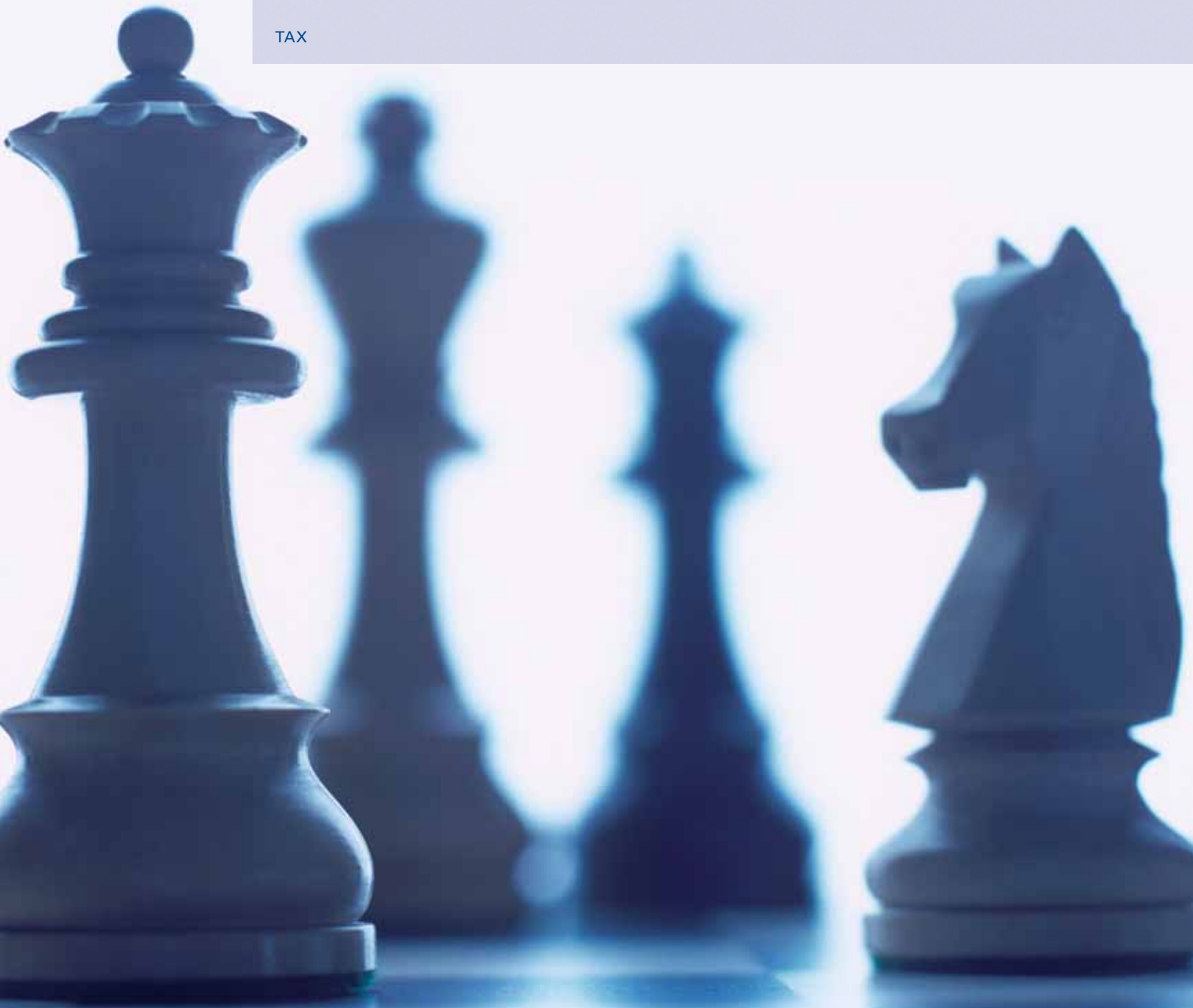




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Steve Fortier

KPMG in the United States
303 East Wacker Drive, 13th Floor
Chicago, IL 60601-5255
Phone: +1 312 665 1416
Fax: +1 312 275 8404
e-Mail: stevenfortier@kpmg.com

Steve Fortier is the global managing principal of KPMG's Global Transfer Pricing Services (GTPS) practice. He is also national principal-in-charge of KPMG's Economic and Valuation Services practice in the United States. Mr. Fortier has served in a succession of senior leadership roles within KPMG, including: U.S. national transfer pricing leader, regional leader of GTPS in the Americas; regional leader of GTPS in Asia-Pacific; and national leader of KPMG in Australia's transfer pricing practice. He primarily focuses on leading global transfer pricing projects to assist clients in meeting their business and tax objectives.

Mr. Fortier has provided transfer pricing advisory services to leading multinationals across a range of industries. He has developed and implemented corporate transfer pricing strategies in conjunction with business restructurings, supply chain planning, merger and acquisition integration, and shared service center implementations. He has assisted companies in developing global transfer pricing policies and documentation and negotiating Advance Pricing Agreements. In addition, he has assisted companies in resolving transfer pricing disputes with tax authorities in North America, Europe and Asia-Pacific.


Steve Harris

KPMG in the United States
345 Park Avenue
New York, NY 10154
Phone: +1 212 872 6718 (NY);
+1 202 533 3110 (DC)
Fax: +1 212 872 5576
Cell: +1 917 406 4425
e-Mail: sdharris@kpmg.com

Steve Harris' practice focuses on two key components: (1) Asia-Pacific client matters, and (2) transfer pricing controversy. Currently, he is the U.S. leader for GTPS Pacific Rim Initiatives. Since 2000, Mr. Harris has been practice leader for KPMG's Global Transfer Pricing Resolution Network, which focuses on resolving cross-border transfer pricing controversies through mechanisms such as Advance Pricing Agreements and Competent Authority matters.

From 2005 through 2007, Mr. Harris served the U.S. practice as KPMG's principal-in-charge, transfer pricing (East Region). In this capacity, he had overall responsibility for developing and implementing transfer pricing services in the region.

Since 1999, he consistently has been selected by his peers and validated by International Tax Review ('ITR') as a leading global U.S. leading transfer pricing and tax advisor.

Mr. Harris earned his J.D. degree and his LL.M. degree in taxation at Capital University in Columbus, Ohio. He received a B.A. degree from Bowling Green State University, and undertook additional studies at the University of Salzburg, Austria.

Mr. Harris is a member of the American Bar Association Tax Section's Transfer Pricing Committee and the International Fiscal Association (IFA).

Welcome

Welcome to “*A Meeting of Minds*,” KPMG’s inaugural publication focused on transfer pricing dispute resolution and risk management issues. As readers are well aware, there has been a rapid, global proliferation of transfer pricing regulations and penalty regimes over the past 10 years. This, coupled with the growing sophistication of tax authorities, means that multinational companies confront an increasingly challenging risk management landscape.

Thirty-nine Global Transfer Pricing Services professionals, from 19 KPMG-member firms around the world, have contributed to the articles in this publication and distilled their latest thinking on key topics to help you both understand the new environment and, by thinking beyond the current situation, make sound transfer pricing risk management decisions for the future. The publication combines theory and principle with real cases and issues, and describes several approaches that have helped to add real value by resolving controversies and debates. The articles in the pages that follow reflect the current state of play in transfer pricing both geographically and from an issues point of view.

Our thanks to all the authors for their contributions, and to Clark Chandler (KPMG in the United States) for the effort he has put into this publication. We welcome feedback and other input from both our member firms’ clients and tax authorities around the world on the topics and issues discussed here, so that we can achieve an ongoing “Meeting of Minds.” Please convey your feedback to your KPMG adviser, or e-mail us at transferpricing@kpmg.com.

Kind regards,

Steve Fortier
Managing Principal
KPMG’s Global Transfer Pricing Services

Steve Harris
Principal and Practice Leader
KPMG’s Global Transfer Pricing
Resolution Network

Getting to Grips with Transfer Pricing Risk

The adoption of transfer pricing rules all over the world has created a new class of tax risk for multinationals. Hareesh Dhawale (KPMG in the United States), Daisuke Horiguchi (KPMG in Japan), Pascal Luquet (Fidal), Alexey Manasuev (KPMG in the United States), and Richard Slimmen (KPMG in the Netherlands) outline the basic principles of transfer pricing risk management.

Like death and taxes, transfer pricing (TP) scrutiny by the world's tax authorities is a fact of life. As business globalization widens the reach and ambition of multinational enterprises (MNEs), CFOs and tax directors face a plethora of new risks in a growing number of tax regimes with different rules and requirements. This article aims to provide guidance on how the real and potential risks of TP audits and adjustments can be successfully managed, and what taxpayers need to bear in mind when making strategic decisions.

TP-Sensitive Tax Authorities

Survey after survey ranks TP as an important tax issue for many MNEs. There are four main reasons for this continued focus on managing TP risk:

1. Because tax authorities around the world realize that TP is a zero-sum game (an extra point of taxable income gained in one jurisdiction is a point lost in another), they're policing TP compliance with ever-increasing vigilance. This is reflected in the dramatic increase in the quantities of TP documentation demanded by many tax authorities in recent years.

2. The growing divergence of views among tax authorities about what TP should encompass is a second factor. Although the vast majority of tax authorities adhere to the principles set forth in the Organisation for Economic Co-operation and Development (OECD) Transfer Pricing Guidelines to evaluate transfer prices, interpretations vary. In Germany, for example, recent legislation allows a broad definition of what must be paid for when business functions move from Germany to another tax jurisdiction. China has adopted a much narrower view of what the Chinese subsidiary of a foreign group can pay for the use, for instance, of its parent's intellectual property.

3. Because TP rules have been introduced quite recently in many countries, institutional experience in TP administration has not yet been built in such countries. This can create uncertainty because it can lead to adjustments well outside the range considered normal in more mature TP regimes. This lack of experience can also undermine a taxpayer's confidence in the Competent Authority process as protection against double taxation.

Once the significant inter-company transactions are identified, they should be screened for red flags that could attract the attention of tax authorities.



Hareesh Dhawale
KPMG in the United States
Suite 2000
355 South Grand Avenue
Los Angeles, CA 90071-1568
Phone: +1 213 593 6769
Fax: +1 202 403 3863
e-Mail: hdhawale@kpmg.com

Dr. Hareesh Dhawale is a managing director in the U.S. member firms' Washington National Tax practice, specializing in transfer pricing. Dr. Dhawale has conducted numerous transfer pricing studies for clients in industries and sectors as diverse as pharmaceuticals, telecommunications, internet services, computer software, express transportation services, hospitality, oil and gas exploration and drilling, and automotive parts. The transfer pricing studies have been used to assist clients obtain bilateral Advance Pricing

Agreements (APAs) and to develop, document, and defend their transfer pricing and cost sharing policies. Within the pharmaceutical sector, the studies conducted by Dr. Dhawale have employed econometric and statistical tools to value intangible property as well as detailing and promotional activities.

Dr. Dhawale received his Ph.D. in economics from the University of Maryland at College Park and his J.D. from The George Washington University National Law Center. Dr. Dhawale is a CFA charterholder.

4. Finally, many MNEs have observed that tax authorities are getting tougher, and in some cases more litigious, on TP issues at a time when many MNEs are becoming subject to more rigorous controls and risk assessment rules (such as the FIN 48 rules) for dealing with uncertain tax positions. This has obliged companies to invest more time and effort to determine the appropriate level of TP reserves.

Managing the Risk

Since every cross-border inter-company transaction potentially requires dealing with at least two different tax authorities, each of which may look at the same transaction in different ways, it is impossible to eliminate TP risk entirely. However, it can be mitigated by exercising good risk management principles. In KPMG member firms' experience, some of the key steps to effective management of TP risks include:

- developing controls that allow taxpayers to identify significant inter-company transactions and capturing the information needed to assess potential risks

- assessing such transactions to determine if they carry any red flags likely to attract the attention of tax authorities
- identifying options for resolving disputes that may arise
- developing documentation needed to comply with local requirements and establish a starting point for the risk management process.

Note that documentation comes at the end, rather than the beginning, of this process.¹ Given the proliferation of local rules, preparing comprehensive documentation for an MNE with complex international operations can be very costly and should, therefore, be done in conjunction with a risk assessment process to ascertain that money spent on documentation goes to the areas where it can be most effective. Good documentation not only facilitates compliance with local TP rules; it also supports a consistent risk management philosophy. A failure to think through risk management issues up-front can lead to inconsistent or poorly argued reports that could increase TP risk by assuming positions at odds with each other or with the MNE's global policy.

Controls

The first step in assessing TP risk is developing a set of controls that allows a taxpayer to identify and assess risks systematically. Such controls should include:

- a list of material inter-company transactions ranked by size
- a description of the policies used to price the transactions and the steps used to document that these policies are followed
- estimates of the financial results of these transactions in each country.

Red Flags

Once the significant inter-company transactions are identified, they should be screened for red flags that could attract the attention of tax authorities. Perhaps the most common of such red flags is an unusual profit result in either direction. In the case of unusually high profits, each tax authority is likely to focus on factors that support a large claim to those profits. In the case of losses, each tax authority may assert

1. Even for a jurisdiction that reviews transfer pricing from an *ex ante* rather than *ex post* perspective, it could be assumed that the jurisdiction is interested in making sure that the local taxpayer earns an appropriate amount of income, which of course can only be measured after the fact at the end of a tax year.

- A Persistent losses or low operating profits

- B Sharp changes in profitability from prior year(s)

- C Different prices/markups charged between:
 - (i) Related and Unrelated Parties for similar transactions
 - (ii) Various related parties for similar transactions

- D Lack of (sufficient) documentation

- E Absence of or non-adherence to inter-company agreements

- F High royalties with licensee exhibiting low profits or operating losses

- G Royalties charged for soft intangibles, that is, intangibles that are not legally protected, such as business process/systems/methods

- H Significant inter-company management fees

- I Transactions with group company in tax haven

- J Significant asset impairment charges, restructuring charges, inventory write-offs

- K Significant year-end adjustment to inter-company prices

- L Actual behavior not consistent with documented TP policy

- M Closing costs (especially when company was making profits)

- N Separation of functions and risks that does not make sense from a business perspective

Source: KPMG in the Netherlands.

Previously, tax authorities focused mostly on restructuring that led to effective shifts in profit to low tax jurisdictions.

that the local subsidiary is in business to make money, and is being charged too much or paid too little by related parties if it incurs losses over a prolonged period.

Increasingly, more types of restructurings have attracted attention of tax authorities. As such, supply chain restructuring could likely pique the tax authorities' interest. Previously, tax authorities focused mostly on restructuring that led to effective shifts in profit to low tax jurisdictions. Now they are examining many types of restructuring, including closures and the movement of manufacturing operations to cut costs, follow customers, etc. The new German legislation is the clearest example of the trend, but tax authorities the world over are raising similar issues upon audit.

Careless TP management can trigger alarms too. Year-end adjustments without authorization in inter-company contracts could be disallowed and, at worst, may be treated as voluntary contributions ineligible for Competent Authority relief. The lack of a clear identification of which legal entity has developed, and thus owns, key intangibles can lead to disputes with tax authorities. Failure to adhere to inter-company agreements is another source of TP troubles. Other red flags are listed opposite.

Setting Objective

Once the main risks have been identified, the companies can focus on developing policies to manage such risks. The first step here is to identify objectives. Is the objective to:

- minimize conflicts with tax authorities?
- manage predictability for financial statement purposes?
- manage the effective tax rate?
- meet cash-flow goals?
- manage the impact of TP on the business by, for example, maintaining the free flow of know-how throughout the group, or retaining the flexibility to allocate production across different manufacturing sites in ways that make business sense?

Or, Is It a Combination of Some, or All, of These?

Armed with its list of objectives, the taxpayer can then decide what technical positions to adopt and, in view of those positions, how it plans to resolve issues that arise. One of the first considerations is whether the issue can be resolved locally or whether it's likely to need bilateral negotiations between the two tax authorities. The local option could be less expensive, may establish precedents for future disputes (this can be good or bad, depending on the outcome), and can usually be settled more quickly than a bilateral solution. It is for these reasons that the vast majority of TP issues, and virtually all routine issues, are addressed locally. In some cases no realistic bilateral option exists. For example, there may not be a tax treaty between the countries involved, the transaction may involve a low tax jurisdiction, or past experience has shown that the Competent Authority process proved to be unsuccessful (for instance, although the Competent Authority procedure is available in theory, in practice, one of the Competent Authorities may be unwilling to grant double-tax relief).

In other cases, the bilateral resolution of a TP dispute may be the only realistic option, particularly for certain factual situations (such as consolidated losses) or when one of the tax authorities involved has an unconventional position on a particular issue (such as the new German legislation on exit charges, or the U.S. position on stock option expenses). One important advantage of bilateral solutions is that they greatly increase the likelihood that double taxation may be eliminated, particularly where binding arbitration is available, either through the auspices of the Joint Transfer Pricing Forum in Europe, or because it is incorporated into the treaty itself, as in the U.S. treaties with Germany and Belgium and pending protocol for Canada.



Daisuke Horiguchi
KPMG in Japan
Izumi Garden Tower
1-6-1, Roppongi
Minato-ku, Tokyo, 106-6012
Phone: +81 3 6229 8310
Fax: +81 3 5575 0761
Cell: +81 90 2623 1718
e-Mail: daisuke.horiguchi@jp.kpmg.com

Daisuke Horiguchi is a tax partner in KPMG in Japan's Tokyo office where he leads the Global Transfer Pricing Services practice. Since he joined KPMG in 1995, he has been involved in major transfer pricing studies for Japanese multinational pharmaceutical, electronics, and machinery companies as well as studies for many inbound clients. As a tax partner, he has led several bilateral APA cases and has experience in large transfer pricing audits in Japan.

Mr. Horiguchi has written a number of articles on transfer pricing, in particular in the *International Taxation Japan*. Recently his work in transfer pricing has focused on arm's-length prices of intangible assets and service functions, which reflect the divestiture of multinational companies, especially Japanese companies.



Pascal Luquet
Fidal Direction Internationale*
Espace 21
32, Place Ronde
92035 Paris La Défense Cedex
Phone: +33 (1) 5568 1522
Fax: + 33 (1) 5568 1400
e-Mail: pluquet@fidalinternational.com

Pascal Luquet is the partner of the Global Transfer Pricing Services in FIDAL in France.

Mr. Luquet is responsible for a large and varied portfolio of clients. He has a detailed knowledge of French advisory issues, including tax planning methodologies for corporate groups.

Mr. Luquet has extensive experience in tax investigations and, in particular, in transfer pricing audits. On many projects, he has assisted clients throughout the audit process, acted as a primary contact with the fiscal

administration and coordinated the involvement of various fiscal specialists.

Mr. Luquet has led all APA cases managed by FIDAL in France and has broad experience in Mutual Agreement Procedure. He has overseen many significant transfer price planning and documentation projects and applied economic reasoning and other tools to sophisticated tax and valuation problems.

*Fidal is an independent legal entity that is separate from KPMG International and its member firms.

Wait and See, or Take the Initiative

The next key decision is whether to wait for an audit, or apply for an Advance Pricing Agreement (APA), or some other advance ruling. APAs can be time-consuming and expensive to acquire, but they should at least be considered when they may result in one or more of the following outcomes:

- create an opportunity to realize an important objective, such as removing uncertainty or achieving a given TP result
- allow the taxpayer to switch from decision-makers who seem to be entrenched in an unfavorable position to a more open-minded APA team
- change the timeframe being assessed, and thus the facts used in negotiations with the tax authorities
- allow several years to be covered in one negotiation
- establish a favorable precedent for other transactions.



Alexey V. Manasuev
 KPMG in the United States
 2001 M Street, NW
 Washington, D.C. 20036
 Phone: +1 202 533 3786
 Fax: +1 202 315 3672
 Email: amanasuev@kpmg.com

Alexey V. Manasuev is a manager in the International Corporate Services Group of the Washington National Tax practice at the U.S. member firms' Washington, D.C. office. He advises clients and KPMG member firms on international tax (related to both inbound and outbound investments) and transfer pricing issues. Mr. Manasuev also assists clients in Competent Authority and Advance Pricing Agreement matters.

He frequently writes and contributes on various transfer pricing and international tax topics.

Mr. Manasuev is an active member of the ABA Tax Section Transfer Pricing Committee where he chairs the Subcommittee on Important Developments. He is also a member of the International Fiscal Association and New York State Bar Association Section of Taxation.

Mr. Manasuev earned his LL.M. in international taxation in 2002 from New York University School of Law.

Documentation

If a taxpayer decides to adopt a wait-and-see approach, preparation of TP documentation becomes critical. Its primary purpose is simple compliance, of course, but compliance can and, we believe, should be approached strategically. Over the past decade or so, documentation required from taxpayers by tax authorities all over the world has grown and can be very burdensome, driven by the lack of uniformity in certain areas such as:

- Databases taxpayers must use to identify comparables for testing the arm's-length nature of their inter-company pricing.
- Prioritization and application of the methods taxpayers must use to demonstrate arm's length inter-company pricing. Almost all major tax jurisdictions follow OECD Transfer Pricing Guidelines, but the priorities given to particular methods and prescriptions for their application differ.
- The information, data, and documentation that may be required as part of the TP documentation, including the functions and risks of the entities engaged in the inter-company transactions.

Since MNEs often have affiliates in dozens of countries, compliance with each country's rules and the testing of each transaction can be difficult, if not impossible. A core documentation study, based on OECD guidelines, is thus essential. Local documentation should be developed for areas of biggest potential exposure, and care should be taken to determine that pricing elsewhere is consistent with a clearly specified global TP policy, which can be produced in the event of a challenge. The core documents should clearly demonstrate that the global or regional TP policy applies the arm's-length standard and is adhered to.

This core documentation can be evidence to the tax authorities at audit of the taxpayer's good faith effort to develop and adhere to the arm's-length standard. Showing evidence to the tax authority may help reduce the risk of penalties and, if a dispute arises, can shift the burden of proof. More importantly, it can provide a starting point for discussions with tax authorities about the inter-company pricing policy and why it is appropriate.

Conversations with Tax Authorities

A well-written, tightly-argued TP policy statement can have considerable power. It can be evidence of serious and careful thought, confidence in the product of that thinking, and a willingness to defend it against any challenge. It can transform the nature of the conversation with the tax authority from an argument to a discussion. If the taxpayer has a good working relationship with the local tax inspector, documentation can provide a basis for reaching a mutually agreeable settlement of the issues.

But when documentation is being prepared in a particular country, it should at least be reviewed by individuals who have knowledge of local practices. Local tax authorities often expect the documentation to reflect the particular qualities of the entity they are auditing. So even if all distribution affiliates of an MNE perform the same functions and incur the same risk, for example, at least part of the documentation should reflect local input.



Richard F. Slimmen
 KPMG in the Netherlands
 Fascinatio Boulevard 250
 3065 WB Rotterdam
 Phone: +31 (0)10 45 36 860
 Cell: +31 (0) 6 46 23 26 00
 e-Mail: slimmen.richard@kpmg.nl

Richard Slimmen is a senior tax manager with KPMG Meijburg & Co in Rotterdam/Amsterdam and a member of the Global Transfer Pricing Services and Global Transfer Pricing Resolution practices.

Prior to joining KPMG in 2007, Mr. Slimmen was engaged for 19 years with the Dutch Tax Authorities and specialized in transfer pricing. He was a senior member of the Dutch coordination group on transfer pricing and was the APA-coordinator of the

Dutch APA-team. He also acted as Competent Authority in several multilateral and bilateral APA negotiations.

He has in depth knowledge about defense strategies towards the Dutch Tax Authorities.

Mr. Slimmen has handled numerous transfer pricing cases and is active in the TESC practice as well as the automotive practice.

Local tax authorities often expect the documentation to reflect the particular qualities of the entity they are auditing.

It is also important to remember that documentation includes more than a simple transfer pricing study. In many cases, tax authorities will also be interested in inter-company contracts that clearly set out the functions of, and the risks incurred by, the parties and information on the benefits the local entity derived from parental service charges, to the extent inter-company services are provided. Therefore, it is advisable that the material assembled in response to inquiries by the tax authority include not only the formal documentation policies, but also other materials the tax authorities could likely find persuasive.

Conclusion

The continued and growing interest of tax authorities in TP and the proliferation of local rules have made the assessment and management of TP risk a key role of MNE CFOs and tax directors. It is a role, moreover, that takes them far beyond the confines of traditional tax planning into vital business areas such as organizational structure and the configuration of the supply chain. These days, a change in functions and responsibilities or any reorganization of manufacturing could create a potential TP exposure. Therefore, MNEs should have in place effective tools for identifying and measuring risk and a familiarity with both technical and procedural approaches for dealing with TP issues raised by tax authorities.

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.

This article represents the views of the author only, and does not necessarily represent the views or professional advice of Fidal and KPMG in Japan, the Netherlands, and the United States.

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Transfer Pricing Developments at the OECD

The Organisation for Economic Co-operation and Development is the leading international organization for developing common international rules for transfer pricing, but it's not resting on its guidelines. Damian Preshaw (KPMG in Australia), Montserrat Trapé (KPMG in Spain), Dirk Van Stappen (KPMG in Belgium), and François Vincent (KPMG in Canada) summarize its recent contributions.

When issuing revised guidelines in July 1995,¹ the Organisation for Economic Co-operation and Development (OECD) instructed its Committee on Fiscal Affairs (CFA) to monitor implementation of the Transfer Pricing (TP) guidelines in partnership with the tax authorities of OECD member countries and the business community, and to recommend modifications to ensure the model remained adapted to the ever-changing business and regulatory environment. The OECD sees the CFA's monitoring role as an integral part of the agreement on TP methodologies reached in July 1995², and its implementation as the basis of a globally consistent application of the guidelines.

In January 2005 the OECD's Centre for Tax Policy and Administration (CTPA) established a Joint Working Group (JWG) of tax treaty and TP specialists, to address issues that arise during the restructurings of multinational groups. The JWG mandate identifies three key areas of work:

- recognition of transactions presented by a taxpayer
- TP consequences of restructurings not subject to re-characterization
- permanent establishment issues.

Table 1 describes the progress of each project from its public announcement to its status at the time of writing.

The Comparability Project

Although the OECD is expected to release a series of issues notes or a discussion draft on comparability issues in 2008, currently the most recent indicator of OECD thinking on comparability was "*Comparability: Public Invitation to Comment on a Series of Draft Issues Notes*" released on May 10, 2006. It covered four main issues.

Analysis, Documentation, and Compliance Costs

The OECD Guidelines attempt to strike an appropriate balance between the taxpayer's need to show their TP conforms with the arm's-length principle, and a desire to keep compliance costs to a minimum (based on prudent business management principles).

It is evident from the OECD Comparability Issues Notes that the OECD is thinking again about where the appropriate balance lies. It seems to the authors that the OECD is now inclined to require taxpayers to undertake more rigorous comparability analyses and to document them. For example, the OECD Comparability Issues Notes describes a typical 10-step process for identifying comparable transactions.³

Comparability Adjustments

Comparability lies at the heart of the arm's-length principle, and comparability adjustments that increase the reliability of results are crucial when demonstrating that pricing conforms with the arm's-length principle. The preliminary conclusions in the Comparability Issues Notes on making comparability adjustments are that more work is needed to develop a common

1. Organisation for Economic Co-operation and Development (OECD) in Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.

2. Essentially this relates to the consensus reached by the OECD to allow the use of transactional profit methods, albeit as methods of last resort, which the OECD's 1979 Transfer Pricing Guidelines had specifically rejected.

3. *Selecting or Rejecting Third Parties or Third Party Transactions: Degree of Objectivity of the List of External Comparables*, Issues Note, pp 45-48.

Table 1 Projects within the OECD

Project	Origin	Publicity announced	Issues Paper / Progress Report	Discussion Draft	Report	Consultation held with business
Review of comparability	Monitoring procedures for OECD Guidelines – see Annex to OECD Guidelines.	April 2003: Invitation to comment on comparability issues.	May 10, 2006: Comparability: Public invitation to comment on a series of draft issues notes.	<i>Discussion draft expected in 2008.</i>		
Review of transactional profit methods	Monitoring procedures for OECD Guidelines – see Annex to OECD Guidelines, paragraph 19 of the Preface and paragraph 3.55 of the Guidelines.	As above.	February 27, 2006: Invitation to comment on transactional profit methods.	January 25, 2008: Transactional profit methods – discussion draft for public comment.		
Business restructuring	Second CTPA – define Roundtable in Paris, January 26-27, 2005.	Early 2006 with establishment of Business Restructuring Advisory Group (BAG).	<i>Issues notes expected by end of 2008.</i>			Three meetings held with BAG – June 2006, November 2006, June 2007.
Arbitration	Under consideration by OECD/CFA for a number of years. See also paragraph 4.171 of OECD Guidelines.	April 29, 2003: Questionnaire for business on procedures for resolving international tax disputes.	July 27, 2004: Improving the process for resolving international tax disputes.	February 2006: Proposals for improving mechanisms for the resolution of tax treaty disputes.	February 2007: Improving the resolution of tax treaty disputes.	December 2003 (Paris), January 2005 (Washington), March 2006 (Tokyo).

Source: KPMG in Australia.

platform of principle and concepts for comparability adjustments and to provide guidance on working capital adjustments.⁴

Secret Comparables

The OECD's comparability team notes that there are contrasting views on the use by tax authorities of secret comparables when making TP adjustments. On the one hand, most countries recognize that using secret comparables raises various concerns about the fairness and transparency of the process (and thus the confidence of the taxpayer in the reliability of such secret comparables). On the other hand, the information asymmetry between taxpayers and tax administrations makes some countries reluctant to exclude altogether these sources of potentially valuable evidence.

In KPMG member firms' view, tax authorities should not use secret comparables. From a business point of view, taxpayers are best placed to judge whether a transaction is or is not comparable. With secret comparables, it's impossible for them to make that judgment. The same applies to the use of secret comparables in Competent



Damian Preshaw

KPMG in Australia
147 Collins Street
Melbourne, VIC 3000
Phone: +61 (3) 9288 5658
Fax: +61 (3) 9288 6720
e-Mail: dpreshaw@kpmg.com.au

Damian Preshaw is a director in KPMG's transfer pricing practice in the Australian firm in Melbourne. Prior to joining KPMG, he was an international tax counsel in the Australian Taxation Office's (ATO's) transfer pricing practice where he focused exclusively on international transfer pricing and cross-border related party financial dealings and was extensively involved in the ATO's Transfer Pricing Rulings Program.

Mr. Preshaw was an Australian delegate to the OECD's Committee on Fiscal Affairs' Working Party No. 6 and to its steering group on transfer pricing from 1994 to 2003. At the

OECD, he took a lead role in developing the OECD's technical position on transfer pricing and profit attribution issues and in building consensus on transfer pricing issues among OECD member countries.

Since joining KPMG in 2003, Mr. Preshaw has advised clients in a number of industries. His areas of focus have included dispute resolution, cross-border reorganizations, financial services, APAs and profit attribution to permanent establishments. He is also a member of the OECD's Business Restructuring Advisory Group.

Authority proceedings, where a tax authority could overlook a vital factor affecting pricing, and the taxpayer would have no opportunity to point this out.

Loss-Making Comparables

The OECD Comparability Issues Notes state that OECD member countries expressed the view that an independent enterprise would not continue loss-generating activities unless it had a

4. *Determination of and Making Comparability Adjustments Where Appropriate*, Issues Note, pp 49-55.



Montserrat Trapé
KPMG in Spain
Avda. Diagonal, 682
Barcelona, 08034
Phone: +34932532936
e-Mail: mtrape@kpmg.es

Montserrat Trapé focuses on Advance Pricing Agreement and Competent Authority matters. She helps clients with transfer pricing strategies, documentation projects and tax audit defense.

Before joining KPMG, Ms. Trapé led a distinguished career including working as a former senior official in the Spanish National

Tax Office, representative of the Spanish Tax Authorities at the OECD and vice-chair of the European Union Joint Transfer Pricing Forum. She has advised the Inter American Development Bank on transfer pricing regulations. She is a lecturer in different universities and specialized forums.

reasonable expectation of future profits. Simple or low-risk functions, in particular, are not expected to incur losses for prolonged periods. This is not to say a loss-making transaction can never be comparable, however. The OECD's point is that loss-making transactions require further investigation to establish whether or not they are comparable.

KPMG member firms take the view that companies competing in a marketplace can often lose money at arm's length. Losses arise for all kinds of reasons, many of which have nothing to do with TP. Frequently, disputes about transactions between loss-making related parties arise because the tax administrations do not always acknowledge this fundamental fact of business life.

The Transactional Profit Methods Project

On January 25, 2008, the OECD released: *Transactional Profit Methods – Discussion Draft for Public Comment*. The draft proposed a number of changes to transactional profits methods which are, for the most part, welcome. The proposals appear to reflect a desire to bring the OECD Guidelines more into line with the current TP practices of both tax administrations and multinational enterprises (MNEs).

Two proposed changes – the elevation of the transactional net margin method (TNMM) from a method of last resort to an accepted OECD TP methodology (TPM), and the idea of the most appropriate method for demonstrating that TP conforms to the arm's-length model – are likely to have far-reaching consequences.

Acceptance of the TNMM

Promoting transactional profit methods, including TNMM, from methods of last resort to OECD-approved methodologies would be a significant change. In many ways, it is merely a recognition that the TNMM is used much more often in practice, by both tax authorities and MNEs, than was originally envisaged, but it will be of significant benefit when dealing with countries that have previously been reluctant to accept TNMM analyses.

However, taxpayers will have to show that the use of the TNMM is appropriate before using this method, as the concept of the most appropriate method⁵ is accompanied by proposals for a number of safeguards apparently designed to deter tax administrations and MNEs from using the TNMM when there is a more appropriate method. These safeguards stipulate that choice of method should reflect:

- the strengths and weaknesses of each OECD-approved method
- a method's suitability, given the results of the comparability analysis

- the availability of reliable information required by the method
- the comparability of controlled and uncontrolled transactions and the reliability of comparability adjustments that may be required to eliminate differences between them.

These proposed changes will highlight the basic similarities between apparently contrasting TP regimes. The United States, for instance, was often regarded as having a distinctive approach, because its best method rule seemed at odds with the OECD's natural hierarchy of methods. Despite the fact that both approaches relied on the comparability of transactions and entities and the reliability of the comparables and adjustments, some tax authorities rejected documentation prepared for U.S. purposes as contravening the OECD Guidelines and, thus, their domestic rules. The most appropriate method criterion now proposed should help bridge that gap. The downside for MNEs is that they may have to devote more effort to documenting their selection of method.

Use of a Secondary Method

The OECD's TP Guidelines state that "the arm's length principle does not require the application of more than one method and in fact undue reliance on such an approach could create a significant burden for taxpayers," and that "tax examiners should undertake to begin their analyses of transfer pricing from the perspective of the method that the taxpayer has chosen in setting its prices."

The Profits Methods Draft doesn't propose material changes to either statement, but a none-too-subtle effort is made to weaken them by endorsing the use of secondary methods as checks. It proposes, for example, that a secondary method could be used as a sanity check when use of the primary method leads to a commercially unrealistic outcome. However, the question of what is commercially

5. This is the term and similar conceptual approach to that adopted by the Australian Taxation Office some years ago (paragraphs 86 and 343 of Taxation Ruling TR 94/14; paragraphs 3.5-3.6 of Taxation Ruling TR 97/20).

unrealistic is not clear, but it is a term that a number of tax authorities often use when they are not happy with a taxpayer's financial results.

On the positive side, the Profits Methods Draft also proposes a new warning in the guidelines against outcome-oriented approaches, by stating that a "method should not be rejected just because it produces an unusual outcome." Nevertheless, there is a concern that commercial reality will be used by tax authorities and taxpayers to reject approaches that produce results that don't fall into a normal range.

The Business Restructuring Project

The mandate of the JWG⁶ identifies three main areas where work is to be undertaken on TP issues that arise during business restructuring:

- *Recognition of transactions presented by a taxpayer.* This relates to the question of when a tax administration may disregard or re-characterize a particular transaction for TP purposes, and the acceptability and TP consequences of risk-stripping and transfers of intangibles.
- *Consequences of restructurings not subject to re-characterization.* Issues covered here are whether, under the arm's-length principle, an indemnity or any other form of compensation is appropriate on a conversion; how to determine an arm's-length remuneration for the restructured entity and the principal; whether the arm's-length principle applies differently to a restructured activity and an activity set up as low risk, low intangible, and low added value from the beginning; and whether and how to account for group synergies and efficiency gains in the context of a restructuring.
- *Permanent establishment issues.* Questions for the JWG to consider include when a foreign enterprise can be found to have a permanent establishment (PE) following a business restructuring, and whether more guidance is needed on the attribution of profits to a dependent agent PE.

Of all the issues the JWG has considered, two generate more debate and encounter more entrenched views than all the others:

- When might a tax administration disregard or re-characterize a business restructure based on the principles set out in the OECD Guidelines?

- When might an exit charge be payable to the restructured entity as compensation for agreeing to allow the restructuring, and on what basis might the amount of the charge be determined?

Disregarding or Re-Characterizing a Business Restructure

The OECD Guidelines envisage two circumstances where a tax authority might disregard a restructure. The first is where the transaction's economic substance differs from its legal form. The second is where a transaction's legal form and economic substance are the same, but the arrangements affecting it, viewed together, differ from those which would have been adopted by independent enterprises acting in a commercially rational way; the restructure makes it hard for the tax authority to determine an appropriate transfer price.

In the first case, the OECD Guidelines say that a tax administration may disregard the parties' characterization of the transaction and re-characterize it in accordance with its economic substance. In the second case, the same paragraph says that, while it may be proper to respect the transaction, it would nevertheless be appropriate for a tax authority to re-conform its arrangements in their entirety (not only price) to those that might reasonably have been expected if the parties had been independent.

Exit Charges

TP has traditionally focused on transfers of specific tangible goods and services, and intangible property that can be separated from the enterprise, such as trademarks, patents, and contractual rights. Recently, however, some tax authorities seem to be taking a broader view, and are looking at the value of the business itself and reductions in current and future taxable income to determine the value of exit charges. This implicitly means that the shift in goodwill



Dirk Van Stappen
KPMG in Belgium
Prins Boudewijnlaan 24d
Antwerpen, Kontich 2550
Phone: +32 (3) 8211918
Fax: +32 (3) 8253838
Cell: +478 212 526
e-Mail: dvanstappen@kpmg.com

Dirk Van Stappen is a partner with KPMG Tax & Legal Advisers in Belgium. He has over 20 years of experience in advising multinational companies on tax and transfer pricing issues. He heads KPMG's Belgian transfer pricing practice.

Mr. Van Stappen has conducted various transfer pricing assignments, ranging from the preparation of European transfer pricing documentation, audit defense to the negotiation of rulings and APAs. Another area of focus is supply chain tax advisory. From an industry perspective, Mr. Van Stappen has a

particular focus on the chemical, pharmaceutical and consumer goods industry.

Mr. Van Stappen has also been appointed in 2002 (and reappointed in 2007) as one of the 10 (15 as from 2007) European business representatives of the EU Joint Transfer Pricing Forum of the European Commission.

Since 1996 Mr. Van Stappen is also a visiting professor at the University of Antwerp. He is a regular speaker on tax and transfer pricing issues. Furthermore, he has written various articles in both national and international professional journals.

6. We understand that the JWG, as a separate group within the CFA, ceased to exist at the end of 2007 and that the treaty and transfer pricing issues addressed up to that time by the JWG have been referred to the CFA's Working Party No.1 (OECD tax treaty) and Working Party No.6 (transfer pricing) respectively for further work to be undertaken.



François Vincent
KPMG in Canada
600 boul. De Maisonneuve Ouest
Suite 1500
Montreal, Quebec H3A0A3
Phone: +1 514 840 2583
Fax: +1 514 840 2187
e-Mail: fvincent@kpmg.com

François Vincent is the national leader, Canada for the Global Transfer Pricing Services of KPMG international's network of member firms. Mr. Vincent was formerly with the Legal Services of Revenue Canada where he was the principal legal adviser on transfer pricing matters including the implementation of the Advance Pricing Agreement (APA) program. He was also involved in the preparation for litigation of transfer pricing cases.

Mr. Vincent is the author of "*Transfer Pricing in Canada: Second Edition*," published by Carswell in 2005, which is often viewed as an authoritative reference on transfer pricing rules in Canada.

Over the years, Mr. Vincent has been nominated to appear in the *Guide to the*

World's Leading Transfer Pricing Advisers, published in conjunction with *International Tax Review*, as one of the top transfer-pricing advisers in Canada, and as one of the leading individuals in the world for transfer pricing. He is also the Canadian advisor who received the most nominations for the 2006 edition of this guide and one of only three Canadians selected to appear in Euromoney Institutional Investor PLC's Legal Media Group's "The Best of the Best 2007" in the field of transfer pricing.

Under Mr. Vincent's leadership, KPMG's Global Transfer Pricing Services practice in Canada has been named the Canadian transfer pricing firm of the year for the second year in a row at the Americas Tax Awards in September 2007.

associated with restructuring is something that has to be paid for. This has given rise to several issues about when exit charges are payable:

- A broader identification and classification of transfers that have to be paid for in determining whether an exit charge might be payable to the entity to be restructured under various headings, that appear to be derived from taxable profits rather than the prices of the specific intangible (that is, by reference to accounting profits, or profits separately calculated for the purposes of domestic tax law). The identification of the scope of the intangibles transferred will determine not only when the tax authority might expect an exit charge, but also how arm's-length prices are determined with respect to such transfers.
- The use of different valuation approaches related to transfers of discrete intangibles are likely to differ from those used when a tax authority takes a broader view of what has been transferred. Regardless of the tax authority's view of what is being transferred, the exit charge is usually based on generally accepted valuation methods. The normal method is

discounted cash flow, but other methods make more sense in other circumstances. Unfortunately, the OECD Guidelines do not specify acceptable valuation methods.

All this is likely to create conflicts, because the tax authority of the entity paying the exit charge is likely to take a narrower view of which assets have been transferred, than the tax authority of the restructured entity.

PE Issues

The JWG is also considering PE issues that may be raised by restructuring. An example of such an issue occurs when an MNE does not believe it has a PE, does not file returns for a PE, or does not keep records of profits that might be attributable to a PE. If the tax authority disagrees, questions arise about how to attribute a profit to the PE after the fact.⁷

Risk of Countries Going Their Own Way

Despite the OECD's efforts there is no international consensus about how the arm's-length principle applies to business restructures. Thus, a very real risk exists that some countries will

decide to go their own way. Some tax authorities are concerned that restructures are eroding their domestic tax bases and do not feel they can afford to wait for an international consensus to emerge.

Germany introduced new domestic legislation effective January 1, 2008 to deal with the shifting of functions and risks from Germany. It includes controversial commensurate-with-income provisions said to be inconsistent with the arm's-length principle. The Australian Taxation Office published discussion papers in 2007 on how TP rules apply to business restructures. It has stated its intention to issue guidance to taxpayers by the end of 2008.

The risks, for business, if countries go their own way, are: increased compliance costs, because of their need to satisfy several different documentation requirements; increased risk of unrelieved double tax, because tax authorities can't agree on whether a particular business restructure is consistent with the arm's-length principle; and extra costs associated with disruptions to operations and employees when a business restructure is unwound after a tax authority disregards or re-characterizes the new structure for tax purposes.

TP Risk Management Issues

If tax authorities succeed in their efforts to establish their right to disregard taxpayer's structures and re-characterize transactions, MNEs will face several new TP risk management challenges. First, the taxpayer will have to guess, in each case, whether or not the tax authority will invoke its right to disregard or re-characterize, and there is a risk the taxpayer will guess wrong. Second, there is a risk that tax authorities will disagree on what the arm's-length form should be, which will make it harder to resolve disputes at Competent Authority level. Third, tax authorities will be able to impose significant tax costs on normal business decision-making. For example, if a European MNE's major customer moves to China and wants a local

supplier, the MNE must either move its plant to China and pay an exit tax or lose its customer.

Arbitration

The OECD released a discussion draft for *Improving The Resolution Of Tax Treaty Disputes* through arbitration in February 2007. The issues addressed are summarized below.

Introducing an Arbitration Mechanism

From the start, the OECD project arbitration was seen as the final stage of a Mutual Agreement Procedure (MAP) used in cases where the Competent Authorities were unable to reach an agreement, rather than as an alternative way to resolve cross border disputes. As the final phase of the MAP, it gave taxpayers confidence that double tax would ultimately be eliminated and was an incentive for tax authorities to reach a solution before the arbitration phase began.

The OECD proposes that when a case goes to Competent Authorities and an agreement is not reached within two years, it can be submitted to arbitration at the taxpayer's request. But access to the arbitration phase of the MAP would be delayed if the taxpayer still had recourse to administrative or judicial proceedings on the same controversy or if a decision had already been made on the same issue in an administrative or judicial phase.

The OECD proposes that the arbitration decision would be binding for both contracting states and must be implemented, regardless of any time limits in the domestic law of the states. A precondition in the draft model, which led to heated debate at the time – namely that the taxpayer must approve of the arbitrators' decision before it becomes binding for both contracting states, was also discussed.⁸ The OECD's model will only be mandatory for contracting states that incorporate a paragraph affirming it in their tax treaties or otherwise agree to implement it in unresolved cases.

Comparison with U.S. Approach

Since publication of the discussion draft, some countries have taken steps to implement the arbitration process. The United States, for instance, has concluded protocols, now in force, with Belgium, Germany, and Canada that include arbitration clauses.⁹ In all three cases, the format of arbitration favored by the United States is baseball-style or last best offer arbitration. This means that, unlike the OECD model, arbitrators must choose one of the positions proposed by the tax authorities. They cannot create another position to resolve the issue.

The U.S.-Canada clause does not make arbitration mandatory, but does contain an automatic referral to arbitration after the two-year mark has passed. The two-year mark is generally calculated from the time the taxpayer filed complete requests for the MAP with each Competent Authority. The arbitration board has three members: two are chosen by each tax authority and those two choose the third. As is the case in any Competent Authority case, taxpayers may reject the decision of the arbitrators, arbitration decisions do not set precedents, and no reasons are given by the arbitration board for the decision.

Like the OECD's, the U.S. system sees arbitration as an extension of a MAP, not a stand-alone procedure. In practice, this means that, as with the OECD model, arbitration is a strong incentive for Competent Authorities to conclude cases within the allotted two-year period, and only exceptional cases should lead to arbitration. Experience so far in U.S.-Canada cases suggests that this may be wishful thinking. A number of current cases have lasted longer than two years. The taxpayers will, therefore, see the automatic referral to arbitration after two years as a welcome addition to the MAP.

Conclusion

As this article demonstrates, the OECD has been, and continues to be, very active in monitoring TP developments and proposing appropriate changes to its guidelines. It must maintain this level of activity because the risk that some countries will go their own way in vital areas, such as business restructuring, is very real. The OECD should maximize its efforts to develop a consensus on how the arm's-length principle should be applied, and provide guidance on how fundamental TP issues should be addressed on a day-to-day basis.

Well-run Advance Pricing Agreement regimes that offer MNEs an opportunity to obtain certainty and avoid, or significantly reduce, the risk of double taxation, and arbitration procedures that resolve treaty disputes and double-tax issues cost effectively, and within a reasonable period, are crucial for the survival of the all-important arm's-length principle.

7. Reference can be made to the recent Zimmer Case in France.

8. The European Union (EU) has also been active in developing arbitration as an alternative approach to resolving transfer pricing disputes through the creation of a European Arbitration Convention, participation in which is mandatory for all EU member states. Comparison of the OECD approach and that taken by the EU is beyond the scope of this article. However, readers are advised to consider the provisions of both the OECD and the EU Arbitration Convention, especially if consideration is being given to Arbitration in the context of a cross-border dispute involving tax authorities in two EU member states.

9. This protocol has been concluded, but is not in force until formally approved by both governments. Such approval has not yet been achieved in the United States.

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From Global to Latin America Documentation

Transfer pricing rules are now widespread throughout Latin America. Jose Casas (KPMG in Mexico), Eduardo Goldszal (KPMG in Portugal), and Antonio Macias Valdes (KPMG in United States) propose a transfer pricing documentation strategy for the region.

A decade-and-a-half ago, Latin America was a rules-free zone, as far as transfer pricing (TP) was concerned. Today, 10 countries in the region have transfer pricing rules, mostly based on the Organisation for Economic Co-operation and Development (OECD) guidelines.

This spread of TP rules throughout Latin America raises significant documentation issues for multinational enterprises (MNEs) operating in the region, and many are trying to decide whether and how they can adapt their global documentation strategies for use within Latin America, or whether they need different documentation for each country.

As usual, the answer to this question varies from case to case, but common TP features across the region mean there are practical ways to use global documentation in Latin America. But it's not simply a matter of translating documentation into Spanish. Knowledge of, and sensitivity to, regional and local requirements are also essential.

Global Documentation

Apart from Brazil, all Latin American countries with TP rules follow the OECD guidelines, so most TP and documentation policies based on these guidelines can be very helpful for compliance in countries other than Brazil. The same is true of TP documents that follow the recommendations of the European Union (EU) Joint Transfer Pricing Forum.

The EU model consists of two main documents – a core document known as the master file that contains common standard information, and a country-specific document tailored for each jurisdiction. The basic methodology is governed by the OECD guidelines on which, as already noted, the TP legislation in most Latin America countries is based.

Regional Documentation

A regional adaptation of global documentation is advisable because Latin America's business cultures, although similar to each other, are different from those of other regions. The most distinctive regional characteristics are the high value placed on business relationships; consideration of operations from a purely local perspective; and the importance attached to form over content.

Tax authorities generally require taxpayers to present documents in their local languages. The use of Spanish as the official language throughout the region (again, apart from Brazil) facilitates matters, and national tax authorities have also adopted common standards and requirements for documentation that follow the OECD guidelines and share many characteristics on matters such as:

- business structure (shareholders)
- intercompany transactions
- comparability factors (functions, risks and assets of the tested party), commonly referred to as functional analysis
- method(s) used to test the inter-company transactions, including the most appropriate rule suggested by the OECD
- a separate analysis for each inter-company transaction (unless there are particular factors favoring global analysis)
- use of the Transactional Net Margin Method (TNMM).

Another common regional requirement is to file a detailed annual TP return. This usually entails the disclosure of:

- types of inter-company transactions
- number of inter-company transactions
- dates on which the transactions occurred
- transfer pricing method used
- financial result of each transaction (that is, the profit or loss arising from the transaction).

If a parent and its Latin American subsidiary have different fiscal years, documentation prepared by the parent must be adapted for the local fiscal year, because that's the relevant period for the Latin American tax authorities.

Approaches to issues relating to the choosing and use of comparables are also quite consistent across the region. The starting point for a typical economic analysis, when the use of the TNMM is feasible, is the development of a search methodology for comparable transactions or companies with comparable operations. Ideally, comparable companies should be Latin American, but since publicly available information on such companies is often hard to come by, companies outside Latin America, particularly in the United States and Europe, are commonly used and deemed by tax authorities to be valid comparables for analyzing the tested party's functions, risks, and assets. It is therefore often possible to use the same set of comparables across Latin America.



Jose Casas
KPMG in Mexico
Manuel Avila Camacho 176-1
Mexico City 11650
Phone: +52 55 5246 8364
e-Mail: jcasas@kpmg.com.mx

Jose Casas is the partner in charge of KPMG in Mexico's Global Transfer Pricing Services practice, with more than ten years of experience in transfer pricing. He assists clients develop transfer pricing documentation for Mexican companies that belong to multinational groups, obtain Advanced Transfer Pricing Agreements, restructure their transactions from a transfer pricing perspective, and settle transfer pricing audits. Mr. Casas has experience in several industries including pharmaceutical,

maquila, wholesale, retail, chemical, automotive, manufacturing and service companies, as well as financial entities, among others.

Mr. Casas is a member of the College of Public Accountants of Mexico, in which he has been an instructor. He is also currently the president of the Transfer Pricing Commission at the Mexican Institute of Public Accountants.

A Summary of the Key TP Regulations in Each Latin American Country

Country	TP Regulations	Arm's length standard	Contemporaneous documentation	TP information filing	Advance Pricing Agreements
Argentina	1998	✓	✓	✓	X
Brazil	1997	X	✓	✓	X
Chile	1998	✓	X	X	X
Colombia	2004	✓	✓	✓	✓
Costa Rica	N/A	✓	X	X	X
Ecuador	2005	✓	✓	✓	✓
Mexico	1997	✓	✓	✓	✓
Peru	2002	✓	✓	✓	✓
Uruguay	2006	✓	✓ ¹	✓	X
Venezuela	2002	✓	✓	✓	✓

Source: This information came from the local KPMG firms partners referencing tax authority information in their respective countries.

National Documentation

Regionally adapted documentation goes a long way toward satisfying most Latin American documentation requirements, but since local TP rules do vary to some extent, it is not usually enough. Significant variations in national TP rules include:

- In Mexico, deductibility of inter-company service costs based exclusively on an allocation key may be challenged.

- Argentine Income Tax Law allows the use of methods other than those suggested by the OECD and also limits the taxpayer to using only the Argentinean entity as the tested party.
- Peru requires use of the Profit Split Method to analyze valuable intangible property.
- Brazil hasn't followed OECD guidelines in its TP regulations.

The table above summarizes the key TP regulations in each Latin American country.

1. Uruguayan tax authorities are currently drafting rules regarding the content required in the contemporaneous documentation and the tax return. Therefore, transfer pricing documentation and information filing requirements are expected to be applicable to taxpayers starting in fiscal year 2009.



Eduardo Goldszal, Ph.D.
KPMG in Portugal
Av. Praia da Vitória, 71A – 11º
1069-006 Lisbon
Phone: +351 210 110 109
e-Mail: egoldszal@kpmg.com

Dr. Eduardo Goldszal is the partner-in-charge of the transfer pricing practice at KPMG in Portugal. He has many years of experience with transfer pricing planning and documentation in Portugal, the United States and other countries. Dr. Goldszal is a business economist who focuses on transfer pricing, valuation services, and international tax planning.

Before joining KPMG in Portugal Dr. Goldszal was based in the U.S. firm in Miami where he performed transfer pricing analyses

in connection with IRS audits, worldwide documentation requirements, business valuation, and Advance Pricing Agreements. Prior to that, Dr. Goldszal was an economist at Shearman & Sterling in Washington, D.C.

Dr. Goldszal holds a Ph.D. degree in economics from the New School for Social Research in New York City and a master's degree in economics from the University of Illinois at Urbana-Champaign. He is a member of the editorial board of the Journal of Corporate Business Taxation Monthly.

Brazil

Brazil is a particular challenge when developing and defending a TP policy in Latin America. Brazilian TP regulations differ from those of the other Latin American countries and depart from the principles set out in the OECD guidelines. For example:

- Brazil does not have a most appropriate or best method rule – the taxpayer can choose the method that produces the best result from its perspective
- TP analysis can be performed on a per transaction basis and there is no need for a functional analysis
- Brazil's tax authorities accept the use of methods based on predetermined (fixed) gross profit margins, regardless of the nature of the taxpayer's business or industry or of the economic circumstances surrounding its transactions.

A distinctive attribute of Brazil's TP regulations is that, because different methodologies produce different results, the taxpayer can often use the willingness of the tax authorities to accept methods of the taxpayer's choice to help reduce other compatibility problems caused by Brazil's rules; a taxpayer can also experiment with various methods until

finding the one that yields results that are closest to those required by the arm's-length standard.

Managing TP Controversy Risk

Latin American countries with relatively mature TP rules, such as Mexico, Argentina, and Venezuela, have recently greatly increased the number of TP audits and the amounts of tax assessments arising from adjustments to taxable income. As a consequence, MNEs operating in Latin America can have more exposure to tax authority TP inquiries, and should be aware of the available alternatives to mitigate disputes or conflicts with the tax authorities.

Competent Authority

Most Latin American countries have signed treaties with many of their trading partners allowing the use of Competent Authority procedures to avoid or mitigate any economic double taxation, once the taxpayer has had its taxable income adjusted by the tax authority. Therefore, where tax treaty coverage exists with respect to transactions between affiliates in those countries, taxpayers can normally request Competent Authority assistance to address transfer pricing and related issues.

But the effectiveness of the Competent Authority process depends on the experience of the governments involved in the negotiations, how committed they are to reaching a resolution that will eliminate the double taxation, and the effort the tax authorities are prepared to devote to the process. Although, in theory, the Competent Authority process is an efficient way to deal with controversies and double taxation, it's largely untested in the TP area in Latin America and requires the willing involvement of the tax authorities as well as the taxpayer. Also, it's obviously necessary that a tax treaty exist for the affiliates in the affected countries. In this regard, note that the U.S. income tax treaty network with Latin American countries is currently limited to Mexico and Venezuela.

Advance Pricing Agreements

An Advance Pricing Agreement (APA) is either a unilateral or bilateral agreement between a taxpayer and one or more tax authorities, which results in assurance that the tax authorities will not adjust its TP in future. APAs are available in a number of Latin American countries, but not in Brazil or Argentina.



Antonio Macias Valdes
 KPMG in the United States
 355 South Grand Avenue Suite 2000
 Los Angeles, CA 90071-1568
 Tel: +1 213 593 6766
 Fax: +1 213 559 0947
 e-Mail: amaciasvaldes@kpmg.com

Antonio Macias Valdes acts as the U.S. practice's primary liaison to our Latin American Global Transfer Pricing Services practices. His main activities include the coordination to ensure the efficient delivery of the services in close coordination regarding transfer pricing services with our local practices across the Latin America region.

Before joining KPMG, Mr. Macias worked as a senior manager for Ernst & Young in Mexico City. He was a former partner in a transfer pricing boutique firm providing

transfer pricing services in the U.S. and Latin America region. He started his career at PricewaterhouseCoopers in Mexico and Argentina. His experience includes coordinating more than 1,000 studies in Latin America and in developing regional transfer pricing policies addressing local requirements.

Mr. Macias graduated as an economist from the Autonomous Technological Institute of Mexico (ITAM) and obtained a post-graduate diploma in International Tax granted jointly by ITAM and the University of Harvard.

However, with the exception of Mexico, which has concluded numerous unilateral and bilateral APAs – particularly those covering *maquiladoras*, practical APA experience is rather limited in Latin America. This offers both opportunities and challenges: opportunities, because our experience elsewhere is that early adopters of APAs often reach very reasonable agreements with the tax authorities; challenges, because taxpayers may need to make substantial investments in time and resources when working with tax authorities that lack APA experience.

APAs are still relatively new in Latin America, but their benefits are widely recognized and, given the increasing TP activity in this region, they are likely to become more common in future.

Conclusion

The interest of Latin American tax authorities in TP is growing and most countries have implemented documentation requirements. This is a challenge for MNEs, but in many cases they may be able to satisfy these compliance requirements by:

- starting with their global documentation approach
- customizing that approach to meet the common requirements and practices of the region
- refining such regional analyses to meet the needs of specific countries.

MNEs should also consider using Competent Authority and APA options in medium to long-term situations.

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Latin American countries with relatively mature TP rules have recently greatly increased the number of TP audits and the amounts of tax assessments arising from adjustments to taxable income.

The “Sequential APA Strategy:” A Roadmap for Dealing with Developing Transfer Pricing Jurisdictions

Advance Pricing Agreements (APAs) are an attractive alternative to transfer pricing audits and arbitration. Jacek Bajger (KPMG in Poland), Andrew Hickman (KPMG in the United Kingdom), Alexander Loh (KPMG in Germany), and Eduard Sporken (KPMG in the Netherlands) explain how they can be used even in countries with limited experience of APAs.

Under the right circumstances, Advance Pricing Agreements (APAs) can be a viable way to manage transfer pricing (TP) risks. About 40 countries currently operate APA programs, including Australia, Canada, China, France, Germany, Italy, Japan, Mexico, the Netherlands, Poland, South Korea, Spain, the United Kingdom, and the United States. Many other treaty partners that have no legislation or defined APA programs are often willing to use their Mutual Agreement Procedure (MAP) to facilitate resolution of APA cases brought by other tax authorities.

There are certain situations, however, when APAs present a taxpayer with particular challenges. When, for example, a multinational enterprise (MNE) has distribution operations in several tax jurisdictions with similar TP policies, the question arises of how to secure APAs with more than one of them. It is also often unclear how an MNE seeking an APA with a tax authority with no experience of such agreements, and only limited TP experience, should proceed.

This article describes how the pursuit of a sequential set of APAs can help secure the benefits offered by the APA model.

The Quest for Certainty

Increasingly, tough TP enforcement, inconsistent regulatory requirements, and the difficulty of proving arm's-length pricing for some intra-group arrangements suggest that prudent taxpayers should examine ways in which to approach TP as a risk management exercise.

The basic options include:

- keeping your head down and dealing with controversies locally as they arise
- reacting to TP issues as they arise, with the intention of seeking relief from double taxation through the Competent Authority (CA) process or arbitration mechanisms, such as the EU's Arbitration Convention



Jacek Bajger
KPMG in Poland
Chłodna 51
00-867 Warsaw
Phone: + 48 22 528 11 73
e-Mail: jbajger@kpmg.pl

Jacek Bajger is a partner and heads a transfer pricing group within KPMG in Poland's tax department. He focuses primarily in the areas of transfer pricing and the valuation of intangibles for major firms.

Mr. Bajger has more than 12 years of experience in tax and transfer pricing advisory work in Poland. He is a lawyer and licensed tax advisor and has been with KPMG in Poland since 2001. He is responsible for transfer pricing issues, including performance

of the economic analyses aiming at verification of the prices and profitability indicators of entities involved in the related party transactions, preparation of the documentation to the related party transactions, trainings in the area of transfer pricing issues as well as ongoing advisory services for multinational entrepreneurs investing in Poland regarding transfer pricing and general tax consequences.

- anticipating and addressing transfer pricing issues either unilaterally in dialogue with national tax authorities, or bilaterally/multilaterally through the APA process.

APAs in a Nutshell

APAs enable taxpayers to manage TP uncertainties and audit risks proactively. The basic procedure is as follows:

- A taxpayer proposes to one or more tax authorities its proposals for addressing the pricing of selected intra-group, cross-border transactions.
- The tax authority undertakes a review of the taxpayer's proposal.
- The taxpayer and tax authority negotiate an agreement in the case of unilateral APAs or the tax authorities involved negotiate with each other (bilateral/multilateral APAs).
- Once agreement is reached, the parties execute the APA.

However, obstacles and stumbling blocks to the formation of an agreement arise when a taxpayer has provided data that it believes demonstrates the proposed TP method produces arm's-length results, but its proposal is either wholly unacceptable or only partially acceptable to one of more of the tax authorities.

APAs without APA Programs

Until recently, taxpayers eager for the benefits of an APA were destined to be disappointed when one or more of the tax jurisdictions where they were seeking APAs lacked a formal APA program, or had little experience with APAs. That's no longer necessarily the case. A number of such countries in Eastern Europe, Latin America and Asia Pacific have recently opened the door to applications for APAs. This article will describe an approach for obtaining APAs in which one applies for an APA in one jurisdiction and one rolls out this APA approach to other jurisdictions. This approach has been used successfully in the Americas, ASPAC, and Europe. This article covers one particular European case.

Before describing this approach, we will outline the facts of our case study and offer some general APA observations.

Group A is a global manufacturer and distributor of consumer products based in Germany. To market and sell its products in other countries, it has formed a network of affiliated distribution entities in the Netherlands, France, Belgium, and Poland. Group A's key value drivers are its brands and the quality of its products.

APA Procedures in Four EU Member States

Belgium

It is relatively easy to obtain an APA on TP issues in Belgium. It normally takes about three months, but may be quicker depending on the circumstances of the application and can be extended by mutual agreement. An APA is valid for a maximum of five years, unless otherwise agreed. No fee is charged for filing for an APA, but the tax authority requires in-depth functional and risk analyses and an economic analysis demonstrating the arm's-length nature of the TP method proposed. In some cases, a limited economic analysis has been accepted. The Belgian APA process is a flexible system, and the tax authorities show an open attitude towards taxpayers.

France

France's APA procedure was introduced in 1999 by an administrative instruction covering bilateral APAs, based on the MAP clause of double tax treaties derived from Article 25 of the Organisation for Economic Co-operation and Development (OECD) Model Convention. The Finance Amendment Bill 2005 strengthened the system by introducing a legislated procedure and making unilateral APAs – in the form of agreements between the French authorities and applicant companies – available for the first time. Unilateral APAs guarantee the tax authorities won't challenge agreed methods of TP calculation. They are available when:

- there is no APA procedure in the country concerned
- transactions involve many countries, as in the case of a French manufacturer with foreign retail subsidiaries
- transactions give rise to relatively simple TP issues, such as management fees
- transactions involve small or medium-sized companies, because unilateral APAs should allow a streamlined procedure.

The Netherlands

Any APA request must be sent to the competent tax inspector, who will submit it to the Dutch Revenue's APA Team in either Rotterdam or Amsterdam. The Transfer Pricing Coordination Group (TPCG) coordinates implementation in the TP area, and ensures a consistent policy is pursued. The APA Team and the taxpayer agree on a case management plan which sets out the schedule for handling the APA, including information required by the tax authority for its due diligence review. The plan must also state the intended turnaround time of the request.

Poland

An APA procedure was introduced in Poland in early 2006. The first application was filed almost a year later. The APA proceedings are at Ministry of Finance level with no input from local tax offices. By concluding an APA, the Ministry acknowledges the correctness of the choice and

application of a TP method in a transaction between related entities. The APA is then sent to the local tax office. It may cover transactions that started before the commencement of the APA proceedings, but no retroactively-binding decisions (rollback) will be issued by the Ministry. An APA lasts for no longer than five years, but is renewable for another five years.

Before filing an application, it is advisable to take advantage of the consultation period with the Ministry of Finance and present all necessary documents at this stage. Preliminary analysis of the documents and discussions with Ministry representatives before the filing stage increases the chances of a positive outcome.

In the application, a taxpayer must describe any circumstances that may affect proper determination of the transfer price, including a description of the transaction, analyses of assets, functions and risks, a description of the business strategy, etc. The scope of a subsequent APA application will be largely determined by the scope of the information requested in the Polish statutory documentation requirements. The authorities will also need details of agreements and other source documents, information on the proposed period of the APA, and the proposed method. Taxpayers are required by law to choose one of the five OECD-approved methods.

Although it may cost more initially to obtain an APA than to prepare documentation, risk/benefit analyses still need to be undertaken.

Group A is very centralized. All its trademarks and brands are German-owned, the central marketing department is in Germany, all research and development is done in Germany, all products are manufactured in Germany, and the logistics function is managed from Germany.

Group A has thousands of employees, mostly in Germany. The foreign affiliates are primarily responsible for sales and marketing and coordination with Group A headquarters.

The distribution affiliates outside Germany have their own sales, marketing, finance, and other support staff, and the local sales teams are responsible for dealing with local customers on a daily basis. They also negotiate prices and set terms and conditions with customers within constraints imposed by Group A.

When its overall consolidated financial results deteriorated, Group A decided to implement efficiency measures, including the adoption of a more centralized approach to sales and marketing. It also reviewed its transfer prices to ensure compensation for activities in Germany reflected the increase in functions performed, risks borne, and assets employed. This required TP amendments that increased profitability in Germany and reduced the profitability of the foreign distributors.

In considering TP risk, it was felt the tax authorities in Germany were unlikely to deny the increase in the profitability of the parent. The greatest risk was perceived to arise in the Netherlands, France, Belgium, and Poland. Hence, it was decided to pursue an APA in those four countries, but not in Germany. The first step was to prepare and file a unilateral APA request in the Netherlands and then roll this out in unilateral APA applications in the other three countries. This approach, in effect, would lead to a synthetic multilateral APA with the Dutch unilateral APA providing the basis for negotiation with the other tax authorities.



Andrew Hickman
KPMG in the United Kingdom
1 Puddle Dock
London EC4V 3PD
Phone: +44 (0) 20 7694 4478
Fax: +44 (0) 20 7311 2850
e-Mail: Andrew.Hickman@kpmg.co.uk

Andrew Hickman leads the coordination of KPMG's Global Transfer Pricing Resolution network in Europe. He helps clients develop and document their transfer pricing strategies, develop effective dispute resolution plans, eliminate double taxation through Competent Authority/Arbitration procedures, and manage transfer pricing risk through Advance Pricing Agreements (APAs).

Before joining KPMG in the UK, he was responsible for introducing and managing the Inland Revenue's APA program. Mr. Hickman

also acted as the delegated Competent Authority for negotiating with other tax administrations and sought to eliminate, under the Mutual Agreement Procedure of tax treaties, double taxation arising from transfer pricing adjustments. He was the UK delegate at the OECD during the development of the OECD Transfer Pricing Guidelines and contributed significantly to the revised international consensus on transfer pricing. He currently participates in the EU Joint Transfer Pricing Forum.

Poland was initially perceived as the most problematic tax jurisdiction because its APA regime was relatively new. The APA process was started in the Netherlands – expected to be the easiest jurisdiction in which to obtain an APA. The application for the Dutch APA set the time tables for reaching agreement for the subsequent APAs in Belgium and France. Thus, when the Polish APA was negotiated, the APAs had either already concluded, or were close to conclusion, in the other three countries, thus providing the Polish tax authorities information regarding the potential outcome. In this way, negotiations with tax authorities with mature APA regimes strengthened Group A's negotiating position in a jurisdiction where the APA regime was in its infancy.

Documentation vs. APAs

Documentation wasn't thought to be sufficient to manage TP risk in this case, because the profitability of the four affected sales and marketing affiliates had decreased. Documentation was prepared to justify the profitability reductions caused by the commercial changes, but it was anticipated that the changes would trigger TP audits in these jurisdictions. By applying for an APA, Group A sought to manage its potential exposure in a coordinated manner and obtain an outcome much more quickly than waiting for audits.

Although it may cost more initially to obtain an APA than to prepare documentation, risk/benefit analyses still need to be undertaken. When a tax authority audits and proposes an adjustment, resources are needed to defend the audit, appeal against an adjustment, or otherwise advance a case if the taxpayer doesn't agree with the adjustment. So the costs of an APA should not be compared solely with the costs of documentation. An APA front-loads the costs, but ultimately can save costs by avoiding an audit and any subsequent appeals, litigation, or Competent Authority action. A cost-benefit analysis of APAs should consider the costs that might otherwise be incurred from a TP audit over the term of the APA, as well as the benefits of a prearranged agreement.

APA Organization

APA procedures are similar in all jurisdictions, but there are differences and levels of experience vary. In February 2007, the European Commission announced new EU APA guidelines designed to avoid TP disputes and increase legal predictability. The new guidelines are based on a best practice identified by the EU Joint Transfer Pricing Forum. The guidelines explain how EU Member States should conduct APA processes, provide APA information



Alexander Loh

KPMG in Germany
Marie-Curie-Str. 30
D-60439 Frankfurt am Main
Phone: +49 (0) 69 9587 2187
Fax: +49 (0) 1802 11991 2187
e-Mail: alexanderloh@kpmg.com

Alexander Loh is a partner and heads the transfer pricing practice in KPMG in Germany's Frankfurt office. He focuses predominantly on advising, planning and implementing transfer pricing systems from a tax perspective. His clients include the whole spectrum of German subsidiaries of large foreign groups, middle size groups to major German corporations.

During more than 13 years of experience in advising international groups of companies on transfer pricing Mr. Loh has structured and restructured transfer pricing systems including transfers of business and

intangibles and he advised on and coordinated international business restructurings and post merger integrations throughout the value chain. Mr. Loh has assisted clients in designing and implementing transfer pricing documentation systems, he has defended a variety of transfer pricing issues in tax audits and is engaged in mutual agreements and APA procedures. Mr. Loh is a frequent speaker at national and international transfer pricing seminars and author of diverse articles on transfer pricing.

for taxpayers, and describe how some specific problems could be resolved. They are part of a wider EC effort to promote a more streamlined EU-wide approach to TP.

Arbitration vs. APAs

The EU Arbitration Convention – based on tax treaty MAP – provides for mandatory arbitration to eliminate double taxation. Some call arbitration a license for incompetence, because taxpayers should properly document their transfer prices and successfully negotiate their transfer prices with officials seeking in different ways to avoid this procedure. Indeed, the success of the convention could probably be measured by the infrequency of its use.

But, if you know double taxation will be eliminated in any event, what additional value does an APA bring? The answer is twofold. The first is tax *predictability* in advance. With an APA, a taxpayer knows in advance the acceptable allocation of profit between jurisdictions. Arbitration can often eliminate double taxation, but the profit allocation may not be what the taxpayer was expecting and may change the tax payable many years later. The second is *effectiveness*. A taxpayer must deal with audits in one or more jurisdictions before going to arbitration

and that audit can be years after the transactions. This may make it hard to explain the earlier arrangements and produce supporting documentation. With an APA, the taxpayer collaborates with the tax authorities on a forward-looking basis and thus has no need for hindsight. APAs bring tax predictability for the future and can eliminate the inefficiency of uncoordinated retrospective audits.

Execution of the Approach

The APA sequence began in the Netherlands and was followed up in Belgium and France, because these jurisdictions were seen as having mature APA programs. Unilateral agreements confirmed that the operating margins of the sales companies would be seen as arm's length if they fell within an agreed range and outcomes were reached in all three countries separately, based on a Pan-European benchmarking study. Despite initial concerns about the lack of comparables, the study proved acceptable in all three countries.

The Dutch APA team accepted the study, because the outcome was as expected under known Dutch benchmarks.

In Belgium, it is not necessary to perform separate, local benchmarks with only Belgian companies. In the circular of November 14, 2006, the Belgian tax authorities acknowledged that it can be difficult to find Belgian comparables, and said they accept foreign comparables, with appropriate adjustments made. The circular also confirmed that pan-European data may not be rejected automatically, or lead to tax increases and/or penalties.

If clear comparability can be demonstrated, the French tax authorities are similarly willing, in principle, to accept pan-European search results.

When Group A's APA team traveled to Poland, the Polish tax authorities knew that three European countries had already considered unilateral APAs on similar terms and had also accepted the pan-European benchmarking study. They asked for an additional Polish benchmark analysis, however, and during the proceedings they performed additional analyses using industry-specific statistical data to verify the market level of profitability of comparable companies. All of these analyses produced similar inter-quartile ranges.



Eduard Sporken
 KPMG in the Netherlands
 P.O. Box 74600
 1070 DE Amsterdam
 Phone: +31 (0) 20 656 1618
 Fax: +31 (0) 20 656 15 00
 Cell: +31 (0) 6 21 23 88 52
 e-Mail: sporken.eduard@kpmg.nl

Eduard Sporken is a director with KPMG Meijburg & Co in Amsterdam and KPMG's Global Transfer Pricing Services.

Since his graduation from Leiden University in 1988, Mr. Sporken has gained some 20 years experience on tax/transfer pricing matters. He has written numerous articles in several journals.

Mr. Sporken arranged for the successful completion of numerous Dutch unilateral Advance Pricing Agreements (APAs). Mr. Sporken is the project leader of a European Multilateral Advance Pricing Agreement/APA – completed for the Netherlands, Belgium, France, and the UK – to be rolled out to the United States, and for U.S.-Netherlands bilateral APA request.

The Dutch APA team accepted the study, because the outcome was as expected under known Dutch benchmarks.

The Polish tax authorities agreed to regard the results of the Polish sales company as arm's length, if the results were within a range almost identical to the range the taxpayer proposed and the other three European tax authorities had accepted. The range was derived from the Pan-European data, the Ministry of Finance's analysis, and the Polish benchmarking study.

The sequence of unilateral APAs took less time to create than one multilateral APA. For the client, a consistent approach for all jurisdictions and a result that generally corroborated its own Pan-EU TP study were both helpful and reassuring.

Conclusion

This case illustrates how a series of unilateral APAs with tax authorities with APA experience can be used to develop a unilateral APA with another tax authority with limited APA experience. This sequential approach produced a synthetic result equivalent to what might be achieved in a multilateral APA process. The approach met the taxpayer's specific objective – to manage the risks associated with a change in TP policy – given that:

- Only moderate transfer pricing risk was perceived in the non-routine, hub jurisdiction. (Had major risks existed with both tax authorities, a bilateral/multilateral approach may have been required.)
- Only limited differences of view about the definition of transactions, the importance of value chain roles or the valuation approach were expected.
- No consideration was required for past periods.
- One country's lack of experience with bilateral/multilateral APAs.
- The speed with which the sequence was completed compared with the bilateral/multilateral process.

Although this case is European, the approach could be used around the world to help manage TP risk effectively.

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.

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Managing Transfer Pricing Risks in Mergers and Acquisitions

Mergers and acquisitions raise a host of transfer pricing issues. Marc Alms (KPMG in the United States), Dave Rutges (KPMG in the Netherlands), Geoffrey Soh (KPMG in Singapore), and Ágata Uceda (KPMG in the Netherlands) use a recent case study to explore these issues and explain ways to manage them.

Mergers and acquisitions (M&A) are routine for multinational enterprises (MNEs) as they widen the scopes of their businesses and seek efficiency improvements through synergies and scale economies. It is difficult enough at the best of times for acquirers to extract value for their shareholders from M&A deals. It is harder still when due account is not taken of transfer pricing (TP) issues. M&A deals are alive with TP implications, not only in the bringing together of potentially inconsistent TP systems, but also in the integration objectives and financing needs of the acquirers. This article uses a case study to illustrate how these TP issues can arise and offers some suggestions as to how they can be addressed.

The Case in Point

A company resident in a European Union (EU) Member State, but owned by a non-European parent, acquires a division of a U.S. company. The acquisition is financed largely by debt taken out by a company set up for that purpose in the United States. No significant management changes ensue. Although now subject to the ultimate control of its new EU parent, the U.S. business operates, day-to-day, as a U.S.-based company run by its pre-acquisition management team. Historically, the European acquirer has centralized legal ownership of its intellectual property (IP) in a single jurisdiction and ownership of the

acquired company's IP, including its patents, copyrights, and trademarks, is accordingly transferred, after the acquisition, to a European IP holding company wholly owned by the European acquirer. Another complicating factor from the TP point of view is that the acquired company has a very tax-efficient supply chain involving numerous interwoven inter-company transactions and a series of royalty flow-through companies.

These qualities pose immediate, and sometimes conflicting, problems for the post-acquisition restructuring. The high level of third-party debt, for instance, made it imperative that cash required to support the debt was funneled to the legal entity holding it. The acquirer's wish to centralize IP ownership and the consequent transfer of the IP of the acquired company to Europe raised additional tax and TP issues. The acquired company's complicated supply chain obscured the nature of some vital transactions, which led to initial valuation challenges during the post-acquisition purchase price allocations.

All of these concerns were aggravated by the need to make decisions very quickly following the acquisition. It is for this reason that we often recommend that deal-related risk management should begin before the deal is completed. TP risk management should begin during due diligence with an appropriately diligent search for possible TP exposures for the new business. These might include:

- non-arm's length pricing in some or all jurisdictions or business lines
- a lack of TP documentation to support historical inter-company results
- inconsistent application of TP policies (some of which may result from the merger of two companies with different TP systems)
- the existence and status of any inter-company agreements
- the status of any Advance Pricing Agreements (APAs) or similar rulings.

Divestment transactions usually provide for some form of tax equity in the event of future tax examinations of pre-deal years, but it's still important to acquire a thorough understanding of the previous position when assessing and prioritizing how and when to address TP issues after the deal closes.



Marc Alms
KPMG in the United States
345 Park Avenue
New York, NY 10154
Phone: +1 212 872 3659
Fax: +1 212 409 8564
e-Mail: malms@kpmg.com

Marc Alms is a member of our U.S. Global Transfer Pricing Services group and is located at the U.S. member firm's New York office. Mr. Alms' primary areas of focus include Advance Pricing Agreements and Competent Authority matters, and transfer pricing risk management.

Mr. Alms provides advice in transfer pricing planning, documentation and controversy resolution situations. Mr. Alms represents clients in a cross-section of

multinational businesses, including companies in the consumer goods, medical devices, pharmaceutical, retail, financial services, electronics, semiconductor and technology sectors.

Mr. Alms earned his J.D. degree from the University of Pennsylvania Law School. He received a B.A. degree from the University of California at San Diego and undertook additional undergraduate studies in Germany at the University of Göttingen.

Debt Servicing

In our example, the acquirer affected the acquisition through a U.S. subsidiary, which now acts as the global headquarters for the acquired business. It was this company that incurred the debt to finance the deal and now requires sufficient cash flow to meet its debt obligations.

There are two basic ways to match profits with the cash flow needed for debt servicing. The first is to push the debt down to the local affiliates in proportion to their ability to pay. The two potential problems here are whether the prevailing TP regime will allow these local affiliates to generate enough positive cash flow and the need to comply with a wide variety of thin-capitalization rules designed to prevent MNEs from stripping profits from their local affiliates with related or third-party debt to avoid taxes. Such problems may loom large if the profits of affiliates are reduced by revisions of TP policies. Affiliates that are profitable at the operating level, but record losses after substantial interest expense, could attract unwelcome tax authority attention and increase the group's overall TP risk profile.

The alternative is to retain the debt in the U.S. subsidiary and craft a TP policy that channels enough cash through it to service the debt.

The acquirer's wish to centralize IP ownership and the consequent transfer of the IP of the acquired company to Europe raised additional tax and TP issues.



Dave Rutges

KPMG in the Netherlands
Burgemeester Rijnderslaan 10
1185 MC Amsterdam
Phone: +31 206561311
Fax: +31 206561500
e-Mail: rutges.dave@kpmg.nl

Dave Rutges is an international tax and transfer pricing partner based in Amsterdam. He is also a partner in KPMG's Global Transfer Pricing Services practice and the head of the EMA KPMG GTPS practice.

The industries in which Mr. Rutges has specific experience include amongst others financial services, pharmaceutical, biotechnology and the automotive industry. He is a member of KPMG's Global Transfer Pricing Services practice and is leading the Dutch transfer pricing team.

Mr. Rutges holds a degree from Erasmus University, Rotterdam, and he is a member of the Dutch Association of Tax Advisors. He is currently involved in negotiating multilateral, bilateral and unilateral APAs with Dutch and foreign tax authorities and has successfully completed a number of APAs. Mr. Rutges has written a number of articles and is a regular speaker at seminars.

Divestment transactions usually provide for some form of tax equity in the event of future tax examinations of pre-deal years.

Assume the acquired company had previously employed the comparable profits or transactional net margin TP methodology, which allowed its distributors in relatively low-tax jurisdictions to earn profits at the higher end of the comparables range. One way to channel more cash to the debt-laden U.S. subsidiary is to retune the TP policy for tangible goods so that the distributors earn profits lower down the comparables range (assuming, of course, that there are profits to shift in this way). Other options are for the European parent and its U.S. subsidiary (the acquired company's global headquarters) to impose higher charges for services provided to distribution affiliates, or to seek new opportunities to exploit valuable intangible property.

The problem here is that any steps that systematically shift profit from distributors to the debt-laden U.S. subsidiary are likely to attract the attention of tax authorities, and could trigger exit charges for those affiliates which are having their profit levels reduced. Moreover, the financial impact of business decisions that have a significant impact on the TP options available will be hard to predict. To what extent, for example, will the acquired business be integrated with the acquirer's business? If such integration is expected to boost profits in the longer term, could restructuring costs lead to losses in the short term? Other areas of potential TP exposure include:

- risk of additional local country examinations to challenge the reduced profit levels
- potential exit charges when a tax authority claims valuable functions were removed from its tax base
- the inability of the company's accounting systems to provide the data needed to implement and test the new arrangements
- the deductibility of new inter-company charges
- permanent establishment risks and related TP exposures.



Geoffrey Soh

KPMG in Singapore
16 Raffles Quay #22-00
Hong Leong Building
Singapore 048581
Phone: +65 6213 3035
Fax: +65 6220 9419
e-Mail: geoffreysoh@kpmg.com.sg

Geoffrey Soh is a partner with KPMG's transfer pricing practice in Singapore. Mr. Soh has 18 years of professional experience in the area of economic and transfer pricing services. Prior to joining KPMG in Singapore, he worked in a Canadian university and the public sector in the areas of economic forecasting and policy development.

Mr. Soh has managed approximately 400 international transfer pricing engagements

for multinationals in a number of industries. His projects have encompassed the compliance, tax planning, audit defense, and dispute resolution aspects of transfer pricing.

Mr. Soh is a graduate of the University of Alberta, Canada (M.A., Economics) and the University of Calgary, Canada (B.A. Honours, Economics).

Migration of Intangibles

As noted above, it is the acquirer's policy to centralize its IP in a low-tax jurisdiction. During the initial due diligence, it emerged that the acquired company's IP was also owned centrally; all of its legally protected IP, including patents, copyrights, and trademarks, were registered in the name of its parent. Based on this information, the acquirer decided to set up a new company to hold the acquired company's IP in the jurisdiction where it held its own IP. Although this would lead to exit charges, the acquirer believed it could manage this risk by applying for an APA after acquisition in the jurisdiction of the acquired company's former parent.

After the deal closed, however, it became clear that the pattern of IP ownership was not quite as simple as it had seemed during initial due diligence. All legally-protected IP had, indeed, been owned by the former parent, but a number of affiliates had previously paid for the development of some IP that was not legally protected, such as customized applications for local customers, of which they were arguably the economic owners. In the tax

jurisdictions of some of these IP-owning affiliates, APAs are not available and there may even be legal restrictions on changing IP ownership. As a result, it may be very difficult, if not impossible, for the acquirer to effect the organization it had in mind pre-acquisition. This may have negative tax consequences and so limit the acquirer's room to maneuver.

This illustrates the kind of problems that arise in with respect to IP considerations without complete pre-acquisition information. Acquirers should bear in mind, among other things:

- the difference between the legal and economic ownership of IP
- legal, accounting, tax, and other formal restrictions on moving IP from one place to another
- difficulties in separating IP sold from IP retained by the seller
- existing agreements with third parties, such as licensing in or out, that the buyer may have to respect.

Other Supply Chain Issues

A similar problem can arise when the acquired company has a complex supply chain that includes several royalty flow-through companies because supply chain structure and associated legal agreements will dictate how much profit will be earned in different jurisdictions. It is often difficult, in practice, for the buyer to understand the supply chain structure and work out how profits and value should be allocated among the affiliates. This can lead to serious problems if, for example, the buyer has arranged financing on the basis of a perceived set of affiliate values only to find, after closing, that some affiliates that appeared to be the profit generators were mere flow-through companies and their profits were generated elsewhere in the supply chain. This will also have practical implications for the acquirer and possible tax consequences.¹

1. For U.S. companies, this can also increase the risk of future 142 impairment charges if there are significant intercompany transactions between different reporting units. If the purchase price allocation leaves one reporting unit with significant intangibles (including goodwill intangibles) but the transfer pricing structure limits the profits that can be realized by that reporting entity, the transfer pricing may make in a future 142 impairment charge as it does not leave sufficient income in the reporting unit to support the intangibles assigned to that reporting unit.



Ágata Uceda

KPMG in the Netherlands
Burgemeester Rijderslaan 10
1185 MC Amsterdam
Phone: +31 20 656 1141
e-Mail: uceda.agata@kpmg.nl

Ágata Uceda is a senior manager with KPMG Meijburg & Co. in the Netherlands. She has experience with all aspects of transfer pricing documentation, planning and audit defense, including APA negotiations. Today she manages a wide range of assignments covering economic, management, and fiscal aspects of transfer

pricing. In particular, she has hands-on experience with integration of transfer pricing systems after M&A, cost allocation studies, value analysis, and reorganization projects.

A graduate of INSEAD, Ms. Uceda studied business economics at the University of Seville, Spain. She also has an Executive MBA from the University of Edinburgh and ENPC.

TP Risk Management Tools

Rationales for many mergers and acquisitions are based on extensive post-merger supply chain restructuring, which could have major TP implications that would present management with both opportunity and risk. Properly implemented post-close structuring offers taxpayers significant opportunities not only to operate more tax effectively, but also to match cash flow with the financing needs imposed by the debt structure.

But risks also attend any post-close changes to the business structure. The first step in managing these risks is to develop a sufficiently accurate understanding of the target company's TP structure to make key decisions about IP migration and financing that are consistent with, for example, the allocation of debt among the various legal entities. The difficulty here is that these decisions often have to be made during the due diligence phase with limited information. Moreover, systems limitations may reveal that a contemplated supply chain restructuring produces an additional administrative burden or casts doubt on the data used to evaluate certain business flows. It is also vital to evaluate very carefully the quality of the data on which the decision

to proceed with a supply chain restructuring is based. If the success of a contemplated structure is very dependent on the accuracy of results projections, the consequences of actual results that differ significantly from the projected results should also be carefully considered. TP policies can and should be changed to reflect business changes, but tax authorities generally frown on frequent modifications.

Once the major decisions have been made, the next step is to decide what changes to make and the TP risk management approach needed to manage the transition risks. When two companies with very different TP systems are to be merged, or a new company is being formed by spin-off, a global TP planning and documentation project to identify and resolve issues arising is advisable. Global documentation allows a company to adopt a common TP risk management system for all jurisdictions, and serves many purposes. It produces a detailed picture of TP operations in each country, including some that might previously have been unknown. It provides an opportunity to develop a global policy. It acts as a template for inter-company agreements covering all related-party dealings. For the acquirer in our case, a global study would document the

rationales for changing target margins, including detailed descriptions of the functions and risks undertaken by the distributors and why a target margin at the lower end of a comparables range is appropriate. The assistance in drafting inter-company agreements is particularly useful, because tax authorities often give considerable weight to assignments of functions set out in written agreements. They can see them as evidence of a business intent and of a TP policy based on long-term business considerations, rather than a wish to hit a particular profit for a particular year.

Since service flows also change afterwards, a merger or acquisition can be an opportune time for a global cost allocation review aimed at identifying services supplied within a group and allocating their costs to the group members that use them. A change in ownership alters previous patterns of inter-company services and requires a review of activities charged for and systems governing their administration. In our case, for instance, it may be possible to devise a structure where the debt-laden U.S. subsidiary acts as the acquired company's headquarters or where the latter's existing headquarters continues to supply certain global services to foreign affiliates.

It is important to remember, however, that related-party services of this kind are of great interest to tax authorities, and regulations covering them differ. For this reason, any cost allocation analysis should be accompanied by the development of a study and/or procedures that can demonstrate benefits. Without such supporting evidence, tax authorities may disallow the deductibility of the service charges in the paying country. How the provision of such inter-company services is managed in practice will depend on the cost/benefit analysis, the relationships between tax authorities of relevance to the supply chain, the TP sophistication of the main tax authorities, and the complexity of the inter-company business arrangements.

There are various ways to manage these risks, most of which are now well-established in tax jurisdictions that follow the Organisation for Economic Co-operation and Development's guidelines. They include:

- local rulings
- timely TP documentation
- clear inter-company agreements
- bilateral or unilateral APAs
- consistent TP policies to assure local tax authorities that the supply chain is not cherry picking for tax advantages among similarly situated affiliates.

Advance rulings, such as APAs, are particularly helpful during any restructuring – post-merger or otherwise – because they provide the restructurers with documentation that the pricing policies adopted for their new supply chains will be respected by the tax authorities. A taxpayer can seek an APA in most tax jurisdictions, for most sorts of inter-company transactions, not just tangible goods flows. The APA can be particularly valuable when dealing with complex transactions or potentially controversial adjustments in the functional and risk profiles of group companies. Because APAs require active engagement with tax authorities, they provide the taxpayer with an opportunity to put its case up-front.

A change in ownership alters previous patterns of inter-company services and requires a review of activities charged for and systems governing their administration.

Conclusion

TP issues should be on both pre- and post-transaction checklists of priorities, because such issues contain both opportunities and risks. Early TP analysis can allow the new business to integrate TP into its business plans and anticipate local difficulties. Very importantly, the early documentation of TP policy is an essential basis for effective TP risk management.

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.

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Managing Transfer Pricing Audits in ASPAC

Transfer pricing regimes in the Asia/Pacific region are based on the same model, but differ in some important details. Sherry Chang (KPMG in Taiwan), Kim Jarrett (KPMG in New Zealand), Masanori Kawanobe (KPMG in Japan), and Won-Kee Pae (KPMG in Korea) describe the differences, and offer some prescriptions for compliance and audits.

The booming Asia/Pacific (ASPAC) region includes a wide variety of countries and an equally wide variety of challenges for the multinational enterprise (MNE) seeking to bring more efficiency and consistency to the management of its transfer pricing (TP) audits. This article examines some successful TP audit defense approaches used in various countries, highlights the key themes that characterize TP challenges in the ASPAC region, discusses some fundamental differences between ASPAC markets, and provides some practical tips for dealing with TP audits in the region.

A Variety of Experience

An important feature of the ASPAC region is the wide divergence in the experience of regional tax authorities with TP. In terms of focus and approach, a TP audit in an experienced regime, such as Japan, will be very different from an audit in Taiwan, for example, which has only recently introduced TP rules.

In what follows, we have drawn an inherently subjective, but, in our view, useful distinction between jurisdictions that have well-entrenched TP rules with established compliance programs (the mature regimes) and jurisdictions whose TP regimes are of more recent origin. Maturity, in this sense, has nothing to do with economic maturity. It is simply a measure of the levels of experience of tax authorities in dealing with more difficult TP issues.

Countries such as Australia, New Zealand, Japan, and South Korea have mature TP regimes, and correspondingly sophisticated audit and enforcement programs. Other countries, such as Taiwan and Thailand, have relatively new TP regimes and the level of their auditors' experience will vary.

In handling TP audits, it is important to identify the areas where tax authorities are likely to concentrate and the economic (and cultural) factors that can influence TP compliance and audit strategies. Our member firms' experience is that the focus of a TP audit, the kinds of analysis required, attitudes to methodologies, and appetites for litigation can all vary significantly, according to the maturity of the TP regime.

Mature Regimes

When developing an approach for dealing with a TP audit in ASPAC, the taxpayer should be mindful of the likely audit focus in the jurisdiction concerned and prepare for it.

In the mature markets – Japan, Australia, New Zealand, and South Korea – transactions involving goods and management service are still watched closely, but there is a significant and increasing focus on transactions involving intangibles. Complex group financing arrangements are also attracting more attention.

In many markets, a strong link exists between corporate tax and TP. TP audits can be, and often are, inspired by corporate tax audits, particularly when the transaction could result in a significant tax deduction against the local tax base. And both audits can often be conducted by the same people, albeit, in the case of a TP audit, with support from internal specialists. In New Zealand, for example, the debt/equity boundary, particularly if offshore financing arrangements are involved, can come under close scrutiny from both a general tax and a TP perspective.

Japan

The following key transfer pricing risk areas likely to attract the attention of Japan's National Tax Agency (NTA) will give an idea of the nature of a mature TP market.

Intangibles

In Japan, transactions involving intangible property have become high profile targets in recent TP audits. The treatment of intangibles is very complicated because of the difficulties in adducing evidence to support valuation, determining economic (as opposed to legal) ownership, and establishing an appropriate royalty rate.

Many Japanese MNEs have become manufacturing migrants and moved their manufacturing facilities to lower-cost countries in South Asia and China, while typically keeping their intellectual property (IP), such as patents and know-how, in Japan. But the parent may also add value to its overseas manufacturer with its production processes, for which the tax authorities in the home country would expect compensation. This can create TP audit risks in multiple jurisdictions.

A large Japanese manufacturer with operations in China recently received a substantial TP adjustment from the NTA relating to royalties paid by the Chinese subsidiary to the Japanese parent for use of brand names and production technology and equipment. The NTA challenged the arrangement by claiming that the Chinese business was earning considerably higher operating profits than subsidiaries of other Japanese companies in similar situations. The taxpayer defended the arrangement by arguing that the high profit was justified because the China operation had developed many technologies of its own, paid tax in China, and was under pressure from the Chinese tax authorities to reduce its royalty payments.



Sherry Chang

KPMG in Taiwan
68F, Taipei 101 Tower, No. 7, Sec. 5,
Xinyi Road, Taipei, 11049
Phone: +886 2 8101 6666 ext. 04590
Fax: +886 2 8101 6667 ext. 04590
e-Mail: schang1@kpmg.com.tw

Sherry Chang is the partner-in-charge of tax services for KPMG in Taiwan. She leads over 180 full time specialists in Taipei and Taichung. Ms. Chang has also been the managing partner of KPMG's Global Transfer Pricing Services for KPMG in Taiwan. She has been active in advising multinational companies on transfer pricing issues since 2004.

Prior to joining KPMG, Ms. Chang worked in the Taipei Tax Bureau for nine years in charge of tax rules research and tax audits of profit-seeking enterprises income. Accordingly, she is familiar with the internal operations and procedures of the tax assessment of tax authorities.

Ms. Chang's key areas of experience include consulting on transfer pricing, Taiwan and cross-border taxation, and Competent Authority negotiation assistance.

Ms. Chang's clients cover almost all industries including electronics, consumer products, retails, industrial products, chemical and pharmaceutical, transportation, and educational institutions.

Ms. Chang has been a frequent public speaker and contributor of articles on transfer pricing, corporate tax, and tax incentive.

Tangibles

Determining appropriate royalties for a parent's IP can be made all the more difficult by the recent tendency for Chinese manufacturing operations owned by companies based in Japan, Australia, and New Zealand (which has recently signed a Free Trade Agreement with China) to ship manufactured goods directly to distributors in other countries and thus remove their parents entirely from the supply chain.

Contract Service Providers

The use of contract service providers to finance the creation of intangibles can further complicate matters. The NTA's recently amended Transfer Pricing Administrative Guidelines assert that, when assessing contributions to the creation of the intangible, more weight should be given to the company that contributes the labor, management, and technical knowledge (often the Japanese parent or an affiliated, Japan-based company) than the company that provides the financing. This is at odds with the approach of most member countries in the Organisation for Economic Co-operation and Development (OECD), which regard the economic owners of IP as those that bore the financial risk associated with the research and development.

Joint Ventures

The NTA has also begun to audit cross-border joint ventures for compliance with Japan's TP rules. These structures are becoming more common because they enable co-financing of manufacturing operations outside Japan, typically in China, but questions can arise about the economic ownership of the intangibles used in a joint venture.

The inherent commercial tensions in joint ventures are normally resolved by agreements between the joint venturers to transact on arm's-length terms to establish that neither takes advantage of its business relationship with the venture. Despite such agreements, the parties in a joint venture (including those set up in Japan with foreign partners) may nevertheless be deemed to be related parties by the NTA.

Suppose a Japanese company and an unrelated U.S. company set up a 50/50 joint venture. The Japanese company develops and sells products to the joint venture, which is largely managed by the U.S. partner for marketing in the United States. The NTA could argue that the Japanese company sold the product at a less-than-arm's length price and impose a TP adjustment.


Kim Jarrett

KPMG in New Zealand
18 Viaduct Harbour Avenue
Auckland, 1010
Phone: +64 9 363 3532
Cell: +64 21 665 681
e-Mail: kmjarrett@kpmg.co.nz

Kim Jarrett heads the New Zealand transfer pricing and customs practice, and has been involved in providing transfer pricing advice to her clients since the introduction of New Zealand's transfer rules in 1996.

Ms. Jarrett provides transfer pricing advice to a wide range of industries and businesses including distribution companies, manufacturing entities, natural resources exporters, pharmaceutical companies, banking and finance entities. She has also provided advice on a range of technology and intellectual property matters.

Ms. Jarrett has had significant liaison experience with the Inland Revenue Department on transfer pricing audit matters and has negotiated both unilateral and bilateral Advance Pricing Agreements. She also advises on customs issues, and international taxation matters.

Ms. Jarrett has Bachelor of Commerce and Bachelor of Laws degrees from the University of Canterbury, is a member of the New Zealand Institute of Chartered Accountants and is a Barrister and Solicitor of the High Court of New Zealand.

The success or failure of a TP audit can often come down to the tax authority's view on the comparables used to demonstrate the arm's-length nature of related-party transactions.

This situation is interesting for two reasons. First, a 50/50 arrangement meets the related entity test in Japanese regulations, even though the Japanese partner exercises no practical control over the joint venture's management decision-making. Second, since both parties are wholly independent, they have no incentive to collude with one another. In short, there seems every likelihood that the nature and circumstances of the relationship will result in the joint venture operating on an arm's-length basis, and any NTA demand for a TP adjustment would be unjustified.

Low-Risk Distributors

Its current focus on intangibles does not mean that the NTA will not look at more traditional TP risk areas. Increasingly common low-risk structures, involving a guaranteed minimum net margin, can also cause problems in Japan. To demonstrate that a risk is borne by an overseas entity, the entity may need to separately and specifically reimburse the Japanese company for incurring a loss arising from the risk (such as, for a specific bad debt write-off if credit risk is borne by the overseas entity). This is in addition to, and separate from, the TP adjustment required to achieve the subsidiary's guaranteed margin. Attempts to make a TP adjustment perform double duty, by guaranteeing the margin and offsetting a particular risk, can have serious implications for cross-border distribution arrangements employing a low-risk Japanese distributor.

Newer Transfer Pricing Regimes

Elsewhere in the ASPAC region where there is less TP experience, TP requirements may not be well understood by taxpayers and the degree of voluntary compliance with TP rules may be lower.

Tax authorities dealing with new TP systems may be in a similar position and their experience with interpreting TP analyses and methodologies may be limited. MNEs operating in those countries may need to be prepared to invest considerable time in managing these audits sensitively. Often, a cooperative approach with revenue authorities can yield the most benefit.

In countries with newer TP regimes, audits tend to concentrate on tangible property transactions. Related-party loans, guarantees, and management service charges also receive close attention. For the time being, IP transactions are less likely to attract attention.

TP compliance programs may also be relatively untested in these markets. Authorities may be more interested in understanding a taxpayer's TP policies than undertaking audits, particularly in the first few years after the introduction of a TP regime. Tax authorities in Taiwan, which introduced a TP regime a few years ago, have only recently embarked on an audit program. There are often opportunities for MNEs, during these initial learning periods, to achieve speedy resolution of TP disputes through negotiation with the revenue authorities.

Methodologies and Comparables

All the TP regimes in the ASPAC region are broadly based on OECD principles. However, comparability and method selection issues tend to be dealt with differently, and these differences can have direct consequences for the resolution of audit issues. Audits may be concluded more swiftly and easily if taxpayers bear in mind the preferences of the authorities with whom they are negotiating.

The success or failure of a TP audit can often come down to the tax authority's view on the comparables used to demonstrate the arm's-length nature of related-party transactions. Views on the relevance of comparable data differ across the ASPAC region, as does the scope for negotiation around an appropriate data set.

A full description of the methods and their use in each country is beyond the scope of this article. We will focus here on some nonstandard issues in TP audits by some ASPAC tax authorities.



Masanori Kawanobe

KPMG in Japan
Izumi Garden Tower
1-6-1, Roppongi
Minato-ku, Tokyo, 106-6012
Phone: +81 (0) 3 6229 8320
Fax: +81 (0) 3 5575 0761
e-Mail: masanori.kawanobe@jp.kpmg.com

Masanori Kawanobe is a partner in KPMG in Japan and has been an Asia Pacific Regional Lead for KPMG's Global Transfer Pricing Services (GTPS) for four years until the end of 2007. His area of specialization includes cross-border transactions of the medical, biotech, chemical, semi-conductor and other high-tech industries. He has dealt with various tax authorities, including Japan, US, UK, Australia, Thailand, Singapore, Sweden, Germany and France, to a great extent for the APAs as well as for the settlement of Competent Authority discussions.

Mr. Kawanobe received his MBA in Finance and Business Policy from the University of Chicago Graduate School of Business. He is a U.S. CPA and a Chartered Member of the Security Analyst Association of Japan (CMA).

Mr. Kawanobe's publications include "Business Valuation for Management, Chuokeizai in 2003" and "Transfer Pricing Regulations – Application, co-author, Chuokeizai in 2004."

Japan

In Japan, TP methods are specified by law and based on the OECD Guidelines. They include the transactional net margin method (TNMM), which has been acceptable in Japan since 2004 and is now widely used.

Japanese comparables are accepted for Japanese parties. The use of ostensibly appropriate foreign comparables (under the resale price, cost plus, or TNMM methods) by foreign tested parties can lead to complications, however, because of the difficulties the NTA perceives in judging the comparability of companies outside Japan. The NTA's basic concern is that the profits received by an entity in a supply chain should reflect what the entity does and the risks it assumes in the whole supply chain. This means that a thorough understanding of the supply chain is necessary to demonstrate the appropriateness of the MNE's pricing, particularly if the NTA is testing a non-Japanese affiliate.

New Zealand and Australia

In New Zealand, the comparable profits method (CPM) (equivalent to the TNMM) is the most commonly used method and TNMM has, until now, been the most common method for testing transactions involving distribution and manufacturing companies in Australia. However, the recent Roche¹ decision in Australia, where a gross margin (resale price) analysis using internal comparables was found to be more reliable than a TNMM analysis using external data, may prompt a reconsideration of method selection by both taxpayers and tax authorities. Both countries also consider the comparable uncontrolled price method and the residual profit split method for the transactions of intangibles, with the TNMM often used as a check.

In Australia, New Zealand, and Japan, tax authority questions may be asked about the use of the cost plus method to remunerate a subsidiary performing a sales function if a third party would normally be expected to get a return on the sales generated. It is also worth noting that sales-like activity (even when there is no purchase agreement or transfer of title) may also lead to permanent establishment issues.

1. Roche Products Pty Limited v Commissioner of Taxation [2008] AATA 261 (2 April 2008)

Taiwan

Taiwan's tax authority favors the resale price method and normally compares gross margins of related- and unrelated-party transactions initially, despite the fact that taxpayers usually use the CPM in their documentation. Because Taiwan's TP regime is still relatively new, the authority's position on selection of external comparables remains unclear. The early indications from TP audits in the 2004 financial year suggest that a narrow approach is likely to be applied.

South Korea

TNMM is commonly used for audits of intra-group transactions in South Korea. The tax authority tends to focus on whether the TP method chosen is appropriate based on the underlying facts. In the case of MNEs, global TP policies and planning studies may be useful to demonstrate the adoption of a global view of TP. This is often just as important as finding the right comparables for benchmarking.

Outcomes

Negotiated outcomes are common in New Zealand and Australia, but a growing number of complex TP disputes in Australia are ending up in court.

In Japan and most other jurisdictions, audits can take years to conclude and are often extremely time-consuming for management. Tax adjustments following tax authority audits are published in Japan. Since Japan-based MNEs are reluctant to engage in public discussions in the press about their TP and have not, moreover, had much success with internal appeals and litigation against tax adjustments, many prefer to make voluntary adjustments, which often result in double taxation, than risk their reputations as good corporate citizens.



Won-Kee Pae, CPA, Ph.D.
KPMG in Korea
Gannam Finance Center
737 Yeoksam-dong
Gangnam-gu, Seoul 135-984
Phone: +82 2 2112 0260
Fax: +82 2 2112 0902
Cell: +82 10 7313 4419
e-Mail: wpae@kr.kpmg.com

Dr. Won-Kee Pae is a tax partner in the Korean member firm where he leads the Global Transfer Pricing Services practice. He joined KPMG in Korea in 2003 as partner-in-charge of the Japanese Practice in the Korea Office and recently became the GTPS Korea leader. Before joining KPMG in Korea, he worked for another Big Four accounting firm, and largest law firm in Korea. He has been involved in many transfer pricing cases, Competent Authority procedure cases and APA cases, primarily on behalf of Japanese clients.

Dr. Pae has written a number of articles on transfer pricing, in particular in the International Taxation Japan as well as in the Korean magazine. In 2007 he led a presentation at the 17th CAPA (Confederation of Asian Pacific Accountants) in Osaka with respect to international taxation and transfer pricing issues.

Negotiated outcomes are common in New Zealand and Australia, but a growing number of complex TP disputes in Australia are ending up in court.

In South Korea, many complex TP disputes lead to invocations of the Mutual Agreement Procedure (MAP) and, if agreement cannot be reached, to bilateral or unilateral APAs with South Korean and offshore tax authorities. Negotiated outcomes are more common in the newer TP regimes. Of the 18 investigations relating to the first audit year (2004) in Taiwan, for example, 11 have so far been settled. Because of Taiwan's limited tax-treaty network, MAPs and bilateral APAs are not available. This can add to the motivation to settle cases with the tax authority through negotiation.

Practical Advice

In our member firms' experience, the best outcomes are achieved when the taxpayer reacts promptly to audit notices and has all the necessary documentation ready at hand.

Although the TP focus of each ASPAC tax authority differs, there are a number of universal imperatives for taxpayers facing a TP enquiry or, worse, an audit.

- 1. Determine that supporting documentation is available or can be obtained before an audit.** This applies even if there are no statutory or regulatory requirements to maintain TP documentation, as is the case in New Zealand and Japan, where the tax authorities simply recommend that taxpayers have support for their TP policies. Insufficient or poor documentation can greatly increase the chance of a difficult audit.

2. Once an audit begins, taxpayers should provide robust arguments for the prices in the transactions examined. An absence of good documentation and strong arguments can substantially increase the prospect of adverse TP adjustments, monetary penalties, and the risks of subsequent audits, quite apart from the cost of management's time and the impact of an unfavorable audit outcome on the company's reputation.

3. Who should lead a TP audit defense depends on the circumstances and the jurisdiction. In some jurisdictions, it may be best for meetings with auditors to be led by local staff and their local advisers, particularly when the local staff are well versed in the group TP policy, have a good understanding of TP issues, and maintain good relationships with the local tax authority. In other cases, offshore representatives of the taxpayer might be better placed to explain the facts and the policies adopted. There is no one-size fits all when managing a TP audit. The key success factor is managing the scope for tax authority misunderstanding. It is definitely inadvisable, for instance, for members of defense teams to converse with each other in front of tax auditors in a foreign language.

4. Taxpayers should also determine that requests for information are promptly dealt with by suitably senior staff members. It is essential that tax authorities are given appropriate information and that taxpayers are generally open about their TP policies. But care should be taken not to provide irrelevant information, because this could lead to misunderstandings and digressions into nonproductive areas that prolong audits. In particular, taxpayers should apply appropriate controls on information flows. One key to successful audit management is determining that the information provided is correct, complete, and relevant.

5. Taxpayers must be aware of the approach likely to be adopted by the tax authority conducting the TP audit. In New Zealand and Australia, for example, tax authorities will typically request a meeting with the taxpayer and its advisers to discuss issues of interest, whereas in Taiwan, tax officers seldom conduct onsite interviews. Such differences are partly cultural, but also reflect the TP audit experience of tax authorities.

A Case Study: South Korea

In a recent case, we helped a client in a TP audit where the transactions being reviewed included the provision of intra-group services to a South Korean member of the global group and related-party royalty payments. At issue were the suitability of the TP method employed – whether a local benefit was actually derived from the intra-group services provided – and the rate at which the royalty payment was set.

To deal with the audit effectively, we prepared appropriate documentation beforehand to support the company's transfer prices. The parent company's global transfer pricing policies were presented to demonstrate the group commitment to responsible TP management. Information requests from the South Korean tax authorities were dealt with by dedicated client and KPMG teams stationed at the audit site. This fostered consistency in responses to audit queries, control over information flows, and the prompt provision of information. Efforts were also made to cultivate good relationships with the tax authorities at both operational and senior levels. The tax authority's auditors accepted the methodology employed and thus the transfer prices used.

This example illustrates the importance of good preparation, of having specific processes to deal with an audit, and of a general willingness to work with tax officials. Tax authorities can often be more inclined to work collaboratively with taxpayers who can demonstrate that they have taken a reasonable and well-documented approach to TP. In many instances, the outcome can be much better than the protracted and costly adjustment process likely to result if a taxpayer does not prepare for TP audits.

Conclusion

This article has described some of the main TP audit challenges in the ASPAC region. One size does not fit all when dealing with tax authorities in ASPAC, but it is always essential to be well-prepared, to understand which transactions are most likely to be scrutinized, and to know the tax authority's preferences in terms of methodology and analysis. Other things being equal, a tax authority may be more willing to negotiate with taxpayers that can demonstrate a reasonable, well-documented approach to their transfer pricing.

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Transfer Pricing Audits in China: A Hypothetical Case Study

Differences in national transfer pricing regulatory environment can lead to double taxation that may be hard to eliminate. Yvonne Chen (KPMG in China), Brian Cody (KPMG in the United States), Matthias Kaut (KPMG in Germany), and Steven Tseng (KPMG in China) explore the intricacies of a three-country relationship.¹

China's role in the world economy has been evolving and expanding for several years now. Multinational enterprises (MNEs) have been focusing their attention on China as a key hub for operations in the Asia Pacific region. This growing importance of China has led to Chinese affiliates of MNEs assuming larger functional responsibilities and bearing greater risks. Furthermore, the expansion of operations in China has led to increased scrutiny and attention from Chinese tax authorities. The end result is the current transfer pricing environment in China, one where new guidelines have been formulated and where Chinese tax authorities are focused on operations of MNEs in China.

This case study examines this new transfer pricing environment in China. The case study deals with a hypothetical situation for an MNE with its parent operations in the United States and foreign operations in Germany and China. The case explores the audit procedures a typical company would face from the Chinese tax authorities. It also examines the situation from the U.S. and German perspectives and explores potential impacts and recourses available to the MNE.

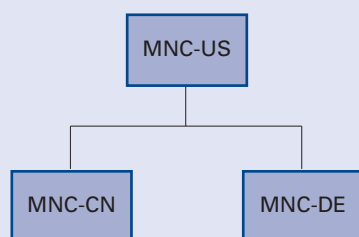
Overall, the case study explores a highly likely situation for an enterprise with large operations in China, and how this affects its transfer pricing on a global level.

Background

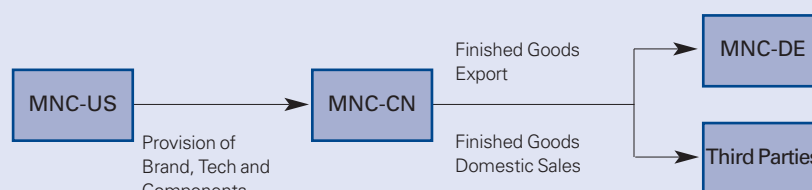
MNC-US is a multinational company in the consumer products industry with proprietary technology and a globally recognized trade name. It is based in the United States, but sells its products all over the world. It has a Chinese manufacturing subsidiary, MNC-CN, which imports key components from its parent. MNC-CN manufactures products for export to an affiliate in Germany, MNC-DE. MNC-CN also sells in China to unrelated parties. The MNC group's organizational structure is shown in Figure 1.

Figure 2 shows the flow of transactions.

¹ The authors also wish to express their gratitude to Alexey Manasuev (KPMG in the United States) and Brian Soloway (KPMG in China) for their invaluable assistance in preparation of this article.

Figure 1 MNC group's organizational structure

Source: For illustration purposes only, KPMG in China.

Figure 2 MNC flow of transactions

Source: For illustration purposes only, KPMG in China.

Cross-Border Transactions

MNC-US is both the legal and economic owner of MNC's technology and intangible marketing assets. It has given MNC-CN the right to use its brand name, trademarks, and know-how to manufacture and sell MNC products in return for an annual royalty. MNC-CN also purchases key components used in the manufacturing process from MNC-US.

MNC-CN exports most of its output to MNC-DE, but it also sells some goods to unrelated consumers in China. Thanks largely to successful local brand-building advertising paid for by MNC-CN, domestic sales have been rising strongly within China.

MNC-CN is currently enjoying a tax holiday under the old income tax laws in China, but because of its very low margins on exports, high royalty payments, and domestic advertising, it has not generated any taxable income since start-up. Under China's old income tax regime, MNC-CN enjoyed a two-year tax holiday and could pay tax at half the standard rate for three years after the year it became profitable. Under transition rules in China's new income tax law, however, MNC-CN will now become a taxable entity.

Table A shows a simplified income statement for MNC-CN.

Engagement

After the release of China's new income tax law, a local Chinese tax official phones MNC-CN's tax director to arrange a meeting.

Before calling, the local tax official undertook some research and identified MNC-CN as a potential audit target based on criteria set out in Circular 143² (most of which are included in the draft Transfer Pricing [TP] regulations). The criteria that would have caused the enterprise to be flagged for attention include:

2. Article 12 of Guoshuifa [2004] 143 – Administration of Tax on Business Transactions between Affiliated Enterprises Rules (Circular 143).

Table A Simplified Income Statement for MNC-CN

MNC-CN	2000	2001	2002	2003	2004	2005	2006	2007	2008
Revenue	100.0	112.3	127.0	145.1	167.9	197.7	237.6	292.6	370.2
Export to MNC-DE	95.0	104.5	115.0	126.4	139.1	153.0	168.3	185.1	203.6
Domestic Sales	5.0	7.8	12.0	18.6	28.9	44.7	69.3	107.5	166.6
Cost of Goods Sold									
Purchases from MNC-US	76.7	85.7	96.4	109.2	125.2	145.5	172.1	208.0	257.9
Local Purchases	10.0	11.2	12.7	14.5	16.8	19.8	23.8	29.3	37.0
Royalty Paid to MNC-US	5.0	5.6	6.3	7.3	8.4	9.9	11.9	14.6	18.5
Advertising Expenses	2.0	2.0	2.0	2.0	3.0	3.0	3.0	5.0	5.0
Admin Expenses	9.8	10.2	10.7	11.3	17.0	17.6	18.4	24.3	25.2
EBIT	(3.4)	(2.5)	(1.2)	0.8	(2.4)	1.9	8.5	11.4	26.6
Operating Margin	-3.4%	-2.2%	-0.9%	0.5%	-1.4%	1.0%	3.6%	3.9%	7.2%

Source: For illustration purposes only, KPMG in China.

Table B Extract from the Circular 363 Financial Forms for Export Sales**MNC-CN: Export Sales**

	2000	2001	2002	2003	2004	2005	2006	2007	2008
Revenue	95.0	104.5	115.0	126.4	139.1	153.0	168.3	185.1	203.6
Cost of Goods Sold									
Purchases from MNC-US	73.7	81.0	89.1	98.1	107.9	118.7	130.5	143.6	157.9
Local Purchases	9.5	10.5	11.5	12.6	13.9	15.3	16.8	18.5	20.4
Royalty to MNC-US	4.8	5.2	5.7	6.3	7.0	7.6	8.4	9.3	10.2
Advertising									
Admin Expenses	4.8	5.2	5.7	6.3	7.0	7.6	8.4	9.3	10.2
EBIT	2.3	2.6	2.8	3.1	3.4	3.7	4.1	4.5	5.0
Operating Margin	2.5%	2.5%	2.5%	2.5%	2.5%	2.5%	2.4%	2.5%	2.5%

Source: For illustration purposes only, KPMG in China.

Table C Extract from the Circular 363 Financial Forms for Domestic Sales**MNC-CN: Domestic Sales**

	2000	2001	2002	2003	2004	2005	2006	2007	2008
Revenue	5.0	7.8	12.0	18.6	28.9	44.7	69.3	107.5	166.6
Cost of Goods Sold									
Purchases from MNC-US	3.0	4.7	7.2	11.2	17.3	26.8	41.6	64.5	99.9
Local Purchases	0.5	0.8	1.2	1.9	2.9	4.5	6.9	10.7	16.7
Royalty to MNC-US	0.3	0.4	0.6	0.9	1.4	2.2	3.5	5.4	8.3
Advertising	2.0	2.0	2.0	2.0	3.0	3.0	3.0	5.0	5.0
Admin Expenses	5.0	5.0	5.0	5.0	10.0	10.0	10.0	15.0	15.0
EBIT	-5.8	-5.1	-4.0	-2.3	-5.8	-1.8	4.3	6.9	21.6
Operating Margin	-115.0%	-65.3%	-33.3%	-12.6%	-20.0%	-4.1%	6.3%	6.4%	13.0%

Source: For illustration purposes only, KPMG in China.

Table D Summary Operating Margin of MNC-CN from Related and Non-related Party Transactions**Operating Margin**

	2000	2001	2002	2003	2004	2005	2006	2007	2008
RPT	2.45%	2.45%	2.45%	2.45%	2.45%	2.45%	2.45%	2.45%	2.45%
Non-RPT	-115.00%	-65.32%	-33.27%	-12.60%	-20.04%	-4.06%	6.25%	6.39%	12.99%
Overall	-3.42%	-2.23%	-0.93%	0.52%	-1.42%	0.98%	3.56%	3.90%	7.19%

Source: For illustration purposes only, KPMG in China.

A local tax official initiates an audit by submitting an audit case plan to the provincial tax bureau for approval.

- substantial related-party transactions, including sales and purchases of tangibles and licensing of intangibles
- inconsistent profit/loss records
- losses, despite growing sales/investment
- persistent losses
- decision-making rights held by affiliated enterprises
- profit margins below the industry average.

An additional marker in this case was the impending expiration of the tax holiday. These indicators led the tax official to initiate an audit.

Audit Procedures

Filing the Case for Audit

A local tax official initiates an audit by submitting an audit case plan to the provincial tax bureau for approval. The provincial tax bureau then forwards the case plan to the State Administration of Taxation (SAT). The TP investigation formally begins once the SAT approves the case plan.

Field Audit

An auditor's first steps are to seek further information, obtain the accounting data, and perform a field investigation. The taxpayer will be asked to complete the functional and risk profile form and the financial form, as provided in Circular 363 [2007]³. A summary of results from the financial form is shown in Tables B and C. The SAT may also request additional information from foreign tax authorities under the exchange of information procedure contained in some tax treaties.

Financial Analysis

Long-term losses: From 2000 to 2005, MNC-CN reported losses or small profits. Form 363 showed a stable profit on export sales during the period, but losses on domestic sales. Table D summarizes the overall earnings before interest and tax (EBIT) margin, and EBIT margins for related-and non-related party transactions from 2000 to 2008.



Steven Tseng

KPMG in China
50th floor, Plaza66, 1266 Nan Jing West Road
Shanghai, 200040
Phone: +86 21 2212 3408
e-Mail: steven.tseng@kpmg.com.cn

Steven Tseng is the partner-in-charge of Global Transfer Pricing Services for KPMG China. He is leading more than 80 full time transfer pricing specialists in China. He has been active in advising multinational companies on transfer pricing issues since 1994. Mr. Tseng's transfer pricing career includes experience in the U.S., Japan, Nordic region and he has been working on transfer pricing in China from 2005.

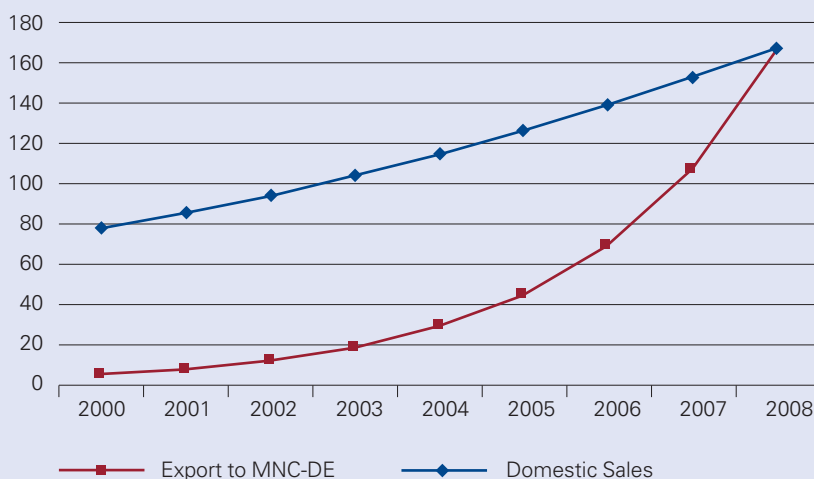
As of October 2007, Mr. Tseng assumed the leadership of the Asia Pacific Region of GTPS for KPMG. The region comprises of

more than 400 full time transfer pricing specialists in key jurisdictions such as Australia, China, India, Indonesia, Japan, Korea, Malaysia, New Zealand, the Philippines, Singapore, Taiwan, Thailand, and Vietnam.

Mr. Tseng is a frequent public speaker and contributor of articles on transfer pricing, valuations and globalization.

He served as the lead partner/ lead economist for several hundred global transfer pricing, business transformation, valuations and post merger integration projects around the world.

Figure 3 Sales Trend



Source: For illustration purposes only, KPMG in China.

Analysis of profit margins from related and non-related party transactions: MNC-CN reported losses or low profits during the period from 2000 to 2005, caused by the losses from its domestic sales (to non-related parties). Despite this overall loss, MNC-CN paid royalties to MNC-US for the use of the brand name, trademarks and know-how.

Different gross margins on exports and domestic sales: Tables B and C told the tax officials that gross margins on domestic sales during this period were a lot higher than the gross margins on export sales.

Determination of Adjustments

The tax officials argue that the prices of MNC-CN's export sales are less than arm's length because the gross margin is lower than that on domestic sales, and that export prices should be increased. They go on to argue that the MNC brand was having little effect in the Chinese market, as evidenced by the fact that

3. Guoshuihan [2007] No. 363 – Circular of the State Administration of Taxation on Intensifying Analytical Investigation into Transfer Pricing.


Yvonne Chen

KPMG in China
50th floor, Plaza 66,
1266 Nan Jing West Road
Shanghai, 200040
Phone: +86 21 2212 3356
e-Mail: yvonne.yw.chen@kpmg.com.cn

Yvonne Chen is a senior manager with the KPMG member firm in China. Prior to coming to KPMG, Ms. Chen was an anti-avoidance official with the Chinese tax authorities in Shanghai for almost 20 years. She has extensive experiences in tax policy,

international tax matters and focused on transfer pricing audits since 1993. Ms. Chen has spent many years in charge of transfer pricing audits and APA matters in the Pudong Tax Bureau in Shanghai.

MNC-CN wasn't earning an abnormal profit on domestic sales and that the increase in profit on domestic sales was caused by the increased marketing spend, which had led to the rapid growth in sales shown in Figure 3.

Since the growth in domestic sales was due to increased advertising expenditure, the tax official argues that these marketing activities have created local marketing intangibles in China, which contribute significantly to the group profit; thus, the residual profit split method (RPSM) should be used to determine the arm's-length nature of the royalty payment.

The taxpayer disagrees and argues that the royalty on domestic sales is in accordance with the arm's-length principle, because it would charge a third party the same royalty rate for use of the brand and trademarks, regardless of profitability.

Furthermore, the taxpayer argues, it has complied with Circular 236⁴ which requires all Foreign-Invested Enterprises and Foreign Enterprises with only one manufacturing operation to maintain minimum levels of profit and not to incur losses. That being so, the taxpayer insists, the transactional net margin method (TNMM) is the appropriate

method, and since MNC-CN earned a margin of 2.5 percent after royalties, its transfer pricing complies with the arm's-length principle.

Adjustments and Penalties

After obtaining the information it had requested and failing to reach agreement, the tax authority asked MNC-CN to do a self-assessment, using the profit split method. MNC-CN self-assessed the proposed adjustment with TNMM as a first line of defense and with a favorable profit split as an alternative.

The tax authority was unconvinced by the self-assessment and decided to apply the profit split method with a high rate of routine return. This decision was subsequently approved by the provincial tax bureau and the SAT and the Assessment Notice was sent to MNC-CN.

Disallowing royalty payment deductions shows MNC-CN earning a profit from its first year of operation in 2000, which becomes the first year of tax exemption. Worse still, business tax and withholding tax paid at the time of the royalty payments is not refundable and cannot be claimed as credits.

No interest is payable on taxes recovered for years before 2008, but under the new Corporate Income Tax law, the adjusted taxes for Financial Year 2008 will attract interest and a further five percentage points will be added if no documented report is prepared for 2008.

Relief

After receiving the Assessment Notice, the taxpayer examines options for seeking relief from double taxation. At first sight, there seems to be three options: seek an administrative review; appeal to the courts; or invoke the Mutual Agreement Procedure (MAP) under the tax treaty.

According to current Chinese regulations, if MNC-CN has a dispute with the tax authorities over a TP adjustment, it should remit a tax payment, interest levy, or late fee to the tax authorities before applying for administrative review. If MNC-CN refuses to comply with the decision of the administrative review, it may file an appeal with the People's Court.

4. Guoshuihan [2007] No. 236 – Circular of the State Administration of Taxation Concerning Tax Assessment Relevant to Foreign or Foreign-Invested Enterprises whose Operations are limited to Production.

The third option involves MNC-US applying for a MAP with the IRS when the Chinese tax authorities make a TP adjustment. This is a common route taken by Chinese companies, but MNC-US's success in avoiding double taxation is highly dependant upon the willingness of the IRS to provide relief from double taxation.

The View from the United States

MNC-US may face two key challenges: a TP risk evaluation for FIN 48 purposes and its need to respond to a potential adjustment from the SAT, because – for the reasons explained above – MNC-CN has been chosen as an audit target.

FIN 48 Valuations

Since uncertain tax positions may affect financial performance, they must be reflected appropriately in a company's financial statements. In the United States, FIN 48 generally requires companies to evaluate their uncertain tax positions and allows them to recognize tax benefits in financial statements only to the extent that they satisfy the FIN 48 requirements. FIN 48 evaluation involves two steps: (1) state whether a position, based on its merits, is more likely than not to be approved by a tax authority or court (recognition phase); and (2) measure the benefits (measurement phase). In TP, recognition of inter-company transactions is relatively easy. Benefits ineligible for recognition are simply recorded as liabilities for financial reporting purposes.

MNC-US must value all inter-company transactions – including foreign-to-foreign transactions such as those between MNC-CN and MNC-DE – to determine whether reserves are needed to cover the possible impact of any tax authorities' challenges to prices in these transactions, assuming those tax authorities have full knowledge of all relevant information. When valuing transactions for FIN 48, each transaction is analyzed as a separate unit of account. In this case, MNC-US must value the following transactions:

Because it's likely that the SAT will disallow MNC-CN's royalty expense deduction, MNC-US may be unable to recognize the full benefit of this royalty expense deduction in China in its financial statements.

- sale of components to MNC-CN
- licensing of brand and know-how to MNC-CN and payment of royalties for this intellectual property by MNC-CN to MNC-US
- sale of finished product by MNC-CN to MNC-DE.

For example, because it's likely that the SAT will disallow MNC-CN's royalty expense deduction, MNC-US may be unable to recognize the full benefit of this royalty expense deduction in China in its financial statements. As discussed, MNC-US would have to value the license of intangible property to MNC-CN with the two-step process. The details and outcome of the FIN 48 analysis will depend on various factors, such as whether the royalties on MNC-CN's domestic and foreign sales should be treated as one or several units of account, the likelihood that the SAT's position will be sustained after the exhaustion of all legal remedies, and several other factors.

Hidden Services

As a parent of the MNC group of companies, MNC-US could be providing some services to both MNC-CN and MNC-DE. The IRS may argue that MNC-US should be compensated for providing these services. Recently, the IRS has adopted temporary services regulations, generally effective for tax years

beginning on or after December 31, 2006. Although these regulations employ a broader general definition of activities, the definition of shareholder activities is narrowed by the new sole benefit criteria. Shareholder activities are activities whose sole purpose is either to protect the renderer's investment in the recipient or in other members of the group, or to facilitate its compliance with its reporting, legal, or regulatory requirements. The narrower definition of shareholder activities leaves more activities in the directly beneficial services category, which must be charged to affiliates. Thus, MNC-US must examine its transactions with MNC-CN and MNC-DE and determine if any services are indeed being provided (as part of this determination, MNC-US would have to document that all beneficial services are adequately compensated and that the services are in fact beneficial), and the appropriate compensation to MNC-US for providing the services (as part of this determination, MNC-US would have to determine the appropriate cost base and mark-up, if any). The SAT usually disallows the deduction of management fees, so MNC-US may end up with double taxation.

The management services fees can be deducted in Germany, but only if they are justified, their supply is evidenced by appropriate documents, and a local benefit is demonstrated.

The U.S. temporary services regulations require total services costs to include all costs, direct and indirect, and stock option costs.

Competent Authority Relief

If the two countries have signed an income tax treaty, and one party in the related party transaction is under a TP adjustment by the tax authority in one of the countries, the other party may apply to the tax authority of its residence for an offsetting adjustment. The tax authorities of the two countries may then enter into negotiations to avoid economic double taxation.

The U.S. and China have an income tax treaty with a MAP article allowing taxpayers in both countries to ask for Competent Authority relief from double taxation. Experience in resolving such Competent Authority cases under the U.S.-China treaty is limited, however, so the process can be lengthy, and it's hard to predict the extent to which relief might be granted.

The question also arises of which double tax treaty is applicable to obtain Competent Authority relief. Although the payment flow for the royalty is between MNC-DE and MNC-CN, the underlying transaction is between MNC-DE and MNC-US, the ultimate owner of the technology. The U.S.-Germany treaty has recently been modified, and now contains a binding arbitration procedure, applicable in TP matters. This would be the preferred option, but since the direct transaction is between MNC-DE and MNC-CN, the German tax authorities might be unwilling to negotiate with the United States without including China. It might turn out, therefore, that the taxpayer's only feasible option is to enter into two separate, though interrelated, MAPs.



Brian J. Cody, Ph.D.
KPMG in the United States
303 East Wacker Drive
Chicago, IL 60601-5212
Phone: +1 312 665 1912
Cell: +1 314 422 2690
e-Mail: bcody@kpmg.com

Dr. Brian Cody has worked in the field of applied economics since 1987, having principally consulted with global companies in a vast array of industries to plan and document their intercompany pricing policies. He has assisted in the negotiation of unilateral and multilateral Advance Pricing Agreements and developed a variety of intercompany transaction structures for companies operating in North, Central and South America, Europe, the Middle East, Asia, and Australia.

Dr. Cody has consulted on a wide range of intercompany pricing issues, including cost

sharing/contribution arrangements, contract services structures, intangible property development, valuation, and migration, intangible property management companies, and group finance arrangements. He has been admitted as an expert economic witness and provided testimony on intercompany pricing and other economic issues in a variety of courts, including Federal District Court, Federal Bankruptcy Court, State of New York Division of Tax Appeals and the North Carolina Department of Revenue.

Requesting Foreign Tax Credit in the United States

In the absence of relief, MNC group could end up with economic double taxation because of an adjustment by the SAT. MNC-US could accept the adjustment (assuming MNC-US concludes the adjustment is justified and supportable) and claim a foreign tax credit (FTC) in the United States for the tax paid in China as a result of the SAT adjustment. But, given that MNC-CN has been enjoying a tax holiday in China, it is doubtful that an FTC would be granted and the IRS could argue that the tax owed as a result of the SAT's adjustment is a noncompulsory payment and, as such, is not creditable in the United States.

Requesting an Advance Pricing Agreement

MNC-US could request an Advance Pricing Agreement (APA) with the tax authorities. Asking the IRS for a unilateral APA for this case only does not appear to be a viable option, although it might be possible to obtain an APA with the IRS for adjustments related to "hidden" services transactions, or other intercompany transactions that relate mainly to MNC-US's exposure in the United States. MNC group might benefit from a bilateral APA with the United States

and China, or a multilateral APA with the United States, China, and Germany. Although U.S.-China bilateral APA experience is limited, if both governments grant an APA, it would be beneficial for the MNC group of companies.

The View from Germany

TP Documentation

Three years after the MNC-CN audit, an audit is announced in Germany for MNC-DE. To improve efficiency, a global TP documentation study, including MNC-DE, was conducted. To prove the arm's-length principle was being applied, a Pan-European set of comparables, based on TNMM, was developed. The study placed MNC-DE's profitability in the inter-quartile range of comparable distributors.

German TP regulations state that TNMM is only suitable for companies performing routine functions and carrying limited risks, such as a contract manufacturer or a limited risk distributor. After reviewing the documents, and particularly the function and risk analyses, the German tax inspector says that MNC-DE can't be classified as such an entity for two main reasons. First, although distributing a global brand, MNC-DE had to incur



Matthias Kaut, Ph.D.
 KPMG in Germany
 Tersteegenstraße 19-31
 40474 Düsseldorf
 Phone: +49 (0) 211 475 7390
 Fax: +49 (0) 1802 119917390
 e-Mail: mkaut@kpmg.com

Matthias Kaut is a partner with the KPMG member firm in Germany and heads the transfer pricing practice in Düsseldorf. Dr. Kaut was the first economist and one of the key drivers behind the built-up of Global Transfer Pricing Services in the German firm after joining KPMG's tax department in 1999. He co-developed the transfer pricing tools used by KPMG's German GTPS practice.

Dr. Kaut has rendered transfer pricing advice with regard to planning, implementing and documenting transfer pricing systems for a range of multinational companies in various industries. He has prepared intellectual property valuations, and analyzed tax effects of shared service centers, contract manufacturing, and commissionaire strategies. He frequently provides TP related audit and M&A due-diligence support.

significant marketing expenses to achieve its target sales, and those expenses were higher than a normal third-party distributor would be willing to incur. As a consequence, MNC-DE must be deemed the economic owner of intangible marketing assets, including the local customer base and the local brand. Second, quite apart from incurring these costs, MNC-DE's distribution function was more than routine, because it added considerable value by formulating its own marketing strategy, choosing distribution channels, and managing the supply chain.

The inspector rejects the chosen TP method for the economic analysis and threatens to impose penalties on top of income adjustments.

Royalties

Since the global brand is recognized in the German market, MNC-US is entitled to receive compensation for use of the brand by MNC-DE. But before it was bought by MNC-US, MNC-DE was a standalone company with its own manufacturing technology and know-how. Now the manufacturing function has been outsourced to China, and thus MNC-DE no longer uses its own know-how. As a consequence, the German tax inspector would claim that in this

situation, a third party could have used its own technology and thus would not pay a royalty for equivalent technology to its U.S. parent. Therefore, MNC-DE should also not pay such a royalty.

Therefore, the tax inspector asks for detailed information on the TP policy and a segmented margin analysis for MNC-CN to see whether the royalties paid by MNC-CN to MNC-US on German product sales were paid for by MNC-DE. MNC-DE argues that this information is not available because MNC-CN can't provide it. The inspector threatens penalties because MNC-DE hasn't provided all available information. New German legislation, enacted in 2008, assumes German subsidiaries of foreign parents do have access to all information of the parent, so the tax inspector claims MNC-DE did indeed indirectly pay MNC-CN's royalties to MNC-US for products exported to Germany. Royalty payments for the brand are accepted, but the deductions for royalty payments for the technology are disallowed and a corresponding income adjustment is proposed.

Conclusion

China's developing role as a hub for business of MNEs has caught the attention of Chinese tax authorities. Transfer pricing in China has been developing for several years now and remains a key focus for authorities. In response, MNEs with operations in China should understand this impact not only on their operations in China, but also its affect on their operations across the globe. Clearly, transfer pricing audit cases are becoming more and more common; understanding the intricacies are crucial for any business that plans to have operations in China now or in the future.

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.

This article represents the views of the author only, and does not necessarily represent the views or professional advice of KPMG in China, Germany, and the United States.

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Clash of Views: U.S. and Indian Attitudes to High Markups

A fundamental disagreement between the United States and India on the taxation of globalization benefits poses difficulties for companies. Komal Dhall (KPMG in United States), Veena Parrikar (KPMG in United States), Rohan Phatarphekar (KPMG in India), and Mindy Piatoff (KPMG in United States) explain the issues and propose an approach.

In the constant search by multinational enterprises (MNEs) for ever lower costs, the evolution of global supply chains has moved from the relocation of manufacturing facilities offshore to the establishment of offshore shared service and call centers, particularly in India. Although there are often various reasons for such offshoring, cost reduction – anticipated and real – is the key prize, and tax treatment is thus an integral part of the calculus of offshoring.

While MNEs seek lower costs from offshoring, tax authorities in favored locations for offshoring seek to deepen their tax bases by clawing back portions of those cost savings through transfer pricing (TP) regimes. India's tax authorities are exceptionally aggressive in this respect. They often insist on markups on cost (profit to be taxed in India) as high as 30 percent, well in excess of levels viewed as appropriate by tax authorities in most developed countries. The Indian tax authorities justify these uniquely high markups in two ways: by using local third-party benchmarks and by alleging substantial location savings.

This article examines some aspects of location savings; briefly reviews the history of location savings in the United States; summarizes U.S. case law; analyzes a particular recent case where the U.S. tax authority considered location savings; contrasts the basic positions of the U.S. and Indian tax authorities; considers the practical implications of the differences between the positions; and proposes a new approach to settling disputes generated by these differences between the United States and India, while further guidance and clarifying legal judgments are awaited.



Rohan K Phatarphekar

KPMG in India
KPMG House, Kamala Mills Compound
448, Senapati Bapat Marg, Lower Parel
Mumbai, Maharashtra 400013
Phone: (+91 022) 3983 6082
Cell: (+91) 98200 36156
Fax: (+91 022) 3983 6089
e-Mail: rohankp@kpmg.com

Rohan Phatarphekar is a partner based in KPMG in India's Mumbai office and is the National Leader of KPMG India Transfer Pricing practice.

Mr. Phatarphekar has more than 16 years of experience in the arena of international/ domestic taxation and Indian regulatory services. He earlier worked for three years with a MNC firm as national head of tax and regulatory services and he was also the chairman of the Asia-Pacific transfer pricing committee. Prior to that, he worked with another Big Four firm in the tax and regulatory

services practice for approximately 11 years which included working in the New York and London offices of that firm. Mr. Phatarphekar initiated the transfer pricing practice there and played a national role working with transfer pricing professionals across six locations in India.

Mr. Phatarphekar is a prolific speaker and has presented in various events in India and internationally. He also contributes articles on regular basis to various national and International publications.

India's tax authorities often insist on markups on cost (profit to be taxed in India) as high as 30 percent.

Location Savings¹

A lower-cost jurisdiction is a jurisdiction that offers cheaper land, labor, and raw materials, and perhaps lower tax rates or tax holidays. Generally, the total cost savings in a lower-cost jurisdiction more than offset additional costs associated with relatively poor infrastructure in areas, such as power and telecoms, which reduce productivity.

This is simple enough in theory perhaps, but far from easy to establish in practice. Since going offshore may be accompanied by changes in technologies, production volumes, or processes, total savings normally result from more efficient production and higher labor productivity as well as location savings. Moreover, in many cases, location savings are passed on to customers in the form of lower prices, and thus do not lead to higher profits. In such cases, simple before-and-after comparisons of costs could overestimate location savings.

It is important to distinguish here between *ex ante* and *ex post* location savings. When making an offshore location decision, a company calculates the location savings *ex ante* on the basis of its current, and thus easily established, costs. When determining the appropriate

transfer price, however, *ex post* information is more readily available. To establish location savings, however, *ex post* costs must be compared with *ex ante* costs which may no longer be available.

How the location savings are shared among unrelated parties will depend on the relative bargaining powers of the seller (in a low-cost location), the buyer (in a high-cost location), and the final customer. The bargaining power depends mainly on the economic or beneficial ownership of intangible property and the monopoly power such ownership bestows. The transaction sequence in the so-called Allen model is as follows: the seller produces a product in the low-cost location and sells it to the buyer in the high-cost location, who then resells it to the end customer without adding further value to it. If, for example, the seller in the low-cost location owns a key intangible that gives it an absolute monopoly, it extracts all the location savings because the high-cost location buyer may be competing with other buyers for the right to market the service or product.

¹ This section is largely based on the following economic literature:
• Eden, Lorraine (2005): 'Went for Cost, Priced at Cost? An economic approach to the transfer pricing of offshored business services.' *Transnational Corporations*, 14.2 (August): 1-53.
• Allen, et al. (2006): *Location Savings – A US Perspective*.

If the low-cost location owns valuable intangibles that are not unique, but confer some degree of market power, the allocation of location savings may be determined by ownership of marketing intangibles. If the low-cost location seller owns the marketing intangibles as well, the buyer would still have to compete with other potential buyers for the right to distribute the product. In this case, all the location savings are retained in the low-cost jurisdiction. But if the high-cost location buyer owns the marketing intangibles, location savings would be shared by both buyer and seller. In other words, the price elasticities of demand and supply determine relative bargaining power between the parent and the offshore affiliate. In the teleservices industry, for example, the parent has different options for call centers; it can set up call center affiliates in other low-cost countries or contract out to third-party call centers in the host country.

Since a call center affiliate cannot easily replace services it receives from the parent (strategic management, research and development, regulatory compliance, financial oversight, etc.), the parent's demand for the affiliate's services is more price elastic than the call center's demand for the parent's services. In this case, most of the bargaining power and, therefore, the location savings accrue to the parent, and the affiliate would receive a normal rate of return for its services.

It is clear, therefore, that what constitutes an appropriate allocation of location savings requires detailed analysis. It is for this reason that, as we shall see, another TP method or principle is often considered more appropriate.



Komal Dhall
KPMG in the United States
345 Park Avenue
Office 6107
New York, NY 10154
Phone: +1 212 954 2044
Fax: +1 212 409 8753
e-Mail: kdhall@kpmg.com

Komal Dhall is a principal in the New York Office of KPMG's Global Transfer Pricing Services practice. Ms. Dhall has in-depth experience in transfer pricing for multinational corporations. She has extensive experience in transfer pricing planning for large and small companies alike in the area of intangible asset planning, 6662(e) and global documentation and Advance Pricing Agreements. Ms. Dhall serves as a key liaison between KPMG in the U.S. and the member firm in India, addressing U.S.-India transfer pricing matters. Ms. Dhall is a

frequent speaker on transfer pricing and related topics.

Ms. Dhall began her career with KPMG in 1998 when she joined the New York City office. Prior to joining KPMG, Ms. Dhall worked for the Federal Reserve Bank.

Ms. Dhall earned her M.A. in Economics from the University of Southern California, Los Angeles, CA. She earned her Bachelor of Business Administration degree in Economics from the University of Oklahoma, Norman, OK.

The U.S. Perspective

Several U.S. court cases have addressed location savings.² They have generally found high profits in low-cost jurisdictions to be largely attributable to other factors, such as manufacturing or marketing intangibles, and the ability of the parent and/or subsidiary to satisfy mutual business needs. The question of who is entitled to the additional profits arising from operating in the low-cost jurisdiction was deemed by the courts to depend on the taxpayer's business circumstances and specific industry. According to the courts, the vital question was how the additional profits might be shared in an arm's-length arrangement.

According to the courts, the vital question was how the additional profits might be shared in an arm's-length arrangement.

All these cases predate 1994 Treasury Regulations³ that require taxpayers to consider adjustments for significant differences in costs attributable to geographic markets with reference to the relative competitive positions of buyers and sellers, but there has been little guidance on what this means in practice. However, several IRS-issued field service advisories⁴ discussing location savings in Puerto Rico report that competitive pressures often require all the location savings to be passed on to the consumer in the form of lower prices.

A Case in Point

In its efforts to increase competitiveness and profitability US Co wants to move its assembly operations to another lower-cost location where it establishes X Co. In making this investment, US Co negotiates an agreement that it believes should provide a reasonable profit to X Co and a reasonable return on investment to US Co, while allowing US Co to cut costs and improve profitability. The negotiations result in arrangements governing the following transactions:

- X Co provides services to US Co (the services), and is paid compensation based on the manufactured component of US Co's 2007 standard cost, less a five-percent discount
- US Co provides technical, logistical, and other relevant training, as well as additional support services to X Co and is paid at cost, or cost plus markup, depending upon the service provided
- X Co pays an incentive/restructuring payment of USD 500,000 a year to US Co in 2008 and 2009, to cover restructuring costs during the transition period.

2. *Eli Lilly & Co. v. Comm'r*, 84 TC 996 (1985) aff'd in part and rev'd in part, 856 F.2d 855 (7th Cir. 1988), *Sundstrand Corp. v. Comm'r*, 96 TC 226 (1991), *National Semiconductor Corp. v. Comm'r*, TC Memo 1994-195, *Compaq Computer Corp. v. Comm'r*, TC Memo 1999-220.
3. *Treas. Reg.* § 1.482-1(d)(4)(iii)(c).
4. *FSA 200011011* (December 6, 1999), 1997 *FSA LEXIS* 4 (July 21, 1997).

It is clear, therefore, that what constitutes an appropriate allocation of location savings requires detailed analysis.

US Co estimates that by outsourcing its assembly it can improve its operating margin by:

- reducing some high U.S. costs, such as labor, employee benefits and rent
- liberating financial resources that US Co can invest in marketing activities, thus enabling the company to expand its customer base, increase business per customer, and devote more resources to product innovation.

This revenue growth and cost reduction is projected to increase US Co's profitability each year. After two years in the start-up phase, X Co is projected to earn profits of approximately cost, plus 30 percent. We took a similar case for an anonymous pre-filing to the Advance Pricing Agreement (APA) program. Despite what we thought were compelling circumstances, the U.S. tax authorities were not content to leave X Co's 30 percent margin to the other jurisdiction, without comparables to corroborate our claim that this was an appropriate cost plus return. They agreed, however, that, given the risk associated with the emerging economy where X Co was located, the comparables could be adjusted for risk.

But suppose X Co was instead set up in India where cost plus 30 percent returns are common, or at least are required by the tax authorities. Would this change the APA discussions? If not, how would this affect US Co's transfer price setting?

The India Perspective

Both India's TP regulations and the TP guidelines issued by the Organisation for Economic Co-operation and Development (OECD) are silent on location savings, but India's position as a major offshoring location means that in practice, its tax authorities are intensely interested in location savings.

Since India's TP regime came into force seven years ago, India's tax authorities have policed it with growing aggression.⁵ The income tax department has recently quadrupled its complement of dedicated TP officers to 70 and tax assessment officers are now legally obliged to refer a taxpayer's case to a TP officer if the total value of inter-company transactions in the assessment year is over INR 50 million (USD 1.25 million). The chances that a subsidiary operating in India will be selected for audit are thus very high. A company operating in India must consider very carefully its transfer pricing policy and the allocation of any location savings.

India's tax authorities insist on assigning high margins to the Indian operations of foreign companies because of their belief that location savings generate significantly higher operating profits. Citing certain empirical data,⁶ the authorities assert that, even after allocating a portion of these location savings to an Indian operation in the form of a high markup, the foreign parent's profitability is still higher than it would have been had it continued its operations in the high-cost location. This is because the high markup is applied to the lower cost base of the Indian operation. This results in lower absolute costs than would be the case if a lower markup was applied to, say, a U.S. cost base. But the tax authorities do not examine a taxpayer's specific circumstances when deciding whether or not additional profits, if any, are attributable to location savings or other factors such as intangibles.

⁵ Nair, Kishore, 24 percent of Indian TP Audits lead to Adjustments, TP Week, February 19, 2008. For the fiscal year ended March 2007, the tax authority completed 1,768 audits, with adjustments assessed in 27 percent of these cases. The total value of adjustments for this fiscal year was approximately USD 858 million.

⁶ The National Association of Software and Services Companies (NASSCOM), Strategic Review, 2006.



Veena Parrikar, Ph.D

KPMG in the United States
500 East Middlefield Road
Mountain View, CA 94043
Phone: +1 650 404 4218
e-Mail: vparrikar@gmail.com

Veena Parrikar is an economist in the U.S. firms' Silicon Valley office, currently on secondment with KPMG's Indian member firm. Dr. Parrikar has nine years of experience in transfer pricing and other economics consulting. Her transfer pricing experience encompasses bilateral and unilateral APAs, operational transfer pricing, supply-chain restructuring, and global documentation in compliance with US and OECD transfer pricing guidelines. Dr. Parrikar has served clients in a wide range of industries, including high-tech, human resource consulting, power

supply, cement, food and agriculture, pharmaceuticals, and consumer goods.

Dr. Parrikar has earlier worked in another Big Four firm and a boutique consulting firm in Washington, DC. She has also served as a visiting assistant professor of economics at DePauw University in Greencastle, Indiana. Dr. Parrikar obtained the Ph.D. degree in Economics from the State University of New York at Buffalo and the M.A. and B.A. degrees in Economics from the University of Bombay, India.

India's tax authorities insist on assigning high margins to the Indian operations of foreign companies because of their belief that location savings generate significantly higher operating profits.

The economic analysis underlying the income adjustments applied by the Indian tax authorities uses the transactional net margin method, analogous to the comparable profits method in the U.S. regulations, and employs Indian companies operating in the same basic industry or performing broadly similar functions, as comparables. But the comparables are usually entrepreneurs that undertake various risks that the captive subsidiaries do not bear, and that own unique intangibles. As a result, such comparables achieve margins ranging from 15 percent to more than 30 percent, depending on their entrepreneurial nature and their intangibles. The authorities acknowledge that some adjustment to the comparables' margins for entrepreneurial risk is appropriate, but until now have not acknowledged a reliable way to make this adjustment.

A Practical Approach

Suppose US Co decided to set up operations in India on the same lines as it had proposed for moving to another jurisdiction? It would have two TP options initially: (1) compensate X Co with a reasonable return, based on arm's-length markups acceptable to the IRS, and try to defend the markups under audit by the Indian tax authorities; or (2) compensate X Co with the higher markups agreeable to Indian tax authorities and defend it to the IRS.

In each case, the taxpayer is taking a position that one of the two tax authorities is likely to challenge, so it has to decide which authority to take on. This decision should reflect (i) an assessment of the technical arguments, given its circumstances (it may be able to demonstrate high start-up costs in India for example, or it may have achieved large cost savings as a result of moving to India, which can be documented, and which are not passed on to its customers); (ii) its relationship with the tax authorities in each country and the probability of achieving a satisfactory resolution; and (iii) the impact if any on other TP or business objectives.



Mindy Piatoff
KPMG in the United States
345 Park Avenue
New York, NY 10154
Phone: +1 212 872 5881
Cell: +1 917 374 2010
e-Mail: mpiatoff@kpmg.com

Mindy Piatoff is a member of KPMG's transfer pricing practice in the U.S. member firm's New York office. Ms. Piatoff has more than 20 years of experience advising clients regarding transfer pricing, international and federal tax issues. Ms. Piatoff's focus is counseling clients with planning and documenting complex transfer pricing issues, helping clients negotiate Advance Pricing Agreements, and helping clients resolve tax controversies with the Internal Revenue Service. Ms. Piatoff has experience assisting clients in many different industries, including: apparel, automotive, chemicals, consumer products, luxury retailers and services.

Ms. Piatoff came to KPMG from the IRS APA Program, where she served as branch chief and acting director. While with the APA Program she managed the successful completion of hundreds of APAs and negotiating positions and participated in numerous bilateral APA discussions and negotiations with tax authorities around the world.

Ms. Piatoff earned her J.D. degree from the University of Connecticut School of Law. She received a M.S. in Taxation from the University of Hartford and a B.S. degree in Accounting from New York University.

For transactions with the United States, the taxpayer should consider using the established India-U.S. Competent Authority relationship to prevent double tax. When the Indian tax authorities have issued an assessment, including TP adjustment, the company can request a Mutual Agreement Procedure (MAP), to support its tax filing position. There is a Memorandum of Understanding (MoU) between the competent authorities of India and the United States, which defers assessment or suspends collection or taxable years covered by MAPs. Previously, this applied only to U.S.-resident companies, but a recent circular⁷ extended the applicability of the MoU to Indian-resident companies in cases where a MAP has been invoked by a U.S. tax resident.

The main problem here is that, although the United States and India have been trading partners for years, they have only recently begun to engage on TP, and have very different approaches to location savings. It's hard to say, at this stage, where this engagement will lead, and even harder for companies to devise TP policies that are appropriate in both

tax jurisdictions. The uncertainty is compounded for U.S. multinationals that must comply with FIN 48. In the meantime, however, collection efforts by the Indian tax authorities can be deferred so long as the case remains active in Competent Authority. This provides a window of opportunity to resolve the case in follow-up settlement negotiations with the local Indian tax officials, to await a more reasonable development of the Indian position, or to see what Indian court rulings might accomplish in forcibly revising the Indian position.

Conclusion

Tax authorities need to develop cohesive economic frameworks to assess the appropriate allocation of location savings, and must apply them judiciously, based on the facts and circumstances of each taxpayer. We expect U.S.-India debates about these issues to become more focused as Competent Authority cases involving TP proliferate. Once the issues are confronted in the courts, more precedents will be established and the response of the U.S. tax authorities to the very high markups demanded by

the Indian tax authorities are expected to become more predictable. Taxpayers are advised to nonetheless consider the Competent Authority option for Indian-initiated transfer pricing adjustments as an effective way to work toward eventual resolution of transfer pricing disputes in general, and location savings issues in particular.

⁷ INSTRUCTION NO 10/2007, Dated: September 23, 2007:
Subject: Indo-US Double Taxation Avoidance Convention (DTAC) -
Suspension of Collection during Mutual Agreement Procedure.

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Managing Transfer Pricing Risk: APAs vs. Audits

Multinational companies confronted by myriad transfer pricing rules have various risk management options. Sean Foley (KPMG in the United States), Yoko Hatta (KPMG in Japan), Fred Johnson (KPMG in the United States), Frédéric Lubczinski (Fidal), and Mindy Piatoff (KPMG in the United States) examine some of the potential advantages and disadvantages of waiting for audits and seeking advanced rulings.

While transfer pricing (TP) regulations were once confined to a handful of industrialized countries, they have since spread rapidly. Now, the next TP audit for a multinational enterprise (MNE) may be as likely to occur in a country with a relatively new TP regime as in a country where the system is well-established. For U.S.-based MNEs, the number of foreign TP adjustments reaching the Competent Authority process now exceeds those initiated by the U.S. authorities.¹

This steady globalization of TP regulations has been accompanied by the emergence of a wide range of procedural options for managing TP and its associated risks, which are designed as much to govern the potential conflicts between tax authorities over the same taxable profits, as to help eliminate double taxation.

The challenge for MNEs confronted by this global array of TP rules and regulations – which, although similar in many respects, can differ in important details – is to develop global TP strategies that help reduce risks, while preserving as far as possible their freedom to develop competitive global supply chains. In our experience, this challenge is best divided into three parts: first, decide the objectives of your TP strategy; second, identify the possible obstacles that could prevent you from achieving your objectives; and third, decide whether to tackle each obstacle passively, by waiting for audits, or actively through Advance Pricing Agreements (APAs) or other advanced rulings.

Setting Objectives

Before deciding whether or not to use APAs, you need a clear idea of your important objectives, and the approach most likely to achieve them. If double-tax relief is the prime objective, for example, and you are not too concerned about the division of your income between two tax jurisdictions, waiting for audits and relying on the Mutual Agreement Procedure (MAP) to provide double-tax relief may be the least expensive, least intrusive way to manage your TP risks, particularly if the transactions involved occur in Europe and you also have access to an arbitration process that will oblige the tax authorities to come to an agreement.

1. In 2007, foreign initiated adjustments by far exceeded the number of U.S. initiated adjustments. U.S. Competent Authority received 93 transfer pricing cases based on foreign-initiated adjustments in 2007 – the highest number on record for the period from 2003 to 2007 – compared with 28 cases based on U.S. adjustments. See, IRS Competent Authority Statistics for 2003-07 (released December 2007), 17 TAX MGMT TRANSFER PRICING REP 679, 17 January 2008; Molly Moses, *Conflicts, Uncertainty Predicted for U.S. Multinationals Despite Expected Completion of IRS Guidance Projects*, 17 TAX MGMT TRANSFER PRICING REP 651, 17 January 2008. These Competent Authority statistics are consistent with the APA Program statistics provided in its most recent Annual Report. In 2007, 64 percent of completed APAs (52) involved foreign multinationals (parent companies) with U.S. subsidiaries. See Announcement 2008-27, 2008-15 I.R.B. 751.

If you are mainly concerned with achieving some other more specific objective, you should decide what approach is more likely to achieve it. This may depend upon your experiences with the local tax authorities, the issues your objective raises, and whether or not it is consistent with local TP regulations. Answering these questions is really a two-step process: you should first determine whether each issue is better resolved locally or multilaterally and then determine whether it may be better to wait for a local audit or to seek an advanced ruling.

Only APAs can offer certainty, so if certainty itself is a prime objective, APAs should be an integral part of the strategy. But it's important to be very clear about what you mean by certainty. Taxpayers typically regard certainty as lowering tax exposure, but financial statement considerations are becoming more important. FIN 48, for example, requires more detailed and explicit assessments of tax risk.

Figure 1 summarizes various objectives and indicates whether or not APAs may be appropriate.

The remainder of this article is devoted to discussing factors that may induce a taxpayer to choose a particular procedural option. Additionally, we will provide some examples of where local rules differ from Organisation for Economic Co-operation and Development (OECD) principles.



Sean Foley
KPMG in the United States
2001 M. Street, NW
Washington, DC 20036
Phone: +1 202 533 5588
Fax: +1 202 315 3087
e-Mail: Sffoley@kpmg.com

Sean Foley is the Americas and U.S. national leader of KPMG's Global Transfer Pricing Services practice in the United States and is based in Washington, DC. Mr. Foley focuses on Advance Pricing Agreements (APA) and Competent Authority matters, transfer pricing risk management, and intangible migration strategies. Prior to joining KPMG, Mr. Foley was the director of the IRS APA Program.

Mr. Foley has an LL.M. in Taxation (with distinction) and a J.D. (*summa cum laude*) from the Georgetown University Law Center.

He clerked for Justice Ruth Bader Ginsburg when she served on the U.S. Court of Appeals and served as legislative director to Congressman Sander Levin, a member of the House Ways and Means Committee.

Mr. Foley is a former adjunct law professor at the Georgetown University Law Center. He writes a monthly column for the *International Tax Review* on U.S. international tax developments and is the current chair of the American Bar Association's transfer pricing subcommittee on services.

Figure 1 Objectives and Considerations

	Forum Favored		
	Documentation/ Audit Defense	APA	Comments
Certainty: Tax and/or Financial Statement		X	
Desire for specific outcome	X	X	Which venue (audit or APA) may be more receptive to the specific technical arguments that the taxpayer hopes to use to achieve its desired results?
Effective Mutual Agreement Procedure with similar tax rates between countries	X	X	Both APA and Competent Authority generally work most effectively if MAP between the countries functions effectively.
Avoid double tax	X	X (Bilateral)	
Cost ²	X	X	Cost may be more uncertain with documentation—either lower than an APA if there is no audit or higher if there is an audit.
Timing ³	X	X	Can the issue be resolved quickly at the local level?
Risk of audit is low	X		
Control over information	X	X	APAs generally require taxpayers to be cooperative and to disclose requested information.
Flexibility	X	X	
Roll-back possibility of including prior years		X	

Source: For illustration purposes only.

2. See pros and cons in Figure 2, page 58.

3. See pros and cons in Figure 2, page 58.



Yoko Hatta
KPMG in Japan
Izumi Garden Tower
1-6-1, Roppongi
Minato-ku, Tokyo, 106-6012
Phone: +81 (3) 6229 8350
Fax: +81 (3) 5575 0761
e-Mail: yoko.hatta@jp.kpmg.com

Yoko Hatta is a transfer pricing partner in the Japanese member firm. She has provided advice to Japanese financial service companies, manufacturers, trading companies, and other specialized industries in connection with corporate and individual tax advice and support for tax controversies. Relative to the corporate tax area, she has handled U.S. tax issues, including transfer pricing issues, branch taxation, various state and local taxation, and U.S.-Japan tax treaty issues such as permanent establishment, foreign tax credit, and Competent Authority

negotiations for more than 10 years. Especially in transfer pricing area, she has participated in numerous bilateral APA discussions and negotiations with tax authorities both in the United States and Japan to resolve transfer pricing disputes.

Ms. Hatta's key areas of experience include consulting on U.S. taxation, transfer pricing planning, tax audit assistance, documentation studies, APA, and Competent Authority negotiation assistance.

Ms. Hatta is a Certified Public Accountant in the United States.

Controversies Generated by Variations on the OECD Theme

Most countries follow the OECD Guidelines, but local implementation can vary significantly. Sometimes these variations lead to situations in which the tax authorities of the two countries involved come to quite different conclusions about the correct pricing and bilateral approaches needed to resolve the matter.

In some cases, taxpayers may opt to wait for audits and a Competent Authority process (assuming one is available) to resolve the differences. This may be the only option when no APAs are available, as in India. In other cases, the taxpayer may choose to seek a bilateral APA to help speed up resolution of such issues. This might be appropriate, for example, if the sums at stake are large enough to make prolonged uncertainty difficult for the taxpayer. (The new German legislation on exit charges could be a case in point.)

Since local authorities are required to compute exit charges with a formula that is not found in TP rules in other tax jurisdictions, this can lead to large differences in the positions taken by two tax authorities that taxpayers may want to try to resolve up-front.

Pre-empting an Audit

If it's clear that one of the tax authorities auditing a transaction is likely to require an adjustment, the tax authority that proposes the initial adjustment can gain a first mover advantage in the Competent Authority process. In our experience, it's very rare for such a first mover to emerge from the Competent Authority process with either a zero adjustment or one that favors the other authority. This may be acceptable if the taxpayer is content with the adjustment, but if the taxpayer would prefer to maintain the *status quo* or shift income in the other direction, it may want to consider using an APA, before the expected adjustment by the first mover authority is proposed.

This can accomplish two objectives: it brings the other tax authority into the debate before an adjustment is proposed and addresses the potential advantage of the first mover, and it can also change the venue. In most countries, the APA process is managed at the national level, rather than the field level where audits are initiated, so part of the strategy is to choose the venue, by waiting for an audit or seeking an APA that appears to offer a more favorable administrative appeal process.

Consider the following example: A U.S. MNE licenses its well-known trademark to its subsidiaries in Canada and France in return for a three percent royalty. Both subsidiaries are distributors earning an operating margin of three percent to four percent a year. The parent isn't concerned about audit exposure in France, but although a recent audit by the Canadian Revenue Authority (CRA) resulted in no adjustment, the Canadian tax examiner said that the three percent royalty to the United States seemed high. This opinion concerned the parent's senior management, because they were considering increasing the royalty to reflect the findings of a recent TP planning study. It also seemed to them very likely, given the prominence of the trademark, that the U.S. Internal Revenue Service (IRS) was just as likely to argue that the royalty rate was too low. They realized that if they waited for an audit dispute with either the United States or Canada, the chances were that the process could take years and might eventually have to go before the United States and Canadian Competent Authorities.



Fred C. Johnson
KPMG in the United States
55 Second Street, Suite 1400
San Francisco, CA 94105
Phone: +1 415 963 7370
e-Mail: fcjohnson@kpmg.com

Fred C. Johnson is a member of our U.S. Western Region Global Transfer Pricing Services group. He is located at the U.S. firms' San Francisco office. Mr. Johnson has more than 16 years of direct experience with complex transfer pricing issues. Mr. Johnson has experience in working with many different industries, including computer and other high-tech equipment/software, automotive, medical devices, telecommunications, retailers, and miscellaneous light and heavy manufacturing. Mr. Johnson's primary areas of focus include

Advance Pricing Agreements (APA) and Competent Authority matters, and transfer pricing risk management.

Prior to joining KPMG, Mr. Johnson spent 16 years at the IRS where he has held positions as a revenue agent, international examiner, APA team leader, and most recently, as a Competent Authority analyst.

Mr. Johnson received a B.A. degree from Methodist College, and undertook additional graduate studies at George Washington University.

In some cases, taxpayers may opt to wait for audits and a Competent Authority process (assuming one is available) to resolve the differences.

By choosing a bilateral APA, the taxpayer was able not only to address a potential dispute with the CRA over whether its three percent royalty was arm's length, but also effectively involved the U.S. Competent Authority in support of its argument for an increased royalty rate. By requesting an APA, the parent helped facilitate certainty without waiting for what it considered the otherwise inevitable audit. Note that since the taxpayer was not worried about its audit exposure in France, there was no need to request an APA for that royalty merely because the taxpayer sought an APA for its royalty with Canada.

Years at Issue

The taxable years for which a taxpayer seeks certainty or relief is often a vital consideration. Field auditors normally confine their analyses to a particular year or years. This may or may not be in the interests of a taxpayer. If a taxpayer is generally profitable, but runs into difficulties and incurs losses for a couple of years, a field auditor reviewing only the loss years would normally ignore previous profitability and the subsequent return to profitability. An APA team, with its forward looking multi-year approach, might be more open to the idea that the two loss-making years should be seen in the context of longer-term profitability.

Field agents may not consider losses incurred outside their jurisdictions and may require a positive return even when the whole transaction earns a loss. A national APA office can take a broader view, looking at the entire transaction and the longer term profitability of the taxpayer. In some circumstances, of course, a broader view may not favor the taxpayer, so each transaction or set of transactions should be analyzed separately.⁴

Consider the following example: A Japanese MNE in the semiconductor business owns subsidiaries that distribute its products throughout the world. In 2001, it recorded operating losses, returned to profitability in 2002 to 2004, lapsed into loss again in 2005 and 2006, but was expecting to have operating profits in 2007.

⁴ National APA offices, however, may not always have flexibility on some issues. For example, in the United States, the APA office has a published position on certain asset intensity adjustments and applicable interest rates that may be difficult to challenge. Similarly, the U.S. APA office has established informal, but often rigid approaches to certain industries that might be problematic for a particular taxpayer. Knowing these idiosyncrasies is important to an informed venue choice.


Frédéric Lubczinski

Fidal Direction Internationale*
 Espace 21 – 32, Place ronde
 92035 Paris La Défense Cedex
 Phone: +33 1 55 68 14 03
 Fax: + 33 1 55 68 14 00
 Cell: +33 6 22 97 86 61
 e-Mail: flubczinski@fidalinternational.com

Frédéric Lubczinski is a senior manager, Global Transfer Pricing Services with Fidal in Paris, France. He obtained a master degree in Finance and Accounting from a French University, and graduated from the French National Tax School (FTA school).

Mr. Lubczinski joined Fidal in 2007 and focuses on transfer pricing. He has negotiated Advanced Pricing Agreements with foreign tax authorities as a member of the French Tax Authorities' APA team (International Unit Affair CF 3) in various sectors including automotive, banking, transportation, and energy. He has experienced transfer pricing

audits when working for the National and International Audit Directorate (DVNI) in a number of sectors including industrial goods, computer, electronic consumer products, automotive, chemical industry, and pharmaceutical industry.

He has also gained experience with Competent Authority resolution (Mutual Agreement Procedure involving French and foreign Tax Authorities). He has worked for ten years as a Tax Inspector with the French Tax Administration.

*Fidal is an independent legal entity that is separate from KPMG International and its member firms.

The IRS audited the U.S. subsidiary for 2002 and 2003 and required no adjustment in a generally difficult audit process. Moreover, the IRS team's information requests kept the company's staff very busy finding documents and preparing analyses. The top managers were concerned that an audit of its loss years would be even more difficult and was likely to result in an adjustment, despite the company's profits history.

So before filing its 2006 tax return, the U.S. subsidiary asked for a unilateral APA for 2006 to 2010, with a roll-back to 2004. The APA team leader acted as a buffer between the U.S. subsidiary's managers and the IRS field team, reviewing information requests and keeping the negotiations focused. An explanation of the business reasons for the losses and the taxpayer's use of an acceptable, multi-year TP methodology resulted in an APA satisfactory to all sides, without an adjustment.

An APA negotiation can also take into account results from open tax years preceding the effective date of the APA through a roll-back mechanism, which uses the agreed TP methodology to settle pre-APA years. Roll-back is not available, however, in all jurisdictions. It is well established in the United States, but Canada and Japan, for example, don't as a rule grant requests in APA submissions for a roll-back to years under audit. It's our experience, however, that both of these countries will, in certain circumstances, negotiate at the Competent Authority level to settle both audit and APA years simultaneously. So which years can be included in an APA request depends as much on local tax authority practice as on the formal rules.

Another potential advantage of APAs is that the Competent Authority may have access to sophisticated economic support that can assist it in reaching a specific resolution that is potentially favored by the company.



Mindy Piatoff
KPMG in the United States
345 Park Avenue
New York, NY 10154
Phone: +1 212 872 5881
Cell: +1 917 374 2010
e-Mail: mpiatoff@kpmg.com

Mindy Piatoff is a member of KPMG's transfer pricing practice in the U.S. member firm's New York office. Ms. Piatoff has more than 20 years of experience advising clients regarding transfer pricing, international and federal tax issues. Ms. Piatoff's focus is counseling clients with planning and documenting complex transfer pricing issues, helping clients negotiate Advance Pricing Agreements, and helping clients resolve tax controversies with the Internal Revenue Service. Ms. Piatoff has experience assisting clients in many different industries, including: apparel, automotive, chemicals, consumer products, luxury retailers and services.

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Ms. Piatoff earned her J.D. degree from the University of Connecticut School of Law. She received a M.S. in Taxation from the University of Hartford and a B.S. degree in Accounting from New York University.

Another potential advantage of APAs is that the Competent Authority may have access to sophisticated economic support that can assist it in reaching a specific resolution that is potentially favored by the company. In a Competent Authority case that comes up from a field audit, the Competent Authority may not focus on economic support and may be more focused on reaching settlement on a number, as opposed to an agreed TP methodology. Moreover, the Competent Authority may be exposed to the issues earlier in an APA case because its analyst is part of the team from the outset.⁵ This can be a significant advantage because the analyst often understands the other country's sensitivities and negotiating position, and can thus help the team focus on important issues and guide the case towards resolution.

Changing the TP Policy

A taxpayer may want to implement a new TP policy without any significant change in the circumstances if, for example, TP has not been a major focus of the tax department in the past, but has become so after a new TP study has indicated a need for a change and identified potential risks in prior years.

But suppose a TP analysis demonstrates that results of a particular affiliate have favored a particular jurisdiction, and arm's-length TP may require a material reduction in the profit recorded in the jurisdiction. The taxpayer may be concerned that implementing a new TP policy that produces a lower return for that jurisdiction could lead to a difficult audit. An APA might be an appropriate choice in this case, because it accelerates the dispute resolution, moves the forum to a national office where analysis might be more neutral, and allows the tax authority to approve a particular TP method.

Consider the following example: In 2003, a U.K. corporation expanding its business abroad established a U.S. subsidiary to distribute its products. It was entirely focused at the time on making a success of its new venture. TP was the last thing on its mind. Several years later, the U.K. parent realized its U.S. subsidiary was not only profitable, but was arguably earning more than it should.

The U.S. subsidiary wasn't worried about an IRS audit for the current year, but was concerned the IRS could react adversely to a significant decrease in profitability following the implementation of a new TP policy. Its management decided that the appropriate way to help resolve the potential issue was to request a unilateral APA. It could not reduce its income in prior years, but it could adjust its income on its current tax return by requesting an APA as from the current year. It was an opportunity to reduce its U.S. income tax burden, by agreeing up-front with the IRS to an arm's-length result and thereby removing the risk of a subsequent audit.

5. For example, in the United States, the Competent Authority assigns an analyst to the APA team. In other countries, the Competent Authority and APA authority may be the same. In yet other countries, such as Japan, the Competent Authority/APA team members do not participate formally until the initial review is undertaken by another office, often at the field level.

Figure 2 Audit vs. APA – the Pros and Cons

TP Documentation Only/Audit Process	
Pros	Cons
Cost of annual compliance relatively low	Time from audit through to appeals to Competent Authority can take years with no hint of the outcome
There may be no audit	Significant resources often have to be devoted providing documents and satisfying IRS requests
	Uncertainty
	Possibility of no change can be low
The APA Process – Unilateral or Bilateral	
Pros	Cons
Annual reporting cost to maintain the APA over its term is low	Initial APA planning and submission cost is high
Reduces the need for future documentation and costs associated with audit and appeals over term of the agreement	Can take a number of years to finalize, but there is more control over the process
Certainty	Change in business may affect APA terms
Flexibility developing practical solutions for complex TP problems	Exposes all aspects of the business because of voluntary nature of the process
Cooperative process with experienced TP professionals considering the case	May impact established working relationships with local tax authorities
APA team leader is a neutral party providing a fresh look	APA office may be locked into a position that is inconsistent with that of the taxpayer
Competent Authority analyst with knowledge negotiating with the other country guides the case from the outset	Competent Authority may be less likely to negotiate a position taken by APA office than one developed by the field
The APA Process – Bilateral Only	
Pros	Cons
In many countries, the Competent Authority analyst experienced in negotiating with the other country can guide the case from the outset	(same as above)
Eliminates risk of double tax	
Eliminates the risk of a future TP audit because the intercompany terms are negotiated with tax authorities on both sides of the transaction in advance	
Allows one Competent Authority to serve as counter-balance to the other	

Source: For illustration purposes only.

There are potential advantages and disadvantages that should be weighed against each other when choosing between seeking an APA and waiting for (and anticipating) an audit.

Assessing the Pros and Cons

There are potential advantages and disadvantages that should be weighed against each other when choosing between seeking an APA and waiting for (and anticipating) an audit. Figure 2 summarizes some of the pros and cons for each alternative. Keep in mind that even when the audit process has begun, the APA option remains open. Although the audit years generally remain under field jurisdiction, combining an audit with an APA can potentially help to streamline the process, reduce controversy and accelerate the Competent Authority process.

What if, after weighing the options, you think that an APA might be a good idea, but you're not convinced? Another audit and the potential consequences may concern you, but it can be difficult to contemplate voluntarily approaching the tax authority. It might not be a simple go or don't go choice. You may be able to more fully analyze the APA option before deciding. Many countries offer pre-filing meetings where a taxpayer can meet the APA program team and discuss its case and possible approach. Some countries will even allow such meetings to be anonymous. In these situations, the taxpayer meets with the APA office, discusses the case and proposed methodology in general terms, and gets feedback. However, you don't have to reveal the name of the company. If you're of two minds (such as, do I go for an APA or take my chances with the audit lottery?), an anonymous pre-filing meeting could be very useful.

Conclusion

Taxpayers will often decide to wait and see what develops. When the risk of adjustment is low, for example, the time and expenses of an APA may not be warranted. On the other hand, the costs of achieving bilateral APA protection may be prohibitive. For example, if the taxpayer has 10 manufacturing sites and 50 distribution entities, the cost of APAs that cover a significant proportion of the TP could be significant. Moreover, many of the APA advantages also have disadvantages. For example, seeking an APA to reduce risk may bring matters to the attention of the tax authority that increases risk, and the taxpayer may have good working relations with the local exam team. The facts addressed in the audit might be more favorable than those in future years, and the taxpayer may not want a decision (particularly if it's bilateral) to serve as a precedent for either tax authority. Finally, it is important to remember that a wait-and-see decision can be reviewed; many APAs occur only after a serious conflict has developed with the local tax authorities. An advantage of the wait-and-see policy is that it provides time for events to unfold and potential exposures to emerge.

But an APA should also be considered. TP audit risks are broadening and TP auditors are generally becoming more rigorous. The good news is that many countries have MAP to help eliminate double taxation. But in many cases, the price of uncertainty may be high, and the road to settlement so long and difficult, that an APA is the better option.

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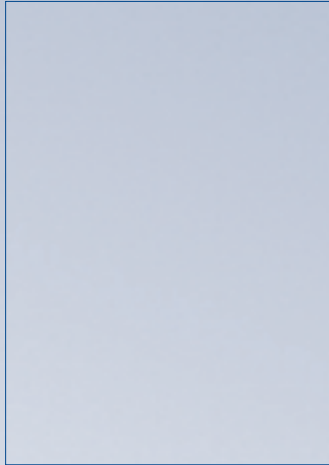
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Author Contact List

Name	Member Country/Firm	Phone	e-Mail
Marc Alms	KPMG in the United States	+1 212 872 3659	malms@kpmg.com
Jacek Bajger	KPMG in Poland	+48 22 528 11 73	bajger@kpmg.pl
Jose Casas	KPMG in Mexico	+52 55 5246 8364	casas@kpmg.com.mx
Clark Chandler	KPMG in the United States	+1 202 533 3186	cjchandler@kpmg.com
Sherry Chang	KPMG in Taiwan	+886 2 8101 6666 ext. 04590	schang1@kpmg.com.tw
Yvonne Chen	KPMG in China	+86 21 2212 3356	yvonne.yw.chen@kpmg.com.cn
Brian J. Cody	KPMG in the United States	+1 312 665 1912	bcody@kpmg.com
Komal Dhall	KPMG in the United States	+1 212 954 2044	kdhall@kpmg.com
Hareesh Dhawale	KPMG in the United States	+1 213 593 6769	hdhawale@kpmg.com
Sean Foley	KPMG in the United States	+1 202 533 5588	Sffoley@kpmg.com
Steve Fortier	KPMG in the United States	+1 312 665 1416	stevenfortier@kpmg.com
Eduardo Goldszal	KPMG in Portugal	+351 210 110 109	egoldszal@kpmg.com
Steve Harris	KPMG in the United States	+1 212 872 6718 (NY) +1 202 533 3110 (DC)	sdharris@kpmg.com
Yoko Hatta	KPMG in Japan	+81 (3) 6229 8350	yoko.hatta@jp.kpmg.com
Andrew Hickman	KPMG in the United Kingdom	+44 (0) 20 7694 4478	Andrew.Hickman@kpmg.co.uk
Daisuke Horiguchi	KPMG in Japan	+81 3 6229 8310	daisuke.horiguchi@jp.kpmg.com
Kim Jarrett	KPMG in New Zealand	+64 9 363 3532	kmjarrett@kpmg.co.nz
Fred C. Johnson	KPMG in the United States	+1 415 963 7370	fcjohnson@kpmg.com
Matthias Kaut	KPMG in Germany	+49 (0) 211 475 7390	mkaut@kpmg.com
Masanori Kawanobe	KPMG in Japan	+81 (0) 3 6229 8320	masanori.kawanobe@jp.kpmg.com
Alexander Loh	KPMG in Germany	+49 (0) 69 9587 2187	alexanderloh@kpmg.com
Frédéric Lubczinski	Fidal	+33 1 55 68 14 00	flubczinski@fidalininternational.com
Pascal Luquet	Fidal	+33 (1) 5568 1522	pluquet@fidalininternational.com
Antonio Macias Valdes	KPMG in the United States	+1 213 593 6766	amaciasvaldes@kpmg.com
Alexey V. Manasuev	KPMG in the United States	+1 202 533 3786	amanasuev@kpmg.com
Won-Kee Pae	KPMG in Korea	+82 2 2112 0260	wpae@kr.kpmg.com
Veena Parrikar	KPMG in the United States	+1 650 404 4218	vparrikar@gmail.com
Rohan K Phatarphekar	KPMG in India	+91 022 3983 6082	rohankp@kpmg.com
Mindy Piatoff	KPMG in the United States	+1 212 872 5881	mpiatoff@kpmg.com
Damian Preshaw	KPMG in Australia	+61 (3) 9288 5658	dpreshaw@kpmg.com.au
Dave Rutges	KPMG in the Netherlands	+31 206561311	rutges.dave@kpmg.nl
Richard F. Slimmen	KPMG in the Netherlands	+31 (0)10 45 36 860	slimmen.richard@kpmg.nl
Geoffrey Soh	KPMG in Singapore	+65 6213 3035	geoffreysoh@kpmg.com.sg
Eduard Sporken	KPMG in the Netherlands	+31 (0) 20 656 1618	sporken.eduard@kpmg.nl
Montserrat Trapé	KPMG in Spain	+34932532936	mtrape@kpmg.es
Steven Tseng	KPMG in China	+86 21 2212 3408	steven.tseng@kpmg.com.cn
Ágata Uceda	KPMG in the Netherlands	+31 20 656 1141	ucedagata@kpmg.nl
Dirk Van Stappen	KPMG in Belgium	+32 (3) 8211918	dvanstappen@kpmg.com
François Vincent	KPMG in Canada	+1 514 840 2583	fvincent@kpmg.com

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