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Transfer Pricing Documentation – Current Issues and Strategies

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Agenda

1. The Current Transfer Pricing Environment
2. Legal and Economic Aspects of Documentation
3. The Modular Approach to Documentation
4. Rationalization of Supply Chains and the Modular Approach
5. Conclusion

1. The Current Transfer Pricing Environment

- Unilateral and Multilateral Transfer Pricing Enforcement Initiatives
- OECD Developments
 - OECD Valuation of Intangibles Project
 - OECD scoping of Article 5 Model Convention (PE)
- European Developments
 - New Documentation Requirements
 - Endorsement by the EU Council of Guidelines on low value services
 - CCCTB

2. Legal and Economic Aspects of Documentation

- Documentation as a Requirement for a Defense against Penalties –
 - The preparation of documentation may protect a taxpayer against penalties if it selects the “most appropriate” transfer pricing method and provides the field examiner with the required information within the legislated time frame
- Documentation as a Strategic Opportunity –
 - Successful resolution of transfer pricing and other tax controversies depends upon *advocacy*
 - Taxpayers should see documentation as the first opportunity to present evidence (economic and otherwise) in support of their positions, first to field examiners, and then potentially to other administrative or judicial audiences

2. Legal and Economic Aspects of Documentation

Legal

Contracts, books and records, invoices, information technology systems, etc.

Economic

Economic, business, and market analysis supporting conclusion that intercompany relationships are arm's length

2. Legal and Economic Aspects of Documentation

- **Legal aspects:** (i) Characterization and presentation of the transaction(s), and (ii) interpretation and application of statutes, administrative guidance, and case law to complex sets of facts
- **Economic aspects:** (i) Identification of relevant economic considerations faced by the parties to the transaction, including what realistic alternatives are available to them and (ii) to be combined with applicable transfer pricing requirements in several jurisdictions

2. Legal and Economic Aspects of Documentation

- Ideal world: A legal documentation package, consisting of a complete set of current agreements, together with supporting invoices and documents, covering all of the transactional flows that exist between members of the MNE group
- Failing to maintain proper legal documentation may trigger penalties, auditor qualifications on the financial statements, or liability for directors

2. Legal and Economic Aspects of Documentation

- Recent issues with legal aspects:
 - Required monitoring of intra-group agreements (merger, demerger, acquisition)
 - Required “audit” of pricing actually applied and its compliance with accepted methods (also from a local – always evolving - viewpoint)
 - Agreements are not enough, reality of services should be evidenced
 - Pricing methodologies to be backed up with detailed invoices (also to cope with currency control rules like in Russia or South Africa)
 - PE risks?

2. Legal and Economic Aspects of Documentation

- Recent issues with economic aspects:
 - Comparables: local or pan-geographic
 - TPM: use corroborating methods if global TPM is not accepted locally
 - Restructuring: exit charges
 - Economic downturn:
 - Do not cut back on TP documentation
 - Show that operating results are consistent with functions and risks
 - Show that operating results are due to factors other than transfer pricing

2. Legal and Economic Aspects of Documentation

	Requirement for <i>ad hoc</i> TP documentation	Penalties
France	Yes	If documentation is not submitted, or if the documentation does not comply with requirements, a EUR 10,000 penalty (for each year verified), or, if higher and depending on the seriousness of the breach, a penalty equal to 5% of the income adjustment, may be applied
Belgium	No formal requirement although (i) lack of <i>ad hoc</i> TP documentation creates substantial risk of a thorough transfer pricing audit and imposition of penalties and (ii) the Belgian tax authorities urge taxpayers to prepare contemporaneous transfer pricing documentation	10% to 200% of additional tax. Penalties are not tax deductible
Germany	No general requirement although taxpayer should document the economic and legal basis for arm's length prices and conditions of transactions with related parties.	If documentation is not submitted, or if the documentation is unusable, a penalty of 5% to 10% of the income adjustment will be assessed, with a minimum surcharge of EUR 5,000. In case of delayed submission, the surcharge may amount up to EUR 1 million, at least EUR 100 per day. These penalty payments are not deductible.
Italy	Yes. Complying with documentation requirements = no penalties in case of tax assessment re transfer pricing aspects	100 to 200% of additional tax (increased by one third if taxable income is derived from foreign sources); Reduced penalty of 30% of the unpaid tax and applicable interest (subject to conditions). Criminal penalties (1-3 years imprisonment) may apply in certain circumstances (tax fraud, significant tax evaded, or significant income not disclosed).
Spain	Yes	If the Tax Authorities (i) do not have to do any value correction: €1,500 per omitted data, or €15,000 for an omitted set of data, (ii) have to do any value correction: 15% of the adjustment (reduced penalties of up to 50% may apply if certain requirements are fulfilled). Additionally, penalties of up to 3% of the turnover of the entity, up to a maximum of €600,000 may apply in certain circumstances (resisting/obstructing Tax Authorities)
UK	No formal rules although taxpayers should keep records which are sufficient to enable them to deliver a correct, accurate and complete tax return.	Up to 100% of tax unpaid through fraud or negligent conduct (absence of documentation likely to constitute negligence); no penalty if taxpayer has made "honest and reasonable" attempt to comply and has evidence to show what it has done.
US	Yes	From 20% (substantial valuation misstatement) to 40% (Gross valuation misstatement)

2. Legal and Economic Aspects of Documentation

- European developments: France
 - Effective date: 1 January 2010 (Administrative circular issued on 4 January 2011)
 - Target: 'large' corporations or group established in France
 - What: general transfer pricing documentation, i.e., not a substitute to traditional evidence required for justifying each and every single transaction
 - When: the first day of a tax audit (although a 30-day 'extension period' will be offered to taxpayers). Failure to provide the required documentation shall trigger a fine up to 5% of the transferred profits in each audited year

2. Legal and Economic Aspects of Documentation

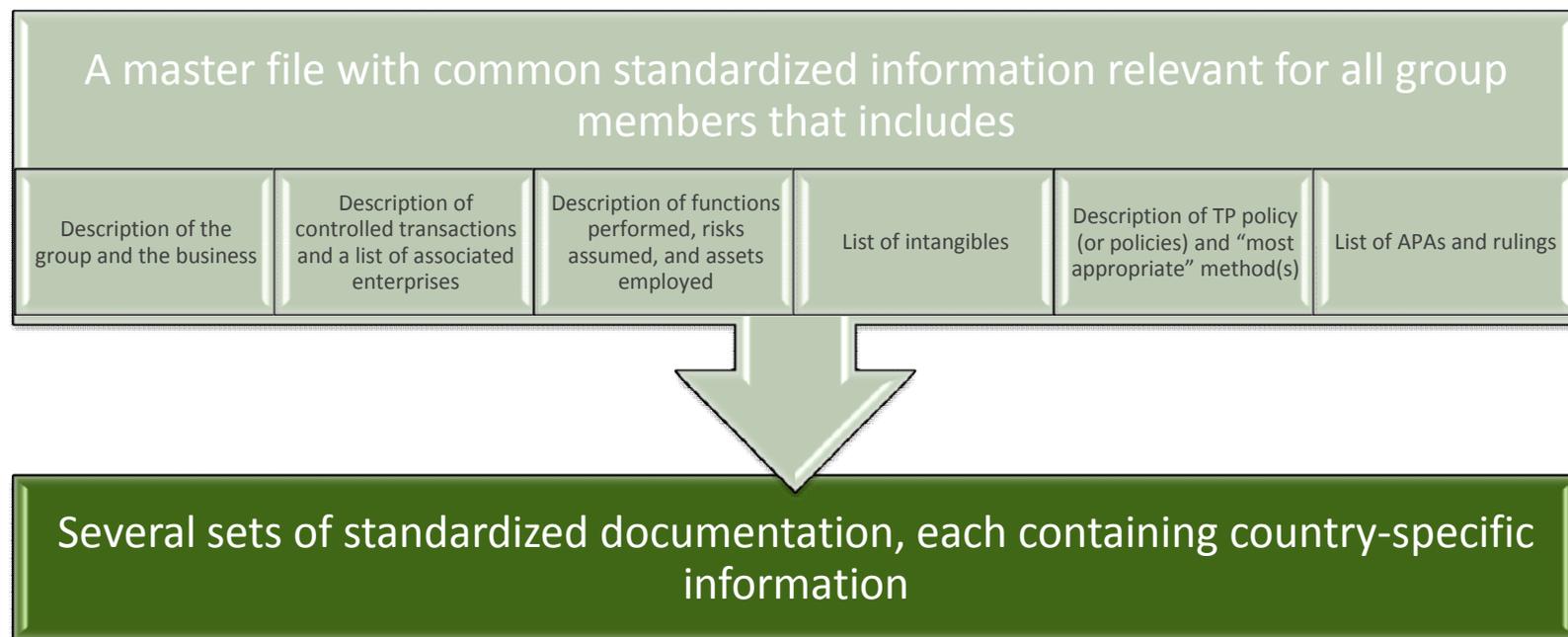
- European developments: Spain
 1. Spain introduced transfer pricing documentation requirements in 2009. These are challenged before courts by taxpayers
 2. Relaxing provisions (30 April 2010):
 - Derogations for documenting related-party transactions were introduced for companies whose (i) net sales in the current period did not exceed EUR 8,000,000 and (ii) related-party transactions did not exceed EUR 100,000 (Royal Legislative Decree 6/2010 of 30 April 2010 on measures to boost economic recovery and employment)
 - Simplification of the statutory documentation requirements regarding related-party transactions also have been proposed for related party transactions of less than EUR 250k

2. Legal and Economic Aspects of Documentation

- European developments: Italy
 - Italy introduced transfer pricing documentation in 2010
 1. Detail of documentation provided via a circular dated 29 September 2010, further updated on 15 December 2010
 - Taxpayers are subject to different documentation requirement depending on their status within the group
 2. Why important? If a taxpayer provides transfer pricing documentation during a tax audit, no tax penalty (which now range from 100 to 200 percent of any additional taxes assessed) will be applied on tax adjustments made by the tax authorities
 3. Critical aspects:
 - Timing provisions
 - Breadth of the documentation to be prepared

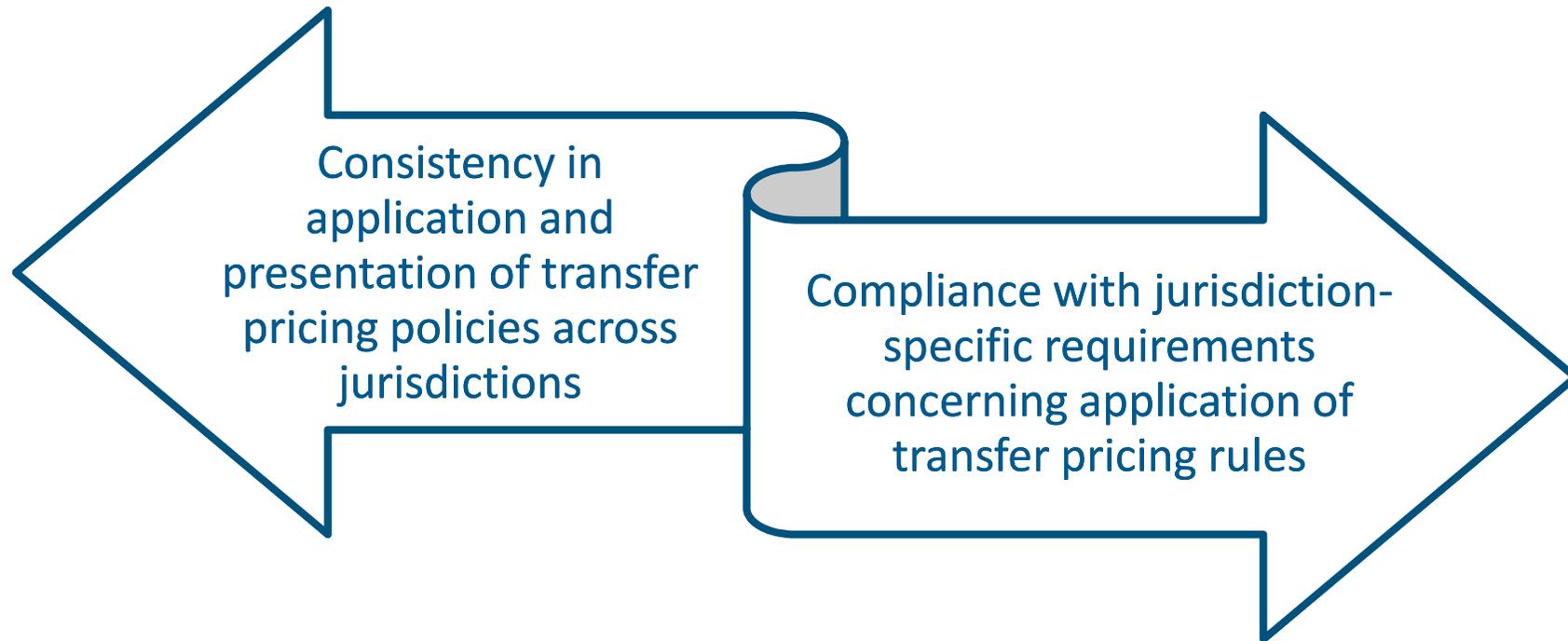
3. The Modular Approach to Documentation

- The current approach of many MNEs is to prepare documentation on a “Master file” basis, generally following the EU Joint Transfer Pricing Forum’s documentation guidelines endorsed by the EU Council in 2006
- This format involves two general items:



3. The Modular Approach to Documentation

- The challenge of preparing transfer pricing documentation on a global basis:



3. The Modular Approach to Documentation

A modular approach can help meet these aims:

Module templates developed centrally:
(TOC, cover sheet, industry data,
description of HQ transactions, definition
of TP Policy, mapping of intercompany
transactions)

Core file modules out of the module
templates and including country specific
information of the division / branch also
produced centrally

Local Template Files based on module
templates and extract from the relevant
country

Production of Local TP documentation –
check local counsel / in-house

3. The Modular Approach to Documentation

- Following a modular documentation approach:
 - Think (and gather information) globally, but
 - Act (and produce documentation) regionally:
 - Consider which countries should be covered
 - Choose appropriate databases to ensure sufficient local/regional comparables
 - Ensure consistency of TP methods across jurisdictions
 - Decide what information to present
 - Consider using regional master file with local supplements

4. Rationalization of Supply Chains and the Modular Approach

- Tax authorities are increasingly challenging the ways MNEs are seeking to rationalize their supply chains, such as by transferring and consolidating the bearing of risk
- Operating companies (manufacturing and sales) may be left performing limited functions and bear limited risks, with a guaranteed routine return set forth in contractual arrangements
- Taxpayers should have robust documentation to defend revised structures on examination
- The assumption of risk is a key economic factor that supports the attribution of profit. The documentation should thus address the factors that bear on the allocation of risks and consequences of assuming risk in the controlled transaction(s)

4. Rationalization of Supply Chains and the Modular Approach

- Agreements and related commercial documentation:
 - Written contracts, correspondence, and other communications, invoices, etc. should be thorough and clear with regard to legal relationships and obligations between parties, especially concerning functions to be performed and divisions of risks assumed by parties to written contracts
 - Documentation should show that parties assuming risks bear the costs, if any, of managing (whether internally or by using associated or independent service providers) or mitigating the risk (e.g., insurance premiums), or bear the costs that may arise if the risks materialize

4. Rationalization of Supply Chains and the Modular Approach

- Transfer Pricing Report and Related Documentation:
 - Transfer pricing report should analyze the transactions, especially with regard to risk, on a “granular” level – potential comparable transactions (internal or external) should be reviewed and the control the parties have over the risks and their respective capacities to bear the financial consequences of the risks assumed should be identified
 - Selection of “most appropriate method” should be based upon nature of risks involved (rather than assuming a cost-plus or TNMM guarantees a low-risk return)
 - Comparable companies supporting routine return should be selected based upon careful assessment of nature and magnitude of risks incurred by tested party (or tested parties)

4. Rationalization of Supply Chains and the Modular Approach

- Taxpayers following a modular documentation approach should be especially mindful of how factors relating to risks are described in the “master file” and in the modules prepared by local counsel
- Master file and local modules should be reviewed for accuracy and consistency
 - Hypothetical: Intercompany contracts identify PrincipalCo as bearing risks relating to business of developing, manufacturing, and selling widgets
 - Parties intend that affiliates in local jurisdictions provide routine services. A transfer pricing report (“TP Report”) is prepared that meets the documentation requirements of Country A. TP Report is consistent with intercompany contracts
 - Local controller in Country B is left to prepare transfer pricing modules for his jurisdiction. Local controller describes his contributions in a way that is inconsistent with bearing of risks in overall structure
 - Country A and Country B tax authorities share documentation packages pursuant to joint audit...

4. Rationalization of Supply Chains and the Modular Approach

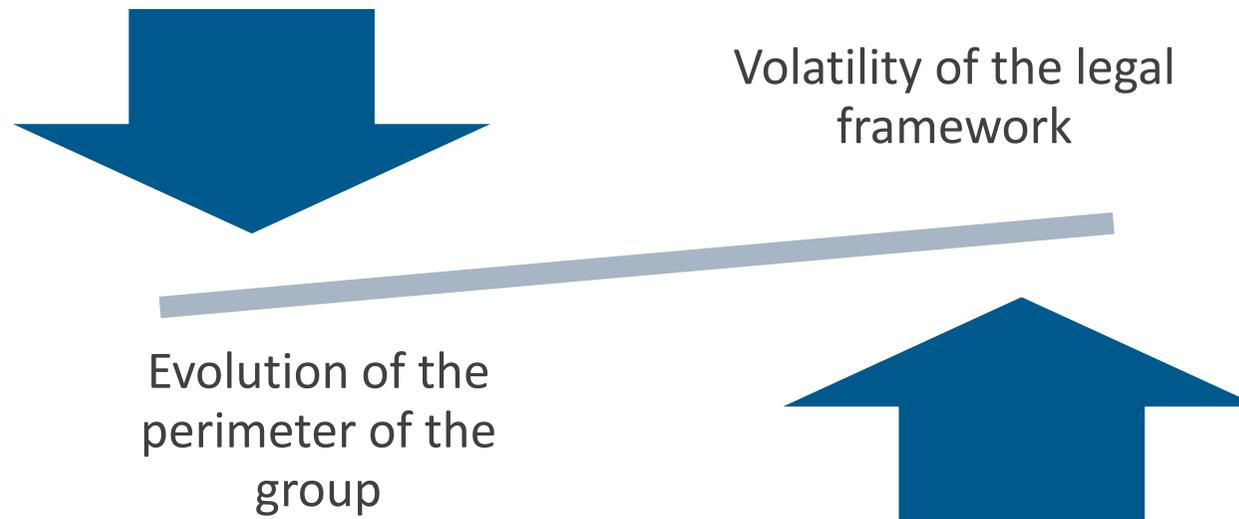
- In Europe, the EU Commission is against any kind of exit taxation but:
 - Germany takes a broad view on the application of the transfer of functions regulation (administrative circular dated 13 October 2010)
 - In several EU countries: increasing transparency required on the export of risks and functions



Increased audit risks and heavier documentation burden

5. Conclusion

- Documentation is never fixed forever



Focus and monitoring

5. Questions



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