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CHAPTER 4 Australia

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§4.31 THE IMPORTANCE OF TRANSFER PRICING FOR MULTINATIONAL COMPANIES OPERATING WITHIN AUSTRALIA

Transfer pricing has been an area of significant focus by the Australian Taxation Office ('ATO') since the early 1990s. At the time of updating this chapter transfer pricing has been at the forefront of the Australian Taxation Office and the treasury. In the 2013-14 Federal budget, the Australian Government announced additional funding for the ATO compliance enforcement over the next year. The combination of significant changes to the Australian domestic transfer pricing rules and additional enforcement activities are expected to raise an extra AUD 1 billion in taxes for the Australian Government. It is therefore important that multinational enterprises (MNEs) which have their head office in Australia or which have subsidiaries or permanent establishments (PEs) in Australia have an understanding of transfer pricing and the ATO's suggested approach to documenting related-party dealings. This is the case whether the MNE is a large, complex, global enterprise, or whether it is a small to medium enterprise (SME) that has recently commenced operations in more than one tax jurisdiction.

Each year the ATO provides the public with a report that summarizes the results of the ATO's taxation Compliance Program for the prior year, as well as areas of focus for the current year. Transfer pricing is consistently featured prominently in this annual report. The ATO, through practical experience and its liaisons with the OECD, IRS, National Tax Agency (Japan) and other international tax authorities, has become increasingly sophisticated with respect to transfer pricing. Each year the ATO focuses on new areas of transfer pricing in order to continually expand its coverage of a range of transfer pricing issues that impact the allocation of profits within MNE groups. Given the past years global economic crisis, the ATO is actively contacting taxpayers regarding transfer pricing through a 'risk review' letter requesting information and

documentation to support the arm's length nature of related-party transactions as discussed further in section §4.06.

Following is a broad overview of the transfer pricing taxation legislation and transfer pricing related taxation rulings in Australia. Some additional areas of recent focus by the ATO are discussed in section §4.05 of this document.

§4.02 REGULATORY FRAMEWORK

[A] Legal Authority

Australia's transfer pricing rules encompasses Subdivision 815-A and Subdivision 815-B, C and D of the Income Tax Assessment Act 1997 ("the ITAA 1997") and Subdivision 284 E of the Income Tax Assessment Act 1953 ("the ITAA 1936"). These new provisions repealed Division 13 of the ITAA 1936 and apply for income years commencing 1 July 2013. Australia's transfer pricing rules also includes the Business Profits and Associated Enterprises Articles of Australia's Double Tax Agreements (DTA). The rules adopt the arm's length principle as the basis for determining whether Australia has been denied its fair share of tax.¹

At the time of this analysis the ATO was in the process of releasing further guidance in respect to the application of the new legislation. This is expected to be released in the first quarter of 2014 year.

[1] Subdivision 815-A of the ITAA 1997

In November 2011 the government issued a consultation paper on measures to align the domestic transfer pricing rules and the relevant provisions of tax treaties more closely with the latest version of the OECD Guidelines. The domestic transfer pricing rules were seen as being out of line with those of treaty partners and the approach taken by the ATO had not been supported by decisions in the Courts.

As a result of this, legislation was introduced to insert subdivision 815-A entitled "treaty equivalent cross-border transfer pricing rules" into the ITAA of 1997 and to clarify the application of the transfer pricing rules and bring them further into line with OECD Guidelines.

Subdivision 815-A provides the Commissioner with a power to adjust the assessable income of Australian residents where he is of the view that the taxpayer has received a 'transfer pricing benefit' in relation to a cross-border related party dealing. A 'transfer pricing benefit' is the difference between an Australian resident's actual profits and the profit it should have earned under arm's length circumstances. Subdivision 815-A focuses generally on arm's length profits rather than on the pricing of the transactions, reflecting the drafting of the Associated Enterprises Articles contained in Australia's DTA's.

1. TR 98/11 – Income tax: documentation and practical issues associated with setting and reviewing transfer pricing in international dealings, para. 1.1 [TR stands for taxation ruling however the rulings are all called TR].

Subdivision 815-A ensures that Australia's tax treaties can be applied as an assessment power independent of the repealed Division 13. These provisions only apply where the requirements of the Associated Enterprises Article of an Australian Double Tax Agreement are met.

Section 815-20 explicitly requires that Subdivision 815-A be interpreted in accordance with the Model Tax Convention on Income and on Capital, and its commentaries, and the Transfer Pricing Guidelines for Multinational Enterprises from the Organisation for Economic Cooperation and Development (OECD).

Subdivision 815-A applies retrospectively to income years starting on or after 1 July 2004.

[2] Tax laws amendments (Countering tax avoidance and Multinational Profit Shifting) Bill 2013 (the bill)

The purpose of the bill is to update the general tax anti-avoidance rules in the Income Tax Assessment Act 1936 (ITAA 1936) and bring the transfer pricing regime in the Income Tax Assessment Act 1997 (ITAA 1997).

This bill introduced the following subdivisions in the ITAA 1997:

- Subdivision 815-B: Arm's length principle for cross-border conditions between entities
- Subdivision 815-C: Arm's length principle for permanent establishments
- Subdivision 815-D: Special rules for trusts and partnerships

These provisions also introduced Subdivision 284-E in the Income Tax Assessment Act 1953 (ITAA 1953) which includes special rules for unarguable positions for cross-border transfer pricing.

Subdivisions 815-B, C and D are consistent with Subdivision 815-A in providing the ATO with broad powers to replace 'actual conditions' with 'arm's length condition' when a taxpayer receives a transfer pricing benefit associated with a non-arm's length condition as a result of an international related party dealing.

The new rules focus on profits and conditions, rather than transactions, which arguably strengthens the Commissioner's quest to apply transfer pricing rules to review the commerciality of taxpayers' arrangements. The ATO is expected to seek to use the provisions of 815-A and 815-B to scrutinize and challenge the international dealings of taxpayers who have business restructures, particularly where they involve the shift of profit making functions offshore, consistent low profitability or losses, and aggressive financing arrangements.

The new provisions will be self-executing in their operations. This means taxpayers must address compliance with the new provisions when lodging their income tax returns and satisfy themselves that the taxable income reflects arm's length conditions.

The new legislation does not include a provision introducing mandatory transfer pricing documentation. Notwithstanding, in practice taxpayers will still be required to keep contemporaneous transfer pricing documentation that meets the requirements of the new provisions otherwise they would not be able to claim a reduction on the base

penalty on the basis that they have a reasonable arguable position (RAP). This means that a failure to keep contemporaneous documentation that meets the requirements of the legislation will mean the taxpayer will not have a reasonable arguable position (RAP) in relation to its transfer pricing position and therefore will be subject to a minimum penalty of 25% of the tax shortfall. The ATO is in the process of clarifying what a RAP means from a transfer pricing perspective.

[a] *Arm's Length Conditions*

The concept of arm's length conditions is the key to the new legislation. Arm's length conditions are the conditions that might be expected to operate between independent entities dealing wholly independently with one another in comparable circumstances (section 815-125(1)).

The concept of conditions includes anything relevant to the economic substance of the entities and their dealings including price, gross margin, net profit and the division of profits.

[b] *Transfer Pricing Benefit*

Subdivision 815-B operates where an Australian entity gets a transfer pricing benefit from actual conditions which differ from the arm's length conditions in connection with the financial or commercial relations. Where an entity gets a transfer pricing benefit, the arm's length conditions are taken to operate for income tax purposes and the taxpayer would be required to make an upwards adjustment to their taxable income. 815-B only applies to increase taxable income, and cannot be used to reduce taxable income via self-assessment.

[c] *OECD Guidance*

The new provisions incorporate the most appropriate and reliable method, and comparability factors consistent with the OECD transfer pricing guidelines. Further subdivision 815-B and 815-C should be interpreted consistently with the OECD Transfer Pricing Guidelines.

[d] *Economic Substance Requirement*

Under the new provisions taxpayers should demonstrate that arrangements such as business restructurings and financing are substantially similar to what would have occurred between independent parties in comparable circumstances. The legal form will not limit the Commissioner's powers to look at the economic substance of what the parties have done to identify the arm's length consideration.

[e] *Reconstruction Powers*

The new provisions provide the ATO with greater powers to reconstruct transactions more extensively than under the OECD transfer pricing guidelines because it gives the ability to the ATO to substitute the arm's length conditions and look to the underlying economic substance of the transactions. Under the OECD transfer pricing guidelines, reconstruction is limited to 'exceptional circumstances'.

[f] *Thin Capitalization*

Section 815-135 deals with the interaction between transfer pricing and thin capitalization. It seeks to confirm the operation of TR 2010/7, i.e. taxpayers who have entered into related party debt should support that the amount of debt and the interest rate is in accordance with the arm's length principle.

[g] *Subdivision 815-C: Arm's Length Principle for Permanent Establishments*

Subdivision 815-C introduces provisions intended to ensure that the profit taxed in Australia from entities operating through a PE is less than it would be if the PE were a separate entity.

The legislation makes it clear that the intention is to maintain a single entity approach, but applied using the separate entity analytical framework to determine the appropriate allocation of the actual revenue and expenses of the entity in determining the appropriate profit of the PE.

[h] *Subdivision 284-E: Special Rules about Unarguable Positions for Cross-border Transfer Pricing*

While documentation is not mandatory, a taxpayer that does not keep transfer pricing documentation that meets the specific requirements of Subdivision 284-E will be treated as not having a RAP, and will attract at least a 25% penalty on the tax shortfall where an income tax adjustment is made by the Commissioner.

Under Subsection 284-255, records (e.g. transfer pricing documentation) must contain:

- An identification of the actual conditions and arm's length conditions.
- Explain the particular way in which the subdivision applies
- The method/s used.
- The comparable circumstances relevant to identifying the arm's length outcomes.
- Should be prepared in English before the time by which the entity lodges its income tax return

CHAPTER 8

China

Glenn DeSouza

Dr Glenn DeSouza is the China leader of Transfer Pricing (TP) for Baker & McKenzie and Managing Director of TPMC, an economic consulting firm. His clients include the world's leading companies in semiconductors, consumer electronics, chemicals, pharmaceuticals, software, luxury goods, retailing and other strategic industries. He founded the mainland practice of PricewaterhouseCoopers and served as the China and Asia Transfer Pricing leader for a group of over 100 professionals. He has been selected by Euromoney in their *Guide to the World's Leading Transfer Pricing Advisers* and has won the Best Economist Award from the US *National Association of Business Economists*.

Dr DeSouza played a major role in the development of statistical methods in transfer pricing in China after arriving there in 1999 as the first TP expert and the only PhD economist and econometrician. He has trained over 500 professionals and tax officials and conducted over 1,000 studies including TP documentation, audits, cash repatriation, bilateral Advanced Pricing Agreements (APAs), equity valuations and business restructuring. He is a former professor at the *University of Massachusetts* and has authored two books and over 300 articles for *BNA*, *International Tax Review* and other leading publications and is a featured speaker at global symposia on China.

CHAPTER 8

China

Glenn DeSouza

All useful knowledge comes from practical experience – Mao Zedong

It does not matter if a cat is black or white, so long as it catches the mice – Deng Xiaoping

INTRODUCTION

In the C-suite, China has become more important to the CEO than any country other than the home country. The fastest growing economy, the factory to the world and now the number 1 market in the world for products ranging from smart phones to automobiles, China is the indispensable country.

China is not only economically dominant but it is also a country which along with India is redefining the transfer pricing rules set in the west. Most multinationals do not realize that their strategies of allocating 'routine profits' to China is under severe attack. To quote a China tax director who has negotiated extensively with SAT, 'It became clear that the SAT believes China has unique factors, including location savings and market premiums, that are not addressed by the Organization of Economic Cooperation and Development transfer pricing guidelines ...'. The China Tax Director also said 'It became clear that the SAT's position on intangibles was not addressed by the proposed definition under the OECD discussion draft.'¹

In 2013, we see China taking positions on Transfer Pricing (TP) that set itself more clearly apart from the positions espoused by the western nations. This certainly creates a potential source of controversy and we will identify the key areas where challenges may develop. Until now the universally acclaimed standard for TP has always been the Transfer Pricing Guidelines issued by the Organisation for Economic Co-operation and Development (OECD). However, in the new UN Practical Manual on

1. Bloomberg BNA 12 Nov. 2012.

Transfer Pricing that was issued in October 2012, there is a special China chapter that takes positions that are in line with the Chinese actual practices.

Some of the key developments are that routine cost-plus returns will no longer be acceptable in a number of cases and instead China will seek to get its fair share of global profits by advancing theories of market premium and location rents. In addition, royalties, once set in place may need to be scaled down over time to reflect the growing contribution of the Chinese subsidiary. Moreover, the use of comparables in China will be viewed with great caution given the lack of available information in developing nations and in particular, the use of Japanese comparables will be accepted only after adjustments have been made to reflect its developed country status.

Also, for those multinationals for whom a significant percentage of their global employees or assets are actually in China, a global formulary apportionment approach may be proposed. Even for companies engaged in such straightforward activities such as manufacturing and contract manufacturing, there will be major changes ahead such as the requirement for toll manufacturers that the cost of raw materials that have been consigned to them will need to be added back into the cost base.

In the China chapter we will first lay out the major macro trends that are making China an indispensable country for global economic reasons as well as for other considerations. In addition, we will also summarize the regulatory framework for conducting TP analyses and documentation as well as the reporting requirements. In addition, we will examine such controversial areas as valuation on sale of offshore entities, interplay with customs and tax and thin capitalization requirements. The purpose is to provide a useful compendium that explains not only the regulatory framework in China, but the practice as well as the evolving trends.

MACRO TRENDS

China emerged in pole position when it overtook Japan to become the world's second-largest economy in February 2011. China's economy is to become twice as big as that of the US and larger than both the US and the EU combined by 2030, according to one of China's leading economists. Other economists are more guarded and the consensus is that China GDP will equal the US by 2020 and double the US by 2050.

China's importance in the world economy cannot be downplayed, including in the realm of TP. No country outside of his or her own will be more important or challenging for the global tax director than China. Because a diverse variety of opinions exist about China, it will be helpful to start by laying out the fundamental ways in which China is redefining the world economic order.

Firstly, China is likely to remain the world's centre of manufacturing. China now manufactures more toys, sews more clothes and produces more electronics than any other nation. Other countries, such as India and Indonesia, lack the agglomeration economies, world class infrastructure and large workforce necessary to provide a realistic alternative in supplying the volume and quality of goods the world demands.

Second, China is becoming a world leader in technology, powered by the world's largest pool of scientists and engineers. Chinese astronauts walk in space and China has the world's longest high-speed rail network and the world's fastest train. China is

also leading the way in solar and wind technology, biotechnology and environmental controls and other industries of the future.

Third, China is the world's greatest market opportunity. For forty out of the fifty American states, China is their number one export market. General Motors sells as many cars in China as they do in America. As an example, the pecan market in Georgia has experienced a doubling in prices over the past three years due to increased Chinese demand.

Fourth, despite varying opinions, China is predicted to be the largest economy in the world by 2020. China is coming off a thirty year run of immense growth. This surge is unique in economic history. At the time of the events in Tiananmen in 1989, the Chinese subsisted on less than USD 300 per capita roughly on par with India. Now the per capita income is about USD 6,000.

§8.01 IMPORTANCE OF TRANSFER PRICING FOR MULTINATIONALS IN CHINA

Transfer pricing enforcement in China has gradually emerged as a major source of tax controversy. The main reasons for this are as follows:

- (1) *Economic significance:* Other than the United States, no other country is more economically dominant than China, thanks to its rapidly-growing market and low cost production platform.
- (2) *Number one source of global profits:* China has emerged as the biggest source of (Multinational Corporation) MNC profits.
- (3) *Onerous new TP Regulations:* A new tax law passed in 2008 introduced a broad platform of TP requirements including mandatory documentation.
- (4) *Step up of audits:* China is running a large budget deficit (15% of the budget) and there is pressure on the Local Tax Bureaus (LTBs) to raise tax revenues and meet specific TP enforcement targets.
- (5) *More assertive tax bureaus:* Foreign investors in China are no longer accorded special tax status as tax officials are increasingly assertive in pursuing their audits.
- (6) *Setting its own rules:* China has introduced a number of concepts that depart from OECD principles, a point of potential future issues. For example, while the US has taken the position that location savings belong in the US by virtue of the US bargaining power, China is asserting that at least some of those location savings should be attributed to the Chinese entity. Recently, there was an APA in Shanghai where some of the location savings were awarded to China.
- (7) *Multiple entities:* In China, the business license specifies and limits the type of functions the company can perform and the products it can make. Thus multinationals in China have a large number of separate legal entities, each of which must prepare documentation. Companies like GE or Siemens, for example, have almost 100 legal entities in China.

- (8) *Communist system*: China is still a communist country, albeit one with Chinese characteristics. There are centralized controls, licenses and permits that are required to operate a business, pay royalties and fees, register an internet license (only a Chinese can get such a license) and to import and export.
- (9) *Ambiguous regulations*: The TP regulations in China are broad and vague. There is no guidance on specific issues such as should loss-making companies be excluded or how many years should be used in calculating profit ratios.
- (10) *Local enforcement*: An additional complexity in China is that the tax enforcement and the TP enforcement is handled by the local official assigned to be in charge of a particular Foreign Investment Enterprise (FIE). Since there are over 2,000 of these local tax zones there is a wide range in how the regulations are enforced. This variability creates an additional level of uncertainty for western investors.
- (11) *Clogged APA process*: Foreign investors seeking APA often find themselves unable to move forward either because of LTB opposition or because State Administration of Taxation (SAT) lacks the capacity to handle the number of requests that come their way.
- (12) *Scarcity of legal options*: The competent authority process is not well developed in China and litigation is not a realistic alternative for western investors at this particular point in time. Therefore given the scarcity of alternatives, the level of exposure to double taxation is significantly greater in China than in other countries.
- (13) *Multiple governmental authorities*: In China, the Ministry of Commerce (MOC), Ministry of Science and Technology (MOST), State Administration of Foreign Exchange (SAFE) and many other governmental authorities have power to directly and indirectly impact TP considerations.

§8.02 TP TRENDS IN 2013

Transfer pricing has found itself in the spotlight at the SAT.

Three trends are compelling the SAT to start focusing more on transfer pricing:

- (i) income tax revenue has been increasing; (ii) MNCs are transferring large amounts of profit out of China; and (iii) domestic Chinese enterprises are increasingly investing abroad, which allows them to use profit-shifting strategies that deprive China of tax revenue.

Income tax revenue has been increasing in relation to total revenue. It now accounts for more than 20% of total tax revenue and is increasingly important for revenue-starved local governments. Additionally, many MNCs are becoming profitable after two decades of operation in China, so income tax issues such as transfer pricing are no longer matters that they can neglect.

There has been wide speculation that MNCs are transferring large amounts of profit out of China. When this speculation is coupled with the observation that other

jurisdictions are tightening their transfer pricing administrations, it confirms the SAT's suspicion that transfer pricing has become a competition for the same tax base among jurisdictions. If China does not tighten its transfer pricing administration, its tax base will end up in other jurisdictions.

Finally, under China's policy of encouraging investment abroad, more and more domestic enterprises have been exposed to profit-shifting concepts as they internationalize. Domestic Chinese enterprises find themselves in the position to take advantage of the same profit-shifting strategies that were previously only available to foreign MNCs.

As a result of these three trends, the SAT will commit more resources to its transfer pricing operations. Quietly but steadily, the SAT is ramping up its transfer pricing capacity. Over the last three years, the SAT has devoted a considerable amount of time to improving the legislative framework for transfer pricing and they have put in place related-party transaction disclosure and contemporaneous documentation requirements. They have also set up an expert panel review system to ensure quality and consistency in transfer pricing adjustments.

Moving forward, the SAT's resources will be focused on three high-stakes industries, i.e., automotive, pharmaceutical and retail, and they will issue guidance on adjustments for those three industries based on industry analysis. In preparation, the SAT has been accumulating experience in using income methods and has issued operational guidance and templates for income methods to value intangibles and shares. As a result, they are more confident and more comfortable in making technical arguments, which allows them to be more aggressive in pursuing transfer pricing adjustments.

§8.03 REGULATORY FRAMEWORK

[A] Political and Tax Structure

Taxpayers need to understand how to manage the differences in the Chinese system when compared to other countries. While still a one party system, it is important to note that it is a meritocracy. Admission to the Communist Party is highly competitive and national exams are given for government positions. Typically more than 100 people sit for every one available. Before they reach a position of power they will have gained significant field experience in various parts of China including working in the remote provinces.

The new leadership team for China will have Mr. Xi Jinping take over as President of the country in early 2013. Xi studied chemical engineering in China's most prestigious Tsinghua University and further majored in Marxist theory and political education. Xi served in four provinces during his political career namely Shaanxi, Hebei, Fujian and Zhejiang. While in Fujian, he was known for his efforts to attract investment from Taiwan and boost free market economy. While in Zhejiang, one of China's most affluent provinces and a centre of China's successful economic development, Xi provided the economic environment which secured growth rates averaging 14% per year. His career in Zhejiang marked by a tough and straightforward stance

Edgar has been involved in transfer pricing projects in Latin American countries, Brazil and the US. Edgar has over seven years of transfer pricing experience. Prior to joining OSY, he was member of the global transfer pricing team of Deloitte.

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CHAPTER 13

Mexico

Iván Díaz Barreiro & Edgar Antúnez

§13.01 IMPORTANCE OF TRANSFER PRICING FOR MULTINATIONAL COMPANIES IN MEXICO

As a country member of the Organisation for Economic Co-operation and Development (OECD), Mexico adopted transfer pricing rules since 1995. From a tax collection perspective, transfer pricing is one of the most important tools for the taxing authorities.

In general, transfer pricing audits are very aggressive, and tax bills are huge (penalties, inflation and interest are very high in Mexico), so companies performing intercompany transactions must be aware of the rules, and moreover, in compliance with such rules.

§13.02 REGULATORY FRAMEWORK

[A] Background

Transfer pricing rules are in place in the Mexican tax regime since 1995, focused on *maquila companies* (in-bond companies).

To avoid constituting a permanent establishment in Mexico.

Once Mexico began to open its economy, adjustments had to be made, not only in the tax law, but also in the practices of the authorities themselves, to extend the application of transfer pricing beyond the *maquila* industry.

The rules that have been incorporated into our laws each year are as follows:

1997

The new law took effect on 1 January 1997. The legal transfer pricing framework was in the Income Tax Law, basically in Articles 58, section XIV, 64, 64-A and 65; in the FTC Articles 34 and 76; and in the MTR.

As is the case of the United States and the OECD, the intention of Mexican law is that, both a firm's profit and taxable income with foreign related parties is determined at market value; with a particular focus on tax deductions. Tax payers need to keep documentation to prove that these transactions comply with the arm's length principle.

According to the Income Tax Law, a taxpayer has the burden of proving that its transactions are carried out at market values and the tax authorities are empowered to verify such situation.

This means that if a company had different types of intercompany transactions and applied the transactional net margin method, it could prove on aggregated basis and indirectly, that some or all of the intercompany transactions subject to the study were at market values.

Clearly, as of 1997, the tax authorities are empowered to review on a per transaction basis that transaction have been carried out at market prices, if it is found that this is not the case, the authorities can determine the market value for these transactions.

For the deficiencies found, the authorities could require the payment of the following:

- (1) the omitted tax, with its respective restatement for inflation;
- (2) the corresponding surcharges; and
- (3) a fine that can vary from 70% to 100% of the omitted tax.

It should be noted that if a taxpayer has a transfer pricing report the tax payer is entitled to a 50% discount in fines.

2000

As of 2000, the aforementioned section XIV of Article 58 was amended, to add the following:

- b) Information related to the functions or activities, risks assumed and assets employed by the taxpayer in each type of transaction;
- c) Information and documentation on transactions with related parties and their amounts, for each related party and for each type of transaction in accordance with the classification and with the data established in Article 65 of the Income Tax Law.
- d) The method applied, including the information and documentation regarding comparable transactions or companies in conformity with Article 65 of the Income Tax Law.

This addition meant that for the studies as of the year 2000, the analyses of transfer prices had to be made in a transactional manner; that is, separate analyses had to be made for each type of transaction performed by the taxpayer (e.g., one analysis for the payment of royalties, another for the payment of services, another for the sale of the product manufactured, etc.).

Also, as of that year, section XV was added to Article 58, establishing the obligation of filing in February of each year, in the authorized offices, the return on operations with related parties resident abroad, providing information related to the

transactions carried out during the calendar year immediately prior, requested on the official format prepared for such purpose by the MFPC.

The exemption for carrying out studies was modified when the quarterly prepayments disappeared, as follows:

Taxpayers engaged in business activities, whose revenues in the preceding year did not exceed Ps. 13,000,000, and taxpayers whose revenues from rendering professional services did not exceed Ps. 3,000,000 in said year, will not be obliged to comply with the terms set forth in this section, except for those taxpayers referred to in the penultimate paragraph of Article 215 of this Law.

In addition to the foregoing, section XV of Article 86 of the Income Tax Law was also created, establishing the following obligation for taxpayers resident in Mexico:

XV. Corporate entities that carry out transactions with related parties must determine their taxable income and authorized deductions, bearing in mind the considerations of prices and amounts for these transactions that would have been used with or among independent parties in comparable transactions. For these purposes, the methods established in Article 216 of the Mexican Income Tax Law shall apply.

This is the provision containing the obligation of having transfer pricing studies for transactions among domestic related parties, although the wording is not as clear with respect to the requirements that must be fulfilled in these studies, as those established for transactions with foreigners, and this situation has given rise to different interpretations.

As a result of this reform, one last paragraph was incorporated into Article 215, establishing the following:

For the interpretation of the terms of this Chapter, the Transfer Pricing Guidelines for Multinational Companies and Tax Administrations shall be applicable, approved by the OECD Board in 1995, or those that replace such guidelines, insofar as they are congruent with the provisions of this Law and of the treaties of which Mexico is a member.

As of that date, the Guidelines are Mexican tax law insofar as they do not contradict the Income Tax Law.

2005

The thin capitalization rules were incorporated in 2005, imported from other laws around the world, but they were adapted to Mexico in the following manner:

Art. 32. For purposes of this title, the following shall not be deductible:
XXVI. Interest derived from the debts the taxpayer has in excess of his capital, coming from capitals taken on loan, that have been granted by one or more persons considered to be related parties in the terms of Article 215 of this Law, provided that the amount of the debts exceeds three times the amount of the stockholders' equity per the taxpayer's statement of financial position, without considering the net profit or loss of such year.

Independently from the obvious complexity of this new article, and without attempting to analyse this provision, it should be noted that these rules applied to transactions carried out both with related and unrelated parties abroad, which was strange.

In view of the existing legal framework in this matter, it was necessary to publish both decrees and administrative rules to make it somewhat more flexible.

2006

Substantial tax reforms were made in Articles 216 and 86, section XV in the tax reform for 2006. In simple terms, these are the adoption of the best method rule contemplated in the United States' law (Best Method Rule) or the rule of the most appropriate method referred to in the OECD Guidelines, both in studies with related parties abroad and with domestic parties.

2007

In this year, the thin capitalization rules underwent significant changes. The matter of non-deductibility of interest focused on debts contracted with related parties abroad. The possibility of obtaining an APA for interest is also contemplated; the rules are now contained in the MTR.

2008

There are changes in the recently published tax reform for 2008 that affect the matter of transfer pricing, as follows:

In the case of losses incurred on the sale of shares, section XVII of Article 32 of the Income Tax Law contains new requisites to be able to deduct the losses incurred on the sale of shares not placed among the investing public at large – to wit:

- (a) The greater of the income between the amount agreed in the transaction and the sales price of the shares determined in conformity with the methodology established in Articles 215 and 216 of the Income Tax Law must be considered.
- (b) Also, whenever the transaction takes place with or among related parties, a study determining the sales price of the shares in terms of Articles 215 and 216 of the Income Tax Law must be presented, and considering the elements contained in clause e) of section I of Article 215.
- (c) For securities transactions, or stock transactions acquired or sold outside the stock market, the buyer (if applicable) and the seller (when there is a loss), must file notice within the ten days following the transaction date, and if applicable, the study on the sales price of the shares, referred to in the preceding clause.

On the other hand, section VII of Article 97 states that the institutions authorized to receive deductible donations must inform the tax authorities with regard to the transactions they have with related parties.

It is important to note that for purposes of the recently created flat-rate business tax (FRBT), the royalties paid or collected among related parties are not subject to the tax. This means that the royalties do not constitute a taxed income, but also not an authorized deduction.

In section III of Article 18, the same FRBT Law establishes that taxpayers who have transactions with related parties must determine their income and authorized

deductions, considering for such transactions, the prices and amounts of considerations that would have been used with or among independent parties in comparable transactions. For these purposes, the methods established in Article 216 of the Income Tax Law will be applied, in the order established in such article.

[B] Competent Authority

The Tax Administration Service (SAT) Law in effect since July 1997, established the SAT as a decentralized body of the MFPC, with the nature of tax authority. SAT's responsibilities include the enforcement of the tax and customs laws and the supervision of the taxpayers so that the latter comply with the tax and customs provisions.

The SAT's internal rules specifically define the specific powers of this decentralized body. In this sense, Article 19 establishes two basic criteria to define the activities of the General Administration of Major Taxpayers, the jurisdiction and the subjects and entities respect to which such jurisdiction can be exercised.

In turn, Article 20 of the SAT internal Rules establishes and the Central Administrations of Transfer Pricing Audit and of International Tax Audit will be the only units empowered to verify the determination of authorized deductions and taxable income in transactions between related parties.

[C] Arm's-Length Standard (or Alternative Standard)

The Arm's-Length Principle was formally adopted in the Mexican Transfer Pricing Rules since 1997, when the legislation was included for all taxpayers performing intercompany cross-border transactions.

§13.03 DETERMINING THE APPROPRIATE INTERCOMPANY PRICE

[A] Methods Available

[1] Transfer Pricing Methods

Article 216 of the Income Tax Law establishes that for purposes of Article 215 of the same Law, the following methods must be utilized by the taxpayers (please note that the 'best method rule' is stated in the Law):

[a] Traditional Methods¹

[i] Comparable Uncontrolled Price Method (CUP)

The CUP compares the price paid/charged for the sale of goods, rendering of services or use or enjoyment of goods in a controlled transaction,² to the price paid/charged for

1. In conformity with the classification of the OECD Guidelines.
2. Transaction held between related parties.

assessment. Jill has extensive industry experience in such areas as high-tech, computer software, biotechnology, medical instrumentation, pharmaceuticals, chemicals, food and beverage, and automotive.

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CHAPTER 17

United States

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§17.01 REGULATORY FRAMEWORK

[A] Overview and Legal Authority of Sections 482 and 6662

The United States tax law governing transfer pricing is covered under Internal Revenue Code section 482 and its associated regulations. While the Code section itself is a single paragraph long, the supporting regulations are several hundred pages in length and comprise economic theory, methods of analysis, and a series of examples designed to assist the taxpayer in understanding how the regulations should be applied to determine arm's-length prices.

Since 1917, the US Congress has empowered the IRS (or the Service) to take actions to more accurately reflect US income through various statutory mechanisms. The arm's-length standard was first introduced in the Revenue Act of 1934 to prevent taxpayers from shifting domestically generated income overseas. The United States first formally incorporated the arm's-length concept in its section 482 regulations in 1968, and these regulations were substantially revised in 1994. From 1934 through today, the arm's-length standard has served as the guiding framework for transfer pricing regulation in the United States. Following the United States' lead, many other industrialized countries have adopted the concept of arm's-length pricing and have developed detailed rules.

Income tax regulations associated with the pricing of intercompany transfers of tangible goods and intangible goods and with the determination of interest for intercompany loans have remained relatively consistent since issuance of the revised regulations in 1994. More recently, the US Treasury Department released updated regulatory guidance related to the provision of intercompany services in 2006 (finalized in 2009) and to cost sharing arrangements in 2009 (finalized in 2011). This increased regulatory activity generally reflects the government view that in many instances

transfer pricing has and is being used by many multinational companies to arbitrarily shift income overseas to jurisdictions that enjoy lower corporate tax rates.

The US transfer pricing tax law also includes section 6662 of the Internal Revenue Code, which dictates the circumstances under which penalties for non-compliance with section 482 will apply and the magnitude of those penalties under different scenarios. In addition to introducing a penalty regime, section 6662 offers taxpayers protection against the imposition of such penalties, provided that the taxpayer satisfies certain documentation requirements.

Specifically, section 6662 defines ten principal documents that a taxpayer is required to prepare prior to the timely filing of the taxpayer's US return each year. Compliance with this contemporaneous documentation requirement generally allows the taxpayer to avoid penalties imposed by the IRS as long as the analysis and supporting documentation is reasonable and done in good faith. The specific documents required can be found in Treasury Regulation section 1.6662-6(d)(2)(iii)(B). These Documents are discussed in more detail in section §17.03[A] below.

[B] Relationship between Section 482 and the OECD Guidelines

Generally, section 482 and the OECD Guidelines follow consistent concepts and articulate similar methods of analysis for different types of transactions. However, given that the US rules are regulations rather than general guidance, they tend to be more detailed and authoritative in nature. The OECD has released many of its updated reports in response to changing regulations in the US.

In addition to differences in the level of detail offered in each framework, there are subtle and not so subtle differences between the two sets of guidance. These differences are often at the heart of transfer pricing controversies, both at the financial reporting level and in tax compliance disputes. Certain key differences between the 482 regulations and the OECD Guidelines are discussed below.

[1] Choice of Method

Section 482 utilizes the concept of 'best method'. According to the 482 regulations, the best method is one that under the facts and circumstances, provides the most reliable measure of an arm's-length result.¹ With this concept, no method is considered more reliable than others a priori.

Contrary to this view, the OECD historically held a strict preference for transactional methods over profit-based methods. Specifically, the OECD Guidelines, first released in final form in 1995 (1995 OECD Guidelines), stated that '[t]raditional transaction methods are the most direct means of establishing if conditions in the commercial and financial relations between associated enterprises are arm's length.'² Chapters I-III of the 1995 OECD Guidelines were revised in 2010 to include new guidance on the selection and application of transfer pricing methods and on

1. Treasury Regulation §1.482-1(c)(1).
2. 1995 OECD Guidelines, Ch. 2.49.

comparability analyses (2010 OECD Guidelines or revised OECD Guidelines).^{3,4} The revised OECD Guidelines largely abandon a hierarchy of methods and instead require that the 'most appropriate method under the circumstances of the case' be employed to determine the arm's length price for any given intercompany transaction, similar to the 'best method rule' under section 482.⁵ Further, like section 482, the revised OECD Guidelines recognize that '[n]o one method is suitable in every possible situation, nor is it necessary to prove that a particular method is not suitable under the circumstances.'⁶

While the 2010 OECD Guidelines remove an explicit hierarchy, preference for traditional transaction methods, and in particular the CUP method, remains. Specifically, the OECD Guidelines state that in instances when both traditional transaction methods and transaction profit methods can be applied in an 'equally reliable manner, the traditional transaction method is preferable' and should be selected.⁷ Traditional transaction methods within the OECD framework include:

- the comparable uncontrolled price (CUP) method;
- the resale price method (RPM); and
- the cost plus method.

The OECD Guidelines further state that where it is possible to identify comparable uncontrolled transactions, '... the CUP method is preferable over other methods.'⁸

Prior to the elimination of the strict hierarchy of methods, inherent conflict between the US' best method rule and the OECD framework existed. For example, transactional methods dismissed as best methods under the 482 regulations were often applied under the OECD Guidelines. While it is anticipated that with the updated 2010 OECD Guidelines such conflicts will be less common, potential remains for inconsistencies between the US' best method rule and the OECD framework's method selection, particularly given the OECD's continued preference for transactional methods. Differences in method selection can in turn lead to inconsistent results when testing the arm's-length nature of a transaction.

[2] The Use of Safe Harbours

In a few instances, the US rules have allowed for the use of safe harbours. Generally, safe harbours in a transfer pricing context provide that the taxpayer need not demonstrate that the pricing of certain transactions meets the arm's-length standard. Specifically, the 482 regulations, under proper circumstances, provide safe harbours

3. The Committee on Fiscal Affairs approved the Revised Guidelines on 22, Jun. 2010, and the OECD Council approved the report for publication on 22, Jul. 2010.
4. Unless otherwise noted, citations within this section refer to the initial 1995 publication of the OECD Guidelines as well as all subsequent revisions through 22, Jul. 2010.
5. OECD Guidelines, Ch. 2.2.
6. *Ibid.*
7. OECD Guidelines, Ch.2.3.
8. OECD Guidelines, Ch. 2.14

for the pricing of intercompany debt, as well as for the pricing of certain low value-added intercompany services.

The OECD Guidelines discuss the benefits and concerns that are associated with its members providing country-specific safe harbours. The clearest benefit to taxpayers is that a safe harbour, when utilized, may dramatically decrease the compliance and examination burdens. The clearest detriment is that a country-specific safe harbour may not be recognized as producing an arm's-length result by other taxing authorities, and using a safe harbour to meet the transfer pricing requirements for one country may expose the taxpayer to otherwise avoidable controversy and potential double taxation.

[3] Profit-Based Methods: CPM versus TNMM

Generally, there are two profit-based methods described under section 482, and two methods described in the OECD Guidelines. One method, the profit split method, is consistent both conceptually and practically in use and application in both frameworks.

However, the comparable profits method (CPM) under the 482 regulations and the transactional net margin method (TNMM) under the OECD Guidelines, although similar in concept, are not quite the same method of analysis. The subtle differences in the methods are often overlooked by taxpayers and practitioners, which has led in many instances to controversy in financial reporting and in tax.

The CPM is discussed in some detail below in section §17.02[B][2], but as a general concept, this method tests the arm's-length nature of a transaction or a group of transactions by testing a controlled entity's profitability against the profits earned by comparable unrelated companies. If an entity's profits are consistent with companies performing similar functions and bearing similar risks, then the prices charged or paid to related parties must be arm's length.

Similarly, the TNMM looks to benchmark a related entity's profitability against the profits earned by comparable companies. The critical difference between the two methods centres on whether different types of transactions can be bundled together for the purposes of testing. Typically, applications of the CPM may incorporate broader definitions of product or functional similarity, both as it applies to defining taxpayer segments to test and as it applies to the selection of appropriate comparables.

[4] Cost Sharing Agreements/Cost Contribution Agreements

One of most obvious and often talked about differences between the 482 regulations and the OECD Guidelines is related to the topic of cost sharing. Cost sharing has been a major focus of the US Treasury and the IRS for several years, and is discussed in great detail in section §17.02[E] below. In December 2008, the US Treasury released voluminous new temporary regulations regarding cost sharing (2008 temporary regulations), which were issued in final form in December 2011 (2011 final regulations). These new regulations require a very strict adherence to form as well as substance, and introduce a specific vernacular that is unique to this section of the regulations. Under these regulations, a taxpayer's ability to operate within the cost sharing framework is

viewed more as a privilege than a right. The regulations require the taxpayer to structure its cost sharing agreement in specific ways and to provide detailed documentation unique to this type of structure.

In contrast, the OECD Guidelines' discussion of 'cost contribution arrangements' (CCA) is less than twenty pages long and focuses on the need for any cost contribution arrangement to be consistent with the arm's-length standard. In many instances, a CCA may meet the general standards set out in the OECD Guidelines, but may not meet the more stringent requirements under section 482.

[C] Summary of Transfer Pricing Regulatory Framework

The US transfer pricing laws and regulations provide rules for determining the accurate taxable income of controlled taxpayers in specific situations.⁹ The rules apply to intercompany transfers between related parties of tangible property, intangible property, and services across international borders, as well as to controlled financial transactions. The specifics of sections 482 and 6662 are discussed in this chapter.

[1] Intercompany Transactions: Identification and Characterization

Generally, to avoid transfer pricing related penalties under the US transfer pricing regulations, all intercompany transactions must be identified, evaluated under the 482 regulations, and documented as occurring at arm's length.

Intercompany transactions include the sale, assignment, lease, license, loan, advance, contribution, or any other transfer of interest in or a right to use any property or money between two or more taxpayers under common control. Identification of intercompany transactions often proves a difficult task, especially in instances where the taxpayer's multinational businesses are highly integrated.

The identification of intercompany transactions is typically best done by performing a detailed analysis of the taxpayer's contribution to the overall supply chain and value chain on a legal entity by legal entity basis. This is called a 'functional analysis'. Generally speaking, a functional analysis should include developing a detailed understanding of each legal entity's functions performed, risks borne, and assets utilized. Understanding each entity's role and contributions relative to the others' allows the taxpayer to better understand how the legal entities interact with one another and therefore identify the intercompany transactions that occur between them. In addition, this detailed factual understanding gives the taxpayer insight into the proper characterization of each identified transaction.

The rules under Treasury Regulation §1.482 on how to evaluate the arm's-length nature of an intercompany transaction are segmented by transaction type, or characterization. In turn, specific sections of the transfer pricing framework address the evaluation of tangible, intangible, and service transactions. Therefore, properly characterizing a transaction is critical to appropriately evaluating its arm's-length nature.

⁹ In this context, accurate taxable income means the income a controlled taxpayer would have earned if dealing at arm's length with related parties.