Briefing

Transfer pricing: quarterly review of developments

Speed read

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 changes are dominated by the final BEPS reports for transfer pricing Actions 8, 9 and 10; however, some important legislative changes should also be considered. There has also been a landmark ruling in Australia in relation to the value of an explicit loan guarantee versus implicit value (with some important extensions to the 2009 GE case principles, despite this case not being mentioned in the ruling).

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BEPS changes to the OECD Transfer Pricing Guidelines

On 5 October 2015, OECD Working Party 6 released final reports for BEPS Actions 8, 9 and 10 (ensuring that transfer pricing outcomes are in line with value creation). Changes will be adopted to *Chapters 1, 2, 6, 7 and 8 of the OECD Transfer Pricing Guidelines.*

There is now a helpful framework for the treatment of risk allocation, and a six step process has been set out in the OECD guidance looking at:

- the nature and sources of risk;
- how risks are allocated to contractual arrangements;
- the potential impact of the arrangements;
- how each is risk managed;
- whether the party assuming risk performs the operational activities, manages the risk, and assesses, monitors and directs risk mitigation; and
- the actual transactions and contractual arrangements.

Contracts are the starting point for the assumption of risk and parties assuming risk must have control and the financial capacity to bear the risk.

Other key changes are as follows:

- It is confirmed that instances of recharacterisation of a transaction should be rare.
- 'Special measures' that would in certain instances have overridden or replaced the application of the arm's length principle have been scrapped after significant consultation and discussion with multinational groups.
- The 'moral hazard' framework has also been scrapped, as this was likely to cause outcomes that were contrary to the arm's length principle in practice.
- The guidance on hard to value intangibles permits tax administrations to apply a behavioural standard. There is also an exemption for 'unforeseeable events' to include situations in which there is a difference between actual and expected outcomes, where assumptions were reasonable at the time of the transaction.
- The guidance on risk and hard to value intangibles has relevance for cost contribution participants assuming risk, exercising conduct, possessing financial capability to bear risk and where actual/expected outcomes diverge.
- The final release of Chapter 10 of the OECD Guidance includes some changes to the low value adding services sections, including a revisal of the recommended range to 5% (from 2%–5%) and a confirmation that the excluded services are not necessarily 'high value' but will require a fact based review and consideration. Support was also provided for a de minimis threshold, above which the simplified approach could not be applied.

Recommended actions:

- Update the functional interview templates to take account of the new guidance and specific processes around risk and control.
- Undertake a review of existing intra-group contracts to ensure that they are clear and reflect conduct/actual performance.
- Assess the stand-alone financial capability of 'risk owners' in the group. Note that capability in isolation is not sufficient to demonstrate control without conduct/actual performance.
- Consider the administrative savings/ease of adopting a separate policy for low value services.

Changes to transfer pricing legislation – US

On 14 September 2015, the US treasury released proposed revisions to guidance governing the pricing of intangible transfers. These revisions are intended to prevent certain behaviours that the IRS perceived as being abusive. The proposed section 367 (IRC) changes (if enacted) and temporary section 482 (IRC) changes would together have the effect of making substantially all intangibles subject to gain recognition by:

- limiting the application of the active trade/business exception to a shortlist of assets which are largely tangible assets or financial assets; and
- eliminating the exception for foreign goodwill and going concern.

The changes would require aggregation of transactions more broadly than the existing regulations for transfer pricing purposes; and eliminate the potential to disaggregate interrelated transactions because they are subject to different code sections given the nature of the transfer. They would also broaden the definition of useful life and eliminate the 20 year ceiling in the current regulations.

Recommended actions: The changes (if enacted) will require an initial risk assessment review for transactions occurring on or after 14 September 2015. The changes relate in the main to transfers of intangible property. In practice, however, many assets may not be caught; for example, assets with a useful economic life exceeding 20 years are rare in practice, despite the IRS having long favoured the concept of an infinite life/no decay for certain types of intangible asset generated in the US.

Changes to transfer pricing legislation – China

The September 2015 draft revision to China's transfer pricing circular has created the requirement for groups operating in China to establish and demonstrate how much value their operations in China bring to the group's global value. This value creation method is consistent with recent changes to the OECD transfer pricing guidance discussed earlier in this article (allocating profits among related group entities by assessing contribution to value creation). There are also some specific allocation items discussed in the circular, including assets, costs, revenue and employee numbers.

Recommended actions: The changes are in line with the approach of the China Tax Administration to transfer pricing audits in recent years. They are also in line with the revised master file recommendations of the OECD, whereby a value chain approach has been recommended to support transfer pricing compliance. As such, the changes are not going to shock too many multinational groups, despite a good degree of sabre rattling from certain quarters. The changes present an opportunity for groups to begin to align general OECD guidance with specific legislative requirements in key operating territories. We have witnessed that a number of groups have already commenced the process of taking the general OECD value chain guidance and applying it to the specific regulations set out in the circular.

Changes to transfer pricing legislation – Russia

On 21 October 2015, the Russian Ministry of Finance prepared a transfer pricing bill that broadened the definition of 'related party' to apply transfer pricing legislation to a group created by a fund (or trust). There has also been a helpful increase in the thresholds for cross-border related party transactions to 60 million Russian rubles (US$1m) and 2 billion rubles (US$30 million) for certain domestic transactions.

Recommended actions: The changes may be helpful to smaller businesses with less material transactions; however, they will not impact large groups that are above the thresholds. The broadening of the related party definition is consistent with definitions in other locations, including the UK, and will be familiar to many of the impacted groups.

Changes to transfer pricing legislation – India

On 19 October 2015, India's Central Board of Direct Taxes (CBDT) issued new legislation, reducing the number of comparables required from nine to six and broadening the range of data points to be used in calculating an arm's length price. These changes were made in an attempt to clarify subjective areas that have resulted in disputes between taxpayers and the tax authorities, and to align India's rules with international practices.

Recommended actions: The arbitrary requirement for a set number of comparables has in the past weakened the quality of the comparable set, which has led to the reduction to six. The changes to the specific data points to be applied may also help to minimise certain disputes and local compliance studies should take this into consideration effective immediately.

Landmark international transfer pricing cases – Chevron

In *Chevron Australia Holdings Pty Ltd v Commissioner of Taxation (No. 4)* [2015] FCA 1092, an Australian transfer pricing ruling provided guidance on what constitutes 'fair loan terms' among related parties – in this instance, a USD$2.5bn credit facility from a US entity to an Australian entity. The arrangement permitted the US entity to raise funds at a low rate, due in part to an explicit guarantee from the ultimate holding company of both the US and Australian entities, and lend to the Australian entity at a higher rate of interest. Central to the argument was the fact that a similar loan between independent entities would ordinarily have involved the provision of security and/or covenants (which would have resulted in the lower interest rate).

Despite no explicit guarantee being in place, the judge considered whether an independent lender would have taken into account the 'implicit support' of a parent to a subsidiary, with the following points being noted from expert witnesses:

Members of G20 and OECD

Argentina	G20
Australia	G20 and OECD
Belgium	OECD
Brazil	G20
Canada	G20 and OECD
Chile	OECD
China	G20
Czech Republic	OECD
Denmark	OECD
Estonia	OECD
Finland	OECD
France	G20 and OECD
Germany	G20 and OECD
Greece	OECD
Hungary	OECD
Iceland	OECD
Ireland	OECD
India	G20
Indonesia	G20
Israel	G20
Italy	G20 and OECD
Japan	G20 and OECD
Korea	G20 and OECD
Luxembourg	OECD
Mexico	G20 and OECD
Netherlands	OECD
New Zealand	OECD
Norway	OECD
Poland	OECD
Portugal	OECD
Slovak Republic	OECD
Slovenia	OECD
Spain	OECD
Sweden	OECD
Switzerland	OECD
Russia	G20
Saudi Arabia	G20
South Africa	G20
Turkey	G20 and OECD
UK	G20 and OECD
United States	G20 and OECD

- In the absence of a legally binding parental guarantee, implicit credit support was found to have 'little, if any' impact on pricing by a lender in the real world.
- One of the key reasons that agency ratings are not solely relied upon by banks when risk rating credits is precisely because they may improperly give allowance for implicit support.
- A subsidiary entity would only receive one notch of uplift to reflect implicit support (based on not having witnessed in practice an increase of three or more notches upon a stand-alone rating of a non-guaranteed, non-core

subsidiary of a multinational).

- The above 'one notch argument' may have additional relevance, if that notch took the rating from investment to non-investment grade.
- The exact notching methods employed by the rating agencies may not be applied with reliance instead placed upon internal credit risk framework analysis with no market evidence that a lender would provide a lower interest rate to a borrower for the notched rating (i.e. no market evidence of any potential economic benefit for notching).

Recommended actions: In Canada, *GE Capital Canada Inc. v Her Majesty the Queen* 2009 TTC 563 demonstrated the ability of a transfer pricing ruling in one jurisdiction to reach across jurisdictions and materialise in dispute resolution discussions, particularly with respect to the economic analysis discussed as part of the case. The *Chevron* case (which included some difference of opinion from economic experts in relation to interest rate pricing) is therefore likely to be analysed and applied by tax inspectors in other jurisdictions. Groups with similar structures should review this case for relevance.

What to look out for in the next few months

Consultation on transactional profits split methods will continue in 2016 and this is expected to be finalised in 2017.

In addition, over 60 jurisdictions have announced commitments to adopt country by country reporting for fiscal periods beginning on or after 1 January 2016. (These are members of the OECD and G20 (see table below); also the EU territories not listed under separate G20/OECD membership are part of the G20, taking the number of jurisdictions reaching agreement to over 60.)

The next few months should see the release of specific legislation in relevant jurisdictions (for example, the Irish Finance Bill) setting out exactly how the country by country filing requirement will operate in practice in that jurisdiction.

Planning ahead: Groups that have a ParentCo in one of the jurisdictions listed in the table (on page 17) should look at populating a dry run of the country by country reporting template for 2015 financials. Groups that have a ParentCo in another jurisdiction (not listed below) should look at the next location down in the group's structure to ensure that any 'surrogate' parent obligations are adhered to. ■

For related reading visit www.taxjournal.com

- Transfer pricing documentation and country by country reporting (Tom McFarlane, 30.10.15)
- Transfer pricing of intra-group management services (Martin Zetter, 30.10.15)

Comment

HMRC's office closures

There is logic behind the closure of HMRC's regional offices, but the move raises significant concerns too.

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On 12 November, HMRC announced a further step in its ten year modernisation programme. A further 137 offices will close, leaving HMRC's operations centred on 13 regional hubs. HMRC says that this will 'bring staff together in more modern and cost-effective buildings in areas with lower rents' and enable it 'to give customers the modern services they now expect at a lower cost to the taxpayer.'

I can see the logic in moving to a smaller number of better equipped hubs; I can also see the potential benefits in moving to an increasingly digital world, but some things concern me about the announcement.

Firstly, I am concerned that we will see yet more experienced people leaving HMRC because of the closures. HMRC will need to put even greater emphasis on training and skills to replace the knowledge and experience being lost.

Secondly, I am concerned – and I say this as someone who has actively championed digital tax administration in this country from, literally, the day that process began – that too much is perhaps being expected of digital transformation. Digital tax accounts, digital channels of communication and intelligent use of big data undeniably hold huge potential, but they are only part of the answer. HMRC still has to raise its game on basic customer service, especially call centre performance and post handling and will need to maintain a clear focus on those areas for years to come. It also needs to commit to some clear and specific performance measures that reflect taxpayers' legitimate expectations of good service when they call or write.

Thirdly, I winced when I read the claim made in the press release that the ten year modernisation programme, now at its half way point, had amongst other achievements 'already resulted in over 80% of people filing their self-assessment returns online'. Electronic filing is certainly a success story for HMRC but SA online filing had already reached a very impressive level before the modernisation programme and is not a result of it. HMRC's *2010/11 Annual Report* said that it was even then achieving a very impressive 78%. It achieved 80% the following year.

I do not envy HMRC's leadership. The task they face has become more difficult with every year that has passed since HMRC was formed. They have consistently been asked to do more and more with less and less. I remain firmly of the view that HMRC is under resourced and I do not believe that we will see service standards return to the levels taxpayers expect unless and until that is addressed. Tax administration in the UK can certainly be made more efficient. I accept that a part of that process is going to be more centralisation and an increasing reliance on digital channels, but a key lesson to be borne in mind during this next phase of the modernisation programme is that headcount should only be reduced when new processes and infrastructure – physical or digital – have proved themselves, not in anticipation of gains that may prove rather more elusive than expected.

This next phase of the modernisation programme will need extremely careful management. I would like to think that in five years' time HMRC could look forward to a period of stability. Experience, however, suggests that might be a forlorn hope. Constant change is, I fear, now an inevitable part of the tax landscape. ■