Briefing

Quarterly transfer pricing update: Autumn 2016

Speed read

An Indian High Court ruling confirms the importance of the underlying economic fact base when considering the arm's length principle. The EC's final decision on fiscal state aid concerning Apple shows it has moved away from transfer pricing and related-party considerations, and towards structural and anti-avoidance considerations, based on the economic reality underlying the transaction. Russia has outlined proposed regulations for country by country reporting and documentation requirements that will take effect from next year. A ruling in Canada illustrates the importance of documenting the rationale for particular corporate structures (including the intended and actual interaction between affiliates). And the IRS releases the final section 385 regulations on the treatment of debt.

Shiv Mahalingham
Duff & Phelps
Shiv Mahalingham is managing director, transfer pricing at Duff & Phelps European transfer pricing team. He assists clients to manage transfer pricing issues in line with the commercial needs of the business. Email: shiv.mahalingham@duffandphelps.com; tel: 07787 433 275.

This update sets out a summary of key changes to international transfer pricing guidance, regulations and case law that have occurred in the past few months. The major changes relate to judgments in different corners of the world, all reaffirming the importance of the economic reality underpinning transactions when assessing international transfer pricing structures.

Indian High Court ruling

On 8 August 2016, in *Commissioner of Income Tax v M/s Merck Ltd* [2016-LL-0809-53], the Mumbai High Court confirmed some important transfer pricing principles in favour of the pharmaceutical group Merck:

- Predatory (i.e. sub-market) pricing as an economic strategy does not in itself render pricing non-arm's length. (It was also noted that the interaction between domestic transfer pricing and customs regulations should be considered in such circumstances.)
- Non usage/deployment of services that are available to an entity does not in itself render pricing non-arm's length, especially where some (but not all) services are used/deployed.
- Despite the many criticisms of benchmarking transactions, such an exercise should be undertaken, with reference to the services that are actually used/deployed.

Recommended actions

The ruling is an important one for all multinational groups operating in India (not just pharma), as it confirms the importance of the underlying economic fact base when considering the arm's length principle. There have been a number of instances in which groups have accepted judgments that may conflict with their own understanding or analysis of transfer pricing economics. This ruling should bolster confidence that a transfer pricing policy based on strong economic arguments should be respected. The judgment is also a reminder that attempting to benchmark transactions is still an important exercise, even if no suitable comparables are found, before moving on to a distinct or more complex method.

India also announced in September 2016 that a total of 103 advance pricing agreements have been finalised, of which 99 are unilateral. However, it is our experience that more favourable transfer pricing agreements can be negotiated in the tribunal stage, as opposed to advance pricing agreement stage (subject to the specific facts in each case).

EC state aid decision published on Apple

On 31 August 2016, the EC set out the final decision on this case, moving away from transfer pricing/related party considerations and towards structural/anti-avoidance considerations, based on the economic reality underlying the transaction. This was most likely in response to fierce international criticism from businesses and government treasury departments (including the US and Ireland) that the EC was creating its own version of the arm's length principle.

Recommended actions

There has been a significant tail off in advance pricing agreement applications in Europe, due to the uncertainty being created by the EC ruling and the concern that even a formal transfer pricing ruling may be construed to be illegal state aid. In the modern 'exchange of information' climate, we have witnessed that tax authorities are keen to enter into multilateral agreements, rather than unilateral. However, this needs to be revisited and rethought; otherwise, the advance pricing agreement process will continue to decline in popularity as a tool for compliance and risk management.

There has been a significant tail off in advance pricing agreement applications in Europe, due to the uncertainty being created by the EC ruling [on Apple]

Russia adopts CBCR and master/local filing for documentation

On 15 September 2016, Russia outlined proposed regulations for country by country reporting (CBCR) and documentation requirements that will take effect from 1 January 2017. These will have the following similarities with other regimes:

- International companies with annual revenues of $750m must report: taxable profits and taxes paid by country, plus revenues including transactions with related parties; accrued corporate income tax for the current year; equity capital; undistributed earnings; head count; tangible assets; and information about

every international group member, including main activity and country of residence.
- Information will be exchanged under the OECD's common reporting standard.
- Country by country reports should be submitted by the parent company of the international group (or by an authorised Russian tax resident member of the group) within 12 months of the end of the financial year.

There are also some additional items proposed:
- Foreign competent authorities will be able to participate in transfer pricing audits upon request. Also, financial organisations (and their clients) must adhere to specific duties and rights in connection with automatic exchanges of information.
- Companies with consolidated annual revenues of $750m must notify the tax authorities about their participation in international groups within three months of the last day of the financial year.
- Failure to notify the authorities or to submit a report, or providing false information, will incur fines of 50,000 rubles ($800) to 500,000 rubles ($8,000). There will be a grandfathering period in 2017 to 2019 during which the penalties will not apply.

In addition, it is confirmed that:
- The transfer pricing master file (and local file) must be submitted within three months of a request from the tax authorities or if requested by a foreign country's competent authorities.
- A parent company of an international group (or an authorised member of the group) would be entitled to submit a master file if they are tax resident in Russia.
- In alignment with OECD recommendations, the master file should include: the group structure, list of entities and countries in which the group operates; group activity, including a description of activities that form more than 5% of revenues; intangible assets; intra-group financial activities; and other aspects, i.e. existing advance pricing agreements, tax rulings and cost/revenue sharing agreements.

The local file should include business activities, related-party transactions (and terms), revenue/expenses, the choice of pricing methods and local financial information.

Recommended actions

It is generally advisable that you prepare your Russian transfer pricing documentation where operations are material.

Tax court of Canada assesses sham transactions in transfer pricing

On 5 October 2016, in *Cameco Corp v The Queen*, Cameco set out an appeal to the Tax Court of Canada, relating to whether or not a 1999 reorganisation creating a Swiss subsidiary was a sham and breached domestic transfer pricing regulations. One key point in addition to whether the intra-group sales were at arm's length is whether the interposition of a Swiss entity was necessary and/or artificial.

The Canadian Authorities have (historically) argued that the reorganisation was a tax avoidance sham and that the transactions should be recharacterised (effectively all of the Swiss affiliate's profits would be assigned to the Canadian entity). The government's opening argument maintained that Cameco is fully entitled to incorporate a foreign subsidiary and move some or all aspects of its business out of Canada to a low-tax jurisdiction, but that its actions didn't adhere to requirements to respect the arm's length principle.

On the face of the transactions, the Swiss entity bought uranium from Cameco Canada (and third parties) and resold it to third party utilities companies. However, it was argued that the Swiss entity did not undertake the necessary economic activity relating to the transactions.

Many readers will be familiar with the concepts here of legal versus economic ownership, but it will be interesting to see how this case turns out in the post-BEPS world.

Recommended actions

Most groups are not involved in transactions/implementing structures without strong commercial rationale. However, it is still important to ensure that the underlying rationale for particular structures is documented (including the intended and actual interaction between affiliates).

IRS releases final section 385 regulations on the treatment of debt

On 14 October 2016, the IRS released final section 385 regulations of the Internal Revenue Code. Whilst these are narrower in scope than the proposed regulations (and extend the effective date of the documentation requirements), most groups with US operations will be faced with a material change in how they treat inter-company debt.

The final regulations eliminate the initial '30-day timely preparation requirement', and instead require documentation to be prepared contemporaneously to the taxpayer's filing of its federal income tax return for instruments issued on or after 1 January 2018.

Recommended actions

Taxpayers should analyse current inter-company debt in alignment with existing transfer pricing policies to determine whether any material exposure exists and ensure that documentation meets the minimum standards ('high degree of compliance') and is prepared in a timely manner.

What to look out

In the UK Autumn Statement on 23 November 2016, expect to see an announcement of the new Cabinet's policy on tax avoidance, as HMRC has already started to issue diverted profits tax preliminary notices to a number of groups relating to transactions lacking economic substance.

This is a clear theme that is starting to emerge in the international transfer pricing arena. ■

For related reading visit www.taxjournal.com

- Ten questions on the Apple state aid decision (Dominic Robertson & Isabel Taylor, 6.9.16)
- Tax rulings and state aid (Conor Quigley QC, 6.10.16)
- Country by country reporting: practical issues (Julie Hughff & Andy Baillie, 6.10.16)
- Quarterly transfer pricing briefing: Summer 2016 (Shiv Mahalingham, 4.8.16)