BEPS Transfer Pricing Workshop

Transfer Pricing Documentation, Risk Assessment and Safe Harbours

Jeju Island - Korea

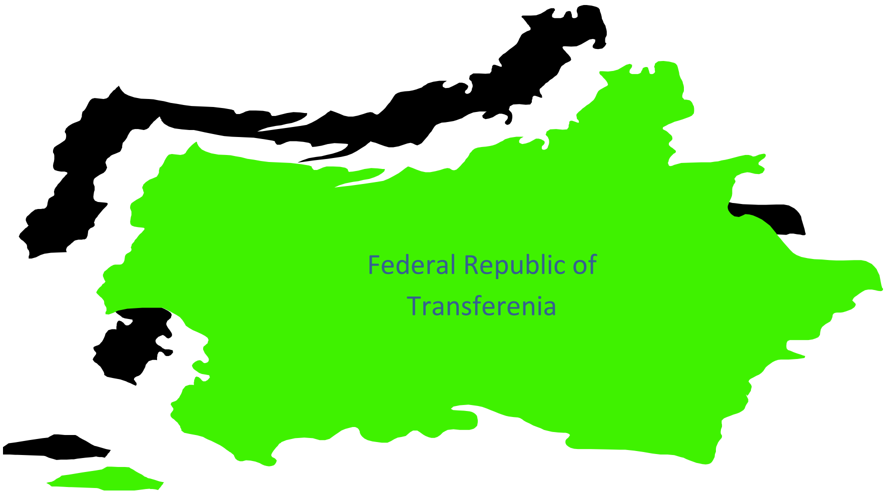
26-30October 2015

13& 14. Case Study on Transfer Pricing Simplification

The Federal Republic of Transferenia has developed transfer pricing legislation and regulations. Due to the limited capacity and resources of both tax authorities and taxpayers,the government asked you to develop some initial proposals, both legal and administrative, for simplification of the transfer pricing legislation and regulations in certain areas.

In what areas would you suggest **simplification proposals**, both legal and administrative, including safeharbours, based upon the TP regulations of Transferenia. What would be the content of your proposals?

Annex: description of the TP legislation and regulations of the Federal Republic of Transferenia



Description of the Transfer Pricing Legislation and Regulations of the

Federal Republic of Transferenia

LEGISLATION	
Existence of Transfer Pricing Laws / Guidelines	This transfer pricing legislation of Transferenia closely follows the OECD Transfer Pricing Guidelines as well as the US Section 482 Regulations. The Tax Authorities of Transferenia, the Income Revenue Departement (IRD) have the possibility to issue unilateral APAs. The IRD issued Transfer Pricing Guidelines (Guidelines) additional guidance on the application of the transfer pricing legislation. Transferenia has stated express agreement with the OECD Transfer Pricing Guidelines. The IRD has indicated that its own Guidelines are intended to supplement the OECD Transfer Pricing Guidelines rather than to supersede them.
Transfer Pricing Scrutiny	The IRD perform audits specifically for transfer pricing issues or may address these issues during an income tax audit. Audits are conducted by way of visits to a taxpayer's premises and interview with personnel. These visits may be preceded by a request for the provision of documentation. A variety of factors determine the selection of the taxpayers subject to an audit: previous disputes with the IRD regarding transfer pricing issues, the industry in which the taxpayer operates, an application for an APA that has been withdrawn or unsatisfactorily resolved, a low level of operational functionality, incurring losses over a sustained period of time, receipt of information from overseas (i.e. transfer pricing disputes with foreign tax authorities), desk audits of tax returns or answers to requests for information (such as no evidence of negotiation with parent, price setting without economic or commercial basis, poor cooperation and limited documentation) triggering the attention to transfer pricing issues. Industries that are more likely to be investigated include: pharmaceuticals, automotive, information technology, advertising, petroleum, insurance and trading houses. The IRD maintains a special focus and conducts annual reviews on the top 100 foreign owned multinationals, the top 40 exporters and the top 10 financial institutions. The IRD's TP pages on the IRD website discuss the IRD's audit targets etc. Specific transactions that incur higher audit risk include payment or receipt of interest, royalties, management fees, fees in relation to intangibles and guarantee fees. Transactions with residents of a country Transferenia does not have a double tax treaty with, or are regarded as a tax haven under Transferenia's CFC rules, and relations between head office and permanent establishment are also likely to be questioned. It is common practice that the outcome of an audit by the IRD is decided as a result of negotiation, by lack of which the logical next step is litigation.

	In order to avoid the latter, a measure of last resort is the dispute resolution procedure with compulsory meetings and obligation of full disclosure of all relevant data before an assessment notice is issued.
Definition of Related Party	The Income Tax Act of Transferenia state that any two companies are associated persons when there is a group of persons that: • have a 5 per cent or more voting right, market value or income interest in the two companies; or • control the two companies by any other means. There are also definitions of associated person for natural persons, partnerships and trusts. The application of the transfer pricing rules can be extended to non-associated parties where there is a collateral arrangement (such as a market sharing arrangement, an arrangement to enter into a particular market, a back-to-back supply arrangement or an income-sharing arrangement).
Transfer Pricing Penalties	There are no specific transfer pricing penalties. The standard shortfall penalties apply in case of adjustments arising from transfer pricing issues: • not taking reasonable care – 20 per cent of the tax shortfall; • unacceptable interpretation – 20 per cent of the tax shortfall; • gross carelessness – 40 per cent of the tax shortfall; • abusive tax avoidance – 100 per cent of the tax shortfall; and • evasion – 150 per cent of the tax shortfall. These penalties may be reduced depending upon the degree of cooperation of the taxpayer and disclosure of the causes of the shortfall. Late payment interest is due from the date on which the tax had to be paid to the date it is finally paid.
Advance Pricing Agreement (APA)	The IRD is allowed to issue unilateral APAs in the form of a binding ruling. Bi- or multilateral APAs may be entered into under the mutual agreement procedure in Transferenia's double tax treaties. The IRD is keen to see more taxpayers seeking APAs in order to avoid potentially costly and time consuming audits, and therefore favours a flexible approach allowing APAs to be concluded in a six-month period. The IRD does not have formal APA guidelines. The IRD suggests a pre-application meeting to make the APA application procedure less time consuming. The IRD has concluded several unilateral and bilateral APAs, most of which with Australia but also with Japan, Switzerland and the US. There is a preference of the IRD for APAs to be concluded on a bi- or multilateral basis.

Safe harbours	The IRD is allowed to develop unilateral Safe Harbours, but has not used this authority so far. The IRD is also allowed to develop and negotiate bilateral or multilateral Safe Harbours
DOCUMENTATION AND DISCLOSURE REQUIREMENTS	
Tax Return Disclosures	The income tax return has to disclose the following items: • payments to non-residents such as dividends, interest, management fees, "know how" payments, royalties or payments on basis of a contract; • whether the company is controlled or owned by non-residents; and • whether the company holds an interest in a foreign controlled company
Level of Documentation	The transfer pricing rules do not contain an explicit statutory provision requiring taxpayers to prepare transfer pricing documentation. The income tax act, however, requires taxpayers to determine transfer prices in accordance with the arm's length principle by applying one (or a combination) of the methods it enumerates. Compliance with this requirement implies, in the IRD's view, the necessity to prepare and maintain documentation to demonstrate how transfer prices have been determined and that the arm's length principle has been complied with. This requirement is based on a double reasoning: first, the burden proof rule whereby the price determined by a taxpayer is deemed to be the arm's length price, unless the IRD can demonstrate a more reliable measure or the taxpayer does not cooperate with the IRD's administration of the transfer pricing rules. Secondly, the application of penalties in case the taxpayer has not exercised reasonable care or has been grossly careless in his determination of an arm's length price. The IRD expects a taxpayer to make a sensible cost-benefit analysis of the preparation and maintenance of documentation before deciding whether a full or limited transfer pricing analysis is appropriate. A limited transfer pricing analysis should contain the following minimum documentation: • identification of the cross-border transactions which are subject to a transfer pricing exposure; • a broad functional analysis of the taxpayer's operations to identify the critical functions being performed; • an estimate of the business risk of not undertaking and documenting a more detailed transfer pricing analysis; and • an estimate of the costs of complying with the transfer pricing rules. A limited transfer pricing analysis does not preclude the IRD from substituting a more reliable measure of the arm's length price where a cost-benefit analysis indicates the need for a full transfer pricing analysis.

	In case of the need of a full analysis, the IRD requests the following documentation: • a functional analysis; • an appraisal of potential comparables; • an explanation of the process undertaken to select and apply the method(s) used to determine the transfer prices, and why it is considered to provide a result that is arm's length compliant; and • details of special circumstances that have influenced the price setting. Taxpayers who prepare documentation on basis of a full analysis or limited analysis (sustained by a sensible cost benefit analysis) are more likely to ensure that the burden of proof shifts to the IRD.
Record Keeping	There are no specific transfer pricing rules for record keeping. General tax rules apply whereby records should be retained for 10 years.
Language for Documentation	The IRD expects documentation to be in English and can ask for a translation into English if documentation is prepared in another language.
Small and Medium Sized Enterprises (SME's)	There are no specific rules for small and medium sized enterprises. If a taxpayer opines, on basis of a sensible cost-benefit analysis, that a limited transfer pricing analysis is a sufficient basis for the preparation and maintenance of his documentation, this does not preclude the IRD from substituting a more reliable measure of the arm's length price if it can sustain this.
Deadline to Prepare Documentation	There is no statutory deadline. However, since the IRD expects taxpayers to exercise reasonable care and to avoid gross carelessness in their transfer pricing approach, it encourages contemporaneous documentation.
Deadline to Submit Documentation	Documentation should be submitted upon request of the IRD.
STATUTE OF LIMITATIONS	
The IRD has the power to issue additional assessment notices during four years as from the end of the calendar year during which the income tax return was filed (except in the case of tax avoidance or evasion). The taxpayer can extend this term by maximum six months by signing a waiver, which generally arises when a dispute is not resolved and additional time allows to settle the dispute by mutual agreement or when another case before a court is likely to resolve the issue in the current dispute.	

TRANSFER PRICINGMETHODS
The IRD accepts the CUP method, the resale price method, the cost plus method, the profit split method and the comparable profits method / transactional net margin method. The most reliable method should be used. The Guidelines specifically allow taxpayers to benchmark the foreign party in particular circumstances where they believe that that is more appropriate to determine the most reliable measure of the arm's length price. However, in such cases, the IRD will test the domestic party to verify whether it receives for its operations a return commensurate with its economic contribution and risks assumed. The IRD acknowledges the lack of suitable publicly available data for local comparables.
COMPARABLES
The taxpayer can use the data of published annual accounts or more detailed information available in some industries. However, the scope of these is limited. Therefore, taxpayers use comparable entities in foreign jurisdictions and the IRD does not prohibit this provided the necessary adjustments are made to eliminate geographical market differences. Under the income tax law, the IRD has the right to access all information in its possession in order to exercise its statutory duty to collect the correct amount of tax. It must be said that although there is judicial authority for this, the IRD as a general rule, exercises this power prudently and as a general rule, will not use secret comparables.
THIN CAPITALISATION
The income tax law provides that interest in excess of an arm's length borrowing capacity will be recharacterised in distributed profits