

DFK International Transfer Pricing Newsletter

April 2011

Introduction

Welcome to the first DFK International Transfer Pricing Group quarterly newsletter covering the following:

- UK Transfer Pricing Requirements by Fiona Cross
- US Transfer Pricing Update by Charles Edge
- Irish Transfer Pricing Summary by Denis O'Frighil
- Dutch Transfer Pricing Summary by Maarten Arts

UK Transfer Pricing Requirements

By Fiona Cross, Chantrey Vellacott DFK, Chair of DFK International Transfer Pricing Group

Background

HM Revenue & Customs (HMRC) adhere in general to the OECD Transfer Pricing Guidelines and apply the arm's length standard. Specific transfer pricing rules exist under domestic law.

HMRC's new approach to transfer pricing work

Large Businesses in the UK identified that a major concern for them was the impact of transfer pricing enquiries on their business.

As a result two years ago the UK Tax Authorities, HM Revenue & Customs (HMRC), set up a new Business International division, responsible for global tax. Transfer pricing specialists have been appointed in the Business International Division, which has signalled an intention to take a harder line in the UK on multinationals transfer pricing.

This was evidenced by AstraZeneca settling on £505m for its transfer pricing dispute with HMRC in 2010.

Who does UK transfer pricing affect?

Generally, the UK transfer pricing legislation only applies to businesses of a certain size as follows:

- Large businesses – defined as those with (i) total worldwide group employees >250 or (ii) total worldwide group turnover of > €50m and total worldwide group balance sheet >€43m.
- Medium sized businesses – not large or small, applies only if so directed by HMRC with notice, going forward

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Small businesses are fully exempt (defined as < 50 worldwide group employees AND total worldwide group turnover or balance sheet <€10m).

It also affects all UK companies regardless of size transacting with related parties in countries without a suitable double tax treaty (broadly tax haven countries).

In determining whether the aforementioned tests are met there is a need to consider all partnerships and linked entities and not just subsidiaries.

What does HMRC require?

UK companies caught under the UK transfer pricing regulations are required to include in their Self Assessment Tax Returns additional taxable income where an “arm’s length price” has not been charged. An “arm’s length price” is one that would result from the transfer of the same goods/services etc between two unrelated entities in similar circumstances.

It applies to a very wide range of transactions, including:-

- The purchase and sale of goods
- The provision of management and other services
- Rents and hire charges
- Transfers of intangible property, such as trademarks, patents, royalties and know how
- Showing of expertise, business contacts, supply systems etc
- Provision of finance and other financial arrangements

The purpose of the legislation is to counter any corporation tax advantage generated by non-arm's length pricing and it takes no account of whether the setting of the original transfer prices has been tax motivated.

The UK transfer pricing legislation applies in certain situations (see below) where there is a transaction between two connected persons and one person controls or participates in the other or both are controlled by a third party. The control person (or persons) must be a body corporate or a partnership although the controlling party could be an individual.

The control provisions deem a 40% participant in a joint venture to control that joint venture. A joint venture, for these purposes, is a company or partnership which is controlled by two persons, each of whom has at least a 40% interest in the venture.

Adequate documentation is required to demonstrate arm's length pricing (see below).



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What transactions does it affect?

The UK transfer pricing legislation applies to UK to UK transactions as well as those overseas.

What documentation should be kept?

There is no set rules on what transfer pricing documentation should be kept; there is only HMRC guidance which has no statutory authority. However “inadequate” documentation can lead to penalties (see below).

Recommended documentation includes:

- Description of related party transactions.
- Functional analysis – i.e. functions performed, assets deployed and risks borne.
- Chosen method for testing arm’s length nature of transfer price.
- Economic analysis/benchmarking.
- Inter-company agreements.

Recommended timing for documentation preparation

The transfer pricing documentation should be prepared at the latest by the time the relevant tax return is filed. However, earlier is preferred to allow for the price applied to be arm’s length.

Penalties for inadequate documentation

Penalties

HMRC can levy a penalty of up to 100% of the “potential lost revenue” i.e. in the context of transfer pricing broadly the additional tax which becomes due as a result of HMRC successfully arguing that additional taxable profit should fall in the UK company due to incorrect transfer pricing.

HMRC transfer pricing enquiries

With increasing pressure to increase the UK tax revenues, HMRC are raising many more transfer pricing enquiries and we can expect even more going forward.



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US TRANSFER PRICING UPDATE

By Charles Edge, Bennett Thrasher PC

Tax authorities around the world are increasingly looking to transfer pricing audits to boost tax revenues and protect the tax base. In the US, new disclosure requirements coming into effect for tax years beginning in 2010 will make it easier for the IRS to identify targets for transfer pricing audits while IRS restructuring and congressional and media attention to transfer pricing issues will result in additional resources being directed at transfer pricing examinations:

Reporting Requirement for Uncertain Tax Positions

In early 2010 the IRS announced the release of a new schedule to be used for the reporting of uncertain tax positions (UTP) by all taxpayers with assets greater to or equal to \$10 million. The filing requirement applies to corporations only, and is to be phased in over a five year period under which taxpayers with assets of \$100 million or greater are required to file beginning in 2010, taxpayers with assets of \$50 million or more are required to file beginning in 2012 and taxpayers with assets of \$10 million or more are to begin filing in 2014.

Disclosure of a UTP is required if the taxpayer or a related entity has recorded a reserve for US federal income tax with respect to the position in audited financial statements, regardless of whether the financial statements are prepared based on US GAAP, IFRS or other country-specific accounting standards. Taxpayers are not required to disclose the amount of the reserve recorded for a particular position; however each position must be given a rank in order of size of the reserve.

The new schedule is intended to help the IRS increase audit efficiency by reducing the time it takes to uncover significant issues and also to help the IRS prioritize the selection of taxpayers for examination.

Of particular concern to taxpayers with cross border transactions, the form requires specific identification of any item that relates to transfer pricing. All other positions are placed in an "other" category.

With a road map to transfer pricing issues now provided to the IRS, we anticipate a significant increase in transfer pricing audit activity in the coming years, as well as an expedited audit selection process.

U.S. Ways and Means Committee Hearings on Transfer Pricing Proposals

In July 2010, the Ways and Means Committee of the US House of Representatives held hearings focused on the shifting of income from the U.S. to low-tax jurisdictions. The hearings related to transfer pricing proposals contained within the Obama Administration's fiscal year 2011 budget which focus on the transfer of U.S. intellectual property to foreign affiliates.



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In advance of the hearings the Joint Committee on Taxation (JCT) released a 132-page report which referenced several studies showing how multinational enterprises shift income to low-tax jurisdictions through the transfer of intellectual property. The report also included six case studies where the US multinational companies each had an average effective tax rate on worldwide income of less than 25 percent during at least one multi-year period since 1999 despite the fact that in each case the company "performed a significant portion of the product development, product specification, manufacturing process development, development of customer relationship, and the creation of other valuable intangible property in the United States, but the rights to exploit the intangible property are either transferred or licensed by an affiliate in a low-tax jurisdiction."

Witnesses testified that there was significant evidence of "substantial income shifting through transfer pricing" and that "with greater resources the IRS could undoubtedly do an even better job of enforcing our transfer pricing rules."

Restructuring at the IRS

Effective October 1, 2010, the IRS reorganized its Large and Mid-Size Business (LMSB) division and renamed it to the Large Business and International (LB&I) division. The LB&I division will include a new international unit with a dedicated transfer pricing director and a chief economist to better coordinate IRS positions on transfer pricing and other international tax issues. The reorganization will centralize the IRS' transfer pricing and related expertise which had previously been split along industry and geographic lines.

Total employees in the international unit will increase by approximately 900, with a significant increase in the number of economists who will focus on transfer pricing and valuation issues. The restructuring and new hiring is consistent with the emphasis on international issues at the IRS and will provide the IRS with the resources and know how to significantly expand its focus on transfer pricing issues.

Outlook for 2011 and beyond:

Recent US media attention to the global tax strategies of multinationals such as Google and others has taken the term "transfer pricing" out of obscurity and thrust it into the public and political spotlight. As a result we expect recent efforts directed at improving the ability of the IRS to identify and successfully challenge transfer pricing positions to continue.

While all aspects of transfer pricing are fair game for review and potential adjustment, transactions involving intangible assets will increasingly attract the attention of auditors in the US and worldwide. Accordingly, taxpayers must be well prepared to defend the valuation of intangible assets as well as the business purpose for restructurings that result in the movement of any assets to low tax jurisdictions.



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In the US, as in many other countries, transfer pricing documentation in the form of a transfer pricing study is essential to defending policies and practices and for providing protection from penalty assessment in the event of an audit. With a shorter time frame between the filing of a tax return and audit selection, taxpayers should be sure to have the documentation completed at the time the tax annual return is filed.

IRISH TRANSFER PRICING SUMMARY

By Denis O'Frighil, Crowleys DFK

The Irish Revenue Commissioners introduced formal transfer pricing legislation for accounting periods commencing on or after 1 January 2011 in relation to transactions based on terms agreed on or after 1 July 2010.

The legislation sets out specific Revenue treatment and expectations of transfer pricing and the related paperwork. Previously, Revenue had relied on general Irish tax legislation regarding tax deductible expenses and the provisions of the various double tax agreements and tax information exchange agreements.

Transfer pricing documentation and a potential re-calculation of profits or losses is required in the following circumstances:

Where a transaction takes place between two associated persons and one or both of the persons is within the charge to tax in Ireland in respect of the profits or gains or losses relating to the transaction **and** the actual pricing of the transaction differs from the pricing that would have been agreed at arm's length, **and** the actual pricing results in the taxable trading income of one of the persons being less than it would have been had arm's length pricing been used.

In these circumstances the results are adjusted to reflect adjustment to arm's length pricing.

Irish tax returns are filed on a self-assessment basis. There is a requirement to retain and/or provide access to certain documentation so that Revenue can audit or examine the arms length basis of the transactions.

The legislative requirement is that a company have transfer pricing documentation available. There is no requirement for documentation to be kept in a standard form. The legislation does not require that the company itself must prepare the documentation or that the documentation must be in the State. If appropriate documentation is available, for example where it has been prepared by an associated company for tax purposes in another jurisdiction, it will be sufficient that that documentation can be made available to the Revenue.



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The Revenue expects that the records retained will be in line with the guidelines of either of EU Transfer Pricing Documentation guidelines and OECD Transfer Pricing guidelines.

The expected level of documentation should identify:

- associated persons for the purposes of the legislation;
- the nature and terms of transactions within the scope of the legislation. Transactions which are repetitive (e.g. regular purchases made by a distributor throughout a period of the same or similar products for resale) may be aggregated, provided any significant changes during the period in the nature or terms of the transactions are recorded;
- the method or methods by which the pricing of transactions were arrived at,
- how that method has resulted in arm's length pricing etc. or, where it has not, what computational adjustment was required and how this has been calculated.
- any budgets, forecasts or other papers containing information relied on in arriving at arm's length terms etc. or in calculating any adjustment made in order to satisfy the requirements of the new transfer pricing legislation;
- the terms of relevant transactions with both third parties and associates.

The Revenue also expects that transfer prices and related documentation should be reviewed at regular intervals to determine whether the pricing remains arm's length.

The documentation should be prepared at the time the terms of the transaction are agreed. This will enable timely completion of tax returns and review of transfer prices if necessary. The level of documentation required to be kept is quite detailed, however many companies will have prepared this documentation on an ongoing basis anyway for their local auditing and reporting requirements.

DUTCH TRANSFER PRICING SUMMARY

By Maarten Arts, Foederer DFK

As in many countries, the Dutch government demands good documentation regarding transfer pricing. Since January 2002 transfer pricing documentation has been required by law.

A company is obligated to have documentation that includes the way mutual pricing is determined and that the circumstances are the same as should be agreed between independent parties. If a company fails to do so, it has to prove otherwise. In which case the burden of proof lies with the company itself instead of the tax authorities.

In most cases the OECD guidelines are followed. The documentation has to be available up front and not afterwards. Although there are many companies that start drafting documentation after the tax authorities have asked several questions.



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The documentation can contain:

- economic research for economic ratio's of similar companies;
- intercompany agreements (for example a cost allocation agreement);
- time registration, cost statements etc.;
- a summary of economic functions and risks;
- organization chart and job descriptions;
- budgets;
- reports of shareholder meetings and board meetings.

Overall you can conclude that the documentation has to be based on clear and objective assumptions.