.;
- transactions on the purchase or sale of participatory interests, shares and other investments, purchase or sale of long-term tangible and intangible assets.

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14 In particular, the special knowledge of employees/management, databases of clients, contractors of subcontractors, etc.
16 Para. 39.2.1.4 of the TCU.
These listed transactions should be recognized for TP purposes regardless of whether they are documented or not. Therefore, confirmation of transactions by documents is not decisive for their recognition for TP purposes.

Given that, the reform may introduce some additional rules in the Ukrainian TP regulations which would allow the tax authorities to identify transactions with intangibles. First of all, the Concept may introduce a requirement to indicate additionally in TP documentation (i.e. the local file) information in relation to intangibles, particularly:

- information about the involvement of a taxpayer in business restructuring or transfer of intangibles during the reporting or preceding period, with an explanation of the transactions;
- a description of transactions on the acquisition of services, intangibles and other business objects different from goods, including a description and justification of their economic feasibility and business purpose (in the absence of such justification it is considered that the value of the transaction is zero).

Also, the reform is expected to introduce a requirement for multinational companies (MNEs) to provide a master file (as described in detail below). The following information on intangibles used by MNEs in their activities should be provided in the master file:

- a general description of the R&D strategy of the MNE;
- a list of intangibles (or their groups), which are owned by the MNE, indicating company owners;
- a list of the most essential intra-group agreements in relation to intangibles (including licence agreements) and the TP policies of MNEs in relation to transactions with intangibles and transactions related to R&D;
- information on the transfer of essential intangibles (also for use) during a reporting year, indicating companies, jurisdictions and compensation.

That said, these expected changes will serve as a tool for identification of transactions with intangibles. There is no further information about whether the reform will introduce any specific rules on the identification of transactions with intangibles.

### 2.2.3. “Substance-over-form” approach towards intangibles

There are no special “substance-over-form” approach rules in Ukrainian TP regulations in relation to transactions with intangibles. However, such an approach for TP purposes should be applicable by default, as it follows from general TP principles established by the Ukrainian TP regulations.

The following in particular implies the priority of the “substance-over-form” approach for the application of TP in Ukrainian TP regulations (also in relation to controlled transactions with intangibles):

- the arm’s length principle as the core of Ukrainian TP regulations, which should be used for determination of the taxable profit of a controlled taxpayer;\(^{17}\)
- a comparability analysis, which is required for correct application of the arm’s length principle, and which includes comparability of functions, assets and risks (FAR);\(^{18}\)

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\(^{17}\) Para. 39.1.1 of the TCU.

\(^{18}\) Para. 39.2.2.2 and 39.2.2.3 of the TCU.
• a FAR analysis with a focus on actually performed functions, undertaken risks and used assets, which *inter alia* mentions such functions as development, marketing, etc.;¹⁹
• last but not least, provision that both documented and non-documented transactions should be recognized for TP purposes.²⁰

Therefore, although Ukrainian TP regulations do not directly contain such a requirement, application of the “substance-over-form” approach in transactions with intangibles based on these principles from a TP perspective is a must, and an analysis beyond simple legal ownership is required. Similarly, it may be necessary to analyse DEMPE functions²¹ in relation to transactions with intangibles, since this is required for the correct application of the arm’s length principle (although DEMPE functions are not directly mentioned in Ukrainian TP regulations and there is no direct requirement to analyse them).

Moreover, the necessity to apply the “substance-over-form” approach for TP analysis in transactions with intangibles is also supported by the approach of the tax authorities in relation to non-TP related tax issues.

In particular, the “substance-over-form” approach is one of the doctrines which should be used by Ukrainian tax authorities for the scrutiny of various transactions for tax purposes. A detailed instruction regarding its application is provided in the Letter of State Tax Service of Ukraine²² No. 3848/7/10-1017/575 dated 15 February 2013. In particular, the letter clarifies that the “substance-over-form” approach requires the tax authorities to take into account the economic results of business transactions regardless of the documentation.

The “substance-over-form” approach is also widely used by Ukrainian courts for the resolution of tax disputes. The latest examples of the application of this approach can be found, for example, in the following cases by the High Administrative Court of Ukraine.²³

In all these cases, the courts followed the “substance-over-form” approach. There is also a sign of the application of this approach by the Ukrainian courts in TP-related disputes.²⁴

To sum up, there are no separate “substance-over-form” approach rules in the Ukrainian TP regulations as of now in relation to transactions with intangibles. The status of DEMPE functions in relation to intangibles is not mentioned directly, either. However, the “substance-over-form” approach may be applied and DEMPE functions may and should be analysed in the transactions with intangibles based on the general provisions of Ukrainian TP regulations. That said, there is no information on whether any more specific and detailed rules in this regard will be introduced in Ukrainian TP regulations with the implementation of the reform.

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¹⁹ Para. 39.2.2.4 and 39.2.2.5 of the TCU.
²⁰ Para 39.2.1.4 of the TCU.
²¹ Development, enhancement, maintenance, protection and exploitation.
²² Former name of the State Fiscal Services of Ukraine.
²³ Court cases No. 814/5234/13-a, No. 821/354/16, No. 826/17720/14 and No. 2a/0370/3879/12.
²⁴ Court case No. P/811/2372/15.
2.2.4. Comparability and group synergies

Comparability issues, as well as the need for comparability adjustments, can also arise because of the existence of MNE group synergies.\footnote{Para. 1.157 s. D.8, chapter I of the OECD TP guidelines (amended by the BEPS final reports 2015 on Actions 8–10).}

Currently, Ukrainian TP regulations do not provide any specific rules for the identification of group synergies for TP purposes. According to the general provisions of Ukrainian TP regulations\footnote{Para. 39.2.2.1 of the TCU.} controlled transactions are considered comparable with uncontrolled transactions provided:

- there are no significant differences between them which can essentially affect the financial results during the application of a particular TP method; or
- such differences may be eliminated by adjusting the terms and financial results of uncontrolled transactions aiming to eliminate any impact on comparability.

Ukrainian TP regulations provide for the following list of elements for the comparability analysis of controlled and uncontrolled transactions:\footnote{Para. 39.2.2.2 of the TCU.}

- the characteristics of goods/services which are the subjects of the transaction;
- the functions which are performed by the parties to the transactions, assets used by them, terms of allocation of risks and benefits between the parties, allocation of responsibilities and other conditions of transactions;
- the established practice of relations and terms of agreements, which essentially influence the prices of goods/services;
- the economic conditions of activity of the parties including analysis of the markets of goods/services which essentially influence the prices of goods/services;
- the business strategies of the parties (if any) which essentially influence the prices of goods/services.

Therefore, group synergies are not mentioned directly for the purposes of comparability analysis.

As of now, there is no information as to whether any separate rules in relation to the identification of group synergies will be introduced in the Ukrainian TP regulations with the implementation of the reform.

2.2.5. HTVI

Currently, Ukrainian TP regulations do not contain any special provisions for the valuation of HTVI. As of now, there is no information on whether any specific rules in this regard will be introduced in the Ukrainian TP regulations with the implementation of the reform.

2.2.6. CCAs

Currently, CCAs are not recognized in Ukraine as a concept. As a basic accounting rule in Ukraine, costs should be allocated with respect to incomes which were gen-
erated by these costs. Any contribution of costs breaking the above-mentioned rule will be very strictly scrutinized by the Ukrainian tax authorities and such deductions may be potentially limited. Moreover, the general approach of the Ukrainian tax authorities is that all costs have to be confirmed by appropriate tangible evidences (i.e. depending on the nature of services at issue) and supported by primary documents.

Also, as of now there is no information about whether any separate rules in relation to CCAs will be introduced in the Ukrainian TP regulations with the implementation of the reform.

2.3. Risk and capital

Ukrainian TP regulations do not contain any special provisions regarding control of the return on capital or compensation for the assumption of risk. As of now, there is no information on whether any separate rules in this regard aligned with Actions 8–10 of the report will be introduced in the Ukrainian TP regulations with the implementation of the reform.

2.4. High-risk transactions

2.4.1. CUP and quoted prices for cross-border commodity transactions

Currently, Ukrainian TP regulations contain special rules in relation to controlled transactions on the import/export of certain commodity goods (i.e. the so-called sixth method).28

In particular, the Cabinet of Ministers of Ukraine approves the list of commodity goods which are subject to these special rules.29 Prices in qualifying transactions should be verified by the CUP based on the prices for the commodity goods in question from international commodity exchanges, the list of which is also approved by the Cabinet of Ministers of Ukraine.30 The range of prices should be calculated based on the prices quoted for the commodity goods for the decade preceding the date of the controlled transaction.

Should the taxpayer decide to use another TP method for the verification of the prices in such a controlled transaction,31 it must provide information on all related parties, which were engaged in the supply chain of the commodity goods traded in the controlled transaction, up to the first non-related party, and indicate their profit level indicators according to the applied TP method. This information should be submitted before 1 May following the reporting year. If this information was not provided or was partially provided by the taxpayer, the tax authorities can verify the prices in the controlled transaction at issue using CUP.

28 Para. 39.2.1.3 of the TCU.
29 Regulation of the Cabinet of Ministers of Ukraine No. 616 dated 8 September 2016, On adoption of the list of goods which have stock exchange quotations, and of international stock exchange markets for verification if conditions of controlled transaction comply with arm’s length principle.
30 Ibid.
31 Particularly RPM, CPM, TNMM or PSM.
It is expected that implementation of the reform will elaborate and detail the above rules in relation to transactions with commodities, particularly in that part of the provisions regarding disclosure of information on related companies involved in the supply chain of such goods (up to the first non-related company). Separate penalties for non-disclosure may be introduced.

2.4.2. Intra-group services

Historically, intra-group services were always the focus of Ukrainian tax authorities and were usually scrutinized.

In this regard, intra-group services transactions are usually tested from the perspective of the “business purpose” doctrine, the “reality of a transaction” doctrine and some others, which are listed in the Letter of the State Tax Service of Ukraine32 No. 3848/7/10-1017/575 dated 15 February 2013. In particular, the “business purpose” doctrine provided that a transaction must have a business purpose, meaning that a taxpayer was expected to obtain a positive economic effect as a result of the transaction (i.e. increase or retention of the asset’s value or the creation of conditions allowing this to be achieved in the future). In turn, the “reality of a transaction” doctrine provides that only business transactions actually performed are recognized for tax purposes, not transactions which are only executed “on paper”.

The Ukrainian tax authorities also usually review that all costs incurred in relation to a transaction should be confirmed by primary documents and appropriate tangible evidence (i.e. depending on the nature of services at issue).

It should be noted that Ukrainian TP regulations do not contain any special provisions regarding intra-group services. As of now, the concept of low value-adding intra-group services is not reflected in Ukrainian TP regulations either.

In the past, however, there was an attempt to introduce special rules for the low value-adding services into Ukrainian TP regulations. A 2015 Reform Draft Law was prepared by the Ministry of Finance. The proposed rules were generally in line with the final report on Actions 8–10 of the BEPS project. In particular, they allowed taxpayers to prepare simplified TP documentation in relation to transactions with qualifying services.

According to the 2015 Reform Draft Law the use of special rules for low value-adding services was allowed only under the following conditions:

(a) the services at issue should be qualified as “low value-adding services”,33 providing that the following criteria should be satisfied:
   • the services are of a supportive nature;
   • the services are not part of core business of the recipient;
   • the services do not require the use of unique and valuable intangibles and do not lead to the creation of such intangibles;
   • the services do not involve significant risks and do not lead to the creation of significant economic risks;

(b) in case of application of CPM, RPM, TNMM the profit level indicator in such transactions should be equal to 5 per cent (based on an appropriate cost base).

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32 Former name of the State Fiscal Services of Ukraine.
33 Some examples of low value-adding intra-group services are: accounting, internal audit, management of accounts receivable/payable, human resources, protection of the environment, IT support (except for services in software development), legal and tax, etc.
The 2015 Reform Draft Law indicated that the simplified TP documentation according to special rules should not be applicable to the following activities:

- services constituting the core business of the taxpayer or its counterparty;
- R&D services (including software development);
- manufacturing services (including the manufacturing of products upon request with the use of the raw materials of the customer or service provider);
- purchasing activities relating to raw materials or other materials that are used in the manufacturing process;
- marketing and sales promotion activities;
- financial transactions;
- services for the search, exploration or extraction of natural resources;
- insurance and reinsurance;
- management services involving senior management which takes key decisions for the taxpayer's activity.

The 2015 Reform Draft Law with the described special rules for low value-adding services was not adopted by the Ukrainian Parliament. However, it is expected that similar rules in relation to low value-adding services will be introduced with implementation of the reform.

2.4.3. Profit splits in the context of value chains

There are no special rules in Ukrainian TP regulations regarding the application of the profit split method in the context of value chains. As of now, there is no information about whether any BEPS-driven changes in relation to PSM in the context of value chains will be introduced in the Ukrainian TP regulations by the reform.

That said, Ukrainian TP regulations contain some provisions regarding the application of the PSM, in particular:

- it provides for the allocation to every party to a controlled transaction of a part of combined profit and loss realized in the controlled transaction which would be realized by non-related party in a comparable uncontrolled transaction;
- if the parties to controlled transaction(s) maintain their accounting and financial reporting according to different standards and methods, their reporting should be brought into accordance with single methodological accounting standards for the purpose of application of the PSM;
- the PSM is most appropriate in the following situations (not exclusively):
  - when controlled transactions are closely related to other transactions performed by the parties to the controlled transactions;
  - when parties to a controlled transaction own (or use) intangibles which essentially affect the profitability level;
- the allocation of profit between the parties to a controlled transaction(s) is performed based on estimated results of their contribution to the combined profit. This allocation is performed according to the criteria based on objective data and is confirmed by information in comparable transactions and/or internal data of parties to the controlled transaction(s) taking into account the functions performed, assets used and economic (commercial) risks borne;
- the combined profit of the parties to a controlled transaction(s) is defined as a sum of profit of the parties to such transaction(s), while residual profit (loss)
is defined as a difference between combined profit (loss) from the controlled transaction(s) and the amount of profit (loss) of parties to controlled transaction(s) calculated in accordance with other TP methods (CUP, RPM, CPM, TNMM) based on a FAR analysis;

- for the allocation of combined or residual profit (loss) between the parties to a controlled transaction(s) the following factors may be used (not exclusively):
  - the amount of expenses of each party in relation to the development of intangibles, whose use influences the amount of actual profit (loss) of the controlled transaction(s);
  - the characteristics of personnel engaged by each party to a controlled transaction(s) which influence the amount of actual profit (loss) of the controlled transaction(s) including the number of such personnel, qualification, time actually spent, payroll costs;
  - the market value of assets used by each party to a controlled transaction(s) and which influenced the amount of actual profit (loss) of controlled transaction(s);
  - other factors which are related to the performance of functions, use of assets, undertaking of commercial risks and the amount of profit (loss) actually received by each party to the controlled transaction(s).

2.5. TP documentation

2.5.1. CbCR

As of now, preparation/submission of CbCR are not required by the Ukrainian TP regulations.

In the past, there was an attempt to introduce a three-tier system of reporting into Ukrainian TP regulations requiring submission of CbCR and the master file in addition to local TP documentation package by the 2015 Reform Draft Law prepared by the Ministry of Finance of Ukraine. As of the date of this report, however, has not been adopted by Parliament.

Now it is expected that CbCR will be introduced into the Ukrainian TP regulations with the implementation of the reform. Brief outlines of expected CbCR rules are as follows:

- Alongside submission of report on controlled transactions, a Ukrainian taxpayer, which is a member of MNE, is required to submit a notice of being a member of an MNE.
- A Ukrainian taxpayer, which is a member of MNE, is required to submit CbCR if the annual turnover of the MNE for the previous year exceeded €750 million. There is also a lower threshold of €50 million in cases where the MNE has a strong relation with Ukraine, particularly:
  - 50 per cent or more of the MNE’s shares are held by Ukrainian tax residents or citizens; or
  - 50 per cent or more of the MNE’s employees are located in Ukraine; or
  - 50 per cent or more of the book value of the MNE’s fixed assets are located in Ukraine; or
  - 50 per cent or more of consolidated income of the MNE is derived from Ukraine.
• CbCR is to be submitted to the Ukrainian tax authorities within 12 months after the end of the financial year of the MNE’s HQ (or the end of the calendar year).
• The report may be submitted in English without translation into Ukrainian.
• The CbCR must include the following information in relation to each country where MNE company(ies) are registered:
  – the country of tax residency;
  – the amount of income from the sale of goods/services (separately to related and to non-related parties);
  – the amount of taxable profit;
  – the corporate profit tax due and paid in the reporting year;
  – the amount of charter capital;
  – the amount of undistributed profits at the end of the reporting year;
  – the average number of employees for the reporting year;
  – the balance value of fixed assets except for (a) funds and their equivalents, (b) intangible assets and (c) financial assets;
  – the country of registration (if this country and tax residency are different);
  – the main types of activity;
  – other information at the discretion of the taxpayer.
• Fines in relation to CbCR are as follows:34
  – the fine for late submission or failure to submit CbCR is approximately €150,000;
  – the fine for failure to include an MNE’s income in CbCR is 1 per cent of the amount of such income but not more than approximately €495,500;
  – the fine for failure to submit CbCR within 10 days after the deadline for payment of the fine for failure to submit CbCR is approximately €495 accruing daily for each further day of non-submission.

It is expected that the above rules in relation to CbCR will be introduced in the Ukrainian TP regulations in line with the announced reform. A draft law is expected by the end of 2016.

In regard to the legal infrastructure for implementation of automatic exchange of CbCR, it should be noted that Ukraine has been a participant in the Convention on Mutual Administrative Assistance in Tax Matters starting from 2009.

However, as of now Ukraine has not joined the Multilateral Competent Authority Agreement on the Exchange of CbC Reports (MCAA CbC) yet, which is required for implementation of automatic exchange of CbCR.

Bilateral treaties on the automatic exchange of TP information have not been signed by Ukraine so far. It should also be noted that Ukraine has not joined the Multilateral Competent Authority Agreement on Automatic Exchange of Financial Account Information (MCAA CRS) either.

That said, the Ministry of Finance of Ukraine and the State Fiscal Service of Ukraine have declared35 their intention of signing the MCAA CRS within the course of the implementation of the reform. Despite that, the Ukrainian authorities have been silent regarding their intention of signing the MCAA CbC. It is possible that after implementing the CbCR rules into the Ukrainian TP regulations and sign-

34 Amounts of fines are indicated for 2016.
ing the MCAA CRS, the next step will be the signing of the MCAA CbC for the implementation of automatic exchange of CbCR.

2.5.2. Master and local files

Currently, Ukrainian TP regulations only provide for a one-tier system of reporting requiring taxpayers to prepare TP documentation consisting of a local file.

A brief description of effective rules regarding TP documentation (i.e. local file) is as follows:

- TP documentation is provided by Ukrainian taxpayers upon the request of the tax authorities within one month from the receipt of the request (the tax authorities may request TP documentation only after 1 May of the year following the reporting one);
- TP documentation is submitted in the Ukrainian language and must include the following information:
  - information about related parties, particularly parties to controlled transactions and persons which own 20 per cent or more of taxpayer’s shares;
  - a general description of activity of MNE (including HQ and subsidiaries), organization chart, description of its business activity, TP policy;
  - a description of controlled transactions and their terms (price, terms for payment and other essential terms of agreements);
  - a description of goods/services including physical characteristics, quality and reputation on the market, country of origin and manufacturer, use of trademarks and other related information;
  - the settlement terms of transactions;
  - the factors which influenced the pricing;
  - information about the functions, assets and risks of the parties to controlled transactions;
  - economic analysis, which includes TP methods used for the verification of the terms of controlled transactions and justification of their selection, amount of income (profit) and expenses (loss) resulting from controlled transactions, profitability level, calculation of arm’s length level of prices/profitability, sources of information, etc;
  - comparability analysis results in relation to commercial and financial terms of transactions;
  - information of self-adjustment and proportional adjustment of the taxable profit and tax performed by the taxpayer (if any).
- the fine for late submission or failure to submit TP documentation is 3 per cent of the amount of controlled transactions (in relation to which documentation was not submitted) but not more than approximately €10,000.36

This being said, the reform may introduce some changes in relation to TP documentation. In particular, the following additional information should be included in TP documentation (i.e. local file):

- a description of management structure of a taxpayer, and its organizational chart;

36 The amount of fine is indicated for 2016.
• a description of the activity and business strategy of a taxpayer including the economic conditions of activity and analysis of the markets for goods/services and the main competitors;
• information about the involvement of a taxpayer in business restructuring or the transfer of intangibles during the reporting or preceding period with an explanation of such transactions;
• a description of transactions on acquisition of services, intangibles and other business objects different from goods including description and justification of their economic feasibility and business purpose (in the absence of such justification, it is considered that the value of such transactions is zero);
• information on the calculation and allocation of income/expenses which are influenced by transactions with controlled parties if such income/expenses are taken into account upon calculation of the profit level indicator in the controlled transaction analysed;
• the introduction of an additional fine in relation to TP documentation; in particular, a fine for failure to submit TP documentation within 10 days after the deadline for payment of the fine for failure to submit TP documentation is approximately €495 accruing daily for each further day of non-submission.37

Adoption of all these changes in Ukrainian TP regulations regarding TP documentation is expected within implementation of the reform.

Speaking about the master files, their preparation/submission are not required by Ukrainian TP regulations as of now. As mentioned in section 2.5.1, there was an attempt in the past to introduce a three-tier system of reporting into Ukrainian TP regulations requiring the submission of CbCR and the master file in addition to the local TP documentation package (the 2015 Reform Draft Law has not been adopted by Parliament as of the date of this report).

Currently, it is expected that the requirement to provide the master file will be introduced in Ukrainian TP regulations with implementation of the reform. Brief outlines of the expected rules regarding master files are as follows:
• a Ukrainian taxpayer, which is a member of MNE, is required to provide the master file if the annual turnover of the MNE for the previous year exceeded €50 million;
• the master file is provided upon request of the tax authorities within 12 months after the end of the financial year of the MNE’s headquarters (or the end of the calendar year) but not earlier than 60 calendar days from the day of receipt of such request;
• the master file is submitted in English with a translation into Ukrainian (no certification is required). In the case of discrepancies between the Ukrainian and English texts the English text will prevail;
• the master file must include the following information:
  – an organizational chart of the MNE including owners, percentage of ownership and jurisdictions;
  – a general description of the MNE’s business activities including (a) a description of supply and value creation chains of up to five types of goods/services of MNE, which generate the major part of its income, as

37 The amount of fine is indicated for 2016.
well as other types of goods/services, the part of which exceeds 5 per cent of its overall income; (b) a description of the most essential goods/services of MNE; (c) a description of the main markets in which the MNE operates; (d) the factors which influence the MNE’s profit; (e) a brief description of the main intra-group service agreements, except for intra-group R&D services (including the TP policy of MNE with an algorithm of allocation of costs and the actual amount of costs); (f) a brief description of the FAR analysis which includes main functions, risks and assets of companies of MNE; (g) information about restructuring of MNE in the reporting year (if any);

– information about intangibles used by MNE companies in their activities including: (a) a general description of the R&D strategy of the MNE; (b) a list of intangibles (or their groups) which are owned by MNE, indicating company owners; (c) a list of the most essential intra-group agreements in relation to intangibles (including licence agreements) and the TP policies of the MNE in relation to transactions with intangibles and transactions related to R&D; (d) information on the transfer of essential intangibles (also for use) during the reporting year indicating companies, jurisdictions and compensation;

– information about the intra-group financial transactions of the MNE, including: (a) a general description of the strategies of the financing of the MNE’s companies; (b) the role of the company(ies) of the MNE which perform a treasury function; (c) the TP policy of the MNE in relation to financial transactions;

– information on the financial condition of MNE including consolidated financial statements for the reporting period (if available);

– information about advance pricing agreements concluded by the MNE’s companies, as well as about tax rulings obtained regarding the allocation of profit between the MNE’s companies which perform activities in different jurisdictions;

• the fines in relation to master files are as follows:38

– the fine for late submission or failure to submit the master file is approximately €150,000;

– the fine for failure to submit the master file within 10 days after the deadline for payment of fine for failure to submit the master file is approximately €495 accruing daily for each further day of non-submission.

It is expected that the above rules in relation to master files will be introduced in Ukrainian TP regulations in line with the announced reform. A draft law is expected by the end of 2016.

2.5.3. Compliance costs

As of now, Ukrainian TP regulations have not been changed as a result of the BEPS project. Therefore, the compliance costs have not changed.

Potential changes to the Ukrainian TP regulations described in this report, such as introduction of CbCR and master files, may increase the compliance costs for

38 The amounts of fines are indicated for 2016.
MNEs. However, this increase should not be significant for the majority of qualifying MNEs (if any at all) since most probably they already prepare them in compliance with the TP regulations of other countries. The potential BEPS-driven implementation of CbCR and master files could increase the compliance costs.

2.6. TP-related measures in other BEPS actions and other measures against BEPS

As of now, TP changes inspired by the BEPS project, which are discussed and expected for implementation in Ukrainian legislation, are provided by the reform. These TP changes are mostly driven by the TP actions of the BEPS project and are listed in section 2.1 and described in detail in the appropriate sections of this report. Among them, there are no pure TP measures which are explicitly driven by non-TP actions of the BEPS project.

That said, it is expected that the reform will also introduce some other non-TP related changes which, however, are also driven by the BEPS project. The most significant of them are mentioned below:

- CFC rules: this measure is driven by Action 3 of the BEPS project. In this regard, CFC rules may be viewed as another anti-avoidance tool, which are compatible with TP rules, and the adoption of which allows a synergy with TP;\(^{39}\)
- rules introducing limitations on deduction of interest and other financial payments with related non-resident companies. This measure is driven by Action 4 of the BEPS project;
- measures on preventing the granting of double tax treaty benefits in inappropriate circumstances. This measure is driven by Action 6 of the BEPS project;
- measures on preventing artificial avoidance of permanent establishment status. This measure is driven by Action 7 of the BEPS project.

2.7. Can BEPS work in favour of MNEs?

As of the date of this report, no BEPS-driven initiatives on information gathering have been introduced into Ukrainian legislation. Automatic exchange of tax (and particularly TP) information is not implemented either. Therefore, there is no possibility currently for Ukrainian taxpayers to obtain any information within the framework of the automatic exchange of tax information.

That said, the reform dis not expected to contain any statements either with regard to the possibility of making public the tax information which was received by Ukrainian tax authorities within the framework of the automatic exchange of tax information.

\(^{39}\) Para. 8, chapter 1, Action 3: 2015 final report OECD/G20 BEPS.
3. What is the future of TP?

As can be seen from previous sections of this report, TP regulations began to play an important anti-avoidance role in Ukraine starting from 2013 and their importance is expected to increase further, especially in the light of recognition of the BEPS project by the Ukrainian government.

Since implementation in 2013, the Ukrainian TP regulations have been already amended several times. They are constantly developing and it is expected that the next leap forward for Ukrainian TP regulations, which is expected with the implementation of the reform, will be heavily influenced by the BEPS project. Indeed, as can be seen from this report, the BEPS project may serve a basis for the next updates of Ukrainian TP regulations. This comes as no surprise, taking into account TP focus of the BEPS project and its worldwide recognition.

In this regard, the following changes in Ukrainian TP regulations are expected to be introduced with implementation of the reform:

• the recognition of transactions between non-residents and their Ukrainian-based permanent establishments as controlled transactions subject to TP control (if respective thresholds are exceeded);
• the introduction of the requirement for Ukrainian-based permanent establishments of non-residents to submit reports on controlled transactions and TP documentation (once TP control is applicable);
• the introduction of the requirement to submit CbCR once certain conditions are met;
• the introduction of the requirement to submit the master file once certain conditions are met;
• the introduction of the requirement to additionally provide in TP documentation (i.e. local file) (a) information on transactions with intangibles and (b) information on calculation and allocation of income/expenses which are influenced by transactions with controlled parties if such income/expenses are taken into account upon calculation of the profit level indicator in the controlled transaction analysed;
• further detail and clarification of rules applicable to export/import transactions with commodities;
• the introduction of special rules for intra-group low value-adding services which are supplied and received within a group;
• an increase of fines for failure to report controlled transactions and for failure to submit TP documentation.

That said, the practice of application of TP in Ukraine is still emerging which is explained by the relatively recent introduction of full-fledged TP regulations and the novelty of the topic for Ukrainian tax authorities and courts. In this regard, the progress of Ukrainian tax authorities in becoming familiar with TP practices should be recognized. Taking into account the announcements of the government’s intention to implement the BEPS-influenced reform, further familiarization of Ukrainian tax authorities with the most recent TP practices will most probably continue. As regards the courts, the first court practice in Ukraine regarding TP matters has already started to emerge and its further development is also expected to be driven by the increasing importance of TP in Ukraine’s life.
Annex

By-laws adopted pursuant to article 39 of the TCU and with the purpose of detailing the TP provisions:

• order of the Ministry of Finance of Ukraine No. 8 dated 18 January 2016, On the adoption of the form and procedure for preparation of the report on controlled transactions;
• resolution of the Cabinet of Ministers of Ukraine No. 977-r dated 18 September 2015, On the adoption of the list of states (territories) which satisfy the requirements of subparagraph 39.2.1.2 of subpara 39.2.1 of para. 39.2 of article 39 of the Tax Code of Ukraine (i.e. list of “low-tax” jurisdictions);
• regulation of the Cabinet of Ministers of Ukraine No. 381 dated 4 June 2015, On the adoption of a procedure for the calculation of a range of prices (profitability) and the median of this range for transfer pricing purposes;
• regulation of the Cabinet of Ministers of Ukraine No. 616 dated 8 September 2016, On the adoption of the list of goods, which have stock exchange quotations, and international stock exchange markets for verification of whether the conditions of controlled transaction comply with arm’s length principle;
• regulation of the Cabinet of Ministers of Ukraine No. 504 dated 17 July 2015, On the adoption of a procedure for advance pricing arrangements in controlled transactions, based on which unilateral, bilateral and multilateral agreements are concluded for transfer pricing purposes;
• order No. 706 of the Ministry of Finance, On approval of the procedure of monitoring of controlled transactions and the procedure for interviewing authorized persons, officials and/or employees of a taxpayer on transfer pricing issues.
Summary and conclusions

The UK’s transfer pricing rules closely follow internationally agreed principles in relation to transfer pricing as set out in the OECD transfer pricing guidelines. The UK legislation requires that the UK’s transfer pricing rules are construed in a manner that “best secures consistency” with the OECD model as set out in article 9 and the OECD transfer pricing guidelines. The UK has a significant number of bilateral double tax treaties in force (more than 120) that follow the OECD model tax convention in respect of article 9, associated enterprises. Having UK transfer pricing legislation in line with OECD principles means that analyses by businesses and the UK tax authority are aligned in relation to transactions with both treaty country and non-treaty country group companies.

The UK government has already legislated to introduce the changes to the OECD transfer pricing guidelines agreed by the G20/OECD and other countries participating in the BEPS project finalized in the BEPS Actions 8–10 report published on 5 October 2015. The changes were made in Finance Act 2016 and apply for accounting periods beginning on or after 1 April 2016. The UK government and UK tax authority have not imposed any limitations or reservations on the revised transfer pricing guidance.

The UK government has also legislated the introduction of country-by-country reporting (CbCR) requirements with effect for accounting periods beginning on or after 1 January 2016. The UK requirements follow closely the internationally agreed template and principles set out by the G20/OECD and other participating countries in the BEPS Action 13 report published on 5 October 2015. There is an exception in that local filing requirements in the UK seek only to include information that it is within the power of the UK company to obtain – that is, information for UK companies and companies that are controlled by UK companies.

The UK government and UK tax authority have not introduced requirements to require a master file and local files in accordance with BEPS Action 13. The UK tax authority believes it has the power to request any information on audit and does not need prescriptive documentation requirements. In practice, UK-par-
ented multinational companies (MNEs) are preparing master files (and local files) for their groups as a result of requirements introduced in other countries.

The expectation is that the UK will continue to update UK transfer pricing legislation to take account of future changes to the OECD transfer pricing guidelines in respect of transfer pricing principles. This includes any changes that arise from the areas of continuing work in relation to BEPS, including further guidance on the use of the profit split method, further work on hard-to-value intangibles and new guidance on the transfer pricing of financing transactions.

1. Current transfer pricing regulations and practice in the UK

The UK transfer pricing rules are set out in Part 4 of the Taxation (International and Other Provisions) Act 2010 (TIOPA). Section 147 TIOPA requires that the arm’s length standard is applied to transactions between parties that are, based on specific conditions, treated as connected, and where there has been a “potential advantage in relation to UK taxation”. UK transfer pricing rules therefore require upward adjustments to UK profits under the UK’s system of self-assessment for corporation tax (or by adjustment under audit by HM Revenue and Customs (HMRC), the UK tax authority). For cross-border transactions, no downward adjustments are permitted and the only recourse to eliminate double taxation is to apply for relief under the mutual agreement procedure article of a relevant double tax treaty or, if available, the European Union’s Arbitration Convention.

Section 164 TIOPA specifically refers to the OECD transfer pricing guidelines. The UK rules on applying the arm’s length principle must be interpreted in a way that “best secures consistency” with article 9 of the OECD model and the OECD transfer pricing guidelines. For corporation tax accounting periods beginning before 1 April 2016 the relevant OECD transfer pricing guidelines on which the UK law is based are the 2010 guidelines. For later periods UK law includes the revisions to the 2010 guidelines agreed by the G20/OECD and other participating countries in the final report on BEPS Actions 8–10 published on 5 October 2015.

By virtue of section 164 TIOPA 2010 the OECD transfer pricing guidelines (in so far as they relate to determining arm’s length pricing) are effectively brought into UK law. There are no detailed, separate, transfer pricing rules included in UK legislation. Changes at the OECD level (such as those arising under BEPS Actions 8–10) can be swiftly introduced into UK legislation without the need to wait for an updated consolidated version of the OECD transfer pricing guidelines from the OECD.

The UK requires transfer pricing documentation to be kept in accordance with the general rules for record-keeping requirements in the UK’s legislation on self-assessment in paragraph 21 of Schedule 18 Finance Act 1998. These rules are not prescriptive as to the form and content of transfer pricing documentation. It is not expected that the UK will adopt the master file and local file requirements put forward under the G20/OECD and other participating countries’ work on BEPS Action 13. The CbCR requirements of Action 13 have been separately legislated

Additional guidance on how the UK tax authority applies the transfer pricing rules is included in their published *International Tax Manual* (from reference INTM410000) onwards. This guidance does not have the force of law but is an explanation of the UK tax authority’s view and approach. It includes details on the process that the UK tax authority follows in respect of assessing cases for risk of loss of tax to the UK Exchequer and selecting transfer pricing cases for audit.

2. The impact of the BEPS project on transfer pricing

2.1. Introduction

The UK transfer pricing legislation (section 164 TIOPA 2010) previously referred to the 2010 OECD transfer pricing guidelines but legislation introduced in Finance Act 2016 updates the reference so that it incorporates the revisions to the OECD transfer pricing guidelines agreed by the G20/OECD and other participating countries in October 2015 as part of the BEPS project. The new legislation has effect for corporation tax purposes for accounting periods beginning on or after 1 April 2016.

2.2. Challenges of transactions with intangibles

2.2.1. Definition of intangibles

The UK transfer pricing rules are directly linked to the OECD transfer pricing guidelines so that instead of having detailed, separate rules, UK legislation and the OECD transfer pricing guidelines are applied in a manner that “best secures consistency”. This means that the guidelines are effectively included in UK law. There is no specific definition of intangibles for transfer pricing purposes in UK legislation so the definition and approach provided in the OECD transfer pricing guidelines prevails. As a result of changes to the UK legislation in Finance Act 2016 the UK legislation effectively includes the new section A (on identifying intangibles) of chapter VI of the OECD transfer pricing guidelines as agreed by the G20/OECD and other participating countries in the October 2015 Actions 8–10 BEPS report. These changes apply to accounting periods beginning on or after 1 April 2016.

2.2.2. Transactions with intangibles

The UK transfer pricing rules are directly linked to the OECD transfer pricing guidelines. The UK government has already taken steps to revise the link included in UK domestic law so that this refers to the updated OECD transfer pricing guidelines as agreed by the G20/OECD and other participating countries in October 2015. The changes to the guidelines in relation to intangibles (agreed as a result of BEPS Actions 8–10) effectively form part of the UK transfer pricing rules.
The UK legislative and UK tax authority’s practical approach to transfer pricing and intangibles is consistent with a “substance-over-form” approach, although this phrase is not used in UK legislation and guidance. Businesses have been required to keep details of intercompany agreements that outline the functions undertaken, assets owned and risks borne by the relevant parties, and under audit have needed to be able to demonstrate that their transfer pricing is supported by the activities undertaken. The contractual arrangements provide a starting point, but may not be determinative.

The revisions to the OECD transfer pricing guidelines resulting from the BEPS project follow similar lines in that they focus on “accurately delineated transactions” and provide a more rigorously defined framework setting out how to approach the transfer pricing of intangibles. The identification of important functions in respect of intangible assets – their “development, enhancement, maintenance, protection and exploitation” – provides this framework. Analysis of the performance and location of key activities including the development, enhancement, maintenance, protection and exploitation of intangibles provides a consistent approach to evaluating transactions involving intangibles and to determining the extent and location of profits and losses. This approach limits the importance of bare legal ownership and provision of funding to make clear that these activities do not provide a right to all (or even a substantial portion) of the returns generated from the exploitation of an intangible.

Commercial reality and what actually happens will continue to be important, since contractual arrangements will not be determinative if the conduct of the parties differs from those arrangements. The updated OECD transfer pricing guidelines also make it clear that returns for assuming risk should be allocated to the party which controls the risk (i.e. has the competence and authority to make decisions about taking on, managing, mitigating and laying off risk) where that party also has the financial capacity to assume that risk.

As the UK tax authority already approaches transfer pricing along these lines, the amendments to the OECD transfer pricing guidelines introduced as part of Actions 8–10 should not represent a major change. Instead, they should provide a consistent framework within which the value and transfer pricing of intangibles can be considered.

2.2.3. “Substance-over-form” approach towards intangibles

The UK approach to transfer pricing with respect to intangibles is already along the same lines as a “substance-over-form” approach albeit such language is not used in the UK legislation. On audit, HMRC will first look to the legal construction of cross-border arrangements, and would then closely review the facts and circumstances surrounding a transaction. This involves an analysis of the functions undertaken by the parties within the MNE group, looking at the location where important functions are carried out, to ultimately confirm or determine the correct transfer pricing.

The problem with this approach (before the changes made during the work on BEPS Actions 8–10) was that the transfer pricing of complex intangibles, such as software brands and other geographically mobile intangibles, was still subject to a great deal of uncertainty and often resulted in challenges from tax authorities. This
was not always a symptom of the transfer pricing focusing only on the legal form but also reflected the difficulty in assessing appropriate rewards for the contributions by individual parties in the absence of a clear and well-defined framework for so doing. (The pre-BEPS guidance on the transfer pricing of intangibles in Chapter VI of the OECD transfer pricing guidelines amounted to only 39 paragraphs.)

The work on BEPS Actions 8–10 resulted in more expansive guidance and the introduction of the “development, enhancement, maintenance, protection and exploitation” framework for analysing important functions relating to intangibles. The changes build on, sharpen and modernize the pre-existing guidance in view of, for example, geographically mobile intangibles in the digital economy. The focus is more clearly on the economic substance of transactions (rather than their legal form), and the OECD transfer pricing guidelines now provide a better-defined framework so that profits from intangibles can be more consistently allocated among the parties contributing to them. The new guidelines also place a stronger emphasis on a holistic review, requiring businesses to consider their whole value chain before selecting the most appropriate method(s) for arm’s length pricing. In some situations involving intangibles where more than one party undertakes development, enhancement, maintenance, protection and exploitation activities this will require a “two-sided” analysis. This may lead to selection of the profit split method as the “most appropriate” to the circumstances. Selection of the most appropriate method is a precursor to allocating profits to the respective parties based on their contributions. The updated guidelines change this approach, as previously businesses were encouraged to “test the simpler party”, which led to one-sided analyses. The G20/OECD and other countries participating in the BEPS project expressed concerns that by looking at the contribution of only one party in the value chain the transfer pricing could be distorted depending on the perspective taken and any facts and circumstances overlooked.

The inherent uncertainties around the valuation of and contribution to intangibles, and the practical difficulties in applying the profit split method, mean that this is expected to remain an area of dispute between businesses and tax authorities – and between tax authorities – despite the additional clarification and guidance provided by the BEPS Actions 8–10 report.

The UK has already taken steps to adopt the revised guidance on the transfer pricing of intangibles as agreed by the G20/OECD and other BEPS participating countries. The UK tax authority is now placing a much stronger emphasis on analysing the “accurately delineated transaction”, including the functions carried out by the relevant entities of the MNE based on the key development, enhancement, maintenance, protection and exploitation functions, and understanding how such intangibles contribute to the end-to-end value chain analysis.

### 2.2.4. Comparability and group synergies

The UK transfer pricing rules effectively incorporate the OECD transfer pricing guidelines and do not contain any provisions to specifically recognize group synergies beyond those already set out in the OECD transfer pricing guidelines. The UK position is in line with the updated guidelines, i.e. that group synergies do not constitute a separately identifiable intangible for which a specific return should be allocated. They should be taken into account as a comparability factor.
when conducting a transfer pricing analysis, and in many cases this will provide appropriate recompense.

Where group synergies passively accrue to a member of an MNE, these benefits should not be separately paid for. In contrast, where there is a concerted effort to exploit such group synergies (which would be expected to incur additional, specifically identifiable costs) a specific reward is required to recognize that effort. The entity taking the specific, concerted action to exploit such synergies is entitled to an appropriate reward taking into account the functions performed, assets owned and risks assumed by that entity.

For example, in the case of a centralized procurement function, the primary objective of a transfer pricing analysis would be to determine the appropriate return for the centralized procurement function taking into account its functional and risk profile and value contribution. No specific reward would be due to the procurement company merely as a result of the other group companies contributing purchasing volumes to the pool. Instead the reward for volume would be returned to the group companies providing it, and the procurement company would receive or retain a reward for the value-added nature of its activities such as negotiating with suppliers, standardizing processes, unifying group purchases or ensuring discounts.

This is in line with the UK tax authority’s current approach, and as the UK legislation effectively incorporates the updated OECD transfer pricing guidelines it is expected that this will continue.

2.2.5. Hard-to-value intangibles

The UK transfer pricing legislation effectively incorporates the updated OECD transfer pricing guidelines in respect of “hard-to-value” intangibles. The Finance Act 2016 updated UK law so that it must be interpreted “as best secures consistency” with the OECD transfer pricing guidelines as updated by the G20/OECD and other BEPS participating countries in October 2015. This means that the new guidance on hard-to-value intangibles, developed as part of BEPS Actions 8–10, in theory at least applies in the UK for corporation tax accounting periods beginning on or after 1 April 2016.

The G20/OECD and other participating countries are working further on hard-to-value intangibles and the implementation of the new rules, and therefore there is some uncertainty as to how and when the guidance updated in October 2015 should be applied internationally. In any event, it is expected that, in line with the general approach, the UK will follow any internationally agreed position published by the OECD.

For new transactions involving the transfer or sale of hard-to-value intangibles, this is expected to encourage, in practice, price adjustment clauses in sale and purchase agreements so that there is a basis for downward adjustments to be made as well as upward ones.

2.2.6. Cost contribution arrangements (CCAs)

As a result of the changes in Finance Act 2016 UK legislation also includes revisions to the guidance on CCAs in chapter VIII of the OECD transfer pricing
guidelines agreed by the G20/OECD and other BEPS participating countries in October 2015. These changes apply in the UK for accounting periods beginning on or after 1 April 2016.

The changes mean that in many circumstances “cost” is no longer the basis for the sharing of contributions, and instead value should be used. The only exception is where, in some services arrangements, cost is a suitable proxy for value.

There remains a key open question, which the G20/OECD and other participating countries have not addressed, of how the changes resulting from the BEPS project will affect existing CCAs. Most CCAs are long-term in nature, and there are many multi-year arrangements that are in, say, year two of a five-year programme of development. Without transitional rules there may be discrepancies in treatment before and after the changes to the rules, leading to potential disputes between businesses and tax authorities and between tax authorities.

2.3. Risk and capital

The G20/OECD and other participating countries’ report on BEPS Actions 8–10 published on 5 October 2015 sets out revisions to section D of chapter I of the OECD transfer pricing guidelines in relation to risk and capital. The changes are substantial – while risk has always been one of the three fundamental elements of transfer pricing (functions performed, assets owned and risks assumed), the new guidance sets out in much more detail the types of risk that can arise in a business and discusses how these should be attributed for transfer pricing purposes.

The changes include a new framework for analysing risks that have been “identified with specificity” and which are “economically significant” to the business.

The legal contractual relationships between the parties remain the starting point for the allocation of risk. However, the contractual allocations will not be determinative if they are not supported by the functional analysis of the control over risk. This means that there must be people within the party receiving a reward for risk that have the competence and the authority to make decisions about the taking on, management and laying off of risk, as well as actually making those decisions. In particular, contribution of capital, which is not supported by decision-making functionality, should only attract a risk-free return. However, to be allocated risk a party has to have the financial capacity to bear the risk.

Such a risk analysis may be complicated where multiple parties contribute to risk management and/or the provision of capital. Particular issues arise in relation to the financial services sector where the provision of capital has always been considered as an essential risk-taking activity for the sector. A footnote in the BEPS Actions 8–10 report notes that the principles analysing risk in the OECD’s 2010 report on the attribution of profits to permanent establishments (largely written with financial services businesses in mind) remain pertinent for the sector.

The complexities around business risks and the link with the provision of capital mean that this is an area which is likely to be the subject of disputes between businesses and tax authorities – and between tax authorities – in the short to medium term.

UK legislation effectively incorporates the OECD transfer pricing guidelines. The Finance Act 2016 ensures that the changes and revisions in relation to risk in
the BEPS Actions 8–10 report agreed in October 2015 are applicable in the UK for accounting periods beginning on or after 1 April 2016.

2.4. High-risk transactions

2.4.1. Comparable uncontrolled price (CUP) and quoted prices for cross-border commodity transactions

The UK transfer pricing rules effectively incorporate the OECD transfer pricing guidelines. The changes relating to commodity transactions agreed by the G20/OECD and other participating countries in October 2015 are brought into UK legislation by the changes made in the Finance Act 2016 and apply for accounting periods beginning on or after 1 April 2016.

The guidance included in the BEPS Actions 8–10 report suggests that benchmarking of commodity transactions within an MNE should “generally” use an analysis based on CUPs (i.e. quoted prices on the open commodities market). These CUPs should be adjusted for comparability factors such as any differences in terms and conditions, the quality of the commodity, and to reflect other pertinent details that may affect the underlying prices.

This provides a clearer set of guidelines, rewarding location-based taxing rights based on where value is created, while giving sufficient flexibility to accommodate scenarios where a CUP analysis is inappropriate (since the requirement for a CUP-based methodology is qualified by the word “generally”).

The rules around pricing date are also helpful given how rapidly commodity pricing can change (thereby rendering a CUP-based analysis effectively useless if a pricing date cannot otherwise be agreed upon). The fall-back position that allows tax authorities to impute a pricing date in certain circumstances could give rise to disputes over the correct price.

Given the newness of this guidance it remains to be seen how the UK tax authority will apply it, and how it will tackle possible disputes.

2.4.2. Intra-group services

The BEPS Actions 8–10 report agreed in October 2015 introduced an elective, simplified approach for low value-adding services which looks to create a simpler route for both payers and recipients of charges to apply transfer pricing.

The approach considers a clearly defined set of common intra-group services that are supportive in nature and therefore low value-adding (e.g. human resources, finance, etc.). Services that are core to the business are excluded from the definition. Once a group has elected to apply the simplified approach (which means that all intra-group services meeting the definition of low value-adding must be included) then the services are allocated using consistent allocation keys between the service recipients, with a fixed mark-up on costs of 5 per cent. The recipient applies a simplified approach to determine that the service is provided, rather than on a transactional basis for every invoice. There are documentation requirements to allow the tax authorities to take comfort that other group companies are being charged for services on the same basis.
The work on the simplified approach for low value-adding services has been broadly agreed by the G20/OECD and other BEPS participating countries, but requires further work as some countries have raised concerns over the need for the simplified approach to be suspended where there are significant charges to an entity. The G20/OECD and other participating countries are considering ratios (based on sales or costs relative to intra-group service charges) where the simplified approach may be set aside. In such a case, the transactional arm’s length approach will be used (as it would if a group does not elect to use the simplified approach).

Intra-group services of this nature are a common issue in transfer pricing, and the reality for MNE businesses is that they are often the subject of lengthy disputes or the cause of double taxation which is out of proportion given their supportive nature. The Actions 8–10 work is helpful, and once countries adopt the rules fully it will help with compliance and administration. However, the issue with support services is often not the mark-up (although the elimination of the need for benchmarking studies for these types of service is helpful for businesses) but the costs themselves. This is particularly an issue where low value-adding services are provided from high-cost locations, such as the UK. The UK tax authority expects that costs incurred in the provision of services for other group companies should be charged out, with an appropriate mark-up on the basis of the transfer pricing guidelines. While the simplified approach will, if widely adopted in practice, provide significant assistance, it is unlikely to resolve all potential disputes.

The UK has effectively incorporated the OECD transfer pricing guidelines (“as best secures consistency”) and the BEPS Actions 8–10 revisions into UK law as a result of the Finance Act 2016 so that the updated guidance on intra-group services is effectively included in UK law. The changes made in Finance Act 2016 apply to accounting periods starting on or after 1 April 2016. The simplified approach represents a change, but the UK tax authority had previously reflected the earlier but not mandatory European Union Joint Transfer Pricing Forum report on low value-adding intra-group services in its approach. The Joint Transfer Pricing Forum’s report looked at similar definitions and concepts, and suggested that a typical mark-up would be in the range of 3–10 per cent.

2.4.3. Profit splits in the context of value chains

The UK has effectively incorporated the OECD transfer pricing guidelines (“as best secures consistency”) and the BEPS Actions 8–10 revisions into UK law as a result of the Finance Act 2016. In line with the guidelines the UK tax authority requires selection of the “most appropriate” transfer pricing method. The standard methods as set out in the OECD transfer pricing guidelines include the CUP, resale margin, cost plus, transactional net margin method and the transactional profit split. Also in line with the OECD transfer pricing guidelines, other methods are acceptable where they are the “most appropriate” in meeting the arm’s length standard. There is no hierarchy of methods, irrespective of the complexity in the value chain of the transaction concerned. A strong CUP is likely to prove the “most appropriate” method but will not be available in many cases.

One of the key objectives behind the BEPS initiative is to ensure that value is allocated to where, and by whom, it is generated, taking into account value creating
activities and accurate delineation of the transactions. Achieving this might in appropriate circumstances require a broader approach than a one-sided analysis (encouraged by the OECD transfer pricing guidelines instruction to “test the simpler party”), so that account can be taken of various contributions, and their relative value, from more than one party.

The G20/OECD and other participating countries are continuing their work on when the profit split method should be used, and how. This includes consideration of when integrated activities occur in parallel and therefore the profit split method might be appropriate, and when activities happen sequentially, suggesting that other methods may be more appropriate. In every case it is the facts and circumstances of the business that will determine when the profit split is most appropriate. Another key consideration is that in many cases a CUP or other method, with suitable adjustments to improve comparability, may give a more accurate result than the inherently complex and more subjective profit split method.

Prior to the BEPS project, some businesses may have identified routine or limited risk activities that could be priced for transfer pricing purposes. Once an appropriate reward was determined for the parties performing those activities (perhaps a cost plus margin or a targeted operating margin), the left-over amount – i.e. the residual profit – would then be the return for the central party or entrepreneur, which might be the owner of intangible assets and/or the entity assuming risks.

Following the BEPS work on transfer pricing, a transfer pricing analysis evaluating all of the contributions including those made by the central party or entrepreneur is needed. This might include a review of the routine and limited risk functions, together with consideration of any role that intangibles might play (and the important development, enhancement, maintenance, protection and exploitation functions associated with those intangibles). After a full review of the relative functions and contributions has been undertaken the appropriate arm’s length share of the profits can be allocated to each party.

This approach provides a more comprehensive study of the relative contributions of the parties (and their corresponding reward), but it also means that the benchmarking exercise is significantly more complex – involving a comparability review of functions related to intangibles, taking into account development, enhancement, maintenance, protection and exploitation functions and potentially also the complexities around hard-to-value intangibles.

Unlike, for example, manufacturing and support services, the development, enhancement, maintenance, protection and exploitation functions for intangibles can be difficult to value and determine in a way that would allow for appropriate benchmarking to evidence compliance with the arm’s length principle. This is made more difficult because of the often unique nature of the intangibles. The selection of comparable data to support the pricing of development, enhancement, maintenance, protection and exploitation can be complicated by differences that are not known or quantifiable. It is essential that profit splits (as with all other methods) are evidenced by reference to arm’s length pricing.

While profit split may be the most appropriate method depending on the facts and circumstances of the case (and particularly in cases involving the development of valuable intangibles) the practical difficulties of implementing and managing a profit split should not be underestimated. This is particularly the case when
multiple countries are involved, due to the timing of local country audits and the potential consequential adjustments required in other participating countries.

2.5. Transfer pricing documentation

2.5.1. CbCR

The UK government introduced legislation in Finance Act 2015 (section 122) giving the UK Treasury the power to make regulations to require MNEs to provide the UK tax authority with a CbCR.

Regulations were subsequently laid out on 26 February 2016 (Statutory Instrument 2016 No. 237) setting out the details of CbCR requirements in the UK. These regulations introduce a reporting requirement for any UK resident ultimate parent entity of an MNE with a consolidated group turnover of €750 million or more. This reporting requirement applies to accounting periods commencing on or after 1 January 2016. Reporting companies will have 12 months from the end of the relevant accounting period to file their CbCR with the UK tax authority.

The interpretation section of the regulations explicitly refers to the G20/OECD and other participating countries’ BEPS Action 13 report so that a number of terms are taken directly from, and so are consistent with, the internationally agreed minimum standard.

The regulations also include a requirement for the top UK entity in an MNE group (or a UK stand-alone entity) to file a CbCR where the ultimate parent entity is resident in a country that either does not require the submission of CbCR or does not exchange information with the UK. This requirement to file a “local” CbCR means that the top UK entity should file a CbCR which includes information on all the entities within the sub-group that it heads. The rationale for this approach, which differs from the G20/OECD local CbCR position, is that the top UK entity has control over the entities it owns and therefore can legally compel the production of information. This is not the case for information on group companies that are not owned by a UK entity. It is possible that more than one UK company will need to file a UK local file if they are not in the same ownership chain (i.e. that they do not share a common UK intermediary parent). There is an exemption from the UK local filing requirement if the information that the UK entity would be required to file has already been included in a CbCR that the UK tax authority can receive (to allow for CbCR by an entity which is a “surrogate” parent in a country which exchanges information with the UK).

The UK has signed and ratified the Convention on Mutual Administrative Assistance in Tax Matters and in addition it has an extensive network of double taxation agreements which allow it to automatically exchange information with bilateral treaty partners. The UK also signed the Multilateral Competent Authority Agreement for the automatic exchange of CbCR on 27 January 2016.

2.5.2. Master and local files

The UK has not introduced legislation to require the provision of a master file and local file as set out in the OECD Action 13 report. The UK tax authority believes
that existing transfer pricing documentation requirements are sufficient to enable it to obtain relevant information in cases in which there may be a risk of underpayment of UK tax as a result of non-arm’s length transfer pricing.

The documentation requirements for transfer pricing are included in the general rules for keeping information for corporation tax self-assessment in the Finance Act 1998. Further details are set out in the UK tax authority’s published guidance (International Manual reference 483030). There is no obligation for businesses to submit transfer pricing documentation with annual tax returns. However, the UK tax authority can request that evidence of compliance with the arm’s length principle be made available in accordance with the record-keeping requirements set out in the International Manual. This means that contemporaneous transfer pricing documentation must be prepared to support the annual tax return and if requested this information must be made available to HMRC within a specified time frame.

2.5.3. Compliance costs

While many MNEs already prepare comprehensive transfer pricing documentation, including functional and economic analyses, the new reporting requirements introduced by BEPS Action 13 require significant additional material to be prepared, analysed and collated in a consistent and prescribed format. The additional work to prepare this information requires additional resources, both from the MNE in terms of preparation and for the tax authorities to review.

From businesses’ perspective, the precise level and impact of these compliance changes depend on their facts and circumstances. A sizeable MNE that has an expensive physical presence across the world, with dedicated tax resources in key territories and regional hubs, will feel the burden very differently from a smaller-scale MNE that has a relatively light but nonetheless wide footprint across the world (and therefore is likely to have limited local tax resources). For many MNEs, particularly smaller MNEs, there are insufficient resources in house to deal with transfer pricing matters including documentation, so that the work is outsourced to professional advisers.

The activity needed to comply with the new requirements of Action 13 places an incremental burden on MNEs, including:

- the preparation of the master file at group level;
- the preparation of local files – including group resources needed to develop local file templates, local resources to populate and customize for local purposes, internal and external reviews, translations of local files and finalization of documents;
- the development of the relevant technology to support the processes for local file documentation and obtaining data for CbCR;
- the retrieval and reporting of relevant and consistent data for CbCR.

Some of the material can be re-used from previously prepared transfer pricing documentation, but most will require at least a process of review and update. In many cases it will be necessary for businesses to collect additional, specifically required information and to undertake further analysis (such as applying the new framework for analysing risk and/or considering the group’s whole value chain) before the revised documentation is compliant with the new guidance. In some cases, information may not be available in the format required (as many businesses report on a
management line basis, and not a statutory accounts basis) – so customization of the data from management reporting systems would also be needed. Finally, new economic analyses may also be required, particularly where a two-sided analysis of transactions across the value chain is appropriate.

Each of these additional areas of work will create an additional burden for businesses. The precise impact on each MNE will depend upon the composition of the MNE, its size and scale, and the complexity and variability of its intra-group transactions.

2.6. Transfer pricing-related measures in other BEPS actions and other measures against BEPS

The UK introduced a new diverted profits tax in the Finance Act 2015 to counter profit shifting. The guidance issued by the UK tax authority states that the diverted profits tax is meant to address erosion of the UK tax base through the diversion of profits that have been generated by UK economic activity. The diverted profits tax has similar aims and objectives to those set out in the G20/OECD BEPS Action Plan but represents unilateral action by the UK government. The UK government’s view is that the diverted profits tax is not subject to existing UK bilateral tax treaties. It remains to be seen whether the courts support this view. The guidance also states that the diverted profits tax is intended to be a closely targeted measure focused on contrived arrangements. The wide drafting of the legislation means, however, that it has the potential to apply more broadly than to “contrived arrangements”.

The diverted profits tax applies to profits arising from 1 April 2015 and seeks to counteract two separate scenarios:

(a) where a group has structured its activities in the UK in a way that avoids the creation of a UK permanent establishment of a foreign company; or

(b) the use of arrangements or entities which lack economic substance, in order to exploit tax mismatches, where the mismatches arise due to UK expenses or through the diversion of income from the UK.

The diverted profits tax is set at a higher rate than the normal rate of UK corporation tax (25 per cent for diverted profits tax compared to the 2016–17 UK corporation tax rate of 20 per cent). Higher rates of diverted profits tax also apply to companies subject to specific tax regimes with additional UK corporation tax rates such as those for oil and gas production and banking. The remuneration for UK-based activities is largely, but not exclusively, computed according to BEPS transfer pricing principles. Credit is given for tax paid overseas. Diverted profits tax has its own rules for notification, assessment and payment. There are limited exemptions from the diverted profits tax for small and medium-sized companies, companies with limited UK sales and expenses and for arrangements that consist only of loan relationships (i.e. those involving debt or similar financial transactions).

In a cross-border transaction context, the diverted profits tax legislation essentially applies where a transaction or series of transactions has been made between group companies and that transaction or series of transactions gives rise to an “effective tax mismatch outcome” (at its simplest, a rate of tax which is lower than 80 per cent of the UK rate) where there is also insufficient economic substance. Where the diverted profits tax legislation applies to the use of arrangements
or entities that lack economic substance it is similar to the objectives of the revisions to the OECD transfer pricing guidelines agreed as part of BEPS Actions 8–10 on transfer pricing. However, in some circumstances under diverted profits tax the parties will be taxed as if they had transacted differently (“the relevant alternative provision”) instead of the transaction actually undertaken. The “relevant alternative provision” is the transaction that it is “just and reasonable to assume” would have been entered into if tax had not been a relevant consideration for any party at any time.

The comparison for diverted profits tax purposes goes beyond looking at the actual conduct of the parties and whether that is consistent with the contractual arrangements as envisaged by the OECD transfer pricing guidelines and can, where all the conditions of the diverted profits tax legislation are met, instead impose a higher rate of tax based on an alternative scenario.

The diverted profits tax, introduced before finalization of the BEPS work by the G20/OECD and other participating countries, is specifically designed to be unilateral in nature, and it is to be hoped that a separate diverted profits tax will no longer be needed when BEPS has been fully implemented globally.

2.7. Can BEPS work in favour of MNEs?

There are two possible benefits of BEPS for MNEs. The first is that BEPS is intended, when fully implemented, to go some way to restoring public trust in the system and framework for the taxation of international businesses.

The second relates to the work by the G20/OECD and other participating countries on dispute resolution and the better operation of tax treaty mutual agreement procedures (BEPS Action 14). The minimum standard for improving mutual agreement procedures and the optional further development of mandatory binding arbitration by 20 countries including the UK are a significant step forward in resolving cross-border tax disputes between governments.

Automatic exchange of information is unlikely, of itself, to be of direct benefit to businesses, as tax authorities that undertake an audit of the transfer pricing of a local entity will still wish to make enquiries and seek additional information in the course of that audit.

3. What is the future of transfer pricing?

The expectation is that the UK will continue to update UK transfer pricing legislation to take account of future changes to the OECD transfer pricing guidelines in respect of transfer pricing principles. This includes any changes that arise from the areas of continuing work in relation to BEPS, including further guidance on the use of the profit split method, further work on hard-to-value intangibles and new guidance on the transfer pricing of financing transactions.

The changes to the transfer pricing guidance under BEPS are extensive, and businesses are dealing with the changes that they need to make to their transfer pricing documentation and their analyses. Similarly, tax authorities are considering the new guidance, and what this means for their approach in tax audits. As it is not
possible for the OECD transfer pricing guidelines to give examples that cover all business circumstances, it is expected that the changes will inevitably increase the number of disputes between businesses and tax authorities and between tax authorities, at least in the short-to-medium term until a common understanding of the new guidance is reached. This is one reason why the G20/OECD and other participating countries’ work on dispute resolution under Action 14 is so important to prevent double taxation of business profits.

One of the key challenges for tax authorities will be in ensuring that the resources they devote to transfer pricing are adequate. Tax authorities will need to be able to cover audits, increasing numbers of disputes and mutual agreement procedures and also, where appropriate, advance pricing agreement programmes. To be effective a tax authority’s resources will need to include suitable transfer pricing skills and experience.
1. Current transfer pricing regulation and practice in the United States

The United States (US) generally follows the OECD transfer pricing (TP) guidelines for multinational enterprises and tax administrations (OECD guidelines). In the US, a two-sentence statute under section 482 of the Internal Revenue Code of 1986 authorizes the Internal Revenue Service (IRS) to allocate income or deductions between related entities where necessary to prevent tax avoidance or to reflect clearly the entities’ income attributable to controlled transactions. The statute itself does not refer to the arm’s length standard. Congress has largely left the development of detailed TP guidance to the Treasury Department and the IRS. To that end, there are hundreds of pages of regulations divided into nine major sections (TP regulations).

The TP regulations provide that the standard to be applied in every case is that of a taxpayer dealing at arm’s length with an uncontrolled taxpayer. They set forth a series of specified methods and elaborate on standards of comparability and the application of the so-called “best method” rule. To apply the best method rule, taxpayers need to evaluate the applicability of the specified methods and select the one(s) that produces the most reliable results. The TP regulations adopt the approach that there is not likely to be just one appropriate transfer price, but rather that the price used in an intercompany transaction will clearly reflect income as long as it falls within a range of arm’s length results, determined by using one of the methods specified in the regulations or an unspecified method. This means that TP is more of an exercise of reasonableness and defensibility, rather than one of absolute accuracy and precision.

In addition to the statute and TP regulations, the US also has a robust body of TP case law going back over 80 years. While some US TP case law is specific to TP regulations that have long since been amended, other case law principles continue to affect current TP practices. For example, while there is only minimal guidance in section 482 or the TP regulations regarding the thresholds for relationships

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1 The first US TP tax statute was enacted in 1928 (then numbered section 45), and the first TP case was decided in 1933 (Gordon Can Co., 29 BTA 292 (1933)).
between parties sufficient to give rise to TP issues, there is a long history of cases on this point, stretching back to 1933.

The IRS has also issued TP guidance through revenue rulings, revenue procedures, private letter rulings, chief counsel advice, responses to TP-related case law and rules for advance pricing agreements (APAs). While these rulings and releases do not have the force of law, they provide useful insight into the IRS’s likely treatment of particular issues and, in the case of APAs, the rules for participating in the IRS’s APA program.

Taxpayers bear the burden of TP compliance. Generally, this takes the form of contemporaneous documentation, which the taxpayer should have in place at the time each (annual) tax return is filed, pursuant to section 6662 and the Treasury Regulations thereunder. Taxpayers pursuing an APA must prepare an annual report that confirms that the taxpayer has met the agreed APA terms and conditions, including any APA adjustments made; this is generally less burdensome than documentation prepared pursuant to section 6662.

2. The impact of the BEPS project on TP

2.1. Introduction

The US has been an active participant in the BEPS project. The primary perception in the US of the impact of the BEPS project on TP issues is that it will lead to an increased compliance burden on a multinational enterprise (MNE). A significant number of MNEs are headquartered in the US (US MNEs), and often the organization and oversight of global compliance work is undertaken at the headquarters in the US. The larger and more global the MNE, the greater the compliance obligations. On 29 June 2016, the Treasury and the IRS released final regulations requiring large US MNEs to prepare and file annual country-by-country reports (CbCR) stating their worldwide profits, taxes, capital, employees, assets and other information, by jurisdiction. As CbCR and master file/local file requirements phase in around the globe, the transition period will pose additional hurdles; resources will be spent simply tracking the legislative and regulatory developments across dozens of relevant jurisdictions.

It is unclear how the US will be affected by the BEPS project in the long term. The BEPS project could have troublesome results for the US if CbCR data are misused. In the US there is grave concern that CbCR data will be used for formulary apportionment, despite the consensus language in the BEPS reports. US MNEs may be forced to reorganize and recalibrate their business structures and operations to the extent that the arm’s length principle is ignored. The US has a lot at stake and it remains to be seen what the long-term impact of the BEPS project will be on the US economy and US MNEs.

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2 See e.g. Action on Decision 2010-005, 2010-49 IRB (IRS’s statement of refusing to acquiesce on the TP-focused Veritas court decision); Rev. Proc. 2015-41, 2015-35 IRB (describing the current procedures for APAs).

3 See generally s. 6662(e); Treas. Reg. §1.6662-6.
2.2. Challenges of transactions with intangibles

2.2.1. Definition of intangibles

There is extensive history of TP disputes in the US relating to intangibles, particularly as it relates to the definition of intangibles and cost sharing arrangements (CSAs). The IRS (and non-US taxing authorities) frequently challenge the pricing of transactions involving intangibles as these transactions are often of high value and viewed as easily transferrable to other jurisdictions. Disputes regarding the definition of compensable intangibles have focused on soft intangibles, including: (a) business opportunities;\(^4\) (b) advantages resulting from operating within an affiliated group;\(^5\) (c) goodwill or going concern value;\(^6\) and (d) workforce in place.\(^7\)

2.2.1.1. Property and ownership

According to the OECD guidelines, the fundamental nature of an intangible is that it is “something which is not a physical asset or a financial asset, which is capable of being owned or controlled for use in commercial activities”.\(^8\) The TP regulations emphasize the importance of economic substance and control for the purposes of identifying the owner of intangible property (IP) between related parties.\(^9\) For instance, in determining which entity should receive income from the exploitation or transfer of intangibles, how intercompany payments relating to intangibles should be allocated between entities, or the price to be paid for intangibles, these regulations provide that it is necessary to first establish which related party “owns” the IP.

Although the theory of ownership has evolved over time, the current iteration of Treasury Regulation §1.482-4(f)(3) focuses on which entity is the owner for intellectual property law purposes or, in the alternative, contractual purposes, “unless such ownership is inconsistent with the economic substance of the underlying transactions”.\(^10\) A licensee can be an owner for tax purposes and enjoy the fruits of investments made in the further development and enhancement of IP even though it may not be the legal owner of the IP. Where an owner is not identified by the relevant jurisdiction’s IP law, contractual agreement, or other legal provisions, the entity that is considered to control the IP will be considered the sole owner of that property for section 482 purposes.\(^11\)

2.2.1.2. Section 936(h)(3)(B)

Section 936(h)(3)(B) defines compensable “intangible property” as any asset falling into one of the following six classes of property, if that property “has substantial value independent of the services of any individual”:

\(^4\) Hospital Corp. of America v. Commissioner, 81 TC 520 (1983).
\(^6\) Veritas Software Corp. v. Commissioner, 133 TC 297 (2009).
\(^8\) OECD Guidance on Transfer Pricing Aspects of Intangibles, ¶ 6.6.
\(^10\) Ibid.
\(^11\) Ibid.
(a) patent, invention, formula, process, design, pattern, or knowhow;
(b) copyright, literary, musical, or artistic composition;
(c) trademark, trade name, or brand name;
(d) franchise, license, or contract;
(e) method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list, or technical data; or
(f) any similar item.
Thus, for IP to be considered compensable, either it must be included in one of the specifically enumerated categories or it must be analogous to one of the items in this list, and have substantial value independent of the services of any individual.

2.2.1.3. Treasury Regulation §1.482-4(b)

The definition of “intangible” under Treasury Regulation §1.482-4(b) is substantially similar to the list of intangibles codified in section 936(h)(3)(B), with the additional statement that for the purposes of section 482, an item is considered to be “similar” to those listed if it derives its value from its intellectual content or other intangible properties, rather than its physical attributes.12

2.2.2. Transactions with intangibles

2.2.2.1. Principal governing rules

Three main sections govern transactions involving intangibles: (a) the cost sharing regulations under Treasury Regulation §1.482-7; (b) the outbound transfer of intangibles under section 367(d); and (c) the controlled transfer, license, and sale regulations under Treasury Regulation §1.482-4.

The regulations governing CSAs were finalized in 2011 with the issuance of Treasury Regulation §1.482-7. In a CSA, related parties agree to share the costs and risks associated with the development of an intangible based on each participant’s share of the reasonably anticipated benefits. Each party has rights to the IP developed from the joint venture based on the ex ante division of rights, typically with respect to a specific geographic area. The participants in a CSA are considered to make cost contributions (i.e. share in ongoing R&D costs) and “platform contributions” (providing existing IP and other resources, capabilities and rights) to the CSA to achieve an anticipated return on those contributions appropriate to the risk of the CSA and the exploitation of the intangibles resulting from the CSA.

With respect to the outbound transfer of IP in a section 351 or section 361 exchange, section 367(d) provides that a taxpayer may elect to recognize an income stream over the useful life of the intangible, which historically was limited to a maximum of 20 years, or upon the disposition of the intangible.13 This income stream is contingent on the productivity, use or disposition of the IP and must be commensurate with the income attributable to the IP.14

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12 Treas. Reg. §1.482-4(b)(6).
13 S. 367(d)(1)(A).
14 S. 367(d)(2).
Treasury Regulation §1.482-4 applies in the context of controlled transfers, licenses and sales between related parties, including royalty-free licenses. Treasury Regulation §1.482-4 prescribes four methods for determining whether an amount charged in a controlled transfer of IP is arm’s length: (a) the comparable uncontrolled transaction (CUT) method; (b) the comparable profits method; (c) the profit split method; and (d) unspecified methods.15

2.2.2.2. Changes to definition of intangibles

In recent years, taxpayers and the IRS have taken different positions regarding the scope of compensable IP under sections 367(d) and 482. Taxpayers have interpreted narrowly the list of enumerated items designated as IP, while the IRS has taken the opposite position. This divergence has led to considerable controversy.

In the midst of numerous taxpayer disputes relating to intangibles, on 14 September 2015, the Treasury and the IRS issued proposed regulations under section 367(a) and 367(d) to prevent taxpayers from transferring foreign goodwill or going concern value in an outbound transfer on a tax-free basis, which the IRS and the Treasury viewed as abusive.16 Both sections 367(d) and 482 define IP by reference to section 936(h)(3)(B). When the Treasury issued proposed section 482 regulations in 1993, it recognized that goodwill or going concern value was not included within the section 936(h)(3)(B) definition of IP, requesting comments as to “whether the definition of IP incorporated in [Treas. Reg.] §1.482-4(b) should be expanded to include items not normally considered to be items of intellectual property such as work force in place, goodwill or going concern value” (58 Federal Regulations 5310, 5312 (21 January 1993) (emphasis added)). Ultimately, the Treasury did not expand the regulatory definition of IP when it issued the final section 482 regulations in 1994. The decision to exclude goodwill or going concern value as a listed intangible in both the Code and the regulations, the explicit recognition by the Treasury that goodwill or going concern value was not included in that definition, and the continued exclusion of goodwill or going concern value from the regulatory definition demonstrate that goodwill or going concern value falls outside of the definition of IP for purposes of section 367(d).

Property Regulation §1.367(d)-1 now applies section 367(d) to all transfers of IP, including foreign goodwill and going concern value.17 These proposed regulations may exceed the IRS’s authority by requiring compensation for property that is not compensable under section 936(h)(3)(B).

2.2.3. “Substance-over-form” approach towards intangibles

The US takes a “substance-over-form” approach to TP, as well as to tax matters more generally. Case law on general substance-over-form principles is robust and dates back more than 80 years to the Supreme Court case Gregory v. Helvering.18

15 Treas. Reg. §1.482-4(a).
17 T.D. 9738 (14 September 2015). the Treasury and the IRS also issued regulations under s. 482 which coordinate the application of ss. 367(d) and 482.
18 293 US 465 (1935).
In that case, Gregory attempted to manipulate her shareholdings through a series of business reorganizations that were designed to conform to tax statutes that would treat them as tax-free transactions but in reality were, in culmination, a disposal of assets at a substantial gain. Helvering, then the Commissioner of the IRS, successfully argued that the substance of the transactions was determinative, not whether they conformed on their face to particular rules. The Supreme Court held that while taxpayers have the legal right to minimize or eliminate taxes if done lawfully, substance will still trump form.19

2.2.3.1. TP regulations

The substance-over-form doctrine is at the core of TP rules in the US. The TP regulations clearly state that substance trumps form. Section 1 of the TP regulations provides that the IRS will respect contractual terms (including consequential allocations of risk) between parties only to the extent that such terms are consistent with the underlying substance of the transactions. If the contractual terms are inconsistent with the economic substance of the underlying transaction, the IRS can ignore such terms, instead imputing terms that match the economic substance of the transaction.20 In determining the economic substance of a transaction, the IRS will give the “greatest weight” to the actual conduct of the parties and the respective legal rights of the parties.21 Specific to IP, additional TP regulations state that economic substance will be determinative regarding ownership of IP for TP purposes, despite local law (including patent and other IP registries) or contractual terms to the contrary.22

In the absence of any written agreement, the IRS can impute a contractual agreement consistent with the economic substance of the transaction.23 Again, in determining the economic substance, the IRS will give the greatest weight to the actual conduct of the parties and their respective legal rights.24 For example, if one controlled party regularly sells all its output to another member of its controlled group, but no written agreement exists, the IRS can impute a purchasing contract between these parties based on their conduct “and determine that the producer bears little risk that the buyer will fail to purchase its full output”.25 Further, unless inconsistent with the taxpayers’ conduct, taxpayers will be treated as following relevant established industry convention or usage (e.g. unless otherwise agreed, payment generally is due at the time and place at which the buyer is to receive goods).26

The TP regulations provide several examples of substance over form in the context of IP issues. One example involves FP, a foreign parent, that holds the AA trademark in the US.27 FP licenses to its US subsidiary, USSub, exclusive

19 Ibid., 293 US at 469–70.
21 Ibid.
24 Ibid.
25 Ibid.
26 Ibid.
manufacturing and marketing rights in the US under the AA trademark. As a result of its sales and marketing activities, USSub develops a valuable customer list. Neither the terms of the contract between FP and USSub nor relevant IP law specify which party owns the customer list. Because USSub has knowledge of the contents of the list and has practical control over its use and dissemination, USSub is considered the sole owner of the customer list for TP purposes.

2.2.3.2. TP case law examples

In the 1996 case Medieval Attractions N.V., Spanish investors purportedly transferred to US entities IP relating to a themed dinner theatre concept, including a trademark. This was supported by written agreements and the registration of the trademark. However, the US Tax Court found that the US entities had been the developers of the intangibles for several reasons, including: (a) other companies had been involved in similarly themed dinner theatre events, so there was no IP specific to the concept; (b) the US employees had developed the features of the show, such as costumes; and (c) only the US entities used the trademarked name, which had not been used prior to their existence. In addition, the written agreements were backdated and sometimes unsigned. On this basis, the US entities’ deductions for royalty payments to the parent company were disallowed because no IP had been transferred to them. The Spanish investors also used loans and the circular movement of money through a variety of different entities to create an interest obligation for the two US entities. The Tax Court found the movement of money to be a sham and disallowed the deduction for the interest payments for several reasons including: (a) the purported reason for the debt – large royalty payments – was a sham because in fact no royalties were owed, as there had been no transfer of IP; and (b) the related-party obligations were not genuine and were overstated.

By contrast, in the 1985 case Eli Lilly & Co., the US Tax Court upheld the taxpayer’s transactions and agreements as having the economic substance to match the form. In that case, patents and knowhow were transferred from the US company to its new Puerto Rico subsidiary (Lilly P.R.), pursuant to written agreement. The assignment was ratified by the boards of directors of the two entities and recorded in the US Patent Office. Following the transfer, Lilly P.R. was the only manufacturer of the relevant products in the US and Puerto Rico, and therefore the only user of the patents in those jurisdictions. Lilly P.R. also protected the patent in two patent infringement suits. The Tax Court thus found that the US entity had indeed transferred the IP to Lilly P.R., rejecting the IRS’s argument that the US developer of the IP would have to forever report the income from those intangibles.

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29 See generally Medieval Attractions, TC Memo 1996-455, at *95–*111 (96-3318 to 96-3322).
30 See generally Medieval Attractions, TC Memo 1996-455, at *111–*121 (96-3322 to 96-3326).
31 Eli Lilly & Co. v. Commissioner, 84 TC 996 (1985); aff’d in part, rev’d in part and rem’d in part 856 F2d 855 (7th Cir. 1988).
2.2.3.3. Impact of BEPS project

It is too soon to know the ultimate impact of the BEPS project on the substance-over-form doctrine in US TP issues. To date, there has not been any significant change in how the IRS or the courts treat transactions with intangibles as a result of BEPS project developments. The reporters do not expect the BEPS project to have a material impact on US TP issues unless or until the Internal Revenue Code or Treasury Regulations are amended. To date, there has been no indication that the latter will happen any time soon.

2.2.4. Comparability and group synergies

2.2.4.1. Comparability factors under Treasury Regulation §1.482-1(d)(3)

The TP regulations do not require that an uncontrolled transaction be identical to a controlled transaction, but that it be “sufficiently similar” to the controlled transaction. The TP regulations detail five comparability factors to analyze the degree of similarity between an uncontrolled transaction and a controlled transaction: (a) functions performed; (b) contractual terms; (c) risks assumed; (d) economic conditions; and (e) property or services transferred. The TP regulations stress that practitioners should consider all five factors; however, the relative weight of each factor depends on the TP method selected and applied.

2.2.4.2. Is synergy a comparability factor or an intangible?

Group synergies refer to the favorable (or disadvantageous) influences that may arise from being part of the enterprise group as a whole. For example, a larger company may benefit from bulk purchase discounts (as compared to a smaller sized company). In general, under US rules, group synergies are comparability factors. Synergies occur when the value from the merger of two companies is greater than the sum of the values that would have been achieved if the organizations had not merged. For example, a merger may produce an operational synergy that allows the consolidated company to reduce overall operating costs. For US accounting purposes (and as reflected in purchase price allocation reports), synergies that are associated with the acquired company are assigned to goodwill and going concern and are considered an intangible.

2.2.4.3. Is group synergy compensable?

Passive association, or benefits that arise as a result of a legal entity’s association with a larger group of companies, is not compensable. For example, a small subsidiary in a large group might obtain favorable pricing on supplies by consolidating purchases with others in the group, but the subsidiary need not pay for that benefit. On the other hand, if group synergies are caused by purposeful group

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33 Treas. Reg. §1.482-1(d)(1).
activities, the costs associated with these activities would be compensable. For example, a small subsidiary may rely entirely on a central merchandising group (in a different subsidiary) to negotiate all its contracts with vendors. The central merchandising group obtains lower prices from the vendors by aggregating group volumes (creating group synergies). Without the central merchandising group, the smaller subsidiary would have to hire a third party to negotiate its contracts. Since the activities performed by the central merchandising group result in a direct benefit to a member of the controlled group, arm’s length consideration is required to be paid by the beneficiary.\footnote{Treas. Reg. §1.482-9(l)(1).} However, the compensation would not include the volume discount element attributable to the volume contributed by the subsidiary.

Synergies arising from acquisitions would generally be regarded as non-compensable intangibles as the TP regulations define compensable intangibles as having “substantial value independent of the services of any individual”,\footnote{Treas. Reg. §1.482-4(b).} and provide a list of examples (which do not include synergies, goodwill or going concern value). Given that: (a) the TP regulations do not specifically mention synergies as intangibles;\footnote{A study by the Joint Committee on Taxation demonstrated that Congress intended that there be an excluded class of intangibles. See Joint Committee on Taxation: General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 (HR 4170, 98th Cong., 2d Sess. P.L. 98-369) (1984), at 434.} and (b) synergies have different characteristics than the intangible items enumerated in the TP regulations, US taxpayers argue that synergies are not compensable intangibles under Treasury Regulation §1.482.

2.2.4.4. Cost sharing regulations

When a target company is acquired and some or all of its assets are contributed to a CSA, the acquisition price method (APM) is an identified method practitioners can use to calculate the platform contribution transaction (PCT) payment among the CSA participants.\footnote{Treas. Reg. §1.482-7(g)(5).} Using the APM, the arm’s length PCT from an acquired company (the “target”) is the acquisition price (adjusted for certain items) for the target divided among the participants based on their reasonable anticipated benefit shares.\footnote{Ibid.} In applying the APM, practitioners generally deduct (or “carve out”) synergies attributable to items outside the delineated cost shared intangibles (as a third party would only pay for intangibles that it reasonably intends to use).

2.2.5. Hard-to-value intangibles

In the US, the IRS has been aggressively litigating TP cases, especially cases involving intangibles. In Veritas Software Corp. v. Commissioner,\footnote{Veritas Software Corp. v. Comr., 133 TC 297 (2009).} the US Tax Court rejected the IRS’s theory that the licensing of intangibles was “akin” to a sale of a business and accepted the taxpayer’s proposed CUT method as the best method for valuing the buy-in payment. The IRS contended that the best method for valuing the buy-in payment was the income (or forgone profits) approach. In

\footnotesize{\textsuperscript{35} Treas. Reg. §1.482-9(l)(1).}  
\footnotesize{\textsuperscript{36} Treas. Reg. §1.482-4(b).}  
\footnotesize{\textsuperscript{37} A study by the Joint Committee on Taxation demonstrated that Congress intended that there be an excluded class of intangibles. See Joint Committee on Taxation: General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 (HR 4170, 98th Cong., 2d Sess. P.L. 98-369) (1984), at 434.}  
\footnotesize{\textsuperscript{38} Treas. Reg. §1.482-7(g)(5).}  
\footnotesize{\textsuperscript{39} Ibid.}  
\footnotesize{\textsuperscript{40} Veritas Software Corp. v. Comr., 133 TC 297 (2009).}
their calculation, the IRS applied an aggregate valuation approach, assuming a perpetual life for the intangible assets and their income stream, and also included assets other than those in existence prior to the CSA. The US Tax Court agreed with the taxpayer that the CUT approach based on the taxpayer’s own licensing agreements with third parties (with some adjustments) was the best method to derive the buy-in payment.41

In another more recent example, Amazon.com Inc. v. Commissioner, the IRS proposed a $2 billion adjustment and a $234 million tax assessment under a CSA in which IP was transferred to a subsidiary based in Luxembourg.42 Practitioners are awaiting the Tax Court’s opinion in this case.

2.2.5.1. Realistic alternatives

In the TP regulations, the selection of the best method must take into account the availability of realistic alternatives to both the buyer and seller engaged in an intercompany transaction. The IRS has used the concept of realistic alternatives to propose large TP adjustments in the context of licensing of intangibles by relying on the following language from the TP regulations:

“[A]n unspecified method should take into account the general principle that uncontrolled Taxpayers evaluate the terms of a transaction by considering the realistic alternatives to that transaction, and only enter into a particular transaction if none of the alternatives is preferable to it ... Therefore, in establishing whether a controlled transaction achieved an arm’s length result, an unspecified method should provide information on the prices or profits that the controlled Taxpayer could have realized by choosing a realistic alternative to the controlled transaction. As with any method, an unspecified method will not be applied unless it provides the most reliable measure of an arm’s length result under the principles of the best method rule.”43

For example, the IRS has argued that in the context of CSA buy-in valuations (under the 1996 CSA regulations), specified methods (such as the residual profit split method) may not provide reliable results due to realistic alternatives. Using this argument, the IRS may select the unspecified income (or forgone profits) method, arguing that the two parties would not agree to enter into a transaction unless both parties would be either the same or better off under the new arrangement. That said, the TP regulations provide that if the district director adjusts the consideration charged in the controlled transaction based on the cost or profit of an alternative, it must take into account material differences between the alternative and the controlled transaction.44 In the case of transactions involving IP or CSA transactions, this provision would require adjustments to the alternative to take into account, for example, the funding of R&D.

41 See Veritas v. Commissioner, 133 TC 297 (2009).
42 Amazon.com Inc. v. Commissioner, TC, No. 31197-12, filed 28 December 2012.
43 Treas. Reg. §1.482-4(d)(1).
2.2.5.2. Aggregate valuation of intangibles

On 14 September 2015, the Treasury and the IRS issued temporary TP regulations which seek, in part, to coordinate the application of sections 367(d) and 482. Section 367(d) deals with US transfers of IP to foreign corporations.45 The temporary TP regulations modify and expand the existing aggregation requirement under Treasury Regulation §1.482-1(f)(2)(i) in the application of the best method rule to measure the value of transferred intangibles. The current aggregation requirement indicates that the combined effect of two or more separate transactions may be considered if the transactions, taken as a whole, are so interrelated that an aggregate analysis provides the most reliable measure of an arm’s length result determined under the best method rule. The temporary TP regulations contend that all value (including synergies) provided between controlled parties requires arm’s length compensation which is to be determined under the best method rule without regard to the form or character of the transaction.46

2.2.5.3. The valuation of intangibles should not hinge upon the tax statute section governing the transaction

The 14 September 2015 release by the Treasury and the IRS of the proposed regulations under section 367 and the temporary TP regulations (on the same date) highlights the interrelation between the activities and transactions covered under these two sections and regulations, and it signals an attempt by the IRS to “clarify the coordination of the application of the arm’s-length standard and the best method rule … under Sec. 482 in conjunction with other Code provisions”.48 The IRS indicated that intangibles should be valued in the same way regardless of the tax code section. In this spirit, the IRS and the Treasury have announced their intention to modify regulations specific to partnerships under sections 482 and 6662.

2.2.6. Cost contribution agreements (CCAs)

CCAs, referred to in the TP regulations as “cost-sharing arrangements”, have been utilized in the US for a number of years. The TP regulations set forth the specific requirements for a qualifying CCA, including substantive and administrative requirements.49 There are three major substantive requirements. First, the controlled participants must make appropriate “cost-sharing” payments, paying each other amounts so that in each taxable year, each controlled participant’s intangible development costs (IDCs) are proportionate to its share of reasonably anticipated benefits (RAB share) from the CCA.50 Second, each controlled participant must make appropriate PCTs, compensating for platform contributions contributed by the other party.51 A platform contribution is a resource, capability or right reasonably

45 On 14 September 2015, the Treasury and the IRS issued proposed regulations under s. 367.
49 See Treas. Reg. §1.482-7(b), (k).
50 Treas. Reg. §1.482-7(b)(1)(i).
51 Treas. Reg. §1.482-7(b)(1)(ii), (c).
anticipated to contribute to developing CCA IP. Third, each controlled participant must receive a non-overlapping, perpetual and exclusive interest in the CCA IP without further obligation to compensate another controlled participant for such interest. The exclusivity may be based on geography, field of use, or another basis meeting the requirements in the TP regulations.

The US CCA rules focus on the costs contributed by the parties, whereas the focus in the BEPS report is on the value contributed. There is overlap: both measures contributed IP based on the value of the IP, and both acknowledge that contributions such as R&D services can be assessed based on (opportunity) cost. However, the overall philosophy and default assessment of contributions is different. In the US, there has been significant controversy regarding the buy-in or PCT payment owed by a CSA participant. However, after the buy-in or PCT payment issue has been resolved, the US rules allow a CSA participant the benefit of funding the development of intangibles regardless of the development, enhancement, maintenance, protection and exploitation (DEMPE) functions. This is a significant difference between the US rules and the BEPS report.

2.3. Risk and capital

The US shares the OECD’s concerns regarding MNEs attempting to artificially shift profits through non-arm’s length transfers of risk and capital. In determining the arm’s length pricing, the US TP regulations require an analysis of, inter alia, risks and economic conditions. Relevant risks to consider include market risks, risks associated with the success or failure of R&D activities, and product liability risks.

2.3.1. Investor model for PCTs under CCAs

In the context of PCTs under a CCA, the TP regulations apply the “investor model”, considering whether the contractual terms and risk allocation are consistent with the rates of return to the parties. Specifically, the investor model evaluates the reliability of a PCT arrangement based on whether, as of the date of the PCT, each controlled participant’s aggregate net investment in the CCA (including contributions of intangibles, services and other resources and costs) is reasonably anticipated to earn a rate of return appropriate to the riskiness of the party’s CCA activity over the entire period. Further, the present value (PV) of the income attributable to a controlled participant must not exceed the PV of income that that party could have earned through an alternative arrangement realistically available to that party.

52 Treas. Reg. §1.482-7(b)(1)(ii), (b)(4).
53 See Treas. Reg. §1.482-7(b)(1)(ii)–(iv).
54 See BEPS TP Report, s. C.4 (especially ¶¶ 8.27–8.29).
55 Treas. Reg. §1.482-7(g); BEPS TP Report, s. C.4.
56 Treas. Reg. §1.482-7(d)(1); BEPS TP Report ¶ 8.27.
57 Treas. Reg. §1.482-1(d)(1).
59 Treas. Reg. §1.482-7(g)(2)(i).
60 Treas. Reg. §1.482-7(g)(2)(iii).
For example, consider a CCA between parent P and its subsidiary S and under which: (a) P contributes rights to patents and other IP (constituting PCTs); (b) both parties contribute to R&D, manufacturing and marketing in their respective geographic areas; and (c) each party receives rights to manufacture and market in their respective geographic areas. If: (i) S’s manufacturing and distribution activities under the CCA are routine and identical to the activities S would undertake if it had instead hypothetically licensed the relevant IP from P; and (ii) P could develop the product without assistance from S, then the PV of an appropriate PCT payment from S to P should be based on the PV of royalties that would have been charged under the hypothetical license (after applying appropriate financial projections and discount rates).61

2.3.2. Substance-over-form

As noted above, the IRS applies substance-over-form – giving greater weight to the economic substance of an arrangement rather than to any written agreement, and imputing appropriate contractual terms where necessary.62 Thus, whether a party actually bears such risks affects the return permitted to that party (e.g. funding patent protection lawsuits, suffering economically from failed R&D, bearing reputational and financial costs for product liability).

2.4. High-risk transactions

2.4.1. Comparable uncontrolled price (CUP) and quoted prices for cross-border commodity transactions

Under the CUP method, an arm’s length price for a controlled sale of tangible property is equal to the price paid in a CUT.63 In certain cases, data from public exchanges or quotation media for industry averages may provide the basis for a CUP. Prior to 1994, US courts rejected the use of industry averages to establish a CUP. For instance, in Nissho Iwai v. Commissioner,64 an American subsidiary purchased timber for sale to its Japanese parent, at a price based on certain CUTs. The Commissioner proposed an adjustment using industry average log sale prices. The Tax Court rejected this evidence, holding that “[i]ndustry averages are, in most cases, of uncertain reliability in determining arm’s-length prices”.65

In 1988, the IRS issued a TP White Paper66 which specifically cited Nissho Iwai and other related cases for the proposition that courts traditionally had been reluctant to accept evidence of industry statistics as comparables. Based on this line of case law, the IRS concluded that “[t]he failure of the regulations to provide guidance in the absence of comparable products and transactions has created problems

61 See Treas. Reg. §1.482-7(g)(2)(iii)(B) Ex. (1).
62 Section 2.2.3 above.
63 Treas. Reg. §1.482-3(b).
64 50 TCM 1483 (1985), aff’d without published opinion, 812 F.2d 712 (2d Cir. 1987).
65 Ibid., at 1498.
in cases involving sales of tangible property” and determined to address this issue in future regulations.67

Beginning in 1994, the Treasury and the IRS expressly authorized the use of data from public exchanges or quotation media to establish an arm’s length price for the transfer of tangible property.68 These rules allowed taxpayers to use so-called “indirect evidence” derived from public exchanges or quotation media as a CUP to establish an arm’s length price for the controlled transfer of tangible property. The new rule was promulgated as Treasury Regulation §1.482-3(b)(5). This approach is most relevant for taxpayers dealing in commodity-type products, such as petroleum.

Under Treasury Regulation §1.482-3(b)(5), information from public exchanges and quotation media may be used to derive an arm’s length price for the intercompany transfer of tangible property so long as “extraordinary market conditions” do not exist and:

(a) the data are widely and routinely used in the ordinary course of business in the industry to negotiate prices for uncontrolled sales;
(b) the data derived from public exchanges or quotation media are used to set prices in the controlled transaction in the same manner as by uncontrolled taxpayers in the industry; and
(c) adjustments are made to the price in the controlled transaction to account for differences in product quality and quantity, contractual terms, transportation costs, market conditions, risks borne and other factors affecting price that would be agreed to by uncontrolled taxpayers.

If these three requirements are met, then the TP regulations authorize the use of data from public exchanges or quotation media to derive an arm’s length price for the transfer of tangible property.

2.4.2. Intra-group services

2.4.2.1. Evolution of the services regulations

In 2009, the Treasury and the IRS issued final TP regulations governing intercompany services.69 The 2009 TP regulations represented the first permanent regulatory guidance relating to intercompany services in over 40 years, since the issuance of the 1968 TP regulations. The 1968 TP regulations provided the first specific guidance governing the pricing of intercompany services, establishing the IRS’s authority to apply section 482 rules to intercompany services.70

Figure 1 illustrates the framework of the current services regulations.

67 1988-2 CB at 469.
68 See Treas. Reg. §1.482-3(b)(5).
Figure 1. The framework of the current services regulations

*a* Determined by applying the “business judgment rule” as set forth in Treas. Reg. §1.482-9(b)(5).

*b* Non-core chargeable services that do not fall within any of the following three categories: black list, white list and low margin.

*c* Services that are not eligible for the services cost method and which are defined as “excluded activities” in Treas. Reg. §1.482-9(b)(4).

*d* Services that are eligible for the services cost method and that the Commissioner specifies by revenue procedure. See Rev. Proc. 2007-13, 2007-1 C B 295.

*e* Services for which the median comparable mark-up on total services costs is less than or equal to 7 per cent.
2.4.2.2. Benefit

A transaction or activity is subject to the general framework of the services regulations if it qualifies as a “controlled services transaction”. This term is broadly defined as any activity that results in a “benefit” to one or more other related taxpayers. A benefit is present if the activity directly results in a reasonably identifiable increment of economic or commercial value that enhances the recipient’s commercial position, or is reasonably anticipated to do so. Four categories of activities are excluded under this benefit test: (a) activities having only an indirect or remote benefit; (b) duplicative activities that provide no benefit to the recipient; (c) shareholder activities; and (d) passive association benefits. The final 2009 TP regulations expand the scope of activities that render a benefit by including activities which were historically considered stewardship activities undertaken for the benefit of the shareholder. This creates a conflict vis-à-vis countries (e.g. China) which apply a broader definition of stewardship activities.

2.4.2.3. Services cost method (SCM)

The regulations make the SCM permanent. The SCM allows certain services to be priced at cost, that is, it permits the services to be reimbursed at cost, without a mark-up. To qualify for the SCM, the service must: (a) be a “covered service”; (b) not be an “excluded activity”; (c) satisfy the business judgment rule; and (d) maintain adequate books and records. To apply the SCM, under the business judgment rule, the taxpayer must reasonably conclude that, in its business judgment, the service “does not contribute significantly to key competitive advantages, core capabilities, or fundamental risks of success or failure in one or more trades or businesses of the controlled group”.

2.4.2.4. White list and blacklist of services

Two categories of “covered services” qualify for the SCM: (a) white list activities; and (b) “low margin covered services”, which consist of other, relatively routine services for which the median comparable mark-up is 7 per cent or less.

The white list of activities consists of various routine, back office or other support services identified by Rev. Proc. 2007-13, which generally do not involve a significant median comparable mark-up. Rev. Proc. 2007-13 lists 101 separate types of services within 19 separate categories, which include (among others) payroll, general administrative, corporate and public relations, accounting, tax, treasury, IT services and legal services.

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71 Treas. Reg. §1.482-9(l).
72 Ibid.
73 Ibid.
74 Treas. Reg. §1.482-9(b).
75 Ibid.
76 Treas. Reg. §1.482-9(b)(5).
The regulations also include a blacklist of activities, which are “excluded activities.”\(^{78}\) These activities tend to be high margin transactions or transactions that require a more robust analysis. The blacklist includes manufacturing, production, extraction, exploration or processing of natural resources, construction, reselling, distribution (or similar services), research, development or experimentation, engineering or scientific activity, financial transactions and insurance or reinsurance services.

2.4.3. Profit splits in the context of value chains

2.4.3.1. Comparable profit split method (CPSM) and residual profit split method (RPSM)

The TP regulations describe two forms of the profit split method: (a) the CPSM; and (b) the RPSM. Under the CPSM, the combined profit or loss of the controlled taxpayers is allocated by reference to the division of the combined profits or losses of uncontrolled taxpayers from transactions between them.\(^{79}\) A percentage is computed for each uncontrolled comparable by dividing the uncontrolled comparable’s profit or loss by the combined profit or loss of the uncontrolled comparables. These percentages are used to allocate the combined profit or loss of the controlled taxpayers.

The RPSM provides a two-step allocation procedure for dividing combined profits among the parties to a controlled transaction.\(^{80}\) The procedure allows each controlled party a rate of return for the routine economic functions that they perform. Any residual combined profit is deemed attributable to non-routine intangibles, and allocated among the controlled parties based on the relative value of the intangibles they have contributed to the combined enterprise.

2.4.3.2. Measuring non-routine contributions by using historical cost data or market benchmarks

In the RPSM, the residual profit allocation must be made to each controlled taxpayer based on the value of each taxpayer’s relative contribution of valuable intangibles. The relative value of each controlled taxpayer’s valuable intangibles may be determined by: (a) reference to external benchmarks that reflect the fair market value of the intangibles; (b) capitalizing and amortizing the cost of developing the intangibles; or (c) comparing the relative value of development expenditures incurred by the controlled taxpayers in recent years, if the intangible development expenditures have been relatively constant over time.\(^{81}\)

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78 Treas. Reg. §1.482-9(b)(4).
79 Treas. Reg. §1.482-6(c)(2)(i).
80 See generally Treas. Reg. §1.482-6(c)(3).
81 Treas. Reg. §1.482-6(c)(3)(i)(B).
2.4.3.3. Courts prefer CUTs

The TP regulations note that the CUT method provides the “most direct and reliable measure of the arm’s length result”, but only where “the uncontrolled transaction involves the transfer of the same intangible under the same, or substantially the same, circumstances”. The US courts have consistently demonstrated a preference for the CUT method even if the comparables are far from perfect and require adjustment. This preference for the CUT method generally applies where the comparable transactions are “internal comparables”, i.e. licenses by the taxpayer of largely the same IP to or from an unrelated party. For example, in the 2016 case Medtronic, Inc. v. Commissioner, the US Tax Court relied upon the CUT method – using an internal comparable (with certain adjustments) – to determine the arm’s length pricing.

2.4.3.4. Concept of a “value chain”

In the Medtronic case, the US Tax Court determined that the IRS’s proposed adjustments were arbitrary, capricious and unreasonable and rejected the IRS’s aggregated “value chain” approach. Using the aggregated value chain analysis, the IRS proposed an adjustment that would have increased Medtronic’s tax obligations by approximately $1.3 billion. The IRS used its value chain analysis to assign returns to group members of the Medtronic MNE. The Tax Court rejected the value chain approach and followed a long line of precedents expressing a strong preference for CUTs.

2.5. TP documentation

2.5.1. CbCR

The US has implemented CbCR through regulatory guidance and IRS Form 8975 (CbCR). Form 8975 contains the fields in the CbCR contained in Action 13. The US relies on section 6038, which gives the IRS the authority to collect information regarding US corporations and partnerships that are controlled by US persons. By relying on this statute, the US will require a US-parented MNE to file Form 8975, but will not provide an option for a foreign-parented MNE to file with the IRS as a surrogate. Form 8975 will be filed with the income tax return (including extensions).

The final CbCR regulations apply to reporting periods of ultimate parent entities of US MNE groups that begin on or after 30 June 2016. As a result, there will be a gap year for those groups with an ultimate parent with a fiscal year that begins prior to 30 June. The Treasury and IRS indicated that such groups will be permitted to elect to file a voluntary Form 8975 for the gap year in the fall of 2017, and the US will share the form with relevant jurisdictions.

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82 Treas. Reg. §1.482-4(c)(2)(ii).
83 See e.g. Veritas v. Commissioner, 133 TC 297 (2009); Bausch & Lomb, Inc. v. Commissioner, 92 TC 525, 598 (1989).
84 TC Memo, 2016-112 (9 June 2016).
85 TD 9773 (30 June 2016).
The US does not have a requirement for a foreign MNE to provide notice to the IRS regarding where the foreign MNE will file its CbCR. The US signed the protocol amending the Convention on Mutual Administrative Assistance in Tax Matters in 2010, but to date, Congress has not ratified it. The US has not signed the model competent authority agreement contained in the OECD’s Action 13 guidance. Moreover, the Treasury and the IRS stated in the preamble to the final CbCR regulations that it will enter into competent authority agreements for the automatic electronic exchange of CbCRs with those jurisdictions with which the US has either an income tax treaty or a tax information exchange agreement. The competent authority agreement will ensure that a foreign tax jurisdiction satisfies the confidentiality requirements, data safeguards and appropriate use restrictions (e.g. the CbCR cannot be used as a basis for assessment or formulaary apportionment). The preamble to the final regulations also indicates that the existence of such agreements will be made publicly available, although the form and content of such announcement is unknown.

2.5.2. Master and local files

The US has not adopted the master and local file practices described in Action 13. Rather, the US will continue to rely on its documentation requirements under the regulations for sections 482 and 6662. Technically, the Internal Revenue Code does not require documentation, but practically taxpayers prepare documentation as a defense to penalties (ranging from 20 per cent to 40 per cent of an underpayment attributable to tax). Contemporaneous documentation is required as a defense to penalties under the specified pricing method safe harbor or the unspecified pricing method safe harbor. Such documentation must be provided to the IRS within 30 days of a request.

The documentation is comprised of principal and background documents. Briefly, a taxpayer must include the following categories of documents: (a) an overview of the taxpayer’s business and accompanying documents (e.g. identification of relevant IP); (b) a description of the organizational structure covering all related parties potentially relevant under section 482, including foreign affiliates whose transactions directly or indirectly affect the pricing of property or services in the US; (c) any documentation specified by the section 482 regulations (e.g. written agreements substantiating an intercompany CSA); (d) a description and explanation of why a particular method was selected; (e) a description and explanation of why alternative methods were not selected; (f) a description of controlled transactions, including terms of sale and internal data used to analyze the transactions; (g) a description of comparables used, how they were evaluated and any adjustments made; (h) explanations of the economic analysis and projections used to develop the method; (i) a description or summary of any relevant data that the taxpayer obtains after the end of the year but before the tax return is filed; and (j) an index to the principal and background documents and a description of the record-keeping system.

86 The US Senate has not ratified a tax treaty in more than six years due to objections raised by one or more Senators regarding tax treaties.
87 Treas. Reg. §1.6662-6(d)(2).
88 Treas. Reg. §1.6662-6(d)(2)(iii), (3), (4).
This documentation is comprehensive and includes all of the elements of the master and local files.

2.5.3. Compliance costs

Since the US has not adopted the master file and local file approach of Action 13, there is no information regarding compliance costs.

2.5.4. TP-related measures in other BEPS actions and other measures against BEPS

President Obama proposed several legislative items to address BEPS. Specifically, he proposed a 19 per cent minimum tax on foreign income. The proposal would affect TP if it became law.

The US taxes worldwide income with deferral for active income earned in a controlled foreign corporation (CFC). The administration proposes to apply a per-country tax on the foreign earnings of entities taxed as corporations and their CFCs. The minimum tax would be a tax of 19 per cent less 85 per cent of the per-country foreign effective tax rate. In computing the income subject to the minimum tax, an entity would be entitled to an allowance for corporate equity (ACE). The ACE is a risk-free return on equity invested in active assets, and would not apply to passive assets held by the entity.

The administration notes that the reason for change is that companies can defer US tax on active earnings with the ability to currently deduct expenses in the US that subsidize the deferred income. The proposal notes that this “provide[s] US multinationals with the incentive to locate production overseas and shift profits abroad, eroding the US tax base”.

The proposal is also designed to address the foreign tax credit system that “allows companies to utilize credits from high-tax foreign source income such as dividends to reduce US tax on low-tax foreign source income such as royalties”. To date, Congress has not considered this proposal, and it is unlikely that the next administration will include this proposal in its budgets.

The House of Representatives is currently considering a proposal that would apply a border adjustable tax to all imports of goods, services and intangibles (most likely through a denial of cost of goods sold for such imports). The proposal would also exempt gross revenues from exports from US corporate tax. Additionally, interest expenses in excess of interest income would be denied and carried forward, while assets (other than land) would be currently expensed. Some commentators have described this proposal as eliminating the incentive to manipulate transfer prices to shift income to lower tax jurisdictions and the incentive to move produc-

89 General Explanations of the Administration’s Fiscal Year 2017 Revenue Proposals, Department of the Treasury (February 2016) at 10.
90 Ibid.
tion to lower tax jurisdictions. As of the date of drafting this report, it is unclear if the border adjustable tax will become law.

In both instances, both political parties are considering options that could reduce the incentive to use TP to engage in BEPS.

2.6. Can BEPS work in favor of MNEs?

To date, there have been no initiatives to use the BEPS platform to benefit MNEs.

3. What is the future of TP?

It is clear that the OECD has endorsed the arm’s length principle as the bedrock of TP. What is unclear is how countries will apply the arm’s length principle. Fear persists that certain countries will use formulary apportionment under the guise of applying the arm’s length principle. If that happens, the future of TP will be a tsunami of double tax disputes. Currently, most tax authorities are strapped for resources and are not equipped to handle an increased volume of double tax disputes. Embracing mandatory arbitration in income tax treaties will bring discipline to the process for resolving double tax disputes. However, certain countries are refusing to accept mandatory arbitration by asserting that it compromises national sovereignty. In short, the future of TP is clear as mud.
Summary and conclusions

As Valdes Costa said in 1978, international operations “can undoubtedly lead to the distortion of prices implied by the transfer of the tax burden from one country to another”.¹ That is why a full understanding of the scope of the new transfer pricing (TP) guidelines and their impact on the country is important.

Even though it is true that loopholes or inconsistencies in international taxation rules expose a number of weaknesses that create opportunities for the erosion of the tax base and the shifting of profits (BEPS), changes made by the BEPS project seem to go beyond a possible solution to this problem.

The arm’s length principle has been adopted by Uruguay since 2006, in line with the international standards. However, most of the TP topics analysed in the present project are not discussed in the domestic legislation.

As stated throughout this report, the different proposals reveal the complexity, sophistication and subjectivity that the practical application of the arm’s length principle presents. These difficulties could become even greater in countries such as Uruguay, given the relatively emerging state of their practice, the scanty regulations on the matter, the absence of a jurisprudence background and the lack of specialist tax courts.

Beyond these difficulties, the most sensitive aspect of this project lies in the coherent interpretation made by each country of the arm’s length principle for aligning TP outcomes with the activities that create value. Once the new measure becomes applicable, profits are expected to be reported where the economic activities that generate them are carried out and where value is created.

Although Uruguay adopts a substantial approach based on economic reality, and, in that sense, the place where such activities are performed will be taken into account, there are no specific provisions regarding what creates value and how this value should be allocated between related parties under the absence or difficulty in

finding comparables. These two questions in particular represent a cornerstone in the interpretation of the arm’s length principle introduced by the BEPS actions.

Domestic legislation does not contain an express provision in this respect, nor does it establish a hierarchical order as to what functions, risks and assets should be considered as creators of value (more specifically, the relative contribution of its functions/assets/risks to value creation), or how this value should be measured when allocating the profit in question.

While the propositions put forward by these actions may be worthy of consideration in theory, their practical application will be extremely complex and subjective. For instance, in the matter of intangibles and risks, it is difficult not only to identify and measure them in a controlled transaction but also in potential comparables, where it may be almost impossible to measure their impact in view of the little or no information that can be accessed publicly.

The changes introduced represent a new paradigm in the interpretation of the arm’s length principle, thus posing a challenge for those countries that adopt it. It would appear that the old discussion between source and residence is taking second place to hypotheses of value creation and how they are interpreted, which will be the new paradigms to consider in the coming years.

Finally it is important to mention that Uruguay is moving towards a new standard of international taxation, a position that has been evident in its adherence to the inclusive framework and the Convention on Mutual Administrative Assistance in Tax Matters, and the signing of the Multilateral Competent Authority Agreement on the exchange of country-by-country reports (CbCR). Nevertheless, given the complexity of the BEPS project TP measures package and the relatively early stages of this practice in Uruguay, there is still a long way to go.

1. Introduction

In October 2015 the OECD submitted the OECD/G20 BEPS project,2 prepared by OECD/G20 country members. The package of measures adopted within the context of the BEPS project gave rise to 15 specific actions on several aspects of international tax. This report analyses how the measures proposed by the actions of the BEPS project related to TP are compatible with the current state of the regime in Uruguay and their possible impact in the future.

2. Current TP regulations and practice in Uruguay

Act No. 18,083 dated 27 December 2006 introduced the TP regime in Uruguay, as known today.3 Although the arguments in the bill of law made reference to Uruguay’s adherence to international standards on the matter, the Act does not

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3 There were some isolated provisions in the past. Acts nos. 18,341 of 30 August 2008 and 18,996 of 7 November 2012 made some later amendments to Act no. 18,083.
make express reference to the OECD TP guidelines,\textsuperscript{4} or to any other specific standard.

Uruguay has adopted the arm’s length principle as a unilateral measure of a general nature to protect its tax base in international transactions between related entities aligned with the OECD guidelines. This principle is also reflected in bilateral agreements signed by Uruguay to prevent double taxation with respect to taxes on income and on capital and for the prevention of fiscal evasion (DTCs).

TP regulations are established only with respect to the Income Tax on Economic Activities (IRAE) in chapter VII of Title 4 of the Coordinated Text Compilation 1996, regulated by Decree 56/2009 (in the reading of Decree 392/2009) and specific resolutions issued by the General Tax Administration (DGI in Spanish).

Table 1 summarizes the main characteristics of this regime.

<table>
<thead>
<tr>
<th>Main aspects</th>
<th>General characteristics</th>
</tr>
</thead>
<tbody>
<tr>
<td>Arm’s length principle</td>
<td>Stated in art. 38 of Title 4 and the laws ratifying the DTC signed by Uruguay (art. 9, DTC)\textsuperscript{a}</td>
</tr>
<tr>
<td>Related party status</td>
<td>Uruguay adopts a broad related party concept, thus covering those hypotheses implying control or management as well as those implying decision power to guide or define the activities of the taxpayer</td>
</tr>
<tr>
<td></td>
<td>This covers operations with non-resident related people or entities</td>
</tr>
<tr>
<td></td>
<td>The law includes expressly the transactions performed by IRAE taxpayers with foreign affiliates, branches, permanent establishments or other types of non-resident entity related to them</td>
</tr>
<tr>
<td></td>
<td>It extends to low or zero tax regimes, without admitting evidence to the contrary, and to certain international operations between related parties where there is a foreign intermediary that is not the effective recipient of the goods. It applies to domestic operations only under very specific circumstances</td>
</tr>
<tr>
<td>TP methods</td>
<td>Although Uruguay adopts the five TP methods proposed by the OECD TP guidelines and requires to select the most appropriate one, domestic regulations do not provide exhaustive guidelines as to how and under what circumstances these methods are to be applied</td>
</tr>
<tr>
<td></td>
<td>As opposed to OECD TP guidelines, Uruguay provides special regulations for the analysis of the import-export of goods listed in transparent markets (so-called commodities)</td>
</tr>
</tbody>
</table>

\textsuperscript{4} Edition 2005, in force in this period.
Most DTCs signed by Uruguay adopt art. 9 of the OECD model. In 5 of the 13 DTCs currently in force, a third paragraph is included in art. 9 aligned with the suggestions of the UN model. The Uruguay–Hungary DTC, dated 25 October 1988, only includes the first paragraph of this article.

Advance pricing agreements.

As seen above, Uruguayan regulations do not include specific provisions on intra-group services, intangibles, risks, cost contribution agreements (CCAs), value chains, other valuation techniques and business restructurings, among other topics proposed by the actions. Except for intra-group services, development of TP practice on the matters previously mentioned is virtually non-existent.
3. The impact of the BEPS project on TP

3.1. Introduction

The first meeting of the BEPS inclusive framework was held on 30 June 2016 where Uruguay participated as a member. According to government declarations, participation will be carried out with prudence and caution regarding implementation times.

The preamble of the bill of law dated 7 July 2016 included some of the recommendations of Actions 13 and 14, mentioning the importance of aligning with international trends on transparency and fiscal cooperation, since not doing so would imply being “left out from those commercial, financial and investment trends which are essential in the development strategy”.

However, some academic opinion has expressed a more critical view of the matter. Blanco, in a presentation at the University of the Republic of Uruguay, argued that the political structure of taxation pursued by this plan has “two significant features: (a) the decrease of the autonomous decision making capacity of states in tax matters; and (b) the establishment of the OECD (and similar organizations) as the new centres of global fiscal power”. Mazz highlights that when the BEPS project proposes the unification of domestic rules and provisions stated in the conventions, it should consider the major economic and regulatory differences existing between members and non-members of the OECD.

Apart from the comments above, the truth is that Uruguay is moving towards a new standard of international taxation, a position that has been evident in its adherence to the inclusive framework and the Convention on Mutual Administrative Assistance in Tax Matters, and the signing of the Multilateral Competent Authority Agreement on the exchange of CbCR. Nevertheless, given the complexity of the BEPS project TP measures package and the relatively early stages of this practice in Uruguay, there is still a long way to go.

3.2. Challenges of transactions with intangibles

3.2.1. Definition of intangibles

Current TP provisions in force in Uruguay do not include a definition of “intangibles”; however, they do mention a series of examples, such as patents, copyrights and trademarks.

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9 Art. 6 Decree 56/2009.
Since TP provisions are included within the IRAE regulations, it is worth asking whether the general provisions on intangibles\(^{10}\) of this tax condition in any way coincide with the concept that should be reached in terms of TP. Although conceptually it would be desirable to reach a common definition, given the harmony that should exist between the definition of income and its amount, they do not necessarily coincide.\(^{11}\)

Based on the interpretive autonomy given by the Tax Code, the report has attempted to draft a possible definition of intangibles in TP based on different regulatory\(^{12}\) and academic opinions\(^{13}\) considered for these purposes. Thus, for TP purposes, intangibles could be defined as goods, even “something”,\(^{14}\) with a special economic capacity, with no substance or physical appearance, which has no monetary or financial nature, and which enables the holder to enjoy the benefits derived from them.\(^{15}\)

With regard to income tax, qualifying goods as intangibles is not conditional on the existence of a legal or contractual protection, although many of the goods fiscally considered as intangibles enjoy this feature.\(^{16}\) Thus, the approach adopted is of an economic nature, broader than the notion of private law, which would also apply to TP.

That said, this definition should also contemplate a nexus to link the goods to their holder so as to recognize and allocate the profits derived therefrom to the holder. For example, accounting standards require the existence of “control”\(^{17}\); actions require the existence of “ownership or control”\(^{18}\); tax regulations require “ownership or power to economically dispose of the goods as the owner would do”.\(^{19}\)

In terms of TP this nexus or link with the owner of the intangible is relevant for its recognition and analysis. This is because the special economic capacity an intangible can generate is closely related to the degree of control its holder can exercise by restricting access to the goods to other individuals or entities, and enabling the holder to generate income on those goods (or a premium income).

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10 Para. (e), art. 21, para. (g), art. 24, art. 66 Title 4, art. 94, Decree 150/2007.
11 In terms of recognition and assessment of intangibles, IRAE provisions state that intangible assets are only those that imply a real investment for the holder, thus not recognizing intangible assets that are self-created or which, for example, have not been paid for. In such cases, intangible assets are fiscally recognized only at the time of their realization, being registered in the hands of their acquirer. In terms of TP, this condition of “real investment” is not required, precisely because this is one of the aspects to be evaluated. The acquisition cost of an asset does not necessarily reflect the value that an independent party would be willing to pay for it.
14 6.6 actions.
15 The reporters discard the condition of “unidentifiable” stated by NIC 38 and s. 18.2 of NIIF PYMES, since for TP an intangible may be transferred together with other assets of the business (such as goodwill) or even be recorded as an expense (such as research expenses).
16 Although IRAE regulations do not define the concept, they provide some examples, such as trademarks, patents, privileges, copyrights, goodwill, commercial names and concessions granted for prospection, etc.
17 NIIF PYMES: 2.15, 2.19. NIC 38: 7, 9, 13/16.
18 6.6 actions.
19 Item (a) art. 2 Title 10.
While there are no express provisions in this regard, the reporters understand that this nexus would be closely related to the “power to economically dispose of the goods as the owner would do”, in line with the general tax provisions, which to some extent would presuppose the existence of control by the owner. To the extent that the intangible may not necessarily be reflected as part of the assets, as it can be reflected as an expense, this notion should also consider the idea of “control” itself.

An additional difficulty is presented when dealing with intangibles whose exploitation rights have been partially assigned. For the actions, licences granting limited rights (e.g. in time, use or geographic area of exploitation) are intangibles themselves, of a nature different from that of the main intangible the subject matter of the assignment. This would imply that, for the purposes of TP, two types of intangible would be recognized (the main intangible and the licence for its use), their holders being different subjects (licensor and licensee). As stated by Perez Perez, an economic dismemberment of the asset would take place, resulting in specific sub-assets, each of which may be subject to circulation. Upon this clarification, assets and sub-assets are to have different consequences when determining their arm’s length remuneration, hence the importance of considering them.

Uruguayan regulations do not include specific provisions in this respect; thus further development on the provision is recommended.

### 3.2.2. Transactions with intangibles

Uruguayan TP regulations do not establish specific provisions on the topic of transactions with intangibles, and nor do they establish guidelines to identify their existence in a given transaction.

When Uruguayan legislation makes reference to the arm’s length principle in article 38 of Title 4, and in general to chapter VII, it does so in connection with the “operations” that IRAE taxpayers carry out with related people or entities. However, there is no definition of the term “operation” within the framework of this regime. To the reporters’ knowledge it should be interpreted in a similar sense to “transaction”, it being reasonable to adopt the definition in paragraph 1.42 of the actions: “A transaction is the consequence or expression of the commercial or financial relations between the parties.” Given the absence of divergence of interests between the related parties and the anti-evasion nature of the regulation, the existence of these special relations between the IRAE taxpayers and their related entities should set up the hypothesis under analysis, which is subject to TP. Should such relations exist, they should have a significance according to the economic reality, whether they have been declared as “operations” by the taxpayer or not.

According to the general criteria set out in article 6 of Decree 56/009, the following should be taken into account: “those elements or circumstances which best reflect the economic reality of the transaction or transactions to a greater extent”.

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20 6.26 actions.
21 6.41 actions.
22 Perez Perez, op. cit., p. 86.
23 Except in relation to comparable transactions, art. 6 Decree 56/2009.
This regulatory provision is relevant because it explicitly establishes the adoption of the principle of the primacy of reality when delineating the transaction, in line with the general principles set out in the Uruguayan Tax Code and paragraph 1.35 of the actions (where it is considered vital to identify the economically relevant characteristics of the commercial or financial relations of the parties, prior to any comparison).

Determining the scope of the term “economic” reality to delineate the accurate transaction regarding intangibles is an extremely complex task that involves not only identifying whether there is an intangible in the transaction under analysis (or not), but also interpreting the true nature of the transaction that will determine, among other things, the allocation of profits to the “owner”.

Regarding the first question, it will depend on the definition of intangibles adopted, and as was stated in section 3.2.1, the Uruguayan tax regime lacks such a definition. The second issue is even more complex to define, as will be discussed in section 3.2.3.

With regard to the nature of the transaction, article 6 of Decree 56/2009 refers to intangibles under two hypotheses: when they are the object of a transfer (“sale, assignment for use or right of use” or in services involving “the transfer or assignment of intangibles”)\(^{24}\) and when they are used as assets in the development of activities (“use of intangibles”).\(^{25}\)

From the analysis of these articles, and the concepts traditionally enshrined in domestic legislation, two possible groups of transactions which imply the transfer or use of intangibles could be inferred:

(a) transactions implying the transfer (total or partial) of intangibles between related parties, under the circulation of goods\(^ {26}\) or the rendering of services,\(^ {27}\) where the intangible itself is the object of the transaction between the parties, alone or together with other goods and services;\(^ {28}\)

(b) transactions involving the circulation of goods or the rendering of services between related parties, where the intangible is not the object of the transaction, but it is used in the economic activity (i.e. it affects the production of goods and services). In that case, the intangible may have been self-created by its owner, or may have been received at a previous stage from related entities – described in (a) – or from independent parties.

Under any of these modalities, intangibles will have an impact on determining the taxable income of IRAE taxpayers. In the absence of specific provisions on the matter, the general principles of TP provided in the domestic law will apply, whatever the nature of the transaction under study.

\(^{24}\) Para. (a), sub- paras. 2 and 4, art. 6 quoted.

\(^{25}\) Para. (b), art. 6 quoted.

\(^{26}\) Expression referred to in the VAT Act, used by extension to IRAE tax.

\(^{27}\) Para. (B), art. 2, Title 10: the rendering of services includes concessions on the use of intangible property, such as trademarks and patents. Definition used by extension to IRAE tax.

\(^{28}\) Rating the transaction as the circulation of goods (disposal) or the rendering of services has different consequences for taxation.
3.2.3. “Substance-over-form” approach towards intangibles

3.2.3.1. Adopting the principle of economic substance for the qualification of the transactions under analysis

As already discussed above, the analysis in terms of TP should adopt a substantive approach based on economic reality. This means that to qualify the transaction under analysis and to quantify the profits that should be allocated to the taxpayer, the true terms and conditions thereof should be identified, since the price of the transaction will reflect or quantitatively express them. Only once the transaction is qualified (i.e. once the actual transaction is accurately delineated), should it be analysed whether the price (if it exists) and the conditions of that transaction align with the normal market practices between independent parties, in situations and circumstances comparable to the qualified transaction. This conclusion is based on the combined application of articles 6 of the Tax Code, 38 of Title 4 and 6 of Decree 56/2009.

3.2.3.2. The notion of economic disposal of the goods and its incidence on the qualification of the transaction

For a transaction to qualify as circulation of goods, the subject matter of the operation must be to deliver the goods with the transfer of “ownership rights or give the recipient the right to economically dispose of them as if they were his/her own”. Should the transaction not qualify as circulation of goods, it will qualify as the rendering of services provided it gives the other party an advantage or benefit that constitutes the cause of the consideration.29

The concept of disposal is interpreted in an essentially economic sense, where, as Shaw states,30 “the transfer of the ownership right of goods delivered is not even important”, thus implying a significant divergence from the solutions provided by private law.

This means that tax regulations provide for the possibility of assigning the goods to a subject that is not the legal owner of the goods, if that subject has the power to decide on the economic disposal of the goods as if they were his/her own. This means, for Blanco,31 to decide on the goods’ destination and assume the risks inherent in this. That is, “this comprises operations which really imply transferring the economic availability of the goods, leaving out those business deals which do not cause this effect, even when formally they do imply the transfer of ownership”.

The exercise of these powers of decision regarding goods the subject matter of a transaction should, in the reporters’ view, necessarily assume a certain level of substantive activity by the subject recipient of the goods. Activity which would be evident is the suitability of the subject and its ability to make the decisions that

29 Classification made by VAT, art. 2 Title 10, that the majority of experts extends to the other economic taxes. Reference to “onerous” is not applicable in this case.
such goods would demand (going beyond mere records or documents formalizing the decisions), on the assets used and the risks assumed as the result of the decisions taken. The recognition of the functions/assets/risks as substantive elements of a certain business presence has been used by the law in the case of intermediaries, when it states that “Assets, risks and functions assumed by the intermediary should be commensurate with trading volumes negotiated”. These substantive elements also comprise having “real presence in said territory and having a commercial establishment where their businesses are managed”. This reference to “commercial establishment”, which presupposes a certain functional coherence and a minimum of organization, reinforces this idea. Because, as noted by Rodríguez, this serves as the instrument to carry out commercial or industrial activities, since “the businessman cannot carry them out without organizing a minimum number of goods”.

Beyond these general guidelines, the truth is that the facts or substantive elements that demonstrate economic disposal of an intangible can be very complex to determine for the interpreter, there being no major regulatory developments in this regard.

Qualifying an operation thus requires a thorough analysis of the facts and circumstances of each particular case, the analysis of functions/assets/risks of all parties involved in the operation being a crucial aspect for its understanding, in line with the proposal of the BEPS project.

3.2.3.3. The role of other subjects contributing (or who have contributed) to the creation of value of the intangible

The actions propose a substantial approach for the allocation of profits derived from the exploitation of intangibles, the legal ownership of the intangible itself not being on its own a determining factor for allocation. The returns the owner may keep will depend on the functions/assets/risks assumed by the owner in relation to the exploitation of the intangible.

In this regard, it seems relevant to distinguish two situations, which, though they can have mathematically similar results, are conceptually different:

(a) When the owner of the intangible is disregarded based on the interpretation that the owner in fact lacks the substantive elements proving his or her status as such, the asset and the income thereof are allocated to another/other subject(s). In this case, it is a hypothesis of inadequate legal forms where the interpreter has the duty to disregard those forms and attribute significance to the situation according to the facts, pursuant to the second paragraph of article 6 of the Tax Code, regardless of other considerations that could be applied.

32 1.66 actions: coincident position.
33 Art. 43 Title 4.
35 Notes on the Actions (15): “exploitation of an intangible includes both the transfer of the intangible or rights in the intangible and the use of the intangible in commercial operations”.
36 Sentence TCA Court no. 256 2 May 2013; Serrana Delgado, La realidad económica y las formas jurídicas en el Derecho Tributario: un intento de disección epistemológica desde las dicotomías, UDELAR, 2008.
(b) When the owner of the intangible is recognized but the income allocated to the owner is to be fiscally adjusted under TP provisions. It is not a question of ignoring the subject and considering it a mere legal fiction. In this case, there is a situation in which the proceeds derived from the exploitation of the intangible should have been allocated (wholly or partially) to another subject(s) on the understanding that these were the ones who took the functions/assets/risks inherent in the exploitation of that intangible.

Regarding this second situation, in accordance with paragraph 6.48 of the actions, the contribution of each member of the group to the creation of value of the intangible should be considered and adequately remunerated. For the actions, the arm’s length principle requires “that all members of the group receive appropriate compensation for any functions they perform, assets they use, and risks they assume in connection with the development, enhancement, maintenance, protection, and exploitation of intangibles”. Regardless of whether these functions/assets/risks are the determinants of the creation of intangible value, it is clear that the legal ownership itself is not a determining element for this purpose, including those intangibles that require legal or contractual protection. Under this new paradigm, “economic ownership” is introduced as a new concept.

This last aspect seems particularly relevant as it has a direct impact on the criteria for the allocation of taxing rights, since economically, these returns will migrate to the jurisdictions where it is interpreted that the key or determinant functions/assets/risks for value creation are located.

Domestic legislation does not contain an express provision in this respect, nor does it establish a hierarchical order as to what functions/risks/assets should be considered as creators of the value of the intangible, or how they should be measured when allocating the income in question. There is no position either on what value (if there is any) would be assigned to records or contracts in cases of intangibles that require legal or contractual protection. Under this new paradigm, “economic ownership” is introduced as a new concept.

3.2.4. Comparability and group synergies

In some circumstances, multinational (MNE) groups can benefit from the interaction or synergies among group members, in a way that independent entities could not do in similar situations. These group synergies may arise as a result of, among other things, the consolidation of purchasing power, the integration of systems, the reduction/elimination of costs involving duplicating efforts, streamlined management, etc. As per paragraph 6.30 of the actions, group synergies are not intangibles because they cannot be owned by an enterprise or controlled by it.

According to the general principle contained in article 6 of Decree 56/2009, comparable transactions are those between which there is no difference affecting the price, the profit margin or the amount of the consideration or – if they do exist – where these can be eliminated to achieve a substantial degree of comparison.

Although a priori synergies may affect the profit margin of a group, it is difficult to identify and quantify them in the comparison.
First, it should be possible to identify the elements that enable this efficiency (or inefficiency) so as to – from there – try to measure their effects on income (i.e. in the price, profit margin or amount of the consideration, as stated by the decree). While the taxpayer may have information that would allow the impact of this variable on the income subject to analysis to be quantified, it would be almost impossible to measure its impact on independent parties to select them as potential items of a comparison. Even if the adjustment could be quantified, it should also be able to be verified or audited, tasks that are not easy to implement when the information comes from abroad or is protected by tax secrecy of the proceedings.

In the spirit of making the Uruguayan regime more flexible and reducing implementation costs, the regulatory decree allowed a comparability analysis to be done either on the situation of the local subject or the foreign subject, without having to justify the choice. In some cases, this ability to change the tested party without justification could save the difficulty stated, when the party is not affected by such synergy.

To date, there are no regulatory or judicial precedents that provide mechanisms to identify (and even less to quantify) group synergies, or any other guidance on this issue.

3.2.5. Hard-to-value intangibles (HTVIs)

Based on the definition proposed by paragraph 6.189 of the actions, it can be said that this kind of intangible is characterized by not having comparables and being exposed to a high degree of uncertainty that makes it difficult to predict its success, at the time their transfer is made. Both elements reveal the practical difficulties in determining their valuation under the arm’s length principle. Domestic legislation does not provide specific provisions on the matter.

According to the general principle contained in article 38 of Title 4, transactions between related parties will be considered for all purposes as agreed between independent parties when their terms and conditions are aligned with normal market practices between independent entities, which necessarily implies a comparison with others.

In the absence of reliable comparables for the valuation of this type of intangible, the methods described in article 41 Title 4 may be ineffective when determining the arm’s length remuneration, the possibility existing in this case of it being necessary to introduce other valuation techniques. While, according to that article, the executive branch may establish other methods for the same purpose, to date, this has not been done.

Similarly, even if these alternative valuation techniques were allowed, the analysis is still not exempt from difficulty, either for the taxpayer or the tax administration, given the high uncertainty existing at the time of the transfer. This uncertainty indisputably affects the determination of assumptions (or underlying hypotheses) used to estimate the cash-flow this intangible may generate in the future and therefore the accuracy of financial projections made. The assumptions used to determine, among other things, the growth rate, the discount rate, the useful life of intangibles and their residual value, the hypothesis on the tax effect on pro-

37 Art. 5 Decree 56/2009.
jected cash-flow and the form of payment affect the final result of the valuation. Slight variations in these variables may result in large differences in the valuation of these HTVIs.\textsuperscript{38}

To assess retrospectively whether the taxpayer took adequate account of the reasonably foreseeable developments at the time of the transaction and the reliability of the information used at that time to determine the value of these intangibles will be a challenge for both the tax administration and the taxpayer at the time of a TP inspection.

To date, there are no specific provisions regarding the use of \textit{a posteriori} information on facts or evidence that are observed after the transfer of HTVIs is made, which could be used retrospectively to assess the reasonableness of the valuation made by the taxpayer at the time of the transfer.\textsuperscript{39} There are no expected provisions contemplating special considerations in terms of HTVIs in the short term.

3.2.6. CCAs

A CCA is a contractual arrangement among entities to share the contributions and risks involved in the joint development, production or the obtaining of intangibles, tangible assets or services with the understanding that such intangibles, tangible assets or services are expected to create benefits for the individual businesses of each of the participants.\textsuperscript{40} The Uruguayan legislation does not contain specific provisions regarding the nature and characteristics of such agreements, or regarding the methodology of analysis that would be most appropriate in these cases. It is not expected that measures in this regard will be introduced, at least in the short term.

The analysis of such agreements should therefore be made within the framework of the general principles enshrined in Uruguayan legislation. According to these principles, the assessor should be in a position to prove that the terms and conditions in the CCA entered into by related parties are aligned with the normal market practices between independent entities, in accordance with the methods of analysis provided for in domestic legislation.

This implies the empirical comparison of the terms and conditions agreed in the CCA between related parties with the terms and conditions agreed in other CCAs entered into between independent parties. In the reporters’ understanding, the literal analysis of article 38 of Title 4 does not state that the behaviour of third parties should be evaluated hypothetically (what independent parties may have done had they acted rationally or logically), as the article requires a comparison with normal market “practices”. It is necessary then to know what such practices are to draw a conclusion from them.

While in theory it would be possible to identify agreements of this nature between independent parties, through the access to international commercial databases where they could be disclosed, in practice, it is not easy to identify comparable agreements.

\textsuperscript{38} 6.158, 6.163 to 6.180 actions.
\textsuperscript{39} 6.192 actions.
\textsuperscript{40} 8.3 actions.
Should it be interpreted that it would be possible to adopt a non-empirical, unverifiable approach, the practical application of this principle would become completely subjective and controversial, which appears to be the new vision of these actions.

3.3. Risk and capital

When discussing BEPS in terms of TP, talking about “risks” is inevitable. This is because risks are easily movable and can carry a significant portion of the income generated. The point that arises here is to determine when or under what circumstances it is understood that a risk is effectively assumed by an entity, even if it never materializes.

According to the actions, risks, as intangibles, play a decisive role in creating enterprise value. According to the actions, risks, as intangibles, play a decisive role in creating enterprise value.41 Depending on how they are allocated among related entities, the income allocated to those entities will be higher or lower and, therefore, the countries where these entities operate will have a higher or lower tax base. As opposed to tangible assets or functions, which – in principle – may be easier to visualize, risks (and intangibles) are often complex to identify and allocate.

Although the Uruguayan legislation adopts a substantive approach in the interpretation, as seen in section 3.2.3.1, there are no specific provisions on TP relating to the allocation of risks between parties, or on what elements, facts or circumstances should be considered for this purpose.

It seems relevant to mention here two old pronouncements of the TCA (although they do not refer specifically to TP matters) that, in analysing the concept of economic availability of the asset, the notions of “decision-making and risk-taking” should be included, factors that are also contained in the actions. The sentence dated 9 December 197542 states that the enterprise grants the merchant the “power to dispose of the containers as the owner would do” for, among other aspects, “risks are the responsibility of the customer” and “the holder of the container can legitimately keep it, destroy it or give it any other destination”. And sentence no. 893 dated 23 October 1991 – by virtue of the economic substance of the specific operation – qualifies a dealer of used cars as a real “owner”, since the dealer can economically dispose of the assets as if he/she were the owner, which is evidenced by the fact that he/she “can decide on the resale price and the potential repairs” (besides the delivery of the asset being irrevocable, which implies a definite delivery of the asset).

According to this background, there is a close relation between decision-making and the risks that arise from them. The person who assumes the risks should be in a position to make decisions that will affect him/her (either to accept them or not, to mitigate their impact or to enjoy the opportunities involved). Beyond these general considerations, local regulations have limited development regarding the notion of risks and the functions/assets inherent in them for their configuration.

Although the actions reflect a similar notion, they extensively develop this issue and interpret that to take a risk for the purpose of TP the entity has to control the

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41 1.56 actions.
42 Concerning containers delivered together with the purchased product.
risk and have the financial capacity to assume it. Risk allocation cannot be “on paper only”.

While the proposition put forward by these actions may be worthy of consideration in theory, in practice it will be an extremely complex and subjective task, not only because of the difficulty of identifying risks (non-tangibles) and measuring their level (full, medium or limited), but because for the arm’s length principle to be effective such risks must be identifiable and measured equally in potential comparables. It is extremely difficult to determine the level of risk assumed by independent parties in view of the scanty information that can be accessed publicly.

The position taken by these actions – if not interpreted in the proper way – runs the risk of strengthening the old claim of developed countries of allocating income to the headquarters company, which – ultimately – will always end up making the decisions, to a greater or lesser extent. In the reporters’ view, the notion of risk should therefore be interpreted very carefully by developing countries, if they do not want income genuinely generated in their territories to migrate to developed countries.

3.4. High-risk transactions

3.4.1. Comparable uncontrolled price (CUP) and quoted prices for cross-border commodity transactions

Paragraphs 2.16A to 2.16E of the action propose a series of special considerations for the analysis of commodity operations. This action is a reaction to the special rules adopted by several developing countries.

Uruguayan legislation provides special provisions for import and export operations of goods with known quoted prices in transparent markets. For this purpose, it distinguishes two groups of operations:

(a) article 42 of Title 4, import and export operations of goods where the publicly known international price can be established through transparent markets, stock exchanges or the like;

(b) article 43 of Title 4, transactions between related parties, aimed at agricultural commodities and, in general, goods whose prices are known in transparent markets, where a foreign intermediary other than the actual recipient of the goods takes part. It also includes other international operations, where the nature and characteristics thereof so justify it.

In both cases, the legislature has adopted a direct comparison between the prices in the controlled transaction with the market values as the analysis methodology, considering for these purposes transparent markets, stock exchanges or the like where these goods are listed.

43 1.98 actions.
44 Executive summary, s. D: “Allocating risks on paper does not in itself shift profit”.
45 2.16A Commodities: physical products for which a quoted price is used as a reference by independent parties in the industry to set prices in uncontrolled transactions.
46 Arts. 42 and 43, Title 4, arts. 9 bis to 13 bis of Decree 56/009 (as amended by Decree 392/009), DGI Resolutions nos. 2,084/009 and 2,269/009, DGI Consultation no. 5,367 of 26 February 2010.
47 The DGI suggested a list of possible transparent markets, notwithstanding others that may be accredited as internationally recognized (s. 9 DGI Resolution no. 2,084/009).
In the reporters’ view, it is not a question of a new analysis method, although some professionals call these articles the “sixth method” as a reference to the Argentinian legislation that gave rise to them. Domestic legislation does not refer to these as a sixth methodology, as established by article 43 “the method of comparable prices between independent parties shall mandatorily applied”. The reporters understand that Uruguayan legislation adopts the CUP method together with a special anti-evasion measure (which, when applicable, may determine that the value of the transaction is shifted away from the arm’s length remuneration in the strict sense, precisely due to the anti-avoidance nature of the measure).

While some differences can be observed in the regulatory texts regarding these two groups of operations, in practice their treatment has been unified, namely:

- Further to the time of the comparison, the regulation adopted a formal criterion subject to the existence (or not) of a written contract between the parties that has been registered with the Chamber of Commerce of National Products (CMPP) under certain conditions, at the taxpayer’s choice. Should the contract not be registered, the quoted price of the goods will be considered on the date the bill of lading or equivalent document is issued. Should it be registered, then the date of the contract will be used. However, the DGI retains the power to question the contract, when the reality of the operation leads to the presumption that the contract modifies previously agreed business terms. Uruguayan legislation provides a relatively simplified approach to this issue. Paragraph 2.16E of the actions has adopted this approach in general terms.

- With regard to reference prices, the regulation provided for the consideration of the higher (or lower) quoted price of the goods in a transparent internationally renowned market either for imports or exports, respectively. Such quotes may be reasonably adjusted to the values of goods placed in the local market, to consider the amounts for insurance and freight. To date, there are still many doubts regarding how these comparability adjustments should be made. On the other hand, paragraph 2.16C of the actions adopts a wider approach allowing reasonably accurate adjustments in order to ensure that the economically relevant characteristics of the transactions are comparable.

Finally, it should be noted that the DGI has the power to establish a special regime for determining notional profits for these operations. This regime is optional and its application period is not to exceed the term of three fiscal years. To date, the DGI has not made use of this power.

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48 Registration of contracts for the sale of goods comprised under arts. 42 and 43.
49 Art. 13 bis Decree 56/2009 and DGI Resolution no. 2,269/009, s. 5 Resolution 2,084/009: this option applies exclusively to contracts whose term does not exceed 240 days.
50 Because the taxpayer has not made use of the option, or having done so, the record made does not meet the conditions set forth by the regulations.
51 Art. 13 bis Decree 56/2009: “the registration of those contracts in which the identity of products, dates or related parties leads to presume that the same modify businesses previously agreed, thus not reflecting the true reality of the operation, shall be deemed void”.
52 Arts. 44 Title 4 and 11 bis Decree 56/009.
3.4.2. Intra-group services

The domestic legislation does not include specific provisions on TP for intra-group services,\(^{53}\) except for certain general provisions on services between a head office and permanent establishments.\(^ {54}\)

Notwithstanding the above, the concept of services, their configuration and necessary conditions for their deduction, among other things, have been analysed by the domestic doctrine from the TP perspective based on the provisions set out in general terms where the IRAE and VAT apply, article 6 of the Tax Code and the arm’s length principle itself enshrined in article 38 of Title 4.\(^ {55}\) From this interpretive work, it can be concluded that the existence of a “benefit” for the recipient is a necessary condition for the effective configuration and provision of intra-group services, without prejudice to other requirements.

Uruguayan legislation does not provide either for a special regime for low value-added services, nor does it support a simplified benefit test approach, as proposed in paragraphs 7.54 and 7.55 of the actions. A solution such as the one proposed would require an express statutory provision. On the other hand, the applicable principles are the general ones for the determination of gross income and deduction of expenses, requiring that the terms and conditions agreed between related parties in the provision of such services are in accordance with the normal market practices between independent entities. Likewise, article 41 Decree 150/007\(^ {56}\) on transactions between head office and permanent establishments expressly provides that for deduction purposes it is essential that services be actually rendered and that their quantification be based on technically sustainable criteria not admitting “distribution procedures established by simple pro rata allocation”.\(^ {57}\)

From the Uruguayan perspective, where local entities of MNE groups are mainly recipients of services, the BEPS risk for the deduction of intra-group services is relatively high. Thus, Santos holds that:

“a global formula for allocating costs, whose results are unrelated to the benefit for the recipient, which does not include the effective use of this service by the local subsidiary and whose amount is significant in relation to what an independent party would have been willing to pay in comparable situations and circumstances would not be technically adequate...”\(^ {58}\)

Finally, regarding the methodology analysis, the general methods set forth in article 41 Title 4 apply. While domestic legislation does not provide for a simplified

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53 Sentence TCA nos. 19/2005 and 562/2007 analysed issues of intra-group services, one of which expressly refers to the concept of shareholder activity.
54 Art. 24 Title 4, arts. 41, 63 and 63 bis, Decree 150/007. The recognition of financial results (profit or loss) between them is not permitted.
56 As amended by art. 3 of Decree 572/009.
57 Position confirmed as per DGI Consultation no. 5214 8 July 2013.
58 Santos, op. cit., p. 599.
determination of arm’s length charges for low value-adding intra-group services, as proposed in paragraph 7.61 of the actions, it is possible to arrive at a similar solution through the mechanism of APAs under article 44 bis of Title 4 and article 15 bis of Decree 56/2009. In the latter case, the taxpayer must submit a specific request for the specific case to the DGI, which has the authority to grant it for a period of up to three fiscal years.

3.4.3. **Profit splits in the context of value chains**

The profit split method has been included by Uruguayan legislation as a valid method for price determination. Subparagraph (d) of article 4 of Decree 56/009 defines this method as one that, when allocating the profit obtained between related parties, applies the proportion that would have been allocated between independent parties. This regulatory rule recognizes that it is possible to distribute the overall profit and allocate it among each of the related parties based on elements such as assets, costs and expenses of each, thus allowing the use of a distribution criterion among participating entities based on internal group information. However, in the reporters’ view, the allocation criterion should be able to be contrasted with the distribution criteria used by independent parties, something that is usually very difficult to verify in practice. Except for the above regulatory rule, there are no specific provisions regarding this method.

As noted, the regulatory development of this method is virtually nil in Uruguay. As for the notion of the value chain, there are no specific provisions in this regard, except as recently established in the bill of law on the content of the master file (see section 3.5.2). Even when there is no express provision in any TP analysis, it is important to understand what the main contributions made by group entities are regarding the creation of value in relation to the transactions that affect the local taxpayer. In that sense, it is understood that such information should be provided in the local report under subparagraph (b) of article 6 Decree 56/2009 and subparagraphs (a), (b) and (c) of paragraph 11 of Resolution 2084/2009.

Although, for the time being, no further provisions are expected regarding the use of the information on the value chain and its practical application in the profit split method, further tax policy development in this regard would be advisable given the impact of these new concepts on TP policies adopted by MNE groups.

3.5. **TP documentation**

3.5.1. **CbCR**

In line with international standards in international fiscal transparency, Uruguay has introduced changes in the TP documentation in accordance with the recommendations of Action 13. The bill of law introduces CbCR and the master file, which are currently under parliamentary discussion.

The requirement of CbCR applies to IRAE taxpayers, head offices with permanent establishments (when one of them is subject to IRAE), and other resident entities that integrate an MNE group with their foreign subsidiaries, branches, permanent establishments or other non-resident entities related to them. These entities will be comprised under this obligation when integrating an MNE group of large
economic dimensions. These entities are exempt from submitting this report when it has to be filed by another entity of the MNE group to a foreign tax administration (with which Uruguay has an agreement of competent authorities for the exchange of information held within the framework of agreements or international conventions), and the report can be effectively exchanged with the DGI.

The project envisages the possibility that the report be submitted by the above-mentioned entities, the ultimate parent entity of the group or other entity designated by the MNE group for the purpose, authorizing the executive branch to establish the conditions under which this submission will operate. In all cases, the DGI must be informed of which entity will submit the report and its tax residence. The content for this report is in line with Action 13.

This report may be used by the DGI to fulfil its duties and for the exchange of information with competent authorities of foreign states in the framework of international agreements or conventions ratified by Uruguay and their respective memorandum of understanding to ensure reciprocity and confidentiality. Once the requirements necessary for the entry into force of the Convention on Mutual Administrative Assistance in Tax Matters and the Multilateral Competent Authority Agreement on the Exchange of CbCR have been fulfilled, Uruguay will be able to automatically and bilaterally exchange CbCR.

3.5.2. Master and local files

The domestic legislation contains specific provisions on formal duties. Taxpayers carrying out transactions subject to the TP regime exceeding an amount of 50 million indexed units in the fiscal year, or notified by the DGI must submit a tax return for information purposes, the documentation of the TP study and their financial statements. This documentation has a structure similar to the local file proposed by Action 13 and may include certain aspects of the master file. Paragraph 11 of Resolution 2,084/009 establishes the minimum contents for this local file (TP study). When the tested party is a foreign entity, the information used must also be certified in the country of origin by an independent auditor, translated and legalized.

Taxpayers that are not required to submit this information must in any case comply with TP rules. The analysis made, as well as the vouchers and supporting documentation to justify it, must be kept for the statute of limitations period established for taxes.

The bill of law sets forth the obligation to submit the master file. Consistent with Action 13, the DGI may request documentation regarding the master file of the MNE group, which will contain information concerning “the organizational

59 MNE group refers to a group of two or more related parties residing in different jurisdictions, and the head office with its permanent establishments. The MNE groups of large economic dimensions are those whose total annual consolidated revenue exceeds the limit set by the executive branch (estimated at €750 million).
60 Act no. 19,428 dated 29 August 2016.
61 Equivalent to approximately US$ 5.8 million.
63 Art. 5 Decree 56/009.
64 Paras. 12 and 13, Resolution 2,084/009.
structure, activities carried out, functions performed, assets used and risks assumed by each one of the entities of the multinational group, intangibles, form of financing and the financial and tax positions of the group”.

3.5.3. Compliance costs

TP provisions apply in general to all IRAE taxpayers carrying out operations subject to this regime. Unlike some countries, no threshold amount has been established below which these provisions would not apply. However, as mentioned in section 3.5.2, only certain entities are required to submit annual information to the DGI.

Further to CbCR, it should only be submitted when the total annual consolidated revenue of the MNE group exceeds a certain amount. Given the threshold amount established by Action 13, very few Uruguayan ultimate parent entities are estimated to be subject to the presentation of this report.

Although the bill of law provides for the submission of the master file, to date there is no information on the limits to be considered by the DGI to require it.

It should be noted that the master file and the CbCR will not be required from those entities comprised in the TP regime by virtue of the extended hypothesis on the related party concept, as described in section 3.6.

Failure to comply with formal duties in this matter is subject to the special regime of sanctions provided for in article 46 bis of Title 4, and may be gradually punished according to the seriousness of the infringement and other circumstances provided for in article 100 of the Tax Code, under the fine regime (whose maximum sum amounts to 6.7 million pesos).65

3.6. TP-related measures in other BEPS actions and other measures against BEPS

To date, Uruguay has introduced very few regulatory changes regarding TP as a result of the actions, compared to all the changes they entail.

In response to Action 14, the bill of law introduced the possibility of reaching APAs with other tax administrations within the framework of the DTCs. The proposed standard is assessed as very positive to the extent that it minimizes uncertainty risks and double taxation of the taxpayer, and also deals effectively with resolving disputes through MAPs.

Regarding other BEPS measures concerning TP it should be noted that Uruguay already had certain special measures in its legislation, such as the treatment of commodities66 and the broad related party concept. In addition to the traditional relation assumptions that refer to the nature of the relationship of the parties, the legislature determined other relationship hypotheses depending on the characteristics of the counterparty and the goods traded. These provisions are comprised under:

65 Currently equivalent to US$ 220,000.
66 Described under section 3.4.1.
• article 40 of Title 4 and its regulation, regarding countries or regimes with low or nil taxation;67
• article 43 of Title 4 and article 10 of Decree 56/009, where, under certain circumstances, the concept of related party extends to the intermediary or even to the entity that is behind it. In the latter case, a second-degree relation nexus is established with the IRAE taxpayer.

3.7. Can BEPS work in favour of MNEs?

If countries converge towards a common interpretation of the arm’s length principle and the proposed measures are adopted in a global, coherent and coordinated manner, there would be a legal framework that would provide security and avoid double taxation internationally. In this sense, the BEPS project will favour MNEs. Otherwise, dispute resolution mechanisms will operate as a safeguard.

In addition, a favourable aspect is that the project recognizes the operations held by related entities as they have actually happened despite not being observed between independent parties. Thus, the actions emphasize that every effort should be made to apply this principle, regardless of the difficulty it may entail.68

With reference to the specific consultation of the general reporter on the automatic exchange of information it should be noted that, under certain circumstances, information accessed by the DGI through the exchange of information could reduce compliance costs for the taxpayer. The bill of law foresees so when exempting taxpayers from submitting the CbCR, provided it can be effectively exchanged by the DGI with other tax administrations within the framework of international agreements signed by Uruguay.

4. What is the future of TP?

As Valdes Costa said in 1978, international operations “can undoubtedly lead to the disfigurement of prices implied by the transfer of the tax burden from one country to another”.69 That is why a full understanding of the scope of the new TP guidelines and their impact on the country is important.

Even though it is true that loopholes or inconsistencies in international taxation rules expose a number of weaknesses that create opportunities for the erosion of the tax base and the shifting of profits, changes made by the BEPS project seem to go beyond a possible solution to this problem.

The arm’s length principle has been adopted by Uruguay since 2006, in line with the international standards. However, most of the TP topics analysed in the present project are not developed in the domestic legislation.

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67 This article is projected to be modified. According to the project, this amendment responds to international standards that promote the incorporation of cooperating and non-cooperating jurisdictions with respect to fiscal transparency.
68 1,122 actions.
As stated throughout this report, the different proposals reveal the complexity, sophistication and subjectivity that the practical application of the arm’s length principle presents. These difficulties could become even greater in countries such as Uruguay, given the relatively emerging state of their practice, the scant regulations on the matter, the absence of a jurisprudence background and the lack of specialist tax courts.

Beyond these difficulties, the most sensitive aspect of this project lies in the coherent interpretation made by each country of the arm’s length principle for aligning TP outcomes with the activities that create value. Once the new measure becomes applicable, profits are expected to be reported where the economic activities that generate them are carried out and where value is created.

Although Uruguay adopts a substantial approach based on economic reality, and, in that sense, the place where such activities are performed will be taken into account, there are no specific provisions regarding what creates value and how this value should be allocated between related parties under the absence or difficulty in finding comparables (especially local comparables). These two questions represent a cornerstone in the interpretation of the arm’s length principle introduced by these actions.

The domestic legislation does not contain an express provision in this respect, and nor does it establish a hierarchical order as to what functions, risks and assets should be considered as creators of value (more specifically, the relative contribution of its functions/assets/risks to value creation), or how this value should be measured when allocating the profit in question.

While the propositions made by these actions may be worthy of consideration in theory, their practical application will be extremely complex and subjective. For instance, in the matter of intangibles and risks, where it is difficult not only to identify and measure them in the controlled transaction but also in potential comparables, it could be almost impossible to measure their impact in view of the scanty information that can be accessed publicly.

The changes introduced represent a new paradigm in the interpretation of the arm’s length principle, thus posing a challenge for those countries that adopt it. It would appear that the old discussion between source and residence is taking second place, the hypothesis of value creation and how it is interpreted being the new paradigms to consider in the coming years.
Bibliography

Summary and conclusions

Expectations and the growing needs of businesses have increased the concerns of multinational companies (MNEs) about tax exposure and the tax compliance burden, given that international tax regime is moving towards the existence of a scenario where tax information is more transparent for governments and more homogeneous for MNE business groups. As a result, the OECD, in 2012, began a project that would cover 15 items, with the sole purpose of avoiding base erosion and profit shifting (BEPS).

In this context, 4 of the 15 action plans proposed by the OECD were directed to the transfer pricing (TP) regime, as BEPS contemplated under Actions 5, 8, 9 and 10 amendments to the OECD TP guidelines and some measures aligned with value creation, the transfer of intangibles which are difficult to value, considerations of low value-adding intra-group services and cost contribution agreements (CCAs). Additionally under Action 13, specific actions on TP documentation aimed at improving the transparency of tax information and providing tax administrations with the tools to identify the appropriate allocation of functions and risks among MNEs.

This report reflects the evolution of the TP system in Venezuela, since joining the tax system in 1999, and the impact of the measures proposed by the OECD through the BEPS plan, in accordance with the current regulatory framework.

Although Venezuela is not a member of the OECD and has not so far expressed its intention of accepting the measures proposed in the BEPS plan, the rules of TP in Venezuela are based on the arm’s length principle stipulated in article 9 of the OECD model tax convention on income and on capital and redirect any consideration not covered by the legislation to the OECD guidelines applicable to TP for MNEs and tax administrations.

After review of the actions referred to by the BEPS project with application to the Venezuelan context, it is noted that the Venezuelan regulatory framework does not provide sufficient guidance on the management of intangibles, treatment for intra-group services or CCAs, and nothing has been written with regard to the premise of creating value for the MNE; in this sense, it is relevant to review and adapt the current legislation to be more in line with international taxation.

* Leads Taxand Venezuela; 28 years’ experience in domestic and international tax law; extensive knowledge of international tax and tax restructuring, and analysis of cross-border transactions and transfer pricing matters

1 Official Gazette no. 5,390 22 October 1999.
Venezuela is one of the pioneering countries in Latin America to incorporate TP tax legislation and should not be left behind in terms of implementation of the initiatives proposed by the OECD through the BEPS project. The objective of all countries should be to eliminate the gap created by the interaction of different fiscal policies and approach a more transparent system through communication between the various tax authorities worldwide.

As part of Actions 8–10, tax legislation in Venezuela is not aligned with the identification of roles and risks commensurate with value creation. It is necessary for Venezuela to adopt a comprehensive and clearly delineated definition of intangibles and to take special measures to assess the transfer of intangibles that are difficult to assess.

Moreover, the TP rules in Venezuela lack consideration of CCAs. It is important to incorporate into the legislation what is conceived of as a CCA, and to ensure that it will not be used against any future subsequent guidelines related to risk recognition and the management of intangibles.

The elective and simplified approach proposed for pricing the intra-group services with low added value entails a thorough analysis of the tax administration and assignment of specialist personnel in order to evaluate the possibility of hosting the profit margin defined in the action plan, or, whether it is possible to define a threshold through key indicators consistent with the activities carried out by Venezuelan companies.

With regard to Action 13, undoubtedly companies in Venezuela belonging to multinational (MNE) groups, will be obliged, with their subsidiaries or parent company, to prepare and submit additional information on transactions, according to the reports agreed; this would be an excellent opportunity for the Venezuela tax administration to amend the scope of the TP documentation it requires from its taxpayers based on a more global view of the MNE group to which a company belongs.

1. Current TP regulation and practice in Venezuela

The rules of TP were introduced into Venezuelan legislation through the partial reform of the Income Tax Law (ITL) which took place in 1999, under the concept of a “safe harbour” regime. The reform also incorporated into the Venezuelan tax law aspects such as the principle of worldwide taxation and other international regulations concerning tax control.

Subsequently, the ITL underwent a significant tax reform on TP in 2001. This reform adopted the OECD guidelines for the very first time, introducing, among other things, the arm’s length principle, connection criteria, methods of analysis, supporting documentation and the introduction of futures contracts; these changes were accompanied in addition by the reform of the master tax code (MTC), in which penalties related to non-compliance with TP regulations and specific rules for audit procedures and anticipated agreements were included.

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In 2007,\textsuperscript{4} the ITL was amended, incorporating a new article into the TP regime in which the thin capitalization rules were included.

Currently, TP in Venezuela is legislated in the ITL, according to the latest amendment made in 2015,\textsuperscript{5} in chapter III, Title VII, articles 109–168 and in the MTC according to the latest amendment made during 2014.\textsuperscript{6}

In addition, the tax administration has incorporated additional regulations for the application of TP, which modify and establish the forms, conditions, requirements and instructions for submission of the informative tax return\textsuperscript{7} and the procedure for the calculation and use of the range or interval of free competition\textsuperscript{8} is established.

The legislation accepts the comparable uncontrolled price (CUP) method, the resale price (RP) method, the cost plus method (CPM), the transactional profit split method (TPSM), and transactional net margin method (TNMM). The legislation gives priority to the use of the CUP method; however, the taxpayer will select the method based on the facts and circumstances of the transactions subject to study, the available information and the relative comparability with independent third parties, which provides the most reliable measure to assess compliance with the arm’s length principle.

The taxpayer must file an annual informative tax return (PT-99) six months after the close of its fiscal year. The legislation does not establish the obligation to submit supporting documentation to the tax authorities; however, this may be requested by the tax authorities at any time.

As mentioned above, Venezuela is not a member of the OECD; however, the rules of TP are based on the OECD guidelines and the arm’s length principle, which are internationally accepted. In addition, article 113 of the ITL establishes the use of the guidelines on TP for MNEs and tax administrations, approved by the council of the OECD, as long as they are consistent with the provisions of the ITL and the international tax treaties concluded by Venezuela.

2. The impact of the BEPS project on TP

2.1. Introduction

So far, the Venezuelan tax authorities have not made any proposal to incorporate changes in the tax legislation in relation to BEPS. In the short term it does not seem plausible that changes in legislation will be applied; however, it should be noted that the BEPS actions are written in the form of amendments to the guidelines of the OECD and that the ITL considered the guidelines as a supplement to the legal rules of TP, which may be applicable for the Venezuelan tax authorities as a last resort.

It is the reporter’s view that in the medium term changes in the current TP rules may be required to implement the changes proposed in the BEPS project and the

\textsuperscript{4} Official Gazette no. 38,628, 16 February 2007.
\textsuperscript{5} Official Gazette no. 6,210, 30 December 2015.
\textsuperscript{6} Official Gazette no. 6,125, 18 December 2014.
\textsuperscript{7} Administrative Ruling no. 2,424, 26 December 2003.
\textsuperscript{8} Administrative Ruling no. 0090, 10 December 2010.
new application parameters of the arm’s length principle, for example, in the management of intangibles or allocation of economic risks, leading to different interpretations as to their application, a situation that the tax authorities should clarify in the future.

On the other hand, no impact of BEPS on the audits made by the tax authorities has yet been seen in Venezuela. However, in recent years the tax authorities have shown a greater interest in carrying out TP audits.

We must also consider that Venezuela’s taxpayer related parties, in many cases, have strict regulatory frameworks which have been subject to new formal obligations, which could impact domestically on the request for information.

2.2. Challenges of transactions with intangibles

2.2.1. Definition of intangibles

In Venezuela there is no specific legal definition of intangibles in its TP rules. The Venezuelan regulatory framework refers to intangibles as concepts such as patents, trademarks or copyright; however, there is no evidence of an exact definition of intangibles.

With regard to tax matters, the ITL mentions in one of its articles a definition such as industrial or intellectual property, royalties and fees for technical assistance or technology services; nonetheless, it does not define clearly how these terms must be understood when they are used, except for royalties or similar units, which are defined as “the amount paid on account of the use or enjoyment of patents, trademarks, copyrights, procedures or rights of exploration or exploitation of natural resources, fixed in relation to a unit of production, sales, exploration or exploitation, regardless of its denomination in the contract”.\(^9\) Even a royalty is not in itself an intangible; it is understood as consideration for its use, as is evidenced by its definition.

Moreover, for TP purposes, the ITL\(^10\) establishes the need to determine the degree of comparability between related and unrelated transactions, in the case of intangible assets, considering the “the form of transaction characteristics (licence or sale), the kind of property right (industrial or intellectual), period, degree of protection and the expected benefits from the use of property rights”, but it does not specify a procedure to identify those characteristics.

For accounting purposes, Venezuela has adopted IAS 38 for the definition and recognition of intangible assets and this is applied for tax purposes; on the other hand, for TP purposes, contrary to what Action 8 in the BEPS project intends, this standard does not achieve the determination of the conditions in which the assignment or use of intangibles are agreed, or how the costs associated with their development can contribute to the generation of value.

There are other guidelines which allow the notion of intangibles in Venezuela to be created; in the first instance, in the domestic Constitution, through article 98,\(^11\)

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\(^9\) ITL, art. 48 (last amendment, 2015).
\(^10\) ITL, art. 122 (last amendment, 2015).
copyright and intellectual property are protected in scientific, literary and artistic works, and inventions, innovations, trade names, patents, trademarks and slogans are also protected.

Through the Industrial Property Law (IPL),\textsuperscript{12} the rights of inventors are protected, as are the discoverers and introducers of creations, inventions or discoveries related to industry, and producers, manufacturers or traders. That law recognizes concepts such as trademarks, patents and industrial designs and establishes procedures for registration, but in no section reflects the contribution of their use to the creation of value of the parties involved, in the processes or the intangible.

The Venezuelan ITL shows clearly the need for a precise definition of intangibles with regard to tax matters, particularly for the purposes of TP, because it does not have sufficient information to identify intangibles, or methodologies to analyse this information and determine the possible economic consequences, consistent with the objectives defined in the BEPS project.

2.2.2. Transactions with intangibles

In principle, and as mentioned in the previous section, in Venezuela there is no clear definition of intangibles; however, that does not imply that for all practical purposes the identification and valuation of a determined transaction is not required.

In Venezuela, usually when it comes to transactions for using any patent, know-how, trade secrets or trademarks and trade names, beyond identifying whether the item is an intangible, the fulfilment of the arm’s length principle is evaluated through the CUP method, comparing the remuneration paid with that established in an independent contract or similar agreements concluded between independent parties. However, in such transactions involving the sale of a trademark or an ongoing business, companies often appeal to financial valuation methods to determine the TP value.

The methods used do not respond precisely to accounting policies, but rather to the methodologies that evaluate business management and, in line with the objectives of the BEPS project, how intangibles contribute to the creation of value, considering the functions performed and risks assumed in relation to their development, improvement, maintenance, protection and exploitation.

In practice, for TP purposes in Venezuela, the use of methods with approaches to income capitalization has been observed; the idea behind the identification and valuation of intangibles lies in the difference between the economic benefits of the intangible for the owner as opposed to the non-owner. The methods most commonly used are based on projected discounted cash flows, considering the incremental income that arises from the possession or use of the intangible or the present value of the licences or the royalties paid for its use.

These methods that consider future expectations tend to be dynamic because it is possible to identify functions and inherent risks of an activity or business; however, it may not be so easy to separate the cash flows attributable to the intangible that is valued; considering future scenarios in the case of Venezuela turns out to be a very uncertain task.

\textsuperscript{12} Official Gazette no. 25,227, 10 December 1956.
2.2.3. “Substance-over-form” approach towards intangibles

In the field of the Venezuelan ITL the principle of substance over form prevails, according to which the legal interpreter should always delve deeply into the true essence of the facts or acts taxed by the tax law. This principle is embodied in article 16 of the MTC, stating that “When the rule concerning the taxable event concerns [matters] defined by other legal provisions, without remission or departing expressly from them, the interpreter could assign the meaning that is closest to the reality considered by the law to create the tax ...”

Additionally, this report should pay particular attention to the fact that the tax administration, according to the determination procedure provided, is:

“able to disallow the formation of companies, the conclusion of contracts and, in general, the implementation of forms and legal procedures, when they are manifestly inappropriate to the economic reality pursued by taxpayers and this translates into a decrease in the amount of tax burden...”

Under the above, the tax administration must show not only that there is a decrease in the amount of tax liability, but that the form chosen by the taxpayer is “manifestly” inappropriate to the economic reality. In other words, there must be legitimate grounds for suspicion that in the taxable transaction, the taxpayer has intended to evade, avoid or reduce the effects of the application of the tax.

In this sense, in referring to TP, the principle of substance over form is reflected directly in compliance with the valuation of a transaction at market price; therefore, the tax authorities must consider the “economic reality” and make sense of it through an economic and commercial analysis of the operation.

Although the ITL in Venezuela makes no special attention of transactions involving intangibles, and the functions assigned within a group of MNEs are not developed, the law does refer in general terms to a need-based function or activity analysis, including the assets used, the risks assumed in the operations and the financial circumstances of each of the parties involved.

Additionally, in the case of intangible assets the “characteristics referring to the form of transaction (licence or sale), the kind of property right (industrial or intellectual), duration, degree of protection and the anticipated benefits for use of property rights” should be considered. However, beyond determining who has legal ownership of an intangible, in the case of an audit and following the principle of substance over form for tax purposes, it is understood that for the tax authorities priority is given to who its real beneficiary is.

2.2.4. Comparability and group synergies

The TP rules in Venezuela do not include aspects related to group synergies or provide any mechanisms to identify them. However, it is clear, as the BEPS project

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13 Official Gazette no. 6,152, 18 November 2014.
14 ITL, art. 121 (last amendment, 2015).
15 ITL, art. 122 (last amendment, 2015).
shows, that MNEs can benefit from the interactions between them, in a manner that independent third parties cannot do in similar situations.

Some possible disputes over TP are related to the characteristics of the Venezuelan market. Studies in Venezuela have shown\(^\text{16}\) that the economically adverse Venezuelan environment is one of the factors that produces a major negative influence in determining the roles of the subsidiaries: “those who perform few value-added activities, usually marketing and sales, depend on the allocation of the headquarters; on the other hand those that carry out a greater number of activities in the value chain, integrate other important points such as the adversity of the environment and the initiatives developed by the subsidiary itself”.

In this sense, special market features may have an impact on the conditions of transactions between related parties. Companies operating in the Venezuelan market have been subject to exchange controls, which remain in force from 13 years ago and the difficulty in acquiring foreign currency has significantly affected the way transactions between MNE companies have carried out in the last five years.

For example, companies in Venezuela have found themselves in serious difficulties when importing raw materials for manufacturing or finished products for resale, due to their inability to access the necessary foreign currency in a timely fashion, which has resulted in the lack of payment to foreign suppliers; however, and in accordance with the foregoing in the BEPS project, being part of an MNE group can lead to benefits in the sense that the Venezuelan company can receive support from its subsidiaries, in that these may grant guarantees to their independent suppliers in order to ensure receipt of the products, a scenario that would not be possible for Venezuelan companies that do not belong to an MNE.

However, this type of benefit may not constitute an advantage for the whole group, unless the import of a raw material is expected to contribute to the manufacturing of a product that may generate a decrease in costs, and the group takes advantage of economies of scale.

Moreover, in recent years due to the economic and political instability prevailing in the country, there has been a decrease in operations carried out by Venezuelan companies which has been reflected in the transfer of functions to other group companies, in the case of MNEs. At first glance, the fact of being part of an MNE group offers a benefit to reduce the subsidiary administrative payroll, centralizing administrative activities through another subsidiary; however, it is appropriate to evaluate to what extent this is an advantage for the group and how the subsidiary should be rewarded for these activities.

### 2.2.5. Hard-to-value intangibles

Venezuela has not contemplated any action on the valuation of hard-to-value intangibles. Even the legislation does not establish criteria that allow the tax authorities to identify when there are no reliable comparable elements in the transfer of an intangible, or to estimate whether the projections of cash flows or expected future revenues to be derived from the intangible transferred, or whether the premises used for its evaluation are truthful.

The actual course of an audit depends greatly on the person or team that is handling the audit. Not having clear parameters when assessing this type of intangible is an inherent risk that can yield very subjective results.

The TP documentation is now more than ever an indispensable tool in the case of transfer of hard-to-value intangibles, so in Venezuela it is necessary to incorporate some kind of legislation on this matter.

2.2.6. CCAs

Venezuelan TP legislation does not specify criteria for CCAs, but redirects their conception and treatment to the OECD guidelines. However, there is no evidence that CCAs have been treated in accordance with the provisions of either the OECD guidelines or the considerations set out in the BEPS project.

Therefore, current legislation only requires information on related agreements, contracts or agreements concluded between taxpayers and related parties abroad, without requiring any analysis beyond this description. In this sense, it is presumed that CCAs are submitted by companies to the tax authorities, like any other contract for the development of intangible and tangible assets or services, and these are evaluated with the normal indicators set out in the TP legislation.

Without having access to the proportion of cost payments assumed and expected benefits, in accordance with the activities of those involved under the agreement, it is not possible to check that the contributions of the parties are consistent with each other. Consequently, there are evident gaps in the assessment of the conditions under which CCAs are established in Venezuela, a loophole that facilitates tax evasion through the entering into of these contracts with related companies abroad, confirming the need for a tax reform.

2.3. Risk and capital

Through Action 9 in the BEPS project, the OECD seeks to align the results in TP with risk taking, capital and value creation; however, Venezuela has not taken any specific action regarding the rules to prevent BEPS, or excessive allocation of capital to group members.

In this context, it should be considered in the first instance that no independent company takes risks without expecting positive returns, so the identification of risks is fundamental in establishing the conditions used for constructing a transaction between related companies. A company that decides to take risks should be able to manage these risks and must have the financial capacity to cover them.

Although the wording of the OECD is a tool for the tax authorities to deal with situations involving a misallocation of resources, the six-step process in Action 9 can help MNEs in Venezuela to review and identify in detail economically significant risks and the distribution of benefits to those group entities that have the ability to manage the risks actually incurred, tools that are not included in the TP legislation in force in Venezuela.
2.4. High-risk transactions

2.4.1. CUP and quoted prices for cross-border commodity transactions

The TP legislation in Venezuela does not specify how transactions with commodities should be treated, but through article 140 of the ITL, priority is given to the CUP method to determine the price or amount of consideration for transactions with related companies; so Venezuelan law does not deviate from the objective set out in the BEPS project, using this method as the most suitable to set the arm’s length price for the transfer of raw materials between related parties.

It is important to mention that the Civil Code\textsuperscript{17} (CC) and the Civil Processing Code\textsuperscript{18} (CPC) embrace the doctrine of the burden of proof, which means that each party must prove its claims. This standard has regulated the burden of proof system; however, it is the opinion of various procedural law specialists that Venezuela has been importing cautious flexibilities into those classic rules, by which it seeks to shift the verification of the facts to the party that holds the most appropriate resources and is in possession of the professional and technical conditions to generate it, looking for more reliable results.

In this sense, even though the reporter has not observed audits that include transactions with commodities, in the case of other transactions between related parties, the tax administration has not objected to the selection of comparables, whether companies or contracts; it assumes that companies have the most reliable tools for identifying roles, risks and technological systems, and are able to provide the most reliable information.

The considerations set out in the BEPS project referring to transactions with commodities, would provide more precise evidentiary support for businesses in Venezuela, the impact of these contributions depending on the commitment of the MNE to adhere to them. It is up to the company to consider all the aspects incorporated into chapter II of the OECD TP guidelines, such as the extent and date of contribution volumes of the contract, the agreed deadlines, delivery conditions, transport, etc. to ensure a more reliable estimation of the arm’s length value to the taxpayer and to the tax authority.

2.4.2. Intra-group services

In Venezuela it is usual to analyse transactions involving the provision of intra-group services relating to the use of trademarks, knowhow, trade secrets, technical assistance, services, information technology or those related to consulting in management administration, marketing, finance and human resources.

For the purposes of income tax, the Venezuelan ITL\textsuperscript{19} does not support:

“the deduction or imputing the cost of expenditures for technical assistance or technical services paid to foreign companies, when such services are provided

\textsuperscript{17} Civil Code, art. 1,354.
\textsuperscript{18} Processing Civil Code, art. 506.
\textsuperscript{19} ITL, art. 27.
or can be provided in the country at the time of their rendering. For these purposes, the taxpayer must submit to the tax authorities, documents and other requirements that demonstrate the steps taken to achieve the procurement of such services within the country."

In addition, in order to determine the net taxable income of a permanent establishment or fixed base, the management and general administrative expenditure must be shown: “however, payments made, where appropriate, by a permanent establishment to the head office or to any of other subsidiaries, affiliates, subsidiaries, parent or related companies in general, by way of royalties, fees, technical assistance or the like in exchange for the right to use patents or other rights or by way of commission payments, for services rendered or for management, will not be deductible ...”

In this sense it is evident that the tax legislation in Venezuela, regarding service charges, only refers to their deduction and support through documents and procedures; however, no criteria have been established to determine whether the services have actually been provided or received or whether the agreed remuneration complies with the principle of full competition. It is worth mentioning that the comparability analysis should be based on characteristics concerning the nature and length of service.

In this context, the fact that there is documentation such as contracts or payments made to an affiliated undertaking for the receipt of a service, as established by the OECD, should not be considered, at first glance, as proof that this service has genuinely been provided, just as their absence should not automatically lead to the conclusion that no services have been rendered.

According to the circumstances in which intra-group services are carried out, it could be verified whether they are actually received by the company under study, as long as the supporting documentation is supplied to the tax administration before the operation is performed.

Therefore, it is essential that the tax administration in Venezuela provides a regulatory framework that establishes a clear definition of intra-group services and which of these are considered low value added, or which qualify as shareholders’ activities or duplicated costs, in addition to providing guidance on the documentation that taxpayers should prepare and submit in order to qualify for use of the simplified approach presented by the OECD.

2.4.3. Profit splits in the context of value chains

The TP law considers, under the OECD guidelines, the use of the profit split method for determining the arm’s length price in accordance with the allocation of operating income obtained between the related parties in the proportion that it would be assigned to or between independent parties.

To do this, the profit of the global operation should correspond to the sum of the net operating profit obtained by each of those involved in the operation and the profits of global operations must be assigned to each of the parties

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20 ITL, art. 122.
21 ITL, art. 138.
involved considering elements such as size of assets, costs and expenses of each of the related parties with respect to the operations performed.

In the event of a residual profit after allocation, this will be distributed to the same related parties, taking into account, among other factors, the significant intangibles used by each of them, in the proportion that it would be distributed by independent parties in comparable transactions.

However, there is much to be defined under Venezuelan law, in the context of creating value in transactions between related parties that are closely interrelated and especially in those cases where it is not possible to apply other methods of TP, because this is impractical and inaccurately segregates the operations.

2.5. TP documentation

2.5.1. Country-by-country reporting (CbCR)

The Venezuelan tax administration has not made any reference to the implementation of CbCR; however, taxpayers in Venezuela should consider the fact that many of its related companies will have a formal obligation to comply with the submission of this report, a situation that could potentially affect the way in which documentation will be required in the future, which may be much more detailed, and possibly MNE groups will tend to standardize their TP studies with the aim of managing the information submitted in the most accurate and timely manner.

In addition, the Venezuelan tax authorities, in accordance with article 113 of the ITL, which stipulates the use of the OECD guidelines in addition to the TP legislation, may request documentation in line with reports defined in Action 13 of the BEPS project.

Moreover, Venezuela does not participate in the Convention on Mutual Administrative Assistance in Tax Matters developed by the OECD; however, with the aim of defining the tax treatment applicable to taxpayers who may have a presence in Venezuela and other countries, it has signed agreements to avoid international double taxation with 31 countries (Austria, Barbados, Belarus, Belgium, Brazil, Canada, China, Cuba, the Czech Republic, Denmark, France, Germany, Indonesia, Iran, Italy, Korea, Kuwait, Malaysia, the Netherlands, Norway, Portugal, Qatar, Russia, Spain, Sweden, Switzerland, Trinidad and Tobago, the United Arab Emirates, the United Kingdom, the United States and Vietnam).

The agreements signed by Venezuela are mainly based on the model proposed by the OECD, and often have provisions on exchange of information on tax matters.

2.5.2. Master and local files

It is understood that the local file is intended to provide detailed information on tax administration intra-group transactions during the period under study and the master file an overview of the business in terms of group activities and global policies. Venezuela has not formally incorporated any of these requirements in alignment with the BEPS project for TP documentation; however, the ITL requests much of the information required by these files.
In this sense, the ITL establishes two formal mechanisms to document the transactions subject to TP, the informative TP return (Form PT-99) and the TP study.

In connection with the PT-99, article 166 of the ITL\textsuperscript{22} establishes the obligation to submit to the tax administration an informative TP return, in which the related party transactions made during the fiscal year are reported. This return should include mainly taxpayer information, the amount of transactions with related parties, company name and address of the parties concerned, the type of relation, the method used and the percentage of remuneration established in the operation.

This declaration must be filed within six months from the closing date of the fiscal year. Currently the PT-99 form is filed in physical mode at the offices of the tax administration. For preparation and filing it is not possible to use official electronic systems that may enable the administration to automatically reconcile information with the income tax returns filed. This clearly shows the lack of integration that exists in the handling of tax information of taxpayers.

Regarding the TP study, the ITL makes no specific mention in the presentation of a study or report; however, the documentation required is usually compiled in this type of format. Article 167 of the ITL establishes a list of requirements relating to the calculation of TP, and some specific analysis carried out for compliance based on the arm’s length principle; other articles seem not to contribute much to the reliability of the results. The documentation does not specifically require details on the intangibles of the group, financial activities or financial and tax positions.

In accordance with the contents of the local and master files, related documentation is required, with functional analysis methods indicating the criteria and objective elements to be considered, information on comparable companies’ operations, risks inherent in the business, the organizational scheme of the company and/or groups, financial statements for the fiscal year of the taxpayer, contracts or agreements concluded between the taxpayer and related parties, and in the case of an MNE, in addition, the main activities carried out by each of the group companies, the place of realization, operations performed between entities of the group, contracts that deal with transfer of shares, capital increases or decreases, redemption of shares, mergers and other relevant corporate changes.

### 2.5.3. Compliance costs

As mentioned above, there is no official statement from the Venezuela tax administration regarding the fulfilment of Action 13 of the BEPS project; however, its implementation, as well as generating costs for the authorities or taxpayers, may provoke a lot of tax audits.

\textsuperscript{22} The ITL 2001 establishes the reporting obligation of the PT-99 declaration in June; however, through the Providence 2424 of 26 December 2003, it is specified that the presentation will be six months after the fiscal year end, for those taxpayers who have a different fiscal calendar year (being understood to be the year ending on 31 December). That legislation has not been amended.
According to the reporter’s experience in TP, tax audit processes and TP verification by the tax administration may take quite a long time, because asymmetries are presented in information handled by taxpayers and that requested by the tax administration. Although article 167 of the ITL lists a series of documents that the taxpayer should have as support of transactions with related parties, no mechanism for identifying the functions and risks assumed by the parties is required. Having more detailed information will allow easier access to the necessary documentation if additional information or a TP audit is required.

Moreover, due to the economic situation currently in Venezuela, transactions with related parties abroad have decreased significantly in this regard; often the cost of preparing documentation by independent specialists may be higher than the amounts traded in transactions with related parties or even than the penalties provided for breaches.

In addition, TP audit processes by the Venezuelan tax authorities incur a significant cost in hours by specialists, often even where the taxpayer has breached a formal duty or it has been determined that the taxpayer does not comply with the arm’s length principle; the penalties provided and adjustment in income do not compensate for the time invested.

The cost–benefit of preparing TP documentation in Venezuela tends to disfavour both taxpayers and tax administrations; if MNEs handled the information at a detailed level this would facilitate the preparation of documentation nationwide.

It is also important that the legislation in Venezuela includes a clause that establishes criteria for determining the relevance of an operation with related parties, as in other jurisdictions where limits are set in terms of the level of operations or the assets of the taxpayer for the preparation and submission of documentation.

2.6. TP-related measures in other BEPS actions and other measures against BEPS

In Venezuela there has been no formal acceptance of the BEPS project, and nor have legislative changes been proposed. It must be considered, however, that some issues addressed by the BEPS project are already regulated by the ITL, aspects such as thin capitalization rules, the restrictions on the corporate tax deduction of interest, among others.

The partial reform of the ITL conducted in 2007, included the thin capitalization rules in Venezuela and thus the deduction of interest paid on debts between related parties was limited. Article 118 of the ITL, today 116, states that “interest paid directly or indirectly to persons considered related parties … will be deductible only to the extent that the amount of the debts … does not exceed the assets of the taxpayer”.

The reform of 2007 also added to Venezuelan law some international taxation rules; however, these need to be adjusted and revised in seeking to achieve accurate and fast targets for the authorities, in terms of international tax policy and avoiding the violation of existing bilateral agreements, even if in the future Venezuela does not commit itself to the implementation of a multilateral single instrument such as that proposed by the OECD.
2.7. Can BEPS work in favour of MNEs?

As mentioned above, Venezuelan legislation lacks many elements for MNEs when it comes to analysing transactions with related companies; in this sense, the BEPS project generates support for MNEs on TP. Moreover, companies can benefit from the information management of an MNE, by implementing the strategies for information gathering raised by the OECD.

Because of the manner in which the information is handled today in different jurisdictions, and given the differences in the TP laws and the inconsistencies that are generated in the global information of the MNE, the full adoption of the measures proposed in the actions in the BEPS project would ensure that the information was handled in the same way and according to the same criteria in all jurisdictions where an MNE was located, ensuring the transparency of the information presented in the statements made to the tax authorities worldwide.

The initiatives for the gathering of information included in the plan generate support internationally for the MNE. This year many companies have adhered to these guidelines, increasing the demands on the accuracy of the information and methodology used by their subsidiaries abroad for the TP studies. Systematizing access to this information would be an advantage for the MNE, as well as having all data for a tax audit so that they can keep better track of the transactions carried out by the company internationally.

Aligning all related companies in the same system for collecting and recording information on foreign transactions will generate a database which could be used to optimize the analysis of commercial relations between related parties, especially those operating in a more decentralized manner. In some cases, MNEs confer a greater degree of freedom on their subsidiaries abroad, even allowing them to develop their own policies; this usually generates a segregation of the information that is considered relevant for some companies, and the adoption of the BEPS plan will shrink this disparity gap in the information.

Venezuelan legislation has not been amended in this regard, and nor is a reform envisioned in the short term. In the same way as mentioned in previous sections the request to MNEs on TP documentation generates pressure in the system. When all companies adopt the information collection system, by default the tax administration will have access to information schematized according to international standards. The accuracy and effectiveness of this, for the Venezuelan case, relies on companies adhering to the new guidelines of the OECD, the BEPS project.

3. What is the future of TP?

The BEPS project has not been formally adopted in Venezuela. Predicting a possible evolution of tax regulations aimed towards the actions proposed by the OECD is difficult, since historically the behaviour of Venezuelan legislators has been unpredictable.

The TP legislation has not been changed since the reform of 2001. And even though subsequently there have been some specific considerations such as the
methodology for calculating the interquartile range, none has contemplated the changes previously made in the OECD TP guidelines of 2010.

The success of the BEPS project will depend largely on the ability and willingness of Venezuelan companies to adapt to the new requirements of management of financial, functional and risk information, and the effective communication they may have with their related companies in the world.

It is up to the tax authorities of all countries, whether members or not of the OECD, to ensure compliance and the constant updating of the rules of TP, adapting their laws to international standards; the fiscal entity is the only body that can make sure the subject is treated with the seriousness it deserves.

The BEPS project is just one of many steps to ensure that TP rules are renewed in all countries and guarantee their truthfulness.
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