Global Transfer Pricing

Asia Pacific Update

Stanley G. Sherwood
International Tax Counsel
PPR
March 5-7, 2012

Scope of Presentation

- Japan
- China
- Hong Kong
- Macau
- Taiwan
- South Korea
- Malaysia
- Australia
- New Zealand

General Transfer Pricing Methods in Asia Pacific

Generally, the Asia Pacific Countries follow OECD Principles of Transfer Pricing which include the follow methods:

- CUP
- Resale Price Method
- Cost Plus
- Profit Split Method
- Transaction Net Margin Method ("TNMM")

Japan

Documentation

- Taxpayers are required to disclose information about their cross-border related-party transactions.
- If a company does not provide such documentation to the tax authorities, the authorities will "presume" an arm's length price based on information gathered through "secret" inquiries and inspections on taxpayer's peer companies and will reassess the taxpayer's taxable income.
- In practice, companies document Transfer Pricing.

Audits-What documents are Tax Officials Looking for?

- Japan's TP guidelines outline the documents tax examiners should inspect during a TP audit
  - A description of the relationship between the taxpayer and each related foreign party;
  - A calculation of inter-company prices
    - *Description of how comparables were chosen*
  - Details of cross-border, inter-company transactions, such as contracts, pricing policies, description of business strategies, etc.

Audit: Multi-Year Process:

EXAMPLE

- Industry Study for 2 years – feels like an audit.
  - Silence at the end. No comments.
- Extensive request for information.
  - Long silent period.

Audit: Multi-Year Process:

- Commencement of the “real” audit.
- Even more extensive requests over 2 – 3 year period:
  - Many meetings
  - Presentations
  - Numerous calculations
  - Detailed information and calculation regarding different channels of business
- Request for overseas (non-Japan) financial information.
- Assertion of methods.
- Mid-stream change in Japanese acceptance of methods (TNMM introduced mid-stream).
- Secret comparables.
- Rejection of comparables.
- Mutual Agreement Procedure.
- APA

Audits-Time Frame

- The length of an audit is variable, but one to two years, or even longer, is typical.
  - TP audits are a specialized function in Japan and are separate from regular corporate tax audits:
    - *There is a sophisticated Transfer Pricing regime*
    - *Transfer Pricing is a key focus of enforcement efforts*

Audits-6038A-like Statute

- During an audit, it is common for Transfer Pricing auditors to request extensive information about foreign affiliates
  - Although Japanese Taxing authorities have broad powers over domestic taxpayers, they have no authority to require information and documents from a non-resident (other than through tax treaties)
    - *Thus, some discretion exists on how respond to a request by a TP audit team for information on foreign affiliates*

      A balancing between the sensitivity of the information requested and maintaining an amicable audit process

Secret Comparables

Tax Authority’s use of Secret Comparables

APAs

- The APA program is well established and extensively used:
  - In fiscal year 2006, OMAP received 105 new bilateral APA applications.
- A taxpayer can expect a unilateral APA to generally take one year and a bilateral to take about two years to finalize.
- Generally, the APAs range from three to five years.

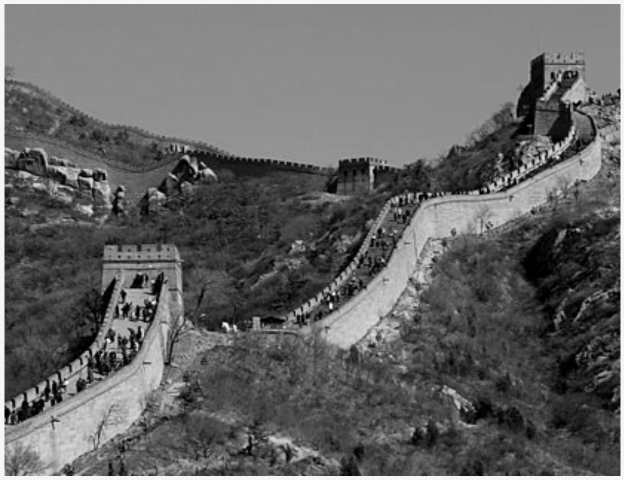
Current Trends

- Applying residual profit split method on an audit
  - In recent Transfer Pricing audits, the NTA appears to be frequently applying the residual profit split method to related party transactions incorporating significant intangibles;
  - Large amounts of additional tax have been imposed on Japanese Companies as a result of the NTA's use of the profit split method with respect to intercompany royalty transactions.

The Effect of the Current Recession

- Modify current APAs?
  - 3 year averages for comparables may no longer be a suitable method in this economic climate.
  - Compromising with Tax Authorities after an APA has been accepted.
    - *Presentation to Competent Authorities;*
      - Gross Domestic Product for Country
      - Percentage decrease for industry as a whole
    - *Compiling Current data for comparables;*
    - *What do you do if a comparable is no longer publicly traded yet you want to negotiate with Competent Authority to lower your agreed upon Operating Margin in APA?*

China



History of Transfer Pricing in China

- 1995 – PRESENT
- SAT Meetings
- SAT Statistics
- Tax Incentives
- APAs

Contemporaneous Documentation

- In 2009, China implemented mandatory contemporaneous documentation rules
- Regulations require both contemporaneous documentation reports as well as nine disclosure forms describing intercompany transactions and related parties
  - Regulations are retroactive to 2008

Documentation Requirements

- Documentation must be prepared in Chinese and must be provided within 20 days of request from the Chinese tax authority:
  - Documentation must highlight the tax incentives enjoyed by relevant related parties
- Consolidated documentation filing for enterprises with multiple establishments in China is NOT allowed.

Who is Likely to be Audited?

- Chapter 5 of the regulations outlines the key targets that will be selected for Transfer Pricing audits
  - Enterprises which/whose
    - *Have significant amounts of related party transactions*
    - *Have experienced long term consecutive losses, low profitability, or fluctuating profits and losses*
    - *Profit levels are lower than industry norms*
    - *Show an obvious mismatch between their profit level and their functional and risk profile*
    - *Have business dealings with related parties in tax havens*
    - *Have not complied with contemporaneous documentation requirements*
    - *Obviously violate the arm's length principle*

Audit Adjustments

- Assuming a profit-based method, if during an audit a taxpayer's profit level is found to be lower than the median of the interquartile range for comparable companies, in principle, the tax authorities should adjust the taxpayer's profit to the median level.
- Interest will be computed on a daily basis on the amount of the deficiency using the Central Bank's benchmark loan interest rate in Yuan, plus an additional 5% penalty.
  - The penalty can be waived if the taxing authorities view the taxpayer's documentation as satisfactory.

Audit Adjustments

- Following any Transfer Pricing audit adjustment, the tax authorities are to review the taxpayer's Transfer Pricing closely over a five year period (previously only three years).
  - Areas to be monitored include the taxpayer's compliance with the contemporaneous documentation requirements and changes in operations, operating results, related party transactions, etc.

APAs

- APA candidates must meet the following requirements:
  - Related party transactions exceed RMB 100 million (Approximately USD $18,615 Million).
  - Business operations have lasted for over 10 years
  - No substantial tax evasion in previous years; and
  - Have reported related party transactions in tax filings and maintained required contemporaneous documentation.

Related Parties

- In the past, Chinese Transfer Pricing rules have applied a 25% or more threshold for related party treatment.
- In the Draft Administrative Regulations of Special Tax Adjustments, the 25% threshold is reduced to 20%.
  - May be an issue for joint-venture companies who are unable to obtain documentary support from a minority owner or its related parties.

Penalties

- A fine of up to RMB 10,000 (USD $1,461.00) for refusing to provide requested information or providing false information;
- Serious offenses may result in a fine between RMB 10,000 and RMB 50,000 (USD $1,461.00 - $7,307.00).

Hong Kong

Limited Enforcement

- Historically, there has been limited Transfer Pricing enforcement.
- Thus, finding high margins in Hong Kong for some companies is not unusual.
- However, other jurisdictions may ask for HK results which, if very high, could influence the taxing authority in the other jurisdiction.

Transfer Pricing

- The Departmental Interpretation and Practice Notes No 46 ("DIPN46") sets out the IRD's approach to transfer pricing.
  - ✷DIPN46 generally follows the OECD Transfer Pricing principles, however it does not formally adopt a Transfer Pricing legislative framework.
- 2010 Transfer Pricing-New Rules

Locality of Profits

- For HK tax purposes, the determining factor in profit tax liability is the source of profits rather than residence
- Whether profits arise in or are derived from HK depends on the nature of the profits and the transactions leading to the profits
- Guiding principle is that one looks to see what the taxpayer has done in order to earn the profits in question and where those actions took place

Macau

TP Rules

- There are no Transfer Pricing rules in Macau.
- This is generally not a problem in Macau, but may involve Transfer Pricing issues in other countries.

Taiwan

Contemporaneous Documentation Requirements

- Documentation must be prepared when the taxpayer files its annual income tax return and must be submitted within one month after tax authorities ask for it.

  - At this time, it must be reviewed by a Taiwanese CPA stating that the Transfer Pricing report was prepared in accordance with the Transfer Pricing Guidelines.

- There is a safe harbor rule that is designed to reduce the compliance burden for the small and medium enterprise ("SME"). Such taxpayer is exempted from having to prepare a transfer pricing report if any one of the following criteria is satisfied:

  - *The total annual revenue does not exceed NT$100 million (USD 2.925 million);*
  - *The total annual revenue is between NT$100 million and NT$300 million (USD $8.777 million)* ***AND***

    (i) The taxpayer utilizes tax credits of less than NT$1 million (USD $29,000) or losses carried forward of the past five years of less than NT$4 million (USD $117,000); and

    (ii) The taxpayer has no overseas related parties;

  - *The total annual controlled transactions amount to less than NT$100 million.*

Penalties

- Penalties can reach 200% of the understated tax in either of the following:
  - The stated transfer price of the controlled transactions are more than two times **<u>or</u>** are less than one half of the arm's length transfer price assessed by the tax authorities.
  - The increased taxable income resulting from the tax authority's adjustment is more than 10% of the total assessed taxable income, and is more than 3% of the assessed net operating income.
  - A taxpayer fails to submit a Transfer Pricing report and supporting documents upon request from the tax authorities during the examination.

Secret Comparables and Litigation

- Tax officials have employed secret comparables in several Transfer Pricing audits.
- No disputes involving Transfer Pricing have been litigated in tax courts.
- To date, all known tax disputes have been settled as a result of negotiation.

Avoid an Audit by being Aware of issues that trigger an audit

- The most common Transfer Pricing issues in an audit involve situations where:
  - A significant amount of profits have been shifted to a tax haven;
  - The company has had consecutive annual losses;
  - There is a significant decrease in the company's profit margin;
  - There are large payments of management fees and/or royalties.

APAs

- APAs are generally extended to taxpayers who meet the following criteria defined in Transfer Pricing Guidelines:
  - The aggregate amount of the controlled transactions over the prospective period of the APA must be at least NT$1 billion (eg. If the APA is for a 3-year period, the aggregate amount of the controlled transactions must be at least NT$1 billion, or approximate US$30 million) **OR**
  - The amount of the controlled transactions must be NT$500 million or more (about US$15 million).
- An APA will be effective for a period of three to five years, or for the duration of the covered transactions in question; whichever is shorter.
  - Generally, an extension of up to five years may be allowed.

South Korea

Transfer Pricing Methods

- Transfer Pricing has become the most important international tax issue affecting Korean multinational taxpayers.
- The Korean National Tax Service ("KNTS") is quite advanced in its enforcement of the Transfer Pricing regulations, and a large number of Transfer Pricing audits have been carried out. This continues to be the case.
- While no particular industry is subject to more scrutiny, certain situations are particularly at risk of challenge:
  - Distributors making losses, and
  - Any change to Transfer Pricing policies that result in a decrease in the amount of tax paid such as cost sharing agreements and intra-group services.
  - The KNTS has strengthened documentation requirements for intra-group services and cost-sharing agreements which indicates an increased focus on these areas.

Transfer Pricing Documentation Required

- The content and format of Transfer Pricing documentation required of Korean taxpayers closely follows the OECD guidelines including:

  - Functional Analysis:
    - *Comprehensive business overview*
    - *Organizational structure*
    - *Description of Controlled Transactions*
  - Transfer Pricing Analysis
    - *Selection of methodologies, comparables, and economic analysis*

  - For **intra-group services**, documentation should include the <u>intercompany agreement, organizational structure, and a detailed description of functions and expenses incurred.</u>
  - For **cost-sharing arrangements**, the documentation should include <u>the cost sharing agreement, details of accounting practices, expected and actual benefits, and details of adjustments between them.</u>

  Note: records should be kept for five years (the statue of limitations).

Contemporaneous Documentation

- It is strongly recommended to prepare contemporaneous documentation to avoid difficulties in satisfying the tight deadline to submit documentation.
- Transfer Pricing documentation may be required to be submitted to the KNTS within 60 days of the request date in the event of a desk audit. Failure to submit requested Transfer Pricing documentation within the appropriate time-frame may attract a fine of up to KRW 30 Million.

Comparables

- Where the tested party is located in Korea, there is a requirement for comparables from the Korean market.
- Detailed information and data on Korean comparables is available from a number of Korean and regional financial databases.

APAs

- The Korean APA program has been in place since January 1, 1997 and allows for unilateral, bilateral and multilateral APAs.
- Interestingly, APAs are increasingly being promoted by the KNTS to help taxpayers eliminate the risk of double taxation and penalties from Transfer Pricing adjustments.

Retroactive "Roll-back" for Unilateral APAs

- Taxpayers may request a rollback of the APA to cover open years as long as the APA application is submitted before the taxpayer is selected for a tax audit.
- By applying for an APA with rollback, a taxpayer can effectively take Transfer Pricing off the table.
- Results negotiated through an APA tend to be more favorable than results obtained through an audit.
- Roll-back period is up to five years.

Penalties

- There is a penalty of up to KRW 30 million for failing to provide documents within 60 days from the request from the Korean taxing authority ("NTS"); one 60 day extension is generally allowed.
- In addition to the monetary penalty, unless the taxpayer provides a justifiable reason the NTS may disregard the supporting documentation presented with a tax appeal if the documents were not submitted within 60 days of the request (or 120 days with the extension).

Korea Customs ACVA

- Korea is currently the only country that has a customs advanced pricing agreement.
- The ACVA program may set a precedent for customs agreements in other countries.

Malaysia

Regulatory Position in Malaysia

- The Internal Revenue Board released the Transfer Pricing Guidelines on July 8, 2003.

- Malaysia Transfer Pricing Guidelines endorses OECD Guidelines.

Contemporaneous Documentation

- There is mandatory contemporaneous documentation:
  - The documentation must include a detailed analysis of the company and its related party transactions;
  - A functional analysis;
  - Comparability analysis that supports the application of one the approved transfer pricing methods in testing the arm's length nature of the related party transactions.

- While there is no deadline to prepare the documentation, upon request, taxpayers are given 21 days to submit transfer pricing documentation:
  - Extensions up to one month may be granted.

- Taxpayers are also required to keep sufficient records for a period of seven years from the end of the tax year.
  - All records relating to any business in Malaysia must <u>be kept and retained in Malaysia</u>.

Audits

- Transfer Pricing Audits can cover the previous six financial years (the statute of limitations).
- Transactions that are most commonly challenged are:
  - Sales and purchases
  - Management fees
  - Royalty fees

Tax Return Disclosure of Related Party Transactions

- Disclosure of Arm’s Length values is required in the tax return for the following transactions:
  - Sales to related companies
  - Purchases from related companies
  - Other payments to related companies
  - Lending to and borrowing from related companies
  - Receipts from related companies

TP Case Law

- There is no Transfer Pricing case law in Malaysia.

Penalties

- There are no specific Transfer Pricing penalties.
- The general penalty for the understatement of taxes is a fine of up to 45% of the tax adjustment.

APAs and MAP

- APAs are available upon request.
- Tax Authorities are encouraging companies to apply for APAs, especially unilateral APAs.
- While there are no formal guidelines on APA, APA guidelines are being developed.
- In the meantime, the IRB indicated that it will consider any terms and conditions which are the norm observed in the Transfer Pricing regimes in other jurisdictions.
- There are no known APAs filed in the country.
- There is an increasing number of MAPs due to adjustments arising from audits.
- Most MAPs are still under investigation.

Australia

Contemporaneous Documentation Requirements

- Documentation is generally only required upon request.
  - If requested, it is expected to be produced within two weeks from the date of request.

Contemporaneous Documentation Requirements:

- If the TNMM is selected, then the taxpayer should:
  - Document the method, and
  - Determine the arm’s length outcome, and
  - Make sure that the outcome accurately characterizes the international dealings between the related parties.
- CUP is a big focus

Penalties

- There is a penalty equal to 50% of the additional tax assessed when there is evidence of a "dominant tax avoidance purpose."
- Penalties range from 10% to 25% in all other cases.
- **Penalties can be mitigated**:
  - There is a discretionary reduction in TP penalties if there is evidence that the taxpayer made a reasonable attempt to comply with the arm's length principle and has contemporaneous documentation.

APAs

- Unilateral, bilateral, and multilateral APAs are generally available options.
- These APAs can apply anywhere from three to five years going forward from the time of application.

New Zealand

Contemporaneous Documentation

- There is no explicit statutory requirement to maintain TP documentation.
  - However, New Zealand law requires taxpayers to determine transfer prices in accordance with the arm's length principal 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.
  - Lack of adequate documentation may make it difficult for the taxpayer to rebut an alternative arm's length transfer price proposed by the government.
  - If the taxpayer's transfer prices are adjusted, the quality of the taxpayer's documentation will be a factor in determining the extent of penalties.