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Analysis of Practical Transfer Pricing Issues: A Comparative EU/US Approach

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12 May 2009

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Topics

- I. Successfully documenting your transfer pricing policy: think globally, act regionally, check locally?
- II. Perspectives on business restructuring
- III. Working Together: recent trends in cost sharing arrangements and intra-group services charges
- IV. Advance Pricing Agreements: guidelines and strategic uses

- I. Successfully documenting your transfer pricing policy: think globally, act regionally, check locally?

Your transfer pricing policy – Think Globally

- In an "ideal world" transfer pricing should be "simple" i.e., MNEs would like to:
 - Have the ability to rely on a standardized set of documentation, prepared centrally, that is valid for all jurisdictions in which it operates (and, ideally, suitable for income tax, customs, and VAT purposes)
 - Take a regional or global approach when assessing transfer prices (i.e., use of regional or global comparables)

Your transfer pricing policy – Think Globally

- Are we there already?
 - No – as, e.g., EU and Asia (to some extent) are still a puzzle
 - In the EU, irrespective of the internal market, each of the 27 member states has a different set of rules for documenting transfer pricing
- Is there a trend toward harmonization / coordination?
 - Yes, at least "regionally" (e.g., EUTPD and PATA Documentation Package)

Your transfer pricing policy – Think Globally

- Challenges of global documentation:
 - Adequately reflect the (economic) differences between the markets (and their consequences on margins, operating expenses, choice of TP method, relevance and availability of comparables, etc.)
 - Make sure to address (legal) differences of concepts and approaches across different jurisdictions (e.g., definition of legal or economic owner of intangible assets in royalties flows, accepted or preferred methods, etc.)

Your transfer pricing policy – Think Globally

- Consequences:
 - Think (and gather information) globally, but
 - Act (and produce documentation) regionally

Your transfer pricing policy – Think Globally

- Benefits of global/regionalizing policies:
 - Streamlined process
 - Good offense and defense
 - Checks on consistency and policy

Your transfer pricing policy – Act Regionally

In the US:

- Transfer pricing adjustment penalties may be reduced if a taxpayer meets two requirements:
 - uses a specified method, and
 - prepares "contemporaneous" documentation
- Similar rules apply for use of unspecified methods
- Documentation must include
 - Overview of business
 - Description of structure
 - Description of controlled transactions
 - Description of TP method(s)
 - Description of comparables and adjustments
 - Economic analysis used

Your transfer pricing policy – Act Regionally

In the EU:

- The Code of Conduct is the main incentive for coordinated documentation approach:
 - The Code of Conduct aims at standardizing the documentation to be provided to tax authorities on the pricing of cross-border intra-group transactions
 - It does not address the method for defining the arm's length nature of the transactions but requires the taxpayer to justify the method used in its documentation, by reference to the OECD framework
 - The Code of Conduct indirectly covers the issue of pan-European comparables and the idea of "Europe as One Market," which supports the use of regional comparables

Your transfer pricing policy – Act Regionally

In the EU:

- Use of regional comparables:
 - Consistent pricing across geography
 - Streamlining of application and defense
 - What if the revenue authority doesn't agree?
 - Ensure inclusion/consistency of local comparables?
 - Explain global or regional nature of the function?
 - Explain contents of "local" database comparables?
 - Address any location savings issues?

Your transfer pricing policy – Act Regionally

- The EU frame for documentation (EUTPD):
 - One set of documentation containing common standardized information relevant for all EU group members (the "master file"), which must include:
 - Description of the group and the business
 - Description of controlled transactions, list of associated enterprises
 - Description of functions and risks
 - List of intangibles
 - Description of TP policy or selected method
 - List of APAs and rulings
 - Several sets of standardized documentation, each containing country-specific information (the "country-specific documentation")

Your transfer pricing policy – Check Locally

- The Code of Conduct is a political commitment
- Member States now have to ensure that any new legislation or administrative practices are compatible with the approach of the Code
- Even Regional Documentation would require local checks and validations (e.g., on the use of English for country-specific documentation):
 - In Belgium: administrative Circular dated 14 November 2006
 - In Finland: new rules taking into account EUTPD since January 2007
 - In Spain: the Royal Decree dated 18 November 2008 includes a detailed description of the new documentation requirements (including a description of the functions undertaken, the assets employed, and risks assumed) and no specification as to the language to be used nor on the use of pan-European comparables

Your transfer pricing policy – Check Locally

- In Norway: new TP documentation rules are effective since fiscal year 2008. Documentation prepared in accordance with EUTPD should meet the Norwegian requirement
- In Greece: article 26 of the Law 3728/2008 replicates EUTPD. New rules are applicable since 18 December 2008. In addition, a list of intra-group transactions has to be filed
- In Slovakia: new rules effective as of 1 January 2009; requires disclosure of intra-group transactions
- In France: new draft decree (17 April 2009) incorporates documentation provisions corresponding, to a large extent, to the EUTPD

Your transfer pricing policy – Check Locally

Details of the French draft Decree (dated 17 April 2009)

- Likely to correspond to the EU guidelines, but:
 - Specific information to be locally customized to reflect local language and local benchmarks
 - Disclosure in the event that changes occurred (in particular in case of business restructuring!)
 - Penalties for not providing TP documentation on a timely basis (i.e., first day of tax audit) are also foreseen (up to 5% of the TP reassessment with a minimum per year of €10,000)
 - High level of details required in the documentation
- Target date for implementation: January 2010
- Scope of the new draft differs from previous versions ('SME' could now escape the new regime but not documentation requirements)

Your transfer pricing policy – Check Locally

The Russian expected move to "more transfer pricing"

- Revival of interest for implementing a new transfer pricing framework
- Move seems to be revenue-driven and aims at tackling tax evasion
- Expected direction:
 - Broader scope of transfer pricing rules to cover, e.g., IP and financing transactions
 - New definition of 'related parties'
 - Introduction of arm's length price concept and of available methods for determining arm's length price (including CUP and Resale Minus)
 - Introduction of documentation requirements (attached to tax return as well as upon request)
 - Penalties for non-compliance
- Target implementation: January 2010

Your transfer pricing policy – Check Locally

- Examples of other elements complicating a successful local implementation
 - Irrespective of EUTPD, EU is a puzzle, where each member state has its own practices and sets of rules
 - Contemporaneous documentation requirements in certain countries entail earlier than expected investments in transfer pricing documentation
 - Level of penalties, remedies available, tax audit strategies, sophistication of tax authorities may differ from country to country

II. Perspectives on Business Restructuring

Business Restructuring

- Business restructuring in practice:
 - Cross-border redeployment by MNEs of functions, assets, and risks; cross-border reallocation of profits
 - Conversion of "full-fledged" distributors / manufacturers into commissionaires / toll manufacturers
 - Migration of intangible assets and risks, together with associated profit potential, often to low-tax jurisdictions
- Issues arising with such transactions:
 - Erosion of the tax base in certain countries
 - Uncoordinated approach and reactions by authorities
 - Uncertainties for everyone, companies and authorities alike

Business Restructuring

- Germany created a concern with new legislation on relocation of functions (2008 Business tax reform act and 4 July 2008 regulations). The legislation introduces the concept of an exit tax
 - The scope of the regime is broad and its compatibility with EU treaty remains questionable
 - Other countries may follow in the present financial context, wherein governments are looking to lock in and increase revenues
 - BUT the financial crisis and lower cash flow forecasts may offer right timing for tax planning
- US has pushed back on this exit tax

Business Restructuring

- France – Zimmer court case: PE risk in case of migration
 - UK company is a manufacturer of orthopedic products
 - It converted its French distributor into a commissionaire
 - The administrative court considered that the commissionaire was acting under the instructions and control of the UK company and therefore was a taxable permanent establishment of the UK company
- Consequences of the Zimmer case:
 - Appeal has been lodged and is still pending
 - Not the end of commissionaire structure but closer look is needed to review respective roles, put in place adequate documentation and agreement

Business Restructuring

- Spain – the 'Roche' case (24 January 2008): PE risk in toll manufacturing arrangement
- Facts:
 - Principal based in Switzerland
 - Toll manufacturing arrangement with a Spanish company
 - Swiss company takes the production risk, gives instructions for manufacturing and is the only client of the Spanish company
- The court held that:
 - The Spanish company is dependent and constitutes a Spanish PE of the Swiss principal

OECD draft comments on Business Restructuring

- The Discussion Draft only covers transactions between related parties in the context of Article 9 of the Model Tax Convention and does not address the attribution of profits within a single enterprise on the basis of Article 7 of the Model Tax Convention
- The analysis is based on the existing transfer pricing rules. In particular, it starts from the premise that the arm's length principle and the TP Guidelines do not and should not apply differently to post-restructuring transactions than to transactions that were structured as such from the beginning

OECD draft comments on Business Restructuring

Discussion draft is composed of four Issue Notes:

1. In light of the importance of risk allocation in relation to business restructurings, the first Issue Note provides general guidance on the allocation of risks between related parties in an Article 9 context and in particular the interpretation and application of paragraphs 1.26 to 1.29 of the TP Guidelines
2. The second Issue Note, "Arm's length compensation for the restructuring itself," discusses application of arm's length principle and TP Guidelines to restructuring itself, in particular the circumstances in which, at arm's length, the restructured entity would receive compensation for the transfer of functions, assets, and/or risks, and/or an indemnification for the termination or substantial renegotiation of the existing arrangements

OECD draft comments on Business Restructuring

3. The third Issue Note examines the application of the arm's length principle and the TP Guidelines to post-restructuring arrangements
4. The fourth Issue Note discusses important notions in relation to the exceptional circumstances in which a tax administration may consider not recognizing a transaction or structure adopted by a taxpayer, based on an analysis of the existing guidance at paragraphs 1.36-1.41 of the TP Guidelines and of the relationship between these paragraphs and other parts of the TP Guidelines

OECD draft comments on Business Restructuring – Mayer Brown Comments

- Avoidance of double taxation is ultimate goal
- Decisions on corporate restructuring should generally be respected by tax authorities
- Tax authorities should rather focus on arm's length remuneration

OECD draft comments on Business Restructuring – Mayer Brown Comments

- Profit / loss potential is appropriately compensated through transfer prices for assets and rights (no separate compensation)
- Urging OECD to express clear position that there should be no exit tax

III. Working Together: recent trends in cost sharing arrangements and intra-group services charges

Cost Contribution Arrangements (CCAs) and Cost Sharing Arrangements (CSAs)

- OECD's CCA: cf. Chapter VIII of the OECD Guidelines: very broad contractual concept, applies to R&D as well as marketing, etc.
- Application of the arm's length principle (proportional between contributions and expected benefits)
- Compare to US CSA, which relates exclusively to innovation, development, and exploitation of intangibles

In the US, new regulations covering CSAs

- The US Department of Treasury and IRS recently released temporary regulations covering CSAs
- The effective date of the regulations is 5 January 2009
- The temporary regulations have the same force and effect as final regulations
- The temporary regulations retain many of the concepts from proposed regulations (2005), together with certain modifications and clarifications

Primary issue in CSAs: valuation of "platform" intangibles and related resources

- Contribution of "platform" technology or other valuable intangibles or resources – starting point for developing and exploiting new intangible property
- Each participant in a CSA must make payments for this "platform contribution transaction" ("PCT payments")
- IRS will closely audit valuation of PCT payments
 - Principles of valuation in cost sharing may be applied in other contexts

Periodic adjustments: IRS's main test for evaluating PCT payments

- Low PCT payments to the US party, *or* high PCT payments by the US party to the non-US party will result in relatively high profitability for the non-US participant in the CSA
- IRS can make periodic adjustments to recalculate PCT payments – application of the "commensurate with income" standard
- Focus should be placed on a careful valuation

Cost sharing agreements within EU

- Most EU countries follow OECD Guidelines
- More and more require reporting of participation in CCA/CSA and changes in arrangement (see documentation)
- On the program of the EU Joint TP Forum: *"the JTPF intends to explore the possible scope and degree to which a common approach to CCAs could be developed within the EU"*

Intra-group services charges

- Allocation of costs between affiliates is a key business issue, strengthened by current economic downturn
- Companies that have grown through acquisitions of operations or subsidiaries often have not developed comprehensive charge-out practices for centralized "home office" services
- Charges are sometimes occurring without appropriate written contractual support or documentation
- Burden of proof?

Intra-group services charges

- The JTPF is now working on intra-group services with the view to avoiding double taxation and excessive compliance costs
- Four questions seem to have high priority:
 - Qualification of the services (shareholder costs, value-adding services, MNE-specific services)
 - Direct vis-à-vis indirect charges
 - Risk categorization (relating to mark-up)
 - Documentation of evidence related to services

Intra-group services: recent trends

- Controversial decision in Italy on intercompany service charges (registered January 2008)
- What is a "benefit" to the recipient of the services?
- Substantiation requires written, detailed agreement and invoices, as well as documentation of the benefits obtained by the subsidiary for each type of service

Intra-group services: recent trends

- In Spain, a taxpayer was denied a deduction for management fees because it failed to produce sufficient evidence.
- Evidence of services cannot be based exclusively on internal reports and documents
- Lesson to learn: Tax authorities may find it easier to conclude that the services were not actually rendered in order to avoid analyzing whether the fees meet the arm's length principle

IV. Advance Pricing Agreements: Guidelines and Strategic Uses

APAs – General Background

- An APA is an advance agreement among a taxpayer, another associated enterprise, and at least one tax authority
- The method used to set transfer prices between the related parties and an acceptable range or point for the prices is set in advance
- The taxing authority is bound to respect the agreed method and will not make adjustments, except in certain circumstances, such as fraud or changes in critical assumptions

Importance of APAs

- Transfer pricing is one of the major issues in any audit of a multinational company
- Latitude given to tax authorities to make transfer pricing adjustments leads to its being a key source of tax uncertainty
- Diligence is key to lower the risk of adjustments, but APAs are important safeguards
- APAs can also be important strategic tools

Strategic use of APAs

- Typical benefits of (unilateral), bilateral, or multilateral APAs
 - Prevent or mitigate double taxation as to the covered transaction
 - In multilateral APAs, the presence of more than one tax authority could help in order to reach a more distributive approach
 - APAs prevent the costs and uncertainties associated with contentious audits
 - Taxpayer involvement and control
 - Dedicated APA team
 - Could be used as a tool to secure certain arrangements (e.g., CSAs in the US)
- Drawbacks
 - APAs, even bilateral (or unilateral) are not available in all jurisdictions
 - No guarantee of success
 - Sensitivity of information disclosed to the authorities
 - Outcome may be more conservative than taxpayer's expectations
 - Cost

US Framework for APAs

- APAs in the US are governed by Revenue Procedure 2006-9
- In its application, taxpayer proposes a TPM and provides data intended to show TPM constitutes the "best method" under Section 482 regulations. APA Team evaluates request by analyzing data and information submitted in support of request
- Steps:
 - Voluntary pre-filing conference
 - APA request submission
 - Evaluation by, and negotiations with, APA Team
 - Annual reporting obligations

EU Framework for APAs

- A long standing practice in The Netherlands and Luxembourg ("rulings")
- Guidelines have been deployed by EU as a tool to avoid cross-border disputes
- Most EU countries have adopted APAs of some sort. Some refuse unilateral APAs (Germany), where others accept only unilateral APAs (Italy)

2007 Report of the EU Joint Transfer Pricing Forum

- *Goal of the Forum:* Find ways of preventing disputes arising from double taxation or the threat of double taxation
- *Four initial ways:* (i) APAs, (ii) simultaneous tax examinations, (iii) prior consultation or agreement, or (iv) expert opinion or mediation
- *Most worthwhile* according to the Forum: APAs, and advocating for better environment for APAs in the EU

Guidelines for Advance Pricing Agreements within the EU

Bilateral / Multilateral APAs – general suggestions:

- Taxpayer and tax administration should work together to establish mutually acceptable terms and conditions
- Withdrawal of the application should not trigger an audit
- **EU Transfer pricing documentation (Code of Conduct dated June 2006) is a useful basis for any APA application**
- Documentation requirements should not be unduly onerous

Guidelines for Advance Pricing Agreements within the EU

An APA application should typically have four distinct stages:

- *Pre-filing /Informal application:* should allow all parties to assess the likely success of the APA. This can save expenses
- *Formal application:* should be as complete as possible and as early as possible. All parties should be involved
- *Evaluation and negotiation of the APA:* the tax administration should formulate its preferred terms and conditions for the APA. The negotiation with the other tax administrations concerned should resolve any differences so that one set of terms and conditions can be provided to all the taxpayers involved. The taxpayer should be involved in the creation of the timetable
- *Formal agreement of APA:* The agreement should be given effect by formal agreements between the tax administrations involved and these agreements should give certainty to those involved in the APA

Guidelines for Advance Pricing Agreements within the EU

- APAs are available in a number of EU Member States: Belgium, the Czech Republic, Denmark, France, Germany, Netherlands, UK, and others
- Some recent news:
 - Poland: since 2007, APAs may be obtained for transactions involving PEs. The maximum period covered by an initial APA is now five years
 - Estonia: APAs available since 2008
 - Portugal: issued APA guidelines on 16 July 2008 in line with the EU report
 - Sweden: proposal to introduce APA Program is on agenda (report from the tax authorities)
 - Russian reform is likely to lead to the introduction of APA program for taxpayers (target date: January 2010)

Conclusion

- Keys for a successful transfer pricing strategy:
 - Be **A**lert
 - Be **P**repared
 - Be **A**ccurate by investing in close monitoring

Q & A



Thank you

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