



DFK International Transfer Pricing Newsletter

July 2011

Introduction

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

- UK to adopt OECD 2010 Transfer Pricing Guidelines by Fiona Cross
- US Transfer Pricing – IRS Reorganizes and refocuses by Ryan Dudley
- German Taxation Rules of Cross-Border Business Restructuring by Roland Graf
- Australian Transfer Pricing Summary by Dario Gamba

UK TO ADOPT 2010 TRANSFER PRICING GUIDELINES

By Fiona Cross, Chantrey Vellacott DFK

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. Legislation will be introduced in the UK to update the definition of "transfer pricing guidelines" to refer to the OECD *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* approved by the OECD for publication in July 2010.

The change to the definition means that UK legislation will reflect the recently updated version of the internationally agreed OECD guidelines. This will provide certainty for business and will ensure that any potential for double tax is minimised.

Operative date

The measure will have effect for accounting periods beginning on or after 1 April 2011.

OECD 2010 Transfer Pricing Guidelines Main Changes

Transfer Pricing Methods

The 2010 OECD Guidelines prescribes the "most appropriate" method whereas previous OECD Guidelines referred to transactional profit methods such as the Transactional Net Margin Method (TNMM) as being a method of last resort, despite being the most commonly used method in practice. However, the Comparable Uncontrolled Price (CUP) method still remains the method of choice, if available.

**For further information,
contact:**

Fiona Cross
Chairperson
Chantrey Vellacott, UK
fcross@cvsdfk.com

Ryan Dudley
Director of Int. Tax Services
Friedman LLP
rdudley@friedmanllp.com

Roland W. Graf
Lawyer Tax Consultant
Peters Schönberger &
Partner
r.graf@psp.eu

Dario Gamba
Director – Tax
DFK Lonsdale Pty Ltd
dariog@dfklonsdale.com.au



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Additional Guidance on Comparable Analysis

The 2010 OECD Guidelines provides more guidance on the selection or rejection of comparable companies, the use of inter-quartile ranges and extreme results arising from comparable companies.

Transfer Pricing Aspects of Business Restructurings

This is dealt with in more detail in the article below by Roland Graf.

US Transfer Pricing – IRS Reorganizes & Refocuses

By Ryan Dudley, Friedman LLP

For many years, the Internal Revenue Service (“IRS”) has provided detailed regulations and guidance relating to transfer pricing and steps taxpayers should take to ensure related party transactions are priced within an arm’s length range. However, the level of enforcement has not been noticeable, except with the largest multinationals. Until recently, most tax auditors had little training or knowledge of transfer pricing and rarely focused on transfer pricing matters.

In the past two years this has changed. Transfer pricing has become a focus area within the IRS. In October 2010, the IRS reorganized the Large & Midsize Business Division and renamed it the Large Business & International Division (LB&I). LB&I included a new international unit with a dedicated transfer pricing director and a dedicated chief economist.

The IRS recruited an additional 40 economists, increasing the total number of economists by 50%, and recruited nearly 900 additional people into the international section, many of whom are focused on transfer pricing. The effect of this reorganization will be to centralize the IRS' transfer pricing expertise and provide greater enforcement capabilities for international compliance and transfer pricing matters.

This reorganization is already having noticeable effects. The number of requests by IRS agents for copies of transfer pricing studies during audits of taxpayers with international affairs has increased from 25% to 80%. We have seen this in our own practice where we have observed a clear increase in the number of Information Document Requests relating to transfer pricing studies by IRS agents during audits. At the same time, there more international agents being assigned to IRS audits.

The IRS is not alone in increasing its interest in transfer pricing and related enforcement. As countries become more desperate for revenue, especially by expanding the tax base rather than increasing the headline tax rate, corporations operating in multiple jurisdictions will face ever-increasing pressure from tax authorities to justify the allocation of revenues and expenses between jurisdictions and consequently a greater risk of being taxed in two jurisdictions on the same profits.



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This environment generates significant uncertainty about transfer pricing positions. In turn, this creates financial reporting issues as special provisions and disclosures may be required to address uncertain tax positions (UTP) (see ASC 740-10, formerly FIN 48).

In addition to financial reporting, there are also specific issues affecting tax reporting under the relatively new uncertain tax position disclosure filing in the United States, Schedule UTP. Schedule UTP has a specific transfer pricing disclosure requirement. While there has been much controversy about the level of detail that corporations need to provide, Schedule UTP requires US corporations to rank their UTPs and highlight which UTPs relate to transfer pricing. In the absence of a transfer pricing study, it is unclear how corporations completing the Schedule UTP will be able to exclude transfer pricing from being an UTP.

Currently the Schedule UTP is only required for corporations with \$100m of assets but this will be reduced to \$10m of assets in the coming years potentially impacting many US clients and US subsidiaries of clients of DFK firms.

All US entities, including subsidiaries of non-US businesses, which transact with related parties outside the United States, face increasing scrutiny and reporting obligations in the United States. With a combination of heightened IRS enforcement, stiff penalties, and potentially GAAP and US tax return reporting obligations, clients with cross border transactions should be reviewing their transfer pricing documentation to ensure it can withstand the scrutiny of the tax authorities and provide certainty to their own accountants and auditors.

German Taxation Rules of Cross-Border Business Restructurings

By Roland Graf, Peters Schönberger & Partner

In a world economy based on the division of labour, the transfer of operative functions to other countries is on the agenda of many multinational companies. The reasons may be manifold – proximity to sales markets (oftentimes as a result of customer pressure) or cost optimisation through lower wage levels or less tax and levy burdens. After the transfer, the value will be created abroad, and as a consequence taxes on potential profits generated through these functions will have to be paid outside the home country. This tax base reduction was a thorn in the side of the German lawmakers who took the corporate tax reform of 2008 as an opportunity to establish rules according to which such kind of cross-border transfer of functions are taxable.

This article provides an overview of the major tax aspects of business restructurings from the German point of view. At the international level, regulations concerning business restructurings have meanwhile been incorporated into Chapter IX of the revised 2010 OECD Guidelines which also contain certain points of the German rules.



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Definition of a business restructuring

According to the German regulations and the OECD Guidelines 2010 a business restructuring is defined as a cross-border redeployment by a multinational enterprise of functions, assets and / or risks. This expression centres around the term 'function'. Only if a function is transferred, the tax consequences, i. e. basically the determination of the so-called transfer package value, will ensue. According to the actual wording of the pertinent German regulation, a function is a business activity consisting of combined operative tasks of a similar nature. It is noteworthy that not only a (part of a) business but also any delimitable unit of a business (i. e. production of a single product) may be deemed a function. Even the deployment of one single employee with important know-how to a foreign subsidiary may lead to a transfer of function (business restructuring).

Valuation of a business restructuring

Basically, the function shifted to a foreign country has to be valued by a procedure (determination of the transfer package value) comparable to the valuation of an enterprise including discounting of anticipated future proceeds, which is set, however, to determine marginal prices (minimum price for the transferring enterprise and maximum price for the transferee enterprise). If no other value can be made credible, the function will be valued at the average of the minimum and the maximum price. From the point of view of the fiscal authorities, this is a way to compensate for lost taxable proceeds by one-time taxation. The remuneration for the value thus determined by the transferee foreign enterprise is said to be justified by the arm's length principle.

Even though the lawmakers provide for the valuation of the transfer package and its inclusion into the tax base as the rule, there are three so called escape clauses in the legal provisions which deem the complex business valuation dispensable. At the same time these clauses are meant to clearly mitigate the tax effects for the companies concerned. As a rule, the escape clauses settle for valuation of major individual intangible assets (i. e. patents, rights or customer base) transferred abroad as well as detailed documentation of these assets. In these cases the taxpayer carries a considerable obligation and burden of proof.

Irrespective of the application of the escape clauses the transferring enterprise is subject to taxation of the transferred function in Germany comparable to the fictitious sale of a (part of a) company. Therefore, the question also arises how the acquisition of the function by the transferee enterprise abroad is treated from a tax point of view. Irrespective of acceptance in the relevant country, in particular regarding valuation of this fictitious purchase of the enterprise, capitalisation or depreciation over a certain useful life span or treatment as immediately tax-deductible operating expense would be conceivable solutions. Since several countries take a sceptical position on German taxation rules for the transfer of functions, complete non-consideration with the consequence of double taxation may occur as well.



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Price adjustment clause

If the actual profit development of the transferee enterprise deviates considerably from the assumptions on the basis of which the price was determined at the date of the transaction, the lawmakers will assume that unaffiliated third parties would have agreed on an adjustment clause as the actual profit development was uncertain. If no such agreement has been concluded and a considerable profit deviation occurs within ten years, a one-time adjustment of the former transfer price for the business restructuring will be made.

Summary

To recap, it can be said that the highly complex legal provisions would be interpreted by German fiscal authorities in a very pro-fiscal sense as expected and as evident from their implementation letter of October 2010. Furthermore, in most cases the enterprises concerned will be uncertain whether the provisions concerning business restructurings will apply to changes of the operating structure of their businesses, and if so, to which extent. To avoid unpleasant surprises within the scope of tax audits in the years to come, it is highly recommendable to take potential tax effects into consideration in early phases of planning, extension or restructuring of foreign investments.

Even though the new OECD rules concerning business restructurings are in many aspects similar to the German Foreign Transaction Tax Act, they are not identical. In Germany, valuation of the transfer package is the rule, whereas OECD rules basically provide for the valuation of individual assets on the basis of standard methods. Therefore, it remains to be seen which rules, maybe based on the OECD Guidelines, will be incorporated into national tax laws by other countries and which consequences will ensue for the taxation of the transferee enterprise in each individual case.

Transfer pricing reviews – ATO increased activity **By Dario Gamba, DFK Lonsdale, Melbourne**

The Australian Taxation Office (ATO) has recently increased its level of activity in relation to transfer pricing reviews on businesses in Australia.

Whilst transfer pricing activity has in the past been targeted to the larger end of town (typically businesses with turnovers in excess of \$AUD200m), we have noticed a significant change in the types of businesses that are being selected for a transfer pricing review.

In particular, the ATO has commenced focus on small to medium sized business in Australia that exhibit a number of factors which includes a history and pattern of making tax losses supported by international dealings with related parties the transactions of which are disclosed and summarized in Schedule 25A of the income tax return.

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The transfer pricing reviews are designed as an on-site information gathering exercise where a series of (from what I have experienced) probing questions are asked by ATO case officers in relation to a business' international dealings including the use of loan accounts, intellectual property, and the provision of goods & services.

In undertaking transfer pricing reviews in Australia and assessing compliance therein, case officers have placed particular emphasis on a business' adoption of the following four (4) tests detailed in Taxation Ruling TR 98/11, namely

- Accurately characterize the international dealings between related entities and document this;
- Select the most appropriate transfer pricing method and document this choice;
- Apply the most appropriate method, determine the arms length outcome and document the process; and
- Ensure documentation is complete and implement support processes. Install review process to ensure adjustment for material changes.

ATO case officers are then required to submit their findings to a transfer pricing review board from which a decision is made by the board as to whether to proceed to a transfer pricing audit.

The outcome of the above and the important lesson that needs to be taken away is that businesses need to take compliance with transfer pricing documentation seriously and be vigilant in maintaining contemporaneous documentation at all times. This will help ensure that the risk of a costly and time-consuming transfer pricing audit is minimized.

- Ends -