TRANSFER PRICING: DEVELOPMENTS, SURPRISES, CHALLENGES

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**Mr. Maruca did not participate in the development of these slides, and they do not reflect his personal views or the IRS' views.

Agenda

- OECD BEPS Project
- US Transfer Pricing Update
- India Update
OECD BEPS Project

High level TP orientation—US ↔ OECD

26 U.S.C. § 482

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses. In the case of any transfer (or license) of intangible property (within the meaning of § 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.

explained in § 482 regs

2010 OECD Model Tax Convention on Income and Capital (“MTC”)—Article 9(1)

Where—

a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or

b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,

and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

explained in Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (“TPGs”)
TPGs—last revised July 2010

Chapter I—The Arm’s Length Principle
Chapter II—TP Methods
Chapter III—Comparability Analysis
Chapter IV—Administrative Approaches to Avoiding and Resolving TP Disputes
Chapter V—Documentation
Chapter VI—Special Considerations for Intangible Property
Chapter VII—Special Considerations for Intra-Group Services
Chapter VIII—Cost Contribution Arrangements
Chapter IX—TP Aspects of Business Restructurings

Timeline—BEPS, TP aspects of intangibles, & TP documentation

2012 2013 2014 2015

TP documentation

intangibles

BEPS

2012
6-04-2012 Discussion Draft—Revision of Chapter VI of TPGs
7-30-2013 White Paper on TP Documentation (“White Paper”)
10-03-2013 Memorandum on TP Documentation & Country-by-Country Reporting (“Memorandum”)

2013
3-7-2013 Revised Discussion Draft—Revision of Chapter VI of TPGs (“RDD”)

2014
2015
TP aspects of **BEPS Action Plan**—intersection with **RDD** and TP documentation initiatives

**Action 8 – Intangibles**

Develop rules to prevent BEPS by moving intangibles among MNE group members—

(i) broad and clearly delineated definition of intangibles;
   - **RDD** → location savings, market features, assembled workforce, and MNE group synergies are comparability factors, not intangibles
   - **RDD** → variety of imprecise definitions of goodwill and ongoing concern value as intangibles.

(ii) ensure profits associated with transfer & use of intangibles allocated in accordance with value creation;
   - **RDD** → focus on contributions to “anticipated value” of intangibles made by other MNE group members through their functions performed, assets used, and risks assumed.
   - **RDD** → to be entitled to all intangible returns, legal owner of intangibles must perform or control “important functions” related to intangibles.

**Deadline:** September 2014

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**TP aspects of **BEPS Action Plan** [cont’d]**

**Action 8 – Intangibles [cont’d]**

(iii) develop TP rules or special measures for transfers of hard-to-value intangibles
   - **RDD**—citing **BEPS Action Plan**—simply replicated language from existing **TPGs** Ch. VI, § C.4, relying on (ex ante) behavior of independent enterprises to posit, e.g., price negotiation clause, or prospective renegotiation.
   - No commensurate-with-income language in Article 9(1) MTC.
   - To what extent will arm’s length principle continue to apply?

**Deadline:** September 2014

(iii) update guidance on CCAs
   - **RDD** → punted on discussion of CCAs.
   - query extent of eventual alignment with § 1.482-7 “platform contribution” notion—“useful life” ↔ “commercial life” for intangibles forming a basis of ongoing R&D.

**Deadline:** September 2015
TP aspects of **BEPS Action Plan** [cont’d]

**Action 9 – Risks and Capital**

Develop rules to prevent BEPS by transferring risks among, or allocating excessive capital to MNE group members—

(i) adopt TP rules or special measures to ensure inappropriate returns won’t accrue solely because of contractually assumed risks or capital provided;
   - To what extent with 2010 Chapter IX “risks” discussion continue to apply?
   - To what extent will arm’s length principle continue to apply?

(ii) align returns with value creation;
   - Parallels notion in **RDD** for intangibles.
   - Signals preference for profit splits?

(iii) coordinate with work on interest expense deductions and other financial payments.

**Deadline:** September 2015

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TP aspects of **BEPS Action Plan** [cont’d]

**Action 10 – Other high-risk transactions**

Develop rules to prevent BEPS by engaging in transactions which wouldn’t (or only rarely) occur between third parties. Adopt TP rules or special measures to—

(i) clarify circumstances in which transactions can be recharacterized;
   - 2010 **TPGs** added ¶¶ 1.65, 9.168–9.169 allowing disregard of structures—in “exceptional cases”—between associated enterprises if (i) substance of arrangements inconsistent with form; or (ii) arrangements “not commercially rational” and structure impedes ability of tax administration to determine appropriate TP.

(ii) clarify application of TP methods—particularly profit splits—in context of global value chains;
   - **RDD** signals preference for profit splits aligning with value creating activities.

(iii) provide protection against common types of base eroding payments, such as management fees & head office expenses.

**Deadline:** September 2015
TP aspects of BEPS Action Plan [cont’d]

**Action 13 – Re-examine TP documentation**

Develop TP documentation rules to enhance transparency for tax administrations, taking into account business compliance costs. Rules will include a requirement that MNEs provide all relevant governments with needed information, using common template, on global allocation of income, economic activity; and taxes paid among countries.

- Common template goes beyond what’s required in White Paper
- White Paper recommended two-tier approach—masterfile & local country file—both likely to be burdensome and costly to comply with.
- October 3 Memorandum teed up possible country-by-country reporting requirements, including variations of income earned and taxes paid by country, and possibly measures other than income and taxes.

**Deadline:** September 2014

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**TP aspects of BEPS Action Plan [cont’d]**

**Action 7 – Prevent artificial avoidance of PE status**

Develop changes to definition PE to prevent artificial avoidance of PE status in relation to BEPS, including through use of—

- commissionaire arrangements; and
- specific activity exemptions.

Work will also address Article 7 profit attribution issues.

- Authorized OECD Approach (“AOA”) introduced 2010 under Article 7(2)—allocates intangibles & risks based on location of functions.
- AOA relied on TPGs for “independent enterprises” fiction created to determine profits attributable to PE of foreign enterprise.
- Does BEPS Action Plan tacitly signal changes to AOA, or adoption of AOA principles in Article 9(1) context?

**Deadline:** September 2015
US Transfer Pricing Update

Bird’s eye view of global tax enforcement

- Overriding administrative strategy: Deter, detect, and respond
- Common implementation strategies:
  - By individual tax authorities
  - Imposed on/expected of taxpayers
  - Between and among tax authorities
- New emphasis on simplicity for lower-value transactions and smaller taxpayers to allow focus on higher-risk transactions
- Increasing taxpayer pressure and tax authority reliance on reputational risk as compliance tool for higher-risk transactions
- Increased efforts to accommodate substantive views of China and India
- Urgent focus on substantive rules to address “base erosion and profit shifting” (BEPS) concerns
IRS TP organization after two years

- The transfer pricing landscape has changed since roll-out of the Transfer Pricing Organization ("TPO")
- Many of the developments are positive:
  - Increased APA completions and reduced APA backlog
  - Improved APA processing times
  - Better relationships with some major treaty partners
  - Broader risk-based focus among IRS examiners (including litigation, MAP)
- Some of the developments are mixed, negative, or too early to say:
  - Resource constraints among treaty partners
  - Domestic budget limitations (back filling, travel, etc.)
  - Excess of "routine" cases in APMA Program?
  - Improvements in audit case selection and development and other audit trends
  - Effectiveness of IPNs?

Updated APMA Revenue Procedure

- Potential issues from the re-draft:
  - Additional procedural rules (time deadlines, etc.)
  - Statute of limitations issues (protective claims, limited waivers)
  - Refine Accelerated Competent Authority Procedure (ACAP)
  - Revise APA renewal procedures
  - Unilateral APAs
  - Taxpayer-initiated adjustments
- Projected timeline for finalization; handling of transitional cases
Taxpayer-initiated TP adjustments

- Authority for such adjustments: Treas. Reg. § 1.482-1(a)(3)
  - Increase U.S. taxable income: any open year
  - Reduce U.S. taxable income: on a timely-filed return
- Acceptance by treaty partners; availability of Mutual Agreement Procedures (MAP) to address corresponding adjustments
- Correlative allocations in connection with taxpayer-initiated adjustments (availability of Rev. Proc. 99-32)
- The “clerical error” scenario: what is a transfer pricing adjustment?
- Applicability of penalties in the United States and other countries
- Intersport Fashions West (Ct. Fed. Claims 2012)

Other US TP issues

- No US-India advance pricing agreements
- US-Canada arbitration
- Pending Litigation
  - BMC Software (Rev. Proc. 99-32)
  - Altera (stock-based compensation)
  - Amazon (cost-sharing buy in)
  - 3M (blocked income)
  - Eaton (Section 936; cancelled APAs)
OECD Guidelines: Rules of the road for bilateral TP cases?

- Statements by Mike Danilack that IRS adjustments need to be sensitive to bilateral considerations and OECD principles
- Impact of recent revisions to the OECD Guidelines (profit-based methods and comparability, business restructuring)
- Future revisions to the Guidelines (CCAs, financial transactions)
- Role of U.N. Practical Transfer Pricing Manual in bilateral cases
- Impact of “baseball” arbitration under treaties

Administrative safe harbors

- Update on IRS effort to draft Memoranda of Understanding on arm’s length return to certain routine functions (e.g., distribution)
- Interaction with OECD safe harbor initiatives
  - OECD Paper and Model MOU (May 16, 2013)
- Scope of the initiative:
  - Reduce work for APMA
  - Overcome general IRS reluctance concerning safe harbors
- Potential expansion to other issues:
  - Arm’s length interest rate
  - Guarantee fees
  - Others
India Update

Backdrop - Litigation timelines in India

Level of Authority/Court

1. Transfer Pricing audit
   - 3 – 4 years from date of filing return
   - Often repetitive additions

2. 1st Appeal
   - DRP/Commissioner Appeals
   - 9 months to 3 years

3. 2nd Appeal
   - Appellate Tribunal
   - 2 – 3 years

4. 3rd Appeal
   - High Court
   - Only substantial questions of law
   - 5 years

5. Final Appeal
   - Supreme Court
   - Final authority on factual issues
   - 5 years

Mutual Agreement Procedure

Domestic Process Timeline 15+ years
APA – a quick recap

- APA program became operational in September 2012
  - Primary aim to stem litigation overload and provide certainty
  - Launched two years ahead of scheduled launch date
- Unilateral / Bilateral / Multilateral option
- Mandatory Pre-filing consultation – anonymous option available
- Estimated timeline
  - Unilateral APAs – 1 year
  - Bilateral/Multilateral APAs – 2 to 3 years
- Flexibility of method for determining arm’s length price
- Valid for maximum 5 years (renewable for another five years)
- Filing fees - Rs 1 million to Rs 2 million
- No Transfer Pricing Audit - only compliance audit
- Audit Officer cannot disturb APA

APA program – experience thus far

- Revenue received 158 formal pre-filing Advance Pricing Agreement (‘APA’) applications as on March 31, 2013
- 90 percent pre-filings converted to applications i.e. 146 APA applications were filed
- Of these, 117 applications have been received for Unilateral APAs and 29 for Bilateral APAs
- Primary focus of APA teams is to reach consensus on Function Asset Risk (FAR) analysis for which planned ‘site visits’ are in full swing
- Based on FAR analysis, benchmarking exercise to be conducted followed by rounds of discussions and negotiations
- Program progressing collaboratively
- More applicants have signed up in current year
- Possible persuasive value for open audit years and litigation
Administrative safe harbors: India’s proposal

- On August 14, 2013, India announced an elective safe harbor for specific categories of transactions, including:
  - software development services (other than contract R&D);
  - information technology enabled services;
  - knowledge process outsourcing services; and
  - Intra-group loans and financial guarantees

- For transactions other than loans and guarantees, the provision generally provides for cost-plus markups of 20% to 30%

- Taxpayers that elect the safe harbor give up rights to Mutual Agreement Procedures for the covered transactions

- Does this provision override tax treaties?

- Impact of safe harbor on impasse concerning APAs

Other developments

- Contract R&D service providers (new instructions)
  - Circular No 2 which recommended Profit Split Method for Indian entities undertaking significant Research and Development (‘R&D’) activities or developing any Unique Intangibles – withdrawn
  - Circular No 3 modified by rationalising guidelines for characterizing a Development Centre as a Contract R&D service provider with insignificant risk

- Central Board of Direct Taxes (‘CBDT’) has issued a detailed ‘Frequently Asked Questions’ on the India APA program

- Recent dialogue between India US Competent authorities generates cautious optimism.
Questions?