Briefing

# Quarterly transfer pricing briefing: Summer 2016


## Speed read

**The major changes to transfer pricing over the last few months relate to OECD discussion drafts on profit splits and interest deductions that could alter the manner in which groups are financed and structured across borders. The recent EC ruling relating to Starbucks has created a potential inconsistency between the arm's length principle and the EU state aid rules. China has formalised value chain requirements into transfer pricing regulations. In the US, separate bodies of law professors have set out arguments purporting that the Tax Court ruling in the *Altera Corp* case was wrongly decided.**



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This update sets out a summary of key changes to international transfer pricing guidance, regulations and case law that have occurred in the past few months.

## OECD consultation on interest deductibility

On 11 July, the OECD issued a discussion draft setting out recommendations for capping interest deductibility in an effort to limit excessive interest payments used in tax avoidance (see bit.ly/29v2joS). This is critical to transfer pricing policy, as groups will not want to enter into complex transactions and economic support analysis if there is going to be a base cap on the level of deductions available.

- The cap will be based on a fixed-rate ratio, capping deductions at 10% to 30% of EBITDA. The discussion draft also explores the following important areas:
- approaches to calculate a group's net third party interest expense;
- a definition of group EBITDA; and
- approaches to deal with the impact of losses on the operation of the group ratio rule.

### Recommended actions

Whilst this is an onerous requirement on groups, it does recognise situations in which companies might take on large amounts of debt for commercial/non-tax reasons. In the UK, we have already witnessed banks holding back finance due to the uncertainty around leaving the EU; and it is likely that intra-group finance will need to increase for many groups. Establishing a commercial trail to support why transactions are entered into is becoming increasingly important when defending transfer pricing relating to those transactions.

Note that whilst purist economists will not be happy with the proposals, safe harbours can reduce the administrative burden on groups in many situations. These should be factored into cost benefit analysis associated with particular financing options.

It is important for impacted groups and industries (especially real estate, financial services and infrastructure industries, where EBITDA is not necessarily an accurate measure of liquidity) to feed into the discussion process. Responses should be sent by email to interestdeductions@oecd.org in Word format, by no later than 16 August 2016.

## OECD consultations on profit splits and the attribution of profits to permanent establishments

On 4 July, the OECD issued discussion drafts relating to profit splits and the attribution of profits to permanent establishments (see bit.ly/2aAvW95 and bit.ly/2aAuTGk).

### Attribution of profits to PEs

The recommendations are to align attribution principles with BEPS action items 8–10 and new guidance in relation to transfer pricing. There are revised concepts/guidance relating to:

- 'regular conclusion' of contracts;
- anti-fragmentation rules; and
- the principal purpose test.

### Profit splits

The recommendations are to improve understanding of when this method should be preferred and how best it should be applied. There is a discussion of the following important items:

- references to profits should apply equally to losses;
- splitting actual profits versus anticipated profits;
- ex ante versus ex post and information reasonably known/foreseen;
- factoring in uncertainty;
- value chain specifics;
- unique situations (including intellectual property); and
- choice of allocation keys/factors.

### Recommended actions

The attribution discussion draft includes some useful examples that may help groups to assess risk and could be applied as a cross check to existing transactions.

The profit split guidance is helpful. Although most groups do not use this as a primary transfer pricing method, the guidance will be of use to those groups which need to corroborate/test their primary method of transfer pricing.

Interested parties are invited to send their comments on the discussion drafts by 5 September 2016 by email to transferpricing@oecd.org.

## China formalises value chain requirements into transfer pricing regulations

On 13 July, the China State Administration of Taxation (SAT) formalised tax reporting requirements for multinational companies operating in China, imposing a value chain analysis (as set out in the September 2015 circular) that may cause more of a company's profits to be taxed in China. Some key departures from the OECD guidance are as follows:

- concept of DEMPEP for intellectual property (the

existing DEMPE functions being development, enhancement, maintenance, protection and exploitation, and the additional 'P' being promotion;
- a push for location savings/specific advantages;
- value chains to consider assets, costs, sales and total headcount per division/location; and
- 'direct' versus 'indirect' economic benefit.

### Recommended actions

Groups will have to prepare local transfer pricing files by June 30 following the year during which the related party transactions occur. The differences in treatment with OECD should be respected and render China one of the 'first tier' countries, along with India, Germany and Italy, that are high risk in terms of transfer pricing challenge.

## EC ruling on the arm's length principle

On 27 June, the European Commission published the non-confidential version of its final decision of 21 October 2015 ruling relating to the state aid investigation into the advance pricing agreement granted to Starbucks. The ruling has created a potential inconsistency between the arm's length principle and the EU state aid rules. It was a matter of time before this issue arose in the international regulatory framework, with advance pricing agreements providing an important tool in tax certainty weighed against tax administrations being criticised for offering agreements on taxation to encourage investment.

> The European Commission ruling relating to Starbucks has created a potential inconsistency between the arm's length principle and the EU state aid rules

The commission acknowledged that the ruling assessing the amount of royalty payments paid from the UK to the Netherlands, in which the payments were received as a tax deductible royalty, may differ from the OECD interpretation for similar transactions. (This is particularly affected by whether failure to adhere to the arm's length principle created an unfair market distortion; and may constitute a different analysis to that required under the OECD model tax convention.) The ruling went so far as to state:

'for any avoidance of doubt, the arm's length principle that the Commission applies in its state aid assessment is not that derived from article 9 of the OECD Model Tax Convention, which is a non-binding instrument … [The arm's length principle is] a general principle of equal treatment in taxation under the EU's binding treaty.'

### Recommended actions

Whilst the EC ruling has raised some issues around consistency, agreements with tax administrations (whether formal advance pricing agreements or informal discussion with tax inspectors) will continue to be an important tool in achieving certainty. However, there is no substitute for a commercially chosen, non-aggressive and well documented transfer pricing policy that does not draw scrutiny from tax administrations.

## IRS *Altera* case and ongoing challenges/appeals

My first transfer pricing this year (see *Tax Journal*, 5 February 2016) set out the court decision and petition filed in *Altera Corp v Commissioner* (TC docket no. 31538-15), challenging the IRS decision on the issue of whether stock-based compensation (SBCs) should be included in a cost sharing arrangement.

The company filed its petition on 18 December 2015, noting that the IRS based the income adjustments not on 2003 regulations, but on temporary and permanent cost sharing regulations adopted in 2009 and 2011, respectively. Altera argued that the requirements of all versions of the regulations are essentially the same and are invalid on the same grounds; and the Tax Court ruled that Treasury erred in promulgating the regulation because it failed to consider stakeholder commentary that unrelated parties never share the cost of SBC. Its failure to explain why it disregarded that evidence, the court said, violated the Administrative Procedure Act.

On 1 and 5 July, separate bodies of law professors set out arguments purporting that the Tax Court was wrong and that the above mentioned cost-sharing regulation is reasonable under the IRS commensurate-with-income standard. In tax code section 482, which governs transfer pricing, they said.

### Recommended actions

Many groups are not including SBCs in cost sharing anymore (and have adjusted FY 2014 filings where they could avoid a secondary adjustment). Most point to the economic substance of agreements, stating that the parties only shared SBC's because the regulations said they were required to as a basis for application in FY 2014. Many other groups are amending agreements with effect from FY 2015 to reflect this.

Certain groups have attempted to take a financial statement benefit for any potential clawback, as well as for the current year, but many have elected not to take a financial statement benefit. It is up to each group to review and to articulate its position on a consistent and reasonable basis. Some groups have excluded SBC's from management charges (and applied the comparability standard, changed the mark-up basis and removed SBCs from the cost base).

## What to look out for in the next few months

On occasion, tax administrations release unpopular 'summer' regulations/guidance that can catch the industry off guard if one is focused on much needed holidays. So keep one eye on the stream of alerts and articles that are still being generated (and have safe travels). ■

**For related reading visit www.taxjournal.com**

- Quarterly transfer pricing briefing: 2015/16 (Shiv Mahalingham, 3.2.16)
- 20 questions on state aid and tax (Jonathan Hare, Stephen Morse & Peter Halford, 24.2.16)
- 30 questions on BEPS (Jill Gatehouse & Susanna Brain, 29.10.15)
- Tax deductibility of corporate interest: the new consultation (Daniel Head & John Monds, 19.5.16)
- BEPS: Preventing the artificial avoidance of the permanent establishment status (Alison Lobb, 29.10.15)
- BEPS: Interest deductions and other financial payments (Charles Yorke, 29.10.15)