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WTS Transfer Pricing Newsletter

Editorial

Dear Reader,

It is our pleasure to present to you the third WTS Transfer Pricing Newsletter for 2015. Transfer Pricing between related parties – and its significant impact on profits reported in different tax jurisdictions – has become the hot topic for international tax authorities in an effort to protect their respective country's tax base over the last couple of years.

In October, the OECD published its final reports in relation to the fifteen action point "Base Erosion and Profit Shifting (BEPS)" project. There is still further work scheduled for 2016 and 2017 such as finalising transfer pricing guidance on the application of transactional profits split methods and on financial transactions. However some of the focus for multinational groups will now shift to the implementation of the new guidance by each individual country's tax authority. It is already clear that local differences in the implementation and interpretation of the international standards will remain and multinational companies will continue to be exposed to significant penalties and double taxation risks if a local tax authority reassesses income as a result of a transfer pricing adjustment.

Consequently, continuous access to information on the most recent developments and changes in the legislation on transfer pricing from a local country perspective is key to mitigate transfer pricing risks before they arise. With this in mind, the WTS Transfer Pricing Newsletter aims to keep you informed about the latest developments in transfer pricing.

Yours sincerely
WTS Global Transfer Pricing Team

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Please find the complete list of all contacts at the end of the newsletter.

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Australia

Multinational Anti-Avoidance Law & Tax Transparency Initiatives

The Australian Government has been working steadfastly with the OECD and, as a key member of the G20, leading the way on various measures to combat multinational tax avoidance. Measures include the Multinational Anti-Avoidance Law, doubling of penalties for taxpayers caught up in profit shifting, Country-by-Country reporting, new transfer pricing documentation standards and mandatory tax disclosures.

Multinational anti-avoidance law

The new Multinational Anti-Avoidance Law (proposed in the 2015 Federal Budget handed down on 12 May 2015 and introduced in Parliament on 16 September 2015) contains two material proposals targeting multinationals with an annual global income of A$1b or more. The new laws (once implemented) are expected to affect close to 1,000 companies. These rules will sit within the general anti-avoidance provisions of the Income Tax Assessment Act 1936. The stated intention (para 1.2 of the Exposure Draft) of the new rules is to counter the erosion of the Australian tax base by multinational entities using artificial or contrived arrangements to avoid the attribution of business profits to Australia through a taxable presence in Australia. They are primarily intended to target entities that have significant sales activity in Australia but book their revenue overseas, thereby paying little or no tax worldwide.

The rules will apply where the following elements are present:

- a non-resident entity derives income by supplying goods or services to Australian customers,
- there is an entity in Australia supporting that supply,
- the non-resident avoids the attribution of the income from the supply to a permanent establishment in Australia,
- the non-resident entity (or a related entity or entities in their corporate structure) is subject to no corporate tax or a low corporate tax rate (either under the law of a foreign country or through preferential regimes) - carve outs exist where the activities in the low/no tax jurisdiction are not directly or indirectly related to the Australian supply or the entity (or entities) has substantial activity in the low/no tax jurisdiction in relation to the relevant Australian supplies.
- it is reasonable to conclude that the division of activities between the non-resident entity, the Australia entity and any other related parties has been designed to protect the relevant taxpayer (usually the non-resident entity) from deriving income that would otherwise be attributable to an Australian permanent establishment, and
- the relevant taxpayer must have entered into or carried out the scheme for the principal purpose (or for one of the principal purposes) of enabling a taxpayer (not necessarily the relevant taxpayer) to obtain a tax benefit, or both to obtain a tax benefit and reduce other tax liabilities under Australian law or under a foreign law.

Where the law applies, the Commissioner of Taxation may ignore the structure and apply the tax rules as if the non-resident entity had been making the supply of goods or services through an Australian permanent establishment. It is important to note that a tax benefit could take into account obligations arising under Australia's royalty and interest withholding tax rules, and is not limited to income tax payable on income derived from the making of Australian supplies.

Country-by-Country reporting

The new law (when it comes into effect) will introduce country-by-country reporting (CbCR) for significant global entities (being multinational groups with annual global income of A$1b or more) for income years commencing on or after 1 January 2016. When implemented, such groups will be required to provide the ATO with a master file (providing an overview of the global group), a local Australian transfer pricing file (that is compliant with the transfer pricing documentation requirements) and a CbCR.

Mandatory tax disclosures

In addition to the new bill, Australia has implemented mandatory tax reporting to further its tax transparency initiative. From 1 December 2015, Australian public companies and foreign owned multinational enterprises operating in Australia whose total income is more than $100m will be subject to mandatory disclosure of their tax affairs (certain Australian-owned private companies are exempt from these reporting requirements). Information to be disclosed includes the entity's name and Australian Business Number, total accounting income, taxable income and income tax payable. The Australian Taxation Office will also be reporting information about Minerals Resource Rent Tax and Petroleum Resource Rent Tax payable by the entity. The information will be obtained from the most recently lodged income tax returns.

Negotiated restructures

The ATO has announced that it will open negotiations with 80 multinationals to encourage them to restructure their Australian business operations (with a view to paying more tax in Australia) following on from Amazon's restructure of their European business partly as a response to Britain's diverted-profits tax.

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Brazil

COST PLUS PROFIT AS AN ALTERNATIVE TO RESALE PRICE LESS PROFIT

Although Brazilian taxpayers are allowed to choose the most favorable method to calculate the transfer pricing adjustments on import transactions, Brazilian taxpayers commonly use the Resale Price Less Profit (PRL) method, which relies solely on information readily available to Brazilian parties (price charged in Brazil, local costs, and import costs).

The use of the Comparable Independent Prices (PIC) and Cost Plus Profit (CPL) methods tends not to be feasible for Brazilian taxpayers due to the absence of price databases in Brazil provide comparables for related party transactions and the large volume of information/documents required to be provided by the foreign related party to prove the production costs incurred abroad.

When applying the CPL method, Brazilian taxpayers are advised to keep the following information and documents (which are required to be translated to Portuguese and notarized, validated and registered by a Notary in the country of origin in order to be valid in Brazil): (a) costs of acquisition of raw materials, intermediary products and packaging materials used in the production process; (b) workforce used in the production process; (c) leases, maintenance and repairs, depreciation, amortization or depletion relating to assets, services or rights applied in the production process; (d) reasonable losses incurred in the production process; and (e) copy of the foreign related party's income tax return.

In September 2013, the General Tax Coordination (Cosit) issued Ruling 13 which confirmed that, when there is a large volume of documents to be provided by the foreign related party, a certification issued by an independent audit firm together with the list of all the commercial invoices related to these acquisitions, would be accepted as sufficient evidence of the cost of goods acquired from the related supplier abroad.

Although this decision only applies to the taxpayer that filed the ruling, the evidencing of costs by means of reports prepared by a reliable and independent third party could make the use of the CPL method feasible for Brazilian taxpayers. As the benchmark under the CPL method is, in summary, production costs incurred abroad plus a fixed profit margin of 20%, this method could be an alternative to the PRL in transactions in which the profit margin of the Brazilian taxpayer is lower than the 40%, 30% or even 20% profit margins required by law.

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China

Enforcement of BEPS in China

1. Significant amendments made to TP regulations echoing BEPS deliverables

On 17 September 2015, China's State Administration of Taxation (SAT) released a public consultation draft of a Circular on Implementation Measures for Special Tax Adjustments (the Discussion Draft). Once finalized this Circular will replace the existing SAT Circular on Special Tax Adjustments (Circular 2) which was published in January 2009 and essentially represented China's transfer pricing guidance.

The Discussion Draft includes elements of the BEPS proposals for transfer pricing and clarifies the SAT's approach to transfer pricing audits, introduces new transfer pricing methodologies and expands the Chinese transfer pricing requirements.

Key points of the Discussion Draft are summarized below:

- **New transfer pricing documentation requirements**
  The Discussion Draft provides that multinational companies will be required to prepare a master file, a local file and a so-called 'special documentation' file. The latter will required for companies engaging in intercompany service transactions or cost sharing agreements and those exceeding a thin cap threshold. The proposed requirements significantly increase the level of disclosure required of MNCs and provide for more effective use by the tax authorities of the information that will be available to them.
- **More complicated transfer pricing methodologies**
  In addition to the traditional five transfer pricing methods, the Discussion Draft introduces new transfer pricing methods: the Value Contribution Apportionment Method (VCM) and Valuation Transfer Pricing Methods. The VCM is based on allocating value across the value chain of a group based on value creation and with reference to assets, costs, sales and the number of employees.
- **Guidance for tax authorities**
  The Discussion Draft provides guidance to local tax authorities in establishing systems for reviewing the greater volume of taxpayer information that will be at their disposal going forward. Government databases are expected to be established for the sharing of information between local tax authorities. Further, a mechanism for grading taxpayers as low risk or high risk and conducting an audit with a corresponding level of scrutiny is planned.

→ **Meticulous assessments for intangible assets**
The BEPS action plan for pricing intercompany transactions involving intangible assets has for the most part been adopted in the Discussion Draft. The Discussion Draft stipulates that the contribution to the value of intangibles by related parties shall be evaluated by considering their contribution in respect of development, enhancement, maintenance, protection and exploitation (DEMPE) to the intangibles in question. In addition, the Discussion Draft introduces 'protection' to the DEMPE analysis.

The Discussion Draft is expected to be effective in 2016. Taxpayers, especially MNCs, will be required to disclose more information for transfer pricing purposes and are advised to conduct a focused review of their transfer pricing arrangements in line with the draft regulations.

2. China's next actions for further enforcement of BEPS

Following the release of the BEPS final reports by the OECD on 5 October 2015, the SAT published the Chinese version on its official website and restated its action plan of further enforcement of BEPS concepts. This included plans:

→ To incorporate BEPS action plans within domestic tax laws and regulations.
→ To establish more offshore tax and transfer pricing teams within tax authorities.
→ To establish a national tax risk monitoring system, including a pilot program to enable local tax authorities to monitor and review filings by multinational groups.

Multinational groups are advised to study how the enforcement of BEPS action plans by China could impact their current business arrangements and future operational plans.

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India

Multiple Year Data + Range Concept

India's Final Rules on the use of 'Multiple Year Data' and 'Range concept' for Transfer Pricing (TP) analysis

The Central Board of Direct Taxes ('CBDT'), India's top tax administration body, has recently provided notification of the final rules on the use of 'multiple year data' and the 'range' concept ('Rules') in determining the Arm's Length Price (ALP). The Rules are effective for reportable transactions undertaken on or after April 1, 2014.

Key highlights of the Rules – use of Multiple year data:

→ Multiple year data would be considered for use in computation of the ALP only if the Resale Price Method (RPM), Cost Plus Method (CPM) or Transactional Net Margin Method (TNMM) are used for benchmarking, and after considering whether the Range concept is applicable.
→ It is mandatory to use current year comparables data unless it is not available at the time of submitting the return of income, in which case data for the two financial years immediately preceding the current year shall be used.
→ If current year comparables data is available at the time of audit, it shall be considered. Where current year data is not comparable on account of either qualitative or quantitative reasons, said comparables may not be considered in the data set.
→ Further, as per the new Rules, the ALP of comparables shall be computed based on the weighted average of data for the current year and two preceding financial years with

weights being assigned to the quantum of an appropriate indicator (i.e., sales, costs, assets employed or other base) based on the transfer pricing method.

Key highlights of the Rules – Range Concept:

- The Rules allow the use of a range concept in determining the ALP only if the Comparable Uncontrolled Price (CUP) method, CPM, RPM or TNMM are used for benchmarking. Where the Profit Split Method (PSM) or Other Method has been applied, the ALPs shall be determined using the 'Arithmetic mean' as contained in the existing regulations.
- The range concept can only be applied if 6 or more comparables are available in the data set, otherwise the Arithmetic mean is to be used.
- A data set is constructed by arranging in ascending order the ALPs of the comparables computed using multiple year data and then by using the following formula to construct the arm's length range:

  35th percentile = Total number of comparables * (35/100)
  65th percentile = Total number of comparables * (65/100)

  If the resultant value derived from the above formula is a fraction number, then the comparable entry appearing on the next higher data place shall be considered.

- Where the transaction price of the tested party falls within the range as constructed above, the transactions of the tested party is accepted to be at ALP.
- Where the transaction price of the tested party falls outside the range as constructed above, then the median (middle value being 50% of the number of comparables arranged in an ascending order) would be taken as the ALP. If the resultant median value is a fraction number, then the median value shall be the comparable entry appearing on the next higher data place. If the resultant median value is a whole number, then the median value shall be the arithmetic mean of the entry for the whole number and the entry immediately appearing on the next higher data place. The transfer pricing adjustment shall be made considering the ALP entry for the Median value.

The introduction of these Rules is expected to change the dynamics of determination of ALPs in the Indian TP arena.

CBDT issued revised/updated guidance on TP Audit procedure

CBDT recently issued an instruction ('New Instruction') to its field officers on the revised guidance on selection of cases for TP audits. This new Instruction, which replaces the erstwhile instruction issued in 2003, outlines the scrutiny procedure that the Assessing Officer (AO) is required to follow before referring any case to a Transfer Pricing Officer (TPO) for determination of ALP of international transactions.
Key points from the New Instruction are:

- Previously, TP cases were selected for mandatory audit based on the monetary value of transactions i.e., aggregate international transactions exceeding INR 150 million during a year were referred to a TPO. New Instruction provides for the selection of cases for TP audit based on 'risk parameters', rather than 'monetary parameters'.
- The AO will be required to record his reasons for being satisfied that 'there is an income or a potential of an income arising and/ or being affected on determination of ALP of an international transaction' before making a reference to a TPO in the following cases:

a) the taxpayer has not filed an accountant's report (TP report) and the AO has noticed that the taxpayer has entered into certain international transactions;
b) the taxpayer has not declared one or more international transactions in the TP report; or
c) the taxpayer has disclosed the international transactions in the TP report, but has made certain qualifying remarks to the effect that said transactions are not international transactions / do not impact the income of the taxpayer.

- New Instruction requires the AO to provide the taxpayer an opportunity to be heard, before the AO records his satisfaction or otherwise. Previously, there was no specific provision in the Income-tax law mandating the AO to provide an opportunity for the taxpayer to be heard before referring a case to the TPO.
- The TPO is required to explain their decision (by means of a speaking order) by moviding details of the data used, reasons for adopting a particular method, etc.
- Further, TPOs are required to maintain a record of references received from the AOs in the prescribed format, which would serve as an important reference for future action and also help in bringing about uniformity in determining the ALP of similar cases.
- Lastly, New Instruction states that, similar to the above, CBDT is considering issuing guidance in relation to Specified Domestic Transactions ('SDT'). However, until the guidance is issued, the manner of reference of a case involving SDT to the TPO for determination of the ALP would be the same as applicable for international transactions.

The rationalization of the case selection process for TP audits is a good initiative taken by the Government of India.

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1) Refer Notification No. S.O. 2860 (E) dated October 19, 2015
2) Instruction No.15/2015 dated 16th October 2015

Italy

Transfer Pricing and Domestic Intercompany Transactions in the Light of New Legislation

A new decree has introduced a historical clarification; transfer pricing rules do not apply to domestic transactions between Italian resident companies, but only relate to cross-border transactions. However, this interpretation has to be read in the light of the new definition of "abuse of law."

The application of the arm's length principle in a domestic tax setting is a much debated issue. On one hand, the current Italian legislation on transfer pricing (article 110, paragraph 7, CIT law ("TUIR")) refers to the use of the arm's length principle on intercompany ("IC") transactions occurring between an Italian entity and a foreign entity. On the other, in recent years there have been a number of Italian Supreme Court decisions, concerning the application of transfer pricing law, ruling that the arm's length principle must also be applied to domestic intragroup transactions.

In October 2015, new legislation came into force, concerning abuse of law (art.10-bis L. 212/2000 - in force from October 1st) and the "growth and the internationalization of the companies" (D.Lgs. 147/2015 - with effect from October 7th). The latter explicitly clarifies that article 110, paragraph 7, TUIR does not apply to IC transactions between Italian companies. Because this is an interpretation of a provision of law, it should also apply retroactively.

The new legislation introduces a legal definition of "abuse of law" which exists when a transaction "lacks any economic substance and, while formally consistent with tax law, is aimed at obtaining undue tax advantages." This definition may also apply retroactively to transactions which have not yet been challenged by the Revenue Agency through a formal deed of assessment.

The above definition revises the set of anti-avoidance rules and replaces all definitions and doctrines previously developed by the tax authorities and the Italian case law, in recent years. The new rule better specifies the boundaries of an abusive behavior by also recognizing that in the presence of proper business purposes, taxpayers should be free to choose the transaction which triggers the lowest tax burden. Furthermore, it establishes that no criminal consequences apply if transactions are deemed "abusive."

Within the current Italian legislative framework, there seems to be room to argue that the arm's length principle can still be applied to domestic intragroup transactions in the case of "abusive" conduct (i.e. a conduct which lacks any economic rationale and is aimed at obtaining undue tax advantages) even though the specific tax provisions on transfer price are not directly applicable.

Having said that, the Italian transfer pricing ("TP") "proper documentation" (comparable to the OECD guideline requirements) can be drafted for penalty protection purposes, on an annual basis, only if the taxpayer falls within the scope of the aforementioned paragraph 7 of Article 110 of TUIR. Hence, this is no longer the case for domestic IC transactions. It should be stressed that the Italian TP documentation is an optional regime, relevant to avoid the application of transfer pricing adjustment-related penalties.

As a consequence, domestic intercompany transactions do not need to be formally documented for Italian transfer pricing purposes (i.e. no "proper documentation" can be drafted to obtain penalties protection). Nevertheless, it is strongly recommended that taxpayers keep any documents which could support the actual "economic substance" of the IC Italian transaction, in case the Revenue Agency activates an audit of the taxpayer and provides evidence of "abuse."

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Korea

Korea 2015 Tax Reform Proposals: Reinforcement of Multinational Enterprises ("MNE")'s Transfer Pricing ("TP") Information Reporting Requirements

As a member country of the OECD and G20, the Korean government reflected the OECD's BEPS project findings in the 2015 tax reform proposals by expanding the scope of required transfer pricing information to be submitted by an MNE when filing the corporate tax returns.

The current Korean TP regulations, namely the Law for the Coordination of International Tax Affairs ("LCITA") state that a taxpayer engaged in international transactions with a foreign related party shall submit the (i) Schedule on International Transactions ("SOIT"), (ii) Statement on Selection of Most Appropriate TP Method, and (iii) Summary of Income Statement of Foreign Related Party with the corporate tax returns.

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2015 Tax Reform Proposals on Transfer Pricing Documentation

2015 LCITA reform proposal imposes the MNE's obligation to submit the "Integrated Information Report on International Transactions" ("IIROIT") in addition to the existing form of SOIT to prevent tax avoidance caused by manipulation of transfer prices as stated in Articles 11(1) and 12(1) of the LCITA.

New Requirement of IIROIT Submission Covering Master File and Local File When Filing Corporate Tax Returns

→ **Information for Submission (Draft):** IIROIT is comprised of Report I and Report II
  - Report I (Master File): Includes information on a MNE's overall legal ownership structure and geographical location of overseas subsidiaries and branch offices, detailed descriptions of top 5 highest ranking products and service offerings representing more than 5 percent of total revenue from the perspective of the group, description of important business restructuring, acquisition of equities, and sale of company.
  - Report II (Local File): Includes detailed description of business activities and business strategies of overseas entities, description of the major related party transactions and the context in which such transactions take place, list of associated enterprises involved in each category of controlled transactions and indication of their relationship with each other, etc.

→ **Applicable Taxpayers:** Domestic corporation and foreign corporation having a permanent establishment in Korea with more than a certain level of transaction volume or assets.(*)
(*) Detailed requirements will be regulated in the Presidential Enforcement Decree of the LCITA which is expected to be available in January 2016.

→ **Deadline of Submission:** Tax return filing deadline

→ **Non-compliance Penalty:** Assessment of penalty less than KRW 10 million

→ **Enforcement Date:** Effective from the business year starting on the first day of 2016

In consideration of the taxpayers' administrative burden in complying with the new reporting requirement, the Korean government legislated only the submission of the Master File and Local File among the three-tiered transfer pricing documentation suggested by the OECD (i.e. (i) Master File, (ii) Local File, (iii) Country-by-Country Report) for 2016, which will be the first year for enforcement of the new regulation. It is expected that the Country-by-Country Report will be considered for adoption by the Korean government in the future tax reform to be proposed in 2016 after reviewing the legislation by foreign countries on this matter.

Our Comments

The Korean tax authority had found difficulties in discovering tax avoidance or judging accurate tax return filings solely by reviewing the SOIT because the SOIT provides only limited information on the amount of related party transactions between a company located in Korea and its overseas related party. Meanwhile, the IIROIT requires information regarding the overall management and international transactions, including the legal ownership structure of domestic and foreign MNEs and the geographical location of overseas subsidiaries and branch offices, as well as detailed description of the business activities and business strategies of the overseas entities. By requiring the IIROIT, it is expected that the tax authority will be able to collect the necessary information to identify business restructurings aimed at tax avoidance or the ownership structure and transaction relationships of a conduit company established in tax havens.

Further discussion on how to submit the IIROIT and its format of reporting is being made by the Ministry of Strategy and Finance. It is expected that the report will be prepared in a

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narrative form similar to the general TP study report, and based on unofficial confirmation it is likely that the taxpayer will be required to submit the report in a softcopy format.

Latvia

Recent transfer pricing judgements in Latvia are leading to increased controversy in application of resale minus method

In recent years the tax authority of the Republic of Latvia – the State Revenue Service (SRS) – has significantly increased its capacity for transfer pricing (TP) audits and this action has resulted in increased TP disputes in the courtroom.

One particular issue, which has been the subject of debate, was analysed in several recent judgments delivered by the Latvian courts. In several cases , the court supported the view presented by the SRS that, whilst applying the resale price method, related parties should gain an arm's length profit both on the gross and operating (EBIT) levels simultaneously. The court in its judgements recalled the regulation provided in Latvian tax law which in general is similar to Paragraph 2.21 of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD TP Guidelines). However, the devil is in the detail and Latvian local tax law states that an entity which purchases goods from related parties and further resells them to unrelated clients should cover its sales and general administration (SGA) costs from its gross profit and earn an appropriate profit on an operating (EBIT) level. OECD TP Guidelines instead use the wording "would seek to cover" its SGA costs and make an appropriate profit.

Based on the formulation provided in Latvian tax law, Latvian courts argue that even if a taxpayer has proved that its gross margin is arm's length, taxpayers should also demonstrate that the operating (EBIT) margin gained in controlled transactions is arm's length. In both reviewed cases, the operating profit level was the issue, as in most cases, the SRS performed its own benchmarking study, which resulted in the conclusion that the operating (EBIT) margin of the audited company fell outside the arm's length range of profits realised by comparable companies.

We assume that the courts' approach stems partially from the incorrect adoption of OECD TP Guidelines in national legislation and partially from the fact that the SRS has made controversial decisions during tax audits, i.e., by applying the resale price method using an operating (EBIT) profit level indicator. If the court decides that the SRS has selected the wrong TP method then, according to Latvian law, the court is not allowed to change the applied TP method during court proceedings. In such circumstances, the court's only option is to declare the decision of the SRS void and annul it.

The described approach is contrary to the OECD TP Guidelines and the aim of the resale price method. Firstly, the main difference between the resale price method and the transactional net margin method is the use of different profit level indicators. The former uses gross margin as a profit level indicator while the latter uses an operating (EBIT) level profit level indicator. Therefore, the main difference between both methods is which profit level indicator is used to substantiate compliance with the arm's length principle. Furthermore, neither Latvian tax law nor OECD TP Guidelines prohibits using more than one TP method to substantiate TP; however, the SRS has not applied this option in cases under review.

As there are several judgments delivered by the Supreme Court and Administrative Regional court in relation to this matter, it is likely that the SRS and the courts will follow the path set by the Supreme Court in the first instance, i.e., that a taxpayer applying the resale price method should have an arm's length gross margin as well as an arm's length operating (EBIT) margin, unless the Supreme Court overturns its practice in cases currently pending before it. For now, we expect even more controversy with respect to the application of the resale price method in Latvia.

1) Case No. A420496211 (final judgment pending before the Supreme Court) and the case No. A420529010 (final judgement pending before the Supreme Court, however previous overturning judgement in the same case was delivered by the Supreme Court in 2014).
2) Clause 86 of the Regulations No. 556 of the Cabinet of Ministers, adopted in 4 July 2006 (Cabinet Regulations)

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Luxembourg

Impact of European Commission's Fiat State Aid decision on Luxembourg's transfer pricing practice

On October 21, 2015 the European Commission (EC) released its final decision on Fiat's State Aid case, concluding that Luxembourg has granted selective tax advantages to Fiat Finance and Trade (FFT). The advantages were granted by way of the issuing of a tax ruling which had the effect of artificially lowering taxes paid by FFT and, which according to the EC, is illegal under EU State Aid rules. As a consequence, the EC ordered Luxembourg to recover the unpaid tax (EUR 20-30 million, including interest) from FFT in order to remove the "unfair competitive advantage" and to "restore equal treatment with other companies in similar situations".

FFT in Luxembourg provides financial services (e.g. intra-group loans and cash pooling) to group companies. According to the EC, the activities are comparable to those of banks and, therefore, the taxable profits should be determined by calculating the return on capital deployed, which is largely in line with the substantiation prepared by FFT's adviser. However, the EC is of the opinion that the ruling "endorses an artificial and extremely complex methodology that is not appropriate for the calculation of taxable profits reflecting market conditions"; in other words, it does not reflect economic reality.

Irrespective of the technical merits of the transfer pricing analysis performed by the adviser, it should be noted that the EC has provided substantial arguments on particular parts of the analyses – e.g. the use of the Capital Asset Pricing Model (CAPU) method and Basel framework, selection of particular comparables, use of particular point within the range, etc. Together with other ruling transparency pressures, we expect and already finding, that it will become harder for taxpayers to obtain certainty in advance on transfer pricing matters, that more detailed economic substantiation will be required and that tax administrations will require a lot more time and resources to assess requests for rulings. Accordingly, we expect that both the number of rulings requested and obtained will decrease.

The OECD TP Guidelines recognize that a real-life (uncontrolled) comparable relation may not exist for all intra-group relations (as is the case for cash pooling), and in such circumstances, an alternative, economic conceptually sound framework is to be used as a means to assess the arm's length nature of such intra-group relations (e.g. CAPM and Basel). It is noted that the EC decision does not acknowledge this commercial reality; indeed, it finds reasons in the purpose of the reference frameworks used (i.e. the purpose of Basel II) to argue against its suitability as a proxy for assessing arm's length conditions. However, since FFT is not a bank or, put differently, has particular functions and maintains intragroup relations that would not occur in third party circumstances, it is hard to see the EC's position that the illegal state aid received by the company would lead to "an unfair competitive advantage over other companies (typically SMEs) that are taxed on their actual profits". As a consequence, multinational enterprises risk being assessed against this (artificial) reference framework for assessing competitive advantage. Although we do not agree with the EC's position on introducing competitive advantage as an argument for assessing transfer pricing policies in this manner, it is still recommended that companies provide, along with their transfer pricing analysis, an analysis of the impact (or non-impact) of the transfer pricing policy on the competitive landscape when requesting a ruling.

Furthermore, the EC introduces concepts beyond the OECD's notion of the arm's length principle. In particular, it refers to the concept of a "prudent independent operator acting under normal market conditions". The EC notes that a prudent market operator "would require a market conform remuneration", which reflects "normal conditions of competition". In explaining this, the EC provides the example that "a market operator would not accept that its revenues are based on a method which achieves the lowest possible outcome if the facts and circumstances of the case could justify the use of other, more appropriate methods". Assuming that, under the OECD TP methods, the most appropriate transfer pricing method has been selected and not the method that maximizes profits at one or the other side of the transaction, this concept of a prudent market operator is, in our view, a fundamentally flawed argument that tries to bridge the gap between a potentially flawed transfer pricing analyses and state aid legislation, introducing an extra layer of legislation which may lead to diverging outcomes under both principles.

Finally, as the FFT case is said to be representative of Luxembourg's ruling practice, the EC decision is a clear signal for companies that have received rulings in the past that it is time for them to review their rulings and the circumstances they operate in against the EC's position. However, the final position may only be determined once further tested in courts in future years.

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Philippines

Transfer Pricing: One of the 2015 Top Priority Programs

As may be recalled, it was only on January 3, 2013, when the much awaited consolidated Transfer Pricing Rules and Regulations in the Philippines were issued by the Department of Finance as embodied in Revenue Regulations ("RR") No. 2-2013. Said RR prescribed the guidelines in determining the appropriate revenues and taxable income of the parties in controlled transactions which is largely based on the Organisation of Economic Cooperation & Development ("OECD") Transfer Pricing Guidelines.

In 2014, the Bureau of Internal Revenue ("BIR") drafted another revenue regulation prescribing the guidelines and procedures in administering the Advance Pricing Agreement ("APA") program. In October 2014, several roundtable discussions took place on the draft RR on APA with the participation of invited panelists from both the private and public sector. However, at the time of this publication the Philippine Tax Bureau has not finalized the RR on APA.

On January 13 of this year, Revenue Memorandum Circular ("RMC") No. 3-2015 was issued by the BIR. Said RMC set out the twenty-seven priority programs/projects of the Philippine government for the calendar year 2015 that are intended to help the Bureau in attaining its revenue target.

Pursuant to this latest RMC, the BIR's collection target for calendar year 2015 stands at PHP 1.72 trillion (approximated USD 39 billion) which is an increase of around 21% from the 2014 collection target.

In order to manage the Bureau's drive for higher revenue collection, the 2015 Top Priority Programs includes a special focus on Transfer Pricing. The Transfer Pricing Program seeks to complement the Transfer Pricing Guidelines of the BIR through RR No. 2-2013.

Further, the proposed Transfer Pricing Program will include the Commercial Database Subscription for Transfer Pricing Studies and the crafting/finalization of related issuances on Transfer Pricing, which are described as the following:

→ Revenue Regulations on Advance Pricing Agreements (APAs);
→ Revenue Memorandum Order on Transfer Pricing Documentations;
→ Revenue Memorandum Order on Transfer Pricing Risk Assessment.

With the issuance of RMC 3-2015, all Bureau offices are thus aligning their activities, projects and other undertakings with the Priority Programs to sustain the positive trend of improved collection efficiency that has been observed over the past three (3) years.

It must be noted that the Bureau's Large Taxpayers Service (LT Audit Division) in coordination with its Legal Group (International Tax Affairs Division) shall be the Lead Offices assigned to handle the Transfer Pricing Program.

With these developments, it is quite apparent that the Tax Bureau has the tendency to explore more areas which are tagged as potential sources of tax collections, in line with the BIR's ambitious revenue collection agenda. It would seem that the Transfer Pricing Program has been explicitly targeted as a promising revenue generating activity. As such, concerned taxpayers with related party transactions must be mindful of their Transfer Pricing compliance.

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Poland

Poland implements BEPS Action 13

On 27 October 2015, the President of the Republic of Poland signed the amendments to both the Corporate and Personal Income Tax Law which implemented inter alia the new transfer pricing documentation (TPD) rules. These rules and regulations are a direct outcome of BEPS Action 13 and the three-tier standardized transfer pricing documentation (TPD) concept.

The signed amendments introduce positive and negative changes for taxpayers. Examples of key positive changes include the increase of the shareholding threshold which qualifies for related party status in addition to the limitation of the transfer pricing requirements for small taxpayers (whose revenue or costs do not exceed EUR 2 million on an annual basis).

The new regulations will refine the scope and content of TPD by requiring new disclosures. The burden of proof that the prices are arm's length will effectively shift to taxpayers in addition to the new reporting requirements (Country-by-Country Reporting and CIT-TP tax form) which will also be imposed on taxpayers.

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The changes are significant and in order to allow taxpayers to prepare themselves, the timing as to when the above changes will become effective varies and is set out below.

Definition of the related parties

So far, entities are recognized to be related by equity interest if one of them directly or indirectly owns at least 5% of the shares in the other entity. Effective from 1 January 2016, the equity interest threshold will rise to 25%.

Events triggering the obligation to develop a Local File

The amendments bring major changes to the current TPD requirements. Currently, the taxpayer is obliged to have TPD for each transaction with a related party which exceeds the annual basis specific threshold ranging from EUR 20k per annum (tax havens) to EUR 100k per annum (tangible goods). From 1 January 2017, the TPD requirements will pertain to taxpayers with overall revenue or costs of over EUR 2 million in a particular tax year or a preceding year.

The documentation should contain the relevant information for all transactions or business events with the related parties that exceed a specific materiality level. The lowest materiality threshold has been set at EUR 50k. This threshold increases pro rata depending on the taxpayer's revenue or costs. The highest materiality threshold is EUR 500k for taxpayers whose revenue or costs exceed EUR 100 million.

New disclosures

New transfer pricing regulations will refine the scope of TPD disclosures. Those taxpayers whose revenue or costs exceed EUR 10 million during a particular tax year will have to include in their Local File comparables or benchmarking study showing that the intercompany prices are arm's length.

Another obligation for Polish taxpayers will be the requirement for a group-wide Master File. The Master File will have to be maintained by taxpayers who are members of an MNE and whose revenue or costs exceed the threshold of EUR 20 million during their financial year.

Both changes will become effective as of 1 January 2017.

Additional reporting obligations

In addition to the changes discussed above, the amendments impose specific reporting duties on taxpayers.

As of 1 January 2016, Polish holding companies for groups with consolidated revenues over EUR 750 million will be required to file the Country-by-Country Reporting (C-b-CR) as stated under the OECD's BEPS Action 13. The qualifying taxpayers will be required to submit the C-b-CR within 12 months from the end of the tax year. This means that the first reports will be filed in December 2017.

Moreover, effective from 1 January 2017, taxpayers will be required to attach to their tax return a designated tax form called CIT-TP. This 5-page tax form with 470 check boxes regarding the specific aspects on intercompany transactions has been developed to allow the tax administration easy collection of the information on related party databases, their segregation and comparison to spot the targets for transfer pricing audits.

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Spain

New CbC reporting obligation and amendments to transfer pricing rules.

On 11 July 2015, Royal Decree 634/2015 was published in the Spanish Official Gazette, approving the new Spanish Corporate Income Tax Regulations (CITR) which complement the provisions on the new Corporate Income Tax Law (CITL) in force from the 1st January 2015 (See WTS TP Newsletter February 2015). The amendments to the previous Law and Regulations are aligned with Action 13 of the OECD's BEPS Project, which aims to enhance transparency for tax authorities by introducing CbC reporting obligations and changes to transfer pricing rules.

Country by Country (CbC) reporting obligations.

The new CbC reporting obligation shall become effective for fiscal years starting from 2016, and applies to Spanish tax resident entities which are the head of a group (as defined in art. 42 of the Spanish Code of Commerce), and are not at the same time a dependent of any other company whether Spanish resident or not, whose consolidated group's net turnover in the immediately preceding fiscal year exceeds €750 million. It also applies to Spanish subsidiaries or Permanent Establishments (PEs) when any of the following circumstances are met:

- There's no CbC reporting obligation in the country of residency of the head company;
- The country in which the head entity is resident has not signed an automatic exchange of information agreement with Spain in relation with these obligations;
- The country in which the head entity is resident has systematically failed to comply and this systematic failure has been notified to the Spanish entity before the reporting fiscal year end.

Spanish entities belonging to a reporting group must notify the Spanish tax authorities before the end of the reporting fiscal year of the name and tax residence of the company within the group filing the CbC report. The CbC report shall be filed within a 12-month period from the close of the reporting fiscal year (i.e. companies whose fiscal year ends 31 December 2016 need to file the CbC report by 31 December 2017), and a specific form will be published by the Spanish tax authorities for these purposes.

The CbC report will have to include the following information per country on an aggregate basis:

- Group revenue, distinguishing between intragroup and third party revenues;
- Profits/Losses before CIT (or analogue tax);
- CIT (or analogue tax) effectively paid including withholding taxes;
- CIT (or analogue tax) accrued including withholding taxes;
- Share capital and equity at the end of the reporting year;
- Average number of employees;
- Tangible assets and real estate investments, different from treasury and receivables;
- List of resident entities, including PE, and the main activity of each entity and
- Other relevant information, and an explanation on the data included in such relevant information.

The information must be provided in Euros, nevertheless the new regulations do not clarify what currency exchange rate will apply when needed.

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Transfer Pricing (TP) documentation

The new CITR maintains the two-tier approach to transfer pricing documentation set forth in the previous regulations, but elaborates on the information that is required to be included in both the master file and local file, mainly in two areas: intangible assets and financial activity. At the same time, establishes a simplified regime for entities belonging to groups with consolidated turnover lower than €45 million in the preceding fiscal year, and an ultra-simple regime for entities belonging to groups under €10 million consolidated turnover.

Master file

Apart from documentation already required by current regulation, the following information is obligatory from 2016 onwards:

→ Main activities of the group with a description of the principal geographic markets where it operates, principal sources of revenue and supply chain of activities representing at least 10% of the group's revenue;
→ Information on the group's intangible assets:
  • General description of the group strategy with reference to the intangible assets' development, ownership and exploitation, including the location of the facilities where the R&D activities are carried out and the identification of the entity or entities responsible for the management of those activities;
  • Amounts of the consideration paid for intangible assets by group related parties;
  • Significant transfers of intangible assets, indicating the involved parties and countries, and amounts paid;
→ Financial activity:
  • Overall description of the group's funding structure, including main agreements with related parties; and
  • Identification of the group entities carrying out the funding activities within the group: incorporation country and location of its effective center of management.

Master file documentation will not be compulsory for entities belonging to groups with consolidated turnover under €45 million.

Local file

The additional information required by the new CITR is:

→ Management structure, organizational chart and entities/people receiving reports on taxpayer activities evolution;
→ Taxpayer activities and business strategy, and when the taxpayer is involved in restructuring operations and intangible asset transfers, transactions must be reported;
→ Main competitors and
→ Reconciliation between data used in the economic analyses and annual financial statements when appropriate and relevant.

Local file of entities belonging to groups with consolidated turnover under €45 million contains the following streamlined content:
→ Nature, characteristics and amounts of related party transactions;
→ Complete identification of taxpayer and related parties involved in the described transactions;
→ Pricing method used for each transaction and
→ Comparable external prices obtained and value or range of values derived from their use.

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The new document on requirements enter into force for fiscal years commencing from 1 January 2016 when the taxpayer belongs to a group with an aggregated turnover higher than €45 million, otherwise the new information requirements enter into force on the 12th July 2015.

The Netherlands

Dutch Implementation of BEPS Action Point 13: TP Documentation and Country-by-Country Reporting

The Dutch government has announced that it will implement new standardised transfer pricing documentation obligations effective from January 1, 2016, in line with Action 13 of the OECD Project "Base Erosion and Profit Shifting" (BEPS-project). Depending on the size of the multinational, three types of reports need to be in place and updated annually: a "country-by-country report"; a "master file"; and a "local file". The rationale behind the new documentation obligations is that it should allow the tax authorities to make a better risk analysis regarding transfer pricing and to efficiently focus on the high risk areas regarding base erosion and profit shifting; adjustments may be made on any available information, not limited to the reports.

Country-by-Country reporting

The Dutch annual country-by-country reporting requirement applies to Dutch taxpayers that form part of a multinational enterprise that has a consolidated revenue of EUR 750 million or more in the previous financial year. The report must be in English or Dutch and needs to be available within 12 months after the end of the financial year of the Dutch taxpayer. It is to be provided either via an international automatic exchange process with the country of the reporting (ultimate parent) entity, or by the Dutch taxpayer of the qualifying multinational enterprise (e.g. if there is no such exchange process in place). Before the end of the year, the Dutch taxpayer qualifying as a reporting entity needs to report to the tax inspector whether it is a reporting entity and if not who the reporting entity is and in which country it is located.

The country-by-country report needs to include the following information for each country in which the multinational is active: revenue, profit before tax, paid profit tax, annual accounts reported profit tax, capital contributed, accumulated profit, number of employees and assets other than cash or cash equivalents. Furthermore, a description of each legal entity of the multinational enterprise needs to be prepared, including the country of tax residence, the country of incorporation and the main business activities of that legal entity.

Not complying with the new legislation regarding the country-by-country reporting can trigger administrative penalties of up to EUR 20,250 if the appropriate amount of tax has been paid in the Netherlands. If insufficient tax has been reported, criminal penalties of up to EUR 20,250 can be imposed and/or imprisonment of a maximum of 4 years. It is expected that the criminal prosecution will not always take place and will focus on the most severe cases.

Master file and local file

The annual master file requirement and annual local file requirement applies to Dutch taxpayers that form part of a multinational enterprise that has a consolidated revenue of EUR 50 million or more in the previous year. Both files need to be in place when the corporate income tax return is filed.

The master file includes an overview of the business of the multinational enterprise, the whole transfer pricing policy and the worldwide allocation of income and economic activities to support the tax authorities in their identification of existing substantial transfer pricing risks. The local file includes information relevant for the transfer pricing analysis regarding transactions between the taxpayer and related group entities in another country. The local file helps substantiate that the legal documentation requirements have been met; as well as substantiates the arm's length remuneration of permanent establishments.

If insufficient tax has been reported and the annual master file and/or annual local file is not available or inappropriate, criminal penalties of up to EUR 20,250 can be imposed and/or imprisonment of a maximum of 4 years.

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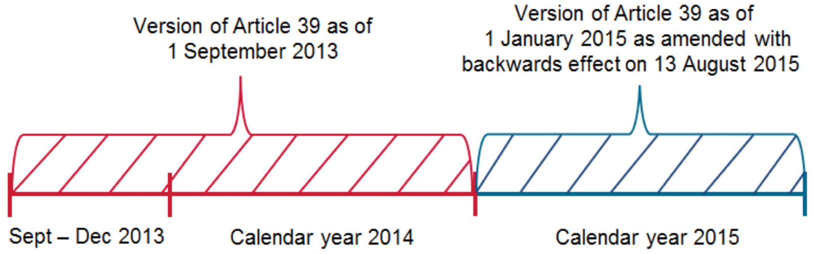
Ukraine

The Variations in the List of Controlled Transactions in Ukraine

Comprehensive transfer pricing ("TP") rules, which were implemented for the first time in Ukraine in September 2013, have already been subject to several significant amendments. Due to these amendments, the list of transactions that a taxpayer shall report and document varies depending on the version of Article 39 of the Tax Code applicable through the period of transactions. In addition to the versions of the Tax Code, a taxpayer shall pay attention to the version of the list of "low-tax" states as periodically adopted and changed by the Cabinet of Ministers of Ukraine ("CMU"), which adds complexity to the issue.

Currently, the definition of controlled transactions in the Tax Code varies depending on the period as follows:



The version of Article 39 of the Tax Code effective within the period from September 1, 2013 to January 1, 2015 requires that the following transactions are to be deemed controlled for TP purposes:

- → Transactions with related non-resident companies;
- → Transactions with related resident companies, when such related residents either:
  - declared a tax loss for the previous year;
  - applied special tax regimes at the beginning of the year;
  - paid profit tax and/or value-added tax ("VAT") at a rate different from the basic one; or
  - did not pay a profit tax or VAT at the beginning of the reporting year;
- → Transactions with non-resident companies, registered in the "low-tax" states included in the list, adopted by the CMU.

The value threshold that gave rise to TP control was as follows: the annual aggregate value of the transactions should be greater than or equal to UAH 50 million with each of the parties. This definition has since been amended, taking effect January 1, 2015. Therefore,

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taxpayers should have reported and documented the transactions that occurred before January 1, 2015 following the above rules.

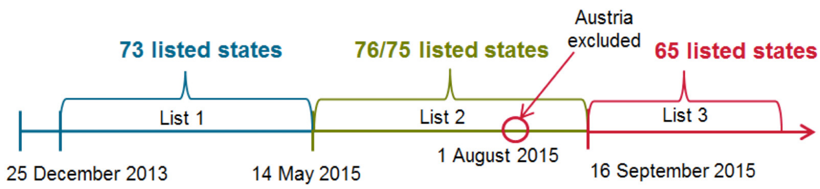
Article 39 of the Tax Code, in the version effective January 1, 2015, excludes local transactions between Ukrainian legal entities and natural persons from TP control, and defines the following transactions as controlled:

- Transactions with related non-resident companies;
- Sale of goods through non-residents acting as commission agents; and
- Transactions with non-resident companies, registered in the "low-tax" states listed by the CMU.

The special new rules target the structures with independent intermediaries. Namely, the transactions may be deemed controlled if the title to the goods, before finally passing to a related party, is first transferred to one or more non-related entities, which act as intermediaries. This rule establishes that tax officers may disregard intermediaries in such structures if such intermediaries (1) do not perform any significant functions; (2) do not use significant assets; and (3) do not bear significant risks in a transaction between related parties.

The new value threshold for recognizing transactions as "controlled" is lower compared to the previous threshold. Namely, the transactions according to the above list will be controlled if (1) annual income of a taxpayer from any sources exceeds UAH 50 million and (2) annual value of such transactions with one counterparty exceeds UAH 5 million.

Apart from the rules of the Tax Code, a taxpayer must also pay attention to the version of the list of "low-tax" states applicable with respect to the transaction. Thus, there were already three versions of the list. The versions of the list are described as follows:



To conclude, Ukrainian legislators have made the complex matter of TP even more complex with numerous amendments to the rules. Even the basic question of identifying controlled transactions requires a careful identification of the applicable set of rules.

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United Kingdom

Tax and transfer pricing update on interest deductibility

Under the Base Erosion and Profit Shifting ('BEPS') programme, the use of interest expense has been identified as an area with significant opportunities for base erosion by multinational corporations.

The OECD paper on Action 4: Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, introduces a "best practice approach" on interest deductibility to address BEPS related risks; it includes the following elements:

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- a core "fixed ratio" rule, that would allow entities to claim interest deductions on all debt, including third party debt, up to a fixed percentage of EBITDA i.e. a ratio in the range of 10% - 30% of net interest: EBITDA;
- Additional optional measures that would include "group ratio" rules based on net third party interest expense or different group ratio rules, such as the "equity escape" rule, that would compare an entity's level of equity and assets to those held by its group, carry forward/back provisions, a de minimis threshold to remove low risk entities and other targeted rules.

It is important to note that a number of operational aspects in relation to the group ratio rules are yet to be determined in 2016. It is further acknowledged that additional work is required in a number of other areas including loss making entities, rules to limit interest deductions for operations in the banking and insurance sectors and transfer pricing rules for financial transactions; this work will be carried out during 2016 and 2017.

In addition, the OECD paper on Action 4 recommends that the best practice approach should apply to all financial payments economically equivalent to interest, such as guarantee and arrangement fees, interest on convertible and zero coupon bonds, forex gains/losses on borrowings and finance lease costs.

Who will be affected?

Subject to a de minimis threshold, the rules would potentially affect a wide range of entities, with the focus on multinational groups and the option for the rules to apply to domestic groups and/or standalone entities. The OECD paper on Action 4 recognises the need for transitional arrangements and suggests that countries would give entities reasonable time to restructure existing financing arrangements before the rules come into effect.

Conclusions

The OECD paper on Action 4 aims to provide a straightforward and coherent approach to interest deductibility practices worldwide. Whilst the recommendations have the general support of the OECD and G20 countries, they need to be legislated domestically. Given that the approach is not mandatory and has within it a number of optional elements, we are likely to see significant variances between how countries choose to adopt these measures.

UK update

On Thursday 22 October 2015, HM Treasury published an open consultation in relation to the OECD paper on Action 4. The UK government recognises that the new rules, as set out in the OECD paper on Action 4, are an appropriate response to BEPS issues; therefore, the UK government is reviewing the rules on interest deductibility in light of the recommendations made in the OECD paper and is seeking views from stakeholders on how to address BEPS issues involving interest deductibility in the UK.

The consultation provides 18 targeted questions and interested parties are invited to provide their responses by 14 January 2016.The HM Treasury consultation suggests that if new rules are introduced in the UK, it is unlikely this would be before 1 April 2017, allowing sufficient time for businesses to adapt to the new rules.

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About WTS

WTS International is a global network of selected consulting firms represented in about 100 countries worldwide. The WTS network includes experienced transfer pricing specialists and international tax professionals in various countries and provides our multinational clients with global resources and transfer pricing expertise. The WTS Global Transfer Pricing Team has extensive experience in structuring and documenting intercompany transactions on a global level. Our highest aim is to provide best possible transfer pricing solutions which are line with your company's global tax strategy and operational model so that you can focus on your core business objectives.

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