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BDO Transfer Pricing Centre of Excellence

Transfer Pricing News

Contents

Welcome to this first issue of BDO *Transfer Pricing News*, produced by the BDO Transfer Pricing Centre of Excellence, in collaboration with the various national practices involved. Our aim in publishing this newsletter is to provide our clients with frequent up-to-date information in the area of transfer pricing worldwide.

Bearing in mind that you operate in several countries, you may be concerned about developments in the transfer-pricing field in countries other than your own because, for example, you may have a permanent establishment in Canada, a subsidiary involved in a cost-sharing arrangement in the United States, or because you may be transferring the operations of a Netherlands subsidiary to Germany. Whenever you conduct cross-border transactions with your related group companies, the local transfer-pricing regulations may affect your business activities.

This first issue of the Newsletter provides insight into recent transfer-pricing developments in Australia, Canada, China, Germany, the Netherlands and the United States.

We trust that this first issue of BDO *Transfer Pricing News* is of interest to you.

1 Australia

Australian Decision Considers Transfer-Pricing Methodology

Roche Products Pty Limited v Commissioner of Taxation [2008] AATA 261 is the first case where an Australian court or tribunal (the Administrative Appeals Tribunal (AAT) in this case) has considered the operation of Australia's transfer-pricing rules and the application of transfer-pricing formulae to particular facts. It will be of substantial importance in conducting future transfer-pricing studies and negotiating transfer-pricing disputes.

The Roche Group sells prescription pharmaceuticals and other products through its subsidiaries around the world. The taxpayer in this case carried on business through three different divisions.

After a transfer-pricing audit, the Australian Tax Office (ATO) determined that amounts paid by the taxpayer to its foreign parent for products that it sold exceeded an arm's length price. The ATO increased the taxpayer's assessable income for each division accordingly.

The AAT was asked to consider the different transfer-pricing methods that can be used to establish an arm's length price and to decide between conflicting expert opinions.

The AAT held that the ATO's assessments were excessive and that the transfer prices adopted by Roche Australia ('RA') for acquisition of products in its consumer and diagnostic divisions were arm's length. The AAT also held that the ATO's assessment relating to RA's prescription division should be set aside and reduced the increase in RA's assessable income that had been determined by the ATO to one of AUD 59 million.

The AAT further held that while the best method to determine the arm's length price for the sale of particular products would seem to be to determine what such products are sold for elsewhere, this is a particularly difficult task with pharmaceutical products, which are rarely sold through third parties.

The ATO has not appealed against the decision. Instead, earlier this year it issued a 'Decision Impact Statement' outlining its view in relation to this decision.

Transfer Pricing Implications of Business Restructuring

Australia has been a part of the discussions taking place at the Organisation for Economic Cooperation and Development (OECD) concerning the transfer-pricing implications of business restructuring, and the ATO has identified this area as one for future review. Under examination will be the rationale behind business restructuring, and whether the Australian party receives adequate consideration for any business activity or assets it may divest itself of as part of any restructuring. The ATO currently has a draft discussion paper on this topic.

Transfer Pricing Implications of Group Financing

The ATO also has a draft discussion paper that considers the operation of the transfer-pricing rules with respect to the financing of group companies. This gives rise to interesting questions concerning the financing of group companies and compensation received. Also, it may be that an Australian company may satisfy Australian thin-capitalisation rules but may still have issues with the level of debt for transfer-pricing rules. We wait for further developments in this area with great interest.

2 Canada

Canadian Transfer Pricing Update

There has been a flurry of activity recently in the Canadian transfer-pricing arena. Most notable are the efforts being made by the Canadian tax authorities to improve their competent-authority services and to assist taxpayers in avoiding double taxation. A new protocol to the United States – Canada double tax treaty was signed in 2007 and was ratified and came into force on 1 January 2008. The protocol added an arbitration procedure to the mutual agreement procedure (MAP) to speed up the process of resolving cases of double taxation. Arbitration will be available for competent-authority cases that have gone on for two years or more from their commencement date.

In December 2008, the Canada Revenue Agency (CRA) published a document that set forth criteria for taxpayers seeking an accelerated competent-authority procedure (ACAP), which allows the resolution of a MAP case to be applied to subsequent years (i.e. yet-to-be audited years). In October 2008, CRA also published a document to clarify its criteria for accepting Advance Pricing Arrangement (APA) rollback to cover transactions in open years.

Despite the above efforts, the CRA's completed MAP cases declined to 49 in 2007-08, the lowest since the CRA began reporting on MAP cases in 2001. The director of the CRA's Competent Authority Services Division (CASD), Patricia Spice, attributed the low number of completed MAP cases to the hiring of several new competent-authority analysts in September 2007, who required at least 18 months of training and experience before they could be comfortable handling cases on their own. Furthermore, the CRA-wide training course on tax treaties was updated, after several years, in 2007-08.

On the basis of our recent interactions with the CRA, we believe that the Canadian tax authorities are doing the best they can in the area of competent-authority services. Therefore, it may be a prudent idea to have cross-border intercompany transactions involving Canada analysed and documented from both the Canadian and the other country's perspectives, or even to consider a bilateral or multilateral APA, if dealing with complex, higher-risk transactions or current transfer-pricing issues involving a large proposed reassessment. This approach could make possible future competent-authority assistance requests easier.

3 China

New Transfer Pricing Regulations

On 8 January 2009, China's State Administration of Taxation (SAT) issued the long-awaited Implementation Regulations on Special Tax Adjustments, setting out detailed guidelines for the special tax adjustments in respect of transfer pricing and other issues stipulated in China's new Enterprise Income Tax (EIT) Law. The guidelines cover the following areas: filing requirements on related-party transactions; contemporaneous documentation; transfer-pricing methods; transfer-pricing audit and adjustments; advance pricing agreements (APAs); cost-sharing agreements (CSAs); controlled foreign corporations; thin capitalisation; the general anti-avoidance rule; and corresponding adjustments and international consultation.

Under the new regulations, a resident enterprise or a non-resident enterprise with an establishment in China whose EIT is calculated using the actual profit method (rather than the deemed profit method) will be required to submit enterprise annual related-party transaction forms (consisting of nine tables) when providing annual EIT returns.

An enterprise may be exempt from contemporaneous-documentation requirements if (a) its annual purchase-and-sale transactions from related parties and other related-party transactions do not exceed CNY 200 million and CNY 40 million, respectively; or (b) if its related-party transactions arise from APA implementation; or (c) if its related-party transactions are solely with domestic related parties and the foreign-owned capital in the enterprise does not exceed 50% of the total capital.

Transfer-pricing audits will focus on enterprises with any one of the following characteristics:

- related-party transactions of a large amount or of frequent occurrence
- long term losses, 'thin' profits, or 'jump' profits
- lower profit levels than is general in the same industry
- profit levels inconsistent with their functions and risks
- transactions with related parties in tax havens
- non-compliance with related-party transaction filing or contemporaneous-documentation requirements or
- obvious violation of the arm's-length principle

Transfer pricing audits and adjustments will not generally be applied to related-party transactions between parties that apply the same effective tax rate if the transactions do not directly or indirectly result in the reduction of China's gross tax revenues.

An enterprise should normally maintain a reasonable profit level if it is engaged in performing purely manufacturing functions for its related parties, but it does not undertake other functions such as business strategies, product development, and marketing. If it has an operating loss, the tax authorities will determine a profit level that they will consider more appropriate.

Generally, an enterprise will qualify as an APA candidate if its annual related-party transactions equal or exceed CNY 40 million, and it has legally implemented related-party transaction filing and contemporaneous-documentation requirements. An APA applies to future related-party transactions that will occur in three to five consecutive years.

A service-related CSA usually applies in a group's purchase or sale strategies. A CSA is subject to filing with the SAT. A CSA may be reached through APAs. Costs allocated by an enterprise under a CSA will not be deductible if the CSA has no reasonable business purposes and economic substance, or if the enterprise's intended operating period, as specified, does not exceed 20 years from the date of the signing of the CSA.

In the thin-capitalisation provisions, non-deductible interest (that is: interest in excess of the standard amount calculated using a stipulated debt-to-equity ratio) directly or indirectly attributable to foreign related parties will be deemed to constitute a dividend, and thus will be taxed if the tax rate on dividend income is greater than that of interest income. The tax amount is the non-deductible interest multiplied by the difference

between the two tax rates. When the dividend tax rate is less than the interest tax rate, income tax already paid in the name of interest income will not be refundable.

Subject to approval from the SAT, general anti-avoidance investigations may be carried out by the tax authorities if an enterprise abuses preferential tax treatment, tax treaties (arrangements), or the company's organisational form, or if it avoids tax via use of a tax haven or performs other arrangements without reasonable business purposes. Tax benefits earned from tax-avoidance arrangements will be cancelled.

If transfer-pricing adjustments are enforced on one party to a transaction, the other related party will be allowed to make corresponding adjustments for the purpose of eliminating double taxation. If the other party is located in a foreign country (or Special Administrative Region, such as Hong Kong) having a tax treaty (arrangement) with China, the SAT may, upon application by the enterprise, consult the other competent authority based on the mutual-agreement procedure stated in the tax treaty (arrangement). Such an application must be submitted within three years of the date on which the enterprise or its related party receives a transfer-pricing adjustment notice.

4 Germany

Inappropriate Management Charges Leading to Hidden Profit Distribution

In a recently published judgment of the German Federal Finance Court (B*undesfinanzhof*), management charges for the services rendered to a company by its Dutch managing directors were regarded as inappropriate although the hourly salary rate was at arm's length. This judgment was based on the fact that the managing directors were shareholders of a foreign affiliate and that their engagement was not part-time but nearly a full-time job. The settlement based on hourly salary rates led to considerably higher costs (approximately EUR 1 million) than would have been the case if the company had engaged personnel itself (the approximate cost of a managing director in the same industry was considered to be EUR 220 000) so that the total amount of the remuneration representing the transfer price did not correspond to the arm's length principle. As independent companies would accept hourly salary rates and hence higher costs only for a short period of time, the German Federal Finance Court regarded the excessive expenses as a hidden profit distribution to the parent.

Note:

According to the judgment of the German Federal Finance Court it is not only decisive for the examination and determination of transfer prices that the elements of the remuneration are arm's length, e.g. the level of the hourly salary rates in the case at hand, but also the total remuneration. For purposes of easier understanding the facts and description of the court's judgment have been simplified.

Arm's Length Principle of Article 9 of the OECD Model Convention Disallows Adjustments Made For Merely Formal Reasons

According to German tax law, a company's agreements with the controlling shareholder or affiliates have to be clear, well-defined and concluded in advance to be accepted by the tax authorities. Otherwise the remuneration constitutes a hidden profit distribution even if the remuneration paid was within the arm's length range.

In the case at hand, a German limited-liability company (GmbH) concluded a management-fee agreement with a related UK company. However, contrary to the agreement, the remuneration actually paid to the UK company for its services was profit-based and higher than what would have been agreed between third parties. The German tax authorities treated the whole management fee as a hidden profit distribution.

The taxpayer appealed on the grounds that the prevailing opinion in German tax literature argues that a double tax treaty that includes an article corresponding to Article 9 of the OECD Model Convention (Art. 9 OECD-MC) prevails against the consequences of the hidden profit distribution as specified in German tax law if the adjustment of profits is based on formal aspects only. According to Art. 9 OECD-MC, profits should be adjusted only "if conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises". In such a case, "any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly".

The Financial Court of Cologne (F*inanzgericht Köln*) followed the opinion expressed in commentaries and outlined above and concluded that with regard to Art. 9 of the United Kingdom – Germany treaty, only the inappropriate portion of the remuneration (management fee) constituted a hidden profit distribution resulting in a profit adjustment. The arm's length portion of the remuneration was recognised as

an allowable cost of the German company, even if the formal agreement was not followed (but at least it was clear that services were agreed in return for adequate remuneration).

Note:

The principles discussed above apply only if a tax-treaty article corresponding to Art. 9 OECD-MC is adopted in the relevant double tax treaty. Where there is no treaty or in the case of purely domestic transactions, the barrier effect of Art. 9 OECD-MC does not apply. In the latter cases, the consequences of the German hidden profit distribution can be avoided only if the requested formalities are satisfied

5 Netherlands

Accelerated mutual agreement procedures in the Netherlands

The mutual agreement procedure ("MAP") is a useful instrument to solve double taxation issues arising between countries. To support taxpayers, the Netherlands aims to enhance the use and the effectiveness of this instrument. For example, taxpayers may request a MAP before all domestic remedies have been exhausted ('early MAP'). Further, the Netherlands aims to improve its extensive treaty network by introducing mandatory arbitration provisions in addition to the existing MAP provisions.

The new Netherlands MAP policy is described in a recently issued Decree. The Decree clarifies the rôle of the parties involved and the relevant procedures, including time frames. The Decree reflects the intention of the Netherlands authorities to solve double taxation disputes as fast and efficiently as possible. The Netherlands authorities aim to keep time and costs within a reasonable limit (i.e. the aim is a maximum two-year time frame). In order to streamline procedures, the authorities intend to communicate proactively with the other states' competent authorities and to determine time limits for the various phases of a MAP.

In addition, the Decree provides a thorough description of the available MAPs in the Netherlands. This includes some new forms of MAP, which can be initiated before a definitive tax assessment, by contrast with a regular MAP.

Under certain circumstances, an accelerated MAP can be initiated in the period when the tax assessment is not yet definitive, especially where legal procedures (e.g. objection, appeal) are still open. In special situations, an accelerated MAP can be requested in the period when the tax assessment is under appeal before a court. Furthermore, an extra accelerated MAP may be conducted when another contracting state makes an adjustment that is not definitive in that other contracting state and the Netherlands authorities have not received a position paper from the other state. However, for applicability of the extra accelerated MAP, the taxpayer must face special circumstances as a result of the adjustment, e.g. financial and/or liquidity problems.

The Netherlands aims to update its extensive treaty network by introducing compulsory arbitration procedures, if no agreement is reached between the competent tax authorities in a mutual agreement procedure. Instead of initiating MAPs on the basis of tax treaties, they can also be initiated on the basis of the EU Arbitration Convention.

Before starting a MAP, the opportunity is open for taxpayers to start an APA procedure. In comparison to the MAP, the main advantage of the advance pricing agreement lies in the circumstance that it is negotiated without the existence of a conflict situation.

Under certain circumstances, the Netherlands allows APAs to be concluded with retroactive effect ('rollback'). An APA provides advance certainty for taxpayers that the transfer-pricing methodology they apply is at arm's length and that no adjustments will be made by the tax authorities as long as the taxpayer follows the terms of the arrangement and the facts and circumstances do not change significantly.

6 United States of America

The Temporary Cost-Sharing Regulations

On 5 January 2009, the Treasury Department and the Internal Revenue Service (IRS) published substantial temporary cost-sharing regulations in the *Federal Register*. These temporary regulations, which come after proposed regulations issued in 2005, contain significant changes to the pre-existing regulations regarding methods of determining taxable income in connection with a cost-sharing arrangement (CSA). The general import of the temporary regulations is the same as that of the proposed regulations, and stems from the IRS's view that intellectual property (IP) has generally been transferred in CSAs for insufficient compensation. Hence, the major focus of the temporary regulations is on a transaction that was formerly known as a 'buy-in transaction', but that is now referred to as the 'platform contribution transaction' (PCT) in the temporary regulations. The most likely result of the changes in the temporary regulations will be significantly increased compensation in PCTs.

The new regulations introduce three concepts that serve to increase the amount paid in PCTs. The first, the 'realistic alternative concept', critical to the Best Method Analysis, holds that uncontrolled taxpayers dealing at arm's length would not enter into a transaction unless a preferable alternative did not exist. The 'best realistic alternative concept', central to the (new) Income Method, reinforces this concept and intends to cap the PCT payor's CSA profit at the level it could have earned pursuing its best alternative. Finally, the investor model, central to Best Method considerations, requires that each controlled participant's 'aggregate net investment' in the CSA "is reasonably anticipated to earn a rate of return equal to the appropriate discount rate for the controlled participant's CSA activity over the entire period of such CSA activity." It clarifies that the period of CSA activity includes the timeframe over which any new intangibles developed by exploiting the cost-shared intangibles are themselves developed and exploited, essentially making for longer useful lives than under the previous regulations.

The regulations contain five specified methods to analyse PCTs: the Comparable Uncontrolled Transaction Method, the Income Method, the Acquisition-Price Method, the Market-Capitalisation Method, and the Residual Profit-Split Method, which has been revised.

Other significant changes to the regulations concern the division of interests, periodic adjustments, and grandfathering of pre-existing CSAs. The temporary regulations now allow interests in developed intangibles to be split along 'field of use' lines, rather than, as in the proposed regulations, exclusively on a geographic basis. Amendments to the periodic adjustment rules include the introduction of exceptions to the adjustment requirements and the contraction of the periodic-return ratio range specified in the proposed regulations from between 0.5 and 2 to 0.667 and 1.5 (this range is further narrowed to between 0.8 and 1.25 if certain documentation requirements are not adhered to). The preamble to the temporary regulations indicates that separate guidance is intended that provides for an exception to periodic adjustments in the context of an Advance Pricing Agreement.

Finally, the temporary regulations do not, as the proposed regulations did, terminate grandfather treatment of existing CSAs upon a 50% change in ownership, subsequent periodic trigger, or material change in the scope of the arrangement. The risk to taxpayers under the 2005 proposed regulations was that prior PCT (buy-in) payments could be adjusted by the IRS using the new proposed methods for pricing such transactions. While the temporary regulations remove this risk, pre-existing CSAs entered into under the prior regulations are still subject to the more complex periodic-adjustment rules of the temporary regulations if there be a material change to the CSA. A CSA in existence on 5 January 2009 will be considered grandfathered if it was previously a qualified CSA under the former Treasury regulations, but only if the written contract is amended to conform to the provisions specified in the temporary regulations.

The temporary regulations do adopt a targeted provision that applies the temporary regulations' periodic adjustment regulations to PCTs that occur on or after the date of a material change in the scope of the grandfathered CSA.

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