



Arm's Length Standard

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In this issue:

The transfer pricing effects of implementing IFRS in the United States	1
India's proposed Direct Tax Code 2009 includes sweeping transfer pricing changes	9
OECD issues draft of revised transfer pricing guidelines chapters.....	11
Denmark issues guidelines on IP valuation	13
Vietnam reveals use of secret comparables to make deemed tax adjustments.....	14
Korean National Tax Services releases second APA annual report.....	15
Transfer pricing adjustments in tax holiday years can result in Vietnamese corporate tax liability	21
Belgium introduces new reporting obligations for non-arm's length transactions and off-balance sheet arrangements	23

The transfer pricing effects of implementing IFRS in the United States

The Securities and Exchange Commission (SEC) on November 14, 2008, released for comment its proposed roadmap for the mandatory transition from U.S. Generally Accepted Accounting Principles (U.S. GAAP) to International Financial Reporting Standards (IFRS) as the basis for financial reporting by U.S. registrants. According to the roadmap, large accelerated filers may be required to file IFRS financial statements for fiscal years ending on or after December 15, 2014, accelerated filers in 2015, and nonaccelerated filers in 2016. Although the SEC has not adopted a final roadmap and timeline, a movement to IFRS will likely directly affect transfer pricing, given that financial data is the backbone of many aspects of transfer pricing.

U.S. multinational corporations should be proactive in understanding how a conversion to IFRS could affect their transfer pricing.¹

Overview of IFRS and the convergence initiative

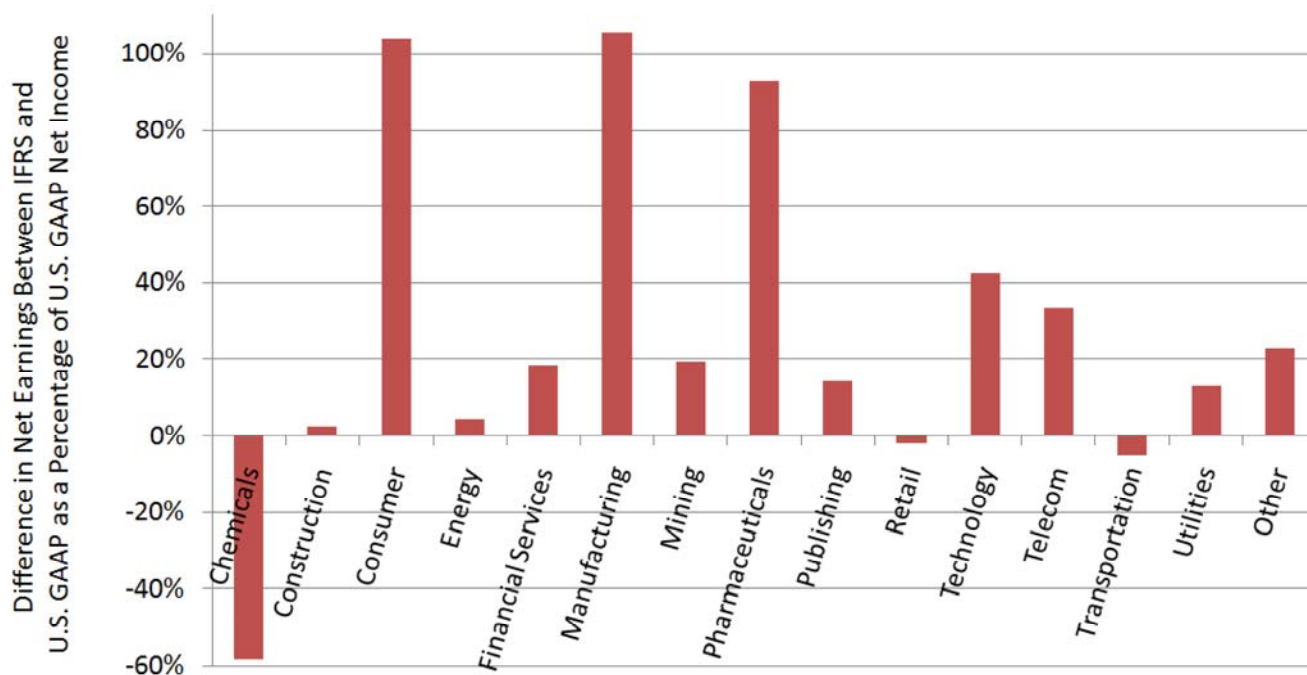
History of IFRS – From 1973 until 2000, the International Accounting Standards Committee (IASC) issued the International Accounting Standards (IAS), which were disseminated to create a standardized set of accounting principles. In 2001, after a full reorganization of the IASC, the International Accounting Standards Board (IASB) was formed. The standards published by the IASB are known as IFRS. The IASB, in addition to the precisely defined IFRS, has adopted all the IAS, which are broadly defined together as IFRS.

¹ As used in this document, "Deloitte Tax" refers to Deloitte Tax LLP, a subsidiary of Deloitte LLP. Please see www.deloitte.com/us/about for a detailed description of the legal structure of Deloitte LLP and its subsidiaries.

In the United States, the accounting principles issued by the Financial Accounting Standards Board (FASB) form U.S. GAAP. The SEC recognizes these accounting standards as authoritative. In general, U.S. GAAP contain “‘rules-based’ standards with specific application guidance,” whereas IFRS are more “‘principle-based’ standards with limited application guidance.”²

While the two sets of accounting standards are similar, the differences between the two may have significant transfer pricing implications for many multinational corporations.

Convergence initiative – The SEC has already allowed some foreign issuers to file financial statements using IFRS. On March 13, 2002, the European Parliament voted to endorse the use of the standards issued by the IASB for all listed companies, with some exceptions, starting no later than 2005. For fiscal years ending after November 15, 2007, the SEC issued a ruling providing that financial statements of foreign issuers prepared in accordance with IFRS no longer had to include a reconciliation to U.S. GAAP.



IFRS are more principles-based than U.S. GAAP, and provide limited industry accounting guidance. However, companies in all industries will be affected by a conversion to IFRS or the more gradual convergence of U.S. GAAP and IFRS, and will likely experience transfer pricing implications. To illustrate this point, we used information from a survey of 131 companies domiciled outside the United States that file IFRS-based financial statements with the SEC, spanning a range of countries and industries. The information was collected primarily from the companies' 2006 20-F forms. These forms were filed when the SEC still required companies that used IFRS to reconcile their financial data with U.S. GAAP.³

² Deloitte, "IFRSs and U.S. GAAP: A Pocket Comparison," 29 December 2008.

URL: <http://www.iasplus.com/dtftpubs/0809ifrsusgaap.pdf>

³ Companies in the 2005 *Financial Times Global 500* with the largest market capitalizations were selected to be included in this analysis. A substantial number of companies were added and deleted during the data collection process. In transfer pricing analyses, the comparable companies selected are typically not Global 500 companies. The comparables should be independent companies that do not perform a mixture of activities. Thus, the results based on the 131 companies may not be representative for the midsize and smaller independent companies that are usually selected as comparable companies in transfer pricing analyses. However, some of the trends may be similar.

The companies in this sample should not be deemed to represent a random sample, and we do not represent that the results can be used for valid statistical analyses. Some of the sectors in the sample have a small number of companies included in them. Thus, caution should be taken before any broad generalizations are made.

Using this data, profits recorded under IFRS were compared to net income recorded using U.S. GAAP. The difference in net earnings between IFRS and U.S. GAAP for these companies, expressed as a percentage of U.S. GAAP net income, is illustrated in Table 1.⁴

The conversion to IFRS will affect individual companies in different ways, but some of the effects may be consistent by industry. Others will be highly factually dependent on factors such as each company's specific financial situation, recent business combinations, or use of stock-based compensation. Until a more rigorous analysis has been conducted on a larger population of companies, we will present some findings based on the analysis of the 131 companies included in the survey across industries.

An example can help illustrate the possible differences by company and industry. In the manufacturing industry, several companies were affected by the accounting treatment of pensions. One company's pension expense reconciliation made U.S. GAAP net income 463 percent higher when converting to IFRS profit. For the average company in the manufacturing sector, the pension expense reconciliation made U.S. GAAP net income 42 percent higher when converting to IFRS profit. For the pharmaceutical sector, the average company in the sample had a change in U.S. GAAP net income when reconciling to IFRS due to differences in the accounting for business combinations, goodwill, and intangibles of 42 percent, with one company having a percentage change in U.S. GAAP net income of 482 percent when reconciling to IFRS.

Table 1 above, combined with Table 3 below, illustrate the fact that across individual companies and industries there may be a large percentage change in net income when converting to IFRS from U.S. GAAP. However, across all companies in different industries, these individual differences on average may be less substantial. For transfer pricing purposes, comparable companies are chosen by selecting companies whose functions performed and risks assumed are most similar to the company being analyzed. So industry-specific differences may have an effect on transfer pricing analyses, for which industry often is a critical factor when selecting comparable companies.

Impact on transfer pricing economic analysis

Selection and application of transfer pricing methods – From a transfer pricing standpoint, the adoption of IFRS will affect different companies' transfer pricing policies in different ways, depending on each company's exact circumstances, functions, and risks. The Internal Revenue Service (IRS) has not yet indicated how it will handle intercompany pricing agreements that are written in the context of U.S. GAAP and continue to be in effect after conversion to IFRS.

For companies that use the comparable uncontrolled price (CUP) method to determine their transfer pricing for tangible goods, essentially no change to their transfer pricing should occur, because the CUP method uses market prices to determine the appropriate price that should be charged between related entities. Market prices are typically not affected by accounting standards.

For companies that use the comparable uncontrolled transaction (CUT) method to determine their transfer pricing for intangible property, the effect on their pricing will depend on the exact details of their contracts with related parties, as well as the contracts of their comparables. The total amount of gross royalty charges or license fees may change for several reasons. Royalty rates charged to or from unrelated parties may be determined by using financial statement data. This could affect the range of arm's length royalty rates. Additionally, an income statement item to which a royalty rate may be applied, such as net revenue, has the potential to change under IFRS.

The data are taken from many companies' first year of data after converting to IFRS. The survey of 131 companies did not allow for a multiple-year analysis, which would be preferred, because different companies converted at different points in time. Many of the differences between U.S. GAAP and IFRS found here may even out over time. However, for transfer pricing purposes, differences in accounting in the first year after converting may significantly affect a given company's transfer pricing for a number of years forward, because multiple years of financial data are typically used for transfer pricing benchmarking purposes.

⁴ For each company, the difference between IFRS profit and U.S. GAAP net income is calculated. This difference is translated into a percentage of the absolute value of U.S. GAAP net income. This percentage is finally averaged across all companies in a given sector.

For companies that use the resale price method (RPM) or the cost plus method, the calculation of gross profits is essential to determining the appropriate transfer price.⁵ In calculating the margins/markups or the base to which those margins/markups are applied, financial earnings generally form the basis of these calculations, which are directly affected by the accounting standards used. It is feasible that a company's overall taxable results using the RPM or the cost plus method may change, solely because of the conversion to IFRS even though there has been no change in the underlying economics of the transactions.⁶

Alternatively, multinational corporations may decide to change their transfer pricing so that the change in accounting standards does not change their overall taxable results. In both instances, tax authorities may require an explanation for the new results.

Transfer pricing using the comparable profits method (CPM) may change substantially as a result of converting to IFRS. This method uses different profit level indicators (PLIs) to determine what the arm's length range of profitability should be for a given company. Common PLIs include the following:

- Return on operating assets = operating profits/operating assets;
- Operating margin = operating profits/sales;
- Berry ratio = gross profits/operating expenses;
- Net cost plus ratio = operating profits/(cost of goods sold + operating expenses)⁷; and
- Gross margin = gross profits/sales.

Financial statement data, most of which is above the EBIT (Earnings Before Interest and Taxes) line, is used to determine those ratios in transfer pricing studies. The change from U.S. GAAP to IFRS will most likely affect those ratios, which may cause a company whose transfer pricing was within the acceptable range of profitability to fall out of that range because the value of the PLIs the company was using changed, the value of the comparable companies' PLIs changed, or both. As an example of how this could occur, IAS 38 covers development costs, which are capitalized under IFRS if certain criteria are met. Similar costs are likely expensed under U.S. GAAP. Depending on whether development costs are expensed or capitalized, the numeric result of a company's PLIs could change. Deloitte Tax's Clark and Riisberg showed in their research comparing European companies that reported their financials under different local GAAPs that, on average, if the same corporation uses a different accounting standard, the value of its PLIs may significantly change.⁸

Decisions will also have to be made with regard to changing the best method selected, should accounting changes cause inconsistencies in the available data. According to IRC § 1.482-1(c)(2), "in determining which of two or more available methods (or applications of a single method) provides the most reliable measure of an arm's length result, the two primary factors to take into account are the degree of comparability between the controlled transaction (or taxpayer) and any uncontrolled comparables, and the quality of the data and assumptions used in the analysis." If the quality of the necessary data for one method deteriorates due to accounting changes, other methods may have to be considered.

⁵ According to IRC § 1.482-3(c)(2)(i) and § 1.482-3(c)(2)(iii), "The resale price method measures an arm's length price by subtracting the appropriate gross profit from the applicable resale price for the property involved in the controlled transaction under review," where "(t)he appropriate gross profit is computed by multiplying the applicable resale price by the gross profit margin (expressed as a percentage of total revenue derived from sales) earned in comparable uncontrolled transactions." According to IRC § 1.482-3(d)(2)(i)–(ii), "The cost plus method measures an arm's length price by adding the appropriate gross profit to the controlled taxpayer's costs of producing the property involved in the controlled transaction," where "(t)he appropriate gross profit is computed by multiplying the controlled taxpayer's cost of producing the transferred property by the gross profit markup, expressed as a percentage of cost, earned in comparable uncontrolled transactions."

⁶ For example, the point in time when revenue is recognized could affect the taxable results from the RPM. One of the major topics being covered in the convergence initiative is when revenue should be recognized. Currently, IAS 18 provides general principles on this topic. However, U.S. GAAP gives much more specific guidance, as does the SEC.

⁷ For intercompany services transactions, the net cost plus margin is the ratio of operating profit to total services costs. Total services costs are defined in IRC § 1.482-9(j).

⁸ Clark, Dick and Kristine Riisberg, "Differences in European and U.S. GAAP: Implications for Transfer Pricing Analysis," *BNA Tax Management Transfer Pricing Special Report*, 13(13) 2004.

One potential issue that could arise concerning the availability of data is that the U.S. Internal Revenue Code currently contains numerous references to U.S. GAAP. The IRS recognizes this as an issue and is working with corporate and industry stakeholders on a resolution to these and other issues arising in connection with a conversion from U.S. GAAP to IFRS.

During the transition period, some companies may decide to file their financials using U.S. GAAP, whereas others may choose to use IFRS. This may cause the comparable data of one or more of the potential comparables to be filed using a different accounting standard than that of the tested party. If adjustments cannot be made for differences in the data, this may affect the results of the transfer pricing analysis.

Profit-based methods – CPM

General expectations – Over time, we can expect the wider adoption of IFRS to render the CPM more reliable, as more companies turn to IFRS. Differences in profitability between comparable companies solely attributed to differences in accounting standards and procedures should be substantially reduced. The remaining differences will be due to other factors, such as geographical differences.

Selection of comparable companies – As previously mentioned, there may be a lengthy transition period during which U.S. public companies shift to IFRS. That period will ultimately be determined by the SEC. During the transition period, some companies will convert their books and records to IFRS, whereas others will continue to report under U.S. GAAP. If appropriate adjustments cannot be made to make the financial data of the comparable companies and the tested party commensurate with each other, the companies and their transfer pricing advisors will have to decide what is the best way to deal with this situation on a case-by-case basis. The tradeoff will be between using highly comparable companies that do not use the same accounting standards as the tested party and using companies with functions, risks, and asset bases that may not be as similar to the tested party as other comparables, but that do use the same accounting standards as the tested party. The IRS has not provided guidance on this issue yet, but companies will be expected to take the initiative in evaluating and documenting why their position supports the arm's length price.

Accounting adjustments – Once the comparable companies are chosen, transfer pricing practitioners make accounting adjustments to each company's financial data to confirm that all the companies are recording their data in a consistent manner. For example, a company in the United States can choose to use the Last In, First Out (LIFO) accounting method to account for its inventory, or the First In, First Out (FIFO) accounting method. A company's choice of which inventory method to use should not affect the comparability of its functions and risks to those of other companies, so adjustments are made to the financial data to determine that the companies are on an equal footing in terms of their financial reporting. The use of IFRS will change the need for some of these adjustments. For example, under IAS 2, the LIFO method is prohibited.

Other accounting adjustments that transfer pricing practitioners typically make include, for example, adjustments to operating expenses, because costs associated with the amortization of intangibles from acquiring another company would not be consistent across all comparable companies that did not acquire another company. Additionally, items recorded in the net periodic pension cost that are not the result of the current period's operating activities are also removed. Under IFRS, these adjustments will still have to be made; however, the underlying figures to which these adjustments are applied may be different under IFRS when compared to U.S. GAAP. For example, differences exist in the way intangibles are treated under IFRS and U.S. GAAP. IAS 19 also deals with how to account for employee benefits, which is different than how employee benefits are handled under U.S. GAAP.⁹

Impact on capital adjustments – Transfer pricing practitioners also make capital adjustments to the financial data of the tested party and the comparables to improve the reliability of the comparisons between them, which can include adjustments for differences in financing terms. For example, if Comparable A pays for a purchase immediately, while

⁹ However, in "Completing the February 2006 Memorandum of Understanding: A Progress Report and Timetable for Completion," published on September 11, 2008, by the FASB and the IASB, the two boards agreed as part of their convergence initiative to make post-employment benefits one of the major fields on which to work to achieve convergence by 2011.

Comparable B pays for the exact same purchase at a later date, and thus increases its accounts payable on its balance sheet, Comparable A should pay a lower price, because it paid for its purchase immediately. Since both transactions have the same economic substance, but are treated differently on the two companies' respective financial statements, adjustments are made so that the companies' financial data actually reflect the economic substance of those transactions. Similar types of capital adjustments are made for accounts receivable and for inventories. Capital adjustments will still have to be made under IFRS, just as they are under U.S. GAAP; however, as with accounting adjustments, the underlying line items to which the adjustments are applied may contain different figures under IFRS when compared to U.S. GAAP.

Another issue is the fact that there is more flexibility in the grouping of accounts under IFRS than under U.S. GAAP. There may be more judgment calls by companies on how they want to present their financials under IFRS than there are under U.S. GAAP. Thus, rigorously examining the notes of financial statements to see which items are included in each line item (and which ones are not) may become significantly more time-consuming under IFRS.

Selection of comparable profit level indicators – During the transition period to IFRS, certain PLIs may no longer be useable for a given company. If adjustments cannot be made to the financial data, then other PLIs, which might not be as appropriate as indicators of profitability, may have to be used. For example, this could occur because under IAS 16, the basis of measurement of property, plant, and equipment may be recorded using either the historical cost or fair value at the date of revaluation minus subsequent accumulated depreciation and impairment losses. Under IAS 17, the requirements for capitalization of leases are different than under U.S. GAAP. If adjustments cannot be made for those differences, the return on operating assets PLI, which is often used for asset-intensive manufacturers, may not be feasible.

Effects on the interquartile range – As previously mentioned, another issue that may arise from a conversion to IFRS is that the interquartile ranges may change even though the economics of the comparable companies did not change. To illustrate this, we examined the 2006 20-F forms of several companies in the same geographic area, industry, and with similar functions, determined by SIC code. For some of the companies we examined, the 20-F contained operating profit and revenue for fiscal years 2006, 2005, and 2004. From those companies' data, we were able to calculate the three-year average operating margin, as illustrated below.

	Three-Year Average U.S. GAAP Operating Margin	Three-Year Average IFRS Operating Margin	2006 U.S. GAAP Operating Margin	2006 IFRS Operating Margin
Company 1	15.9%	19.5%	9.7%	15.6%
Company 2	19.6%	20.3%	19.2%	18.6%
Company 3	28.6%	28.1%	30.2%	28.0%
Company 4	20.4%	25.2%	17.7%	23.8%
Company 5	19.2%	19.7%	19.6%	20.3%
Company 6	13.9%	14.2%	16.0%	16.2%
Upper Quartile	20.4%	25.2%	19.6%	23.8%
Median	19.4%	20.0%	18.4%	19.5%
Lower Quartile	15.9%	19.5%	16.0%	16.2%

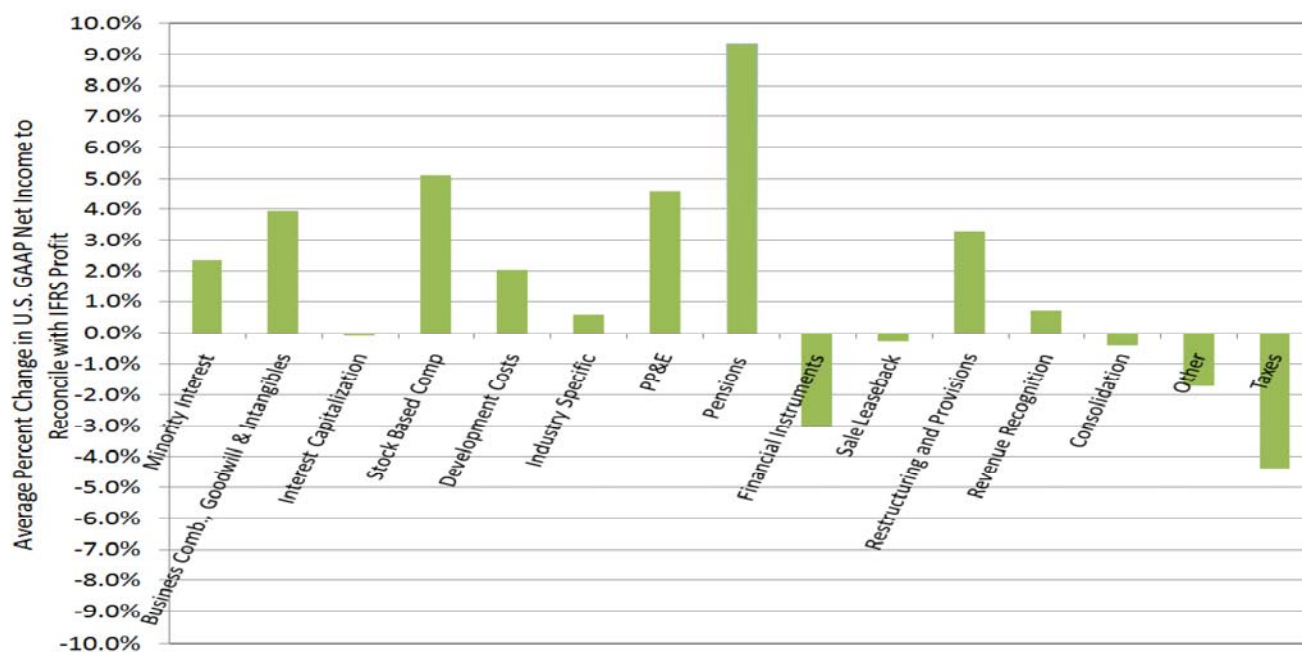
As can be seen, the analyzed companies had a three-year average operating margin interquartile range of 15.9 percent to 20.4 percent under U.S. GAAP, and 19.5 percent to 25.2 percent under IFRS. The median of the three-year average operating margin under U.S. GAAP is 19.4 percent, which is not in the interquartile range of the three-year average IFRS operating margin. In some circumstances, a company may need to adjust its transfer pricing to remain in the arm's length interquartile range after converting to IFRS. Thus, it is possible that a company's overall taxable income could change just by virtue of comparable companies converting to IFRS.¹⁰

¹⁰ This example is not meant to be representative of results that a typical company may expect to see. The example is for illustrative purposes only on the possible effects of converting to IFRS. Each company's individual transfer pricing results will

To further illustrate this point, and some of the issues that might arise if not all companies convert to IFRS at the same time (a likely scenario), suppose the tested party is similar to Company 1 in Table 2. Also suppose it has not converted to IFRS yet, but all the comparable companies have. Under U.S. GAAP, Company 1's operating margin of 15.9 percent would be within the arm's length range. However, when analyzed with companies that have converted to IFRS, its transfer pricing is no longer in the interquartile range. If the tested party, which is assumed to be similar to Company 1, did nothing, its transfer pricing results could be adjusted to the median of the comparable company's IFRS interquartile range for 2006, which would be 19.5 percent. Thus, it is feasible that during the transition period, companies could find themselves outside of the arm's length interquartile range, even though their economics did not change. Companies may need to evaluate their transfer pricing more frequently during this transition period and vigorously document their transfer pricing policies.

Treatment of intangibles and other types of adjustments

IFRS and U.S. GAAP affect different types of line items in varying ways. Intangibles, which even without the convergence initiative can make a basic transfer pricing analysis significantly more complicated, provide a good example. To illustrate how the treatment of different types of items, including intangibles, contribute to the differences between IFRS profit and U.S. GAAP net income, Table 3 shows the percentage change in U.S. GAAP net income that is necessary to obtain IFRS profit by type of adjustment.¹¹ Across the 131 analyzed companies, a 4.0 percent average difference in U.S. GAAP net income and IFRS profit is found due to differences in accounting for business combinations, goodwill, and intangibles only.¹²



vary on a case-by-case basis. No accounting or capital adjustments were made to the data. In a typical transfer pricing analysis, those types of adjustments would usually be made to improve the reliability of the results of the comparable companies.

¹¹ In other words, Table 3 shows the factors contributing to an increase or decrease in U.S. GAAP net income relative to IFRS profit. For example, the adjustment when reconciling pension expenses makes IFRS profit higher than U.S. GAAP net income. This figure is calculated by first categorizing each adjustment necessary to go from U.S. GAAP net income to IFRS profit into one of the designated categories, such as pensions or PP&E, for each company. Then, for each type of adjustment for each company, the adjustment is translated into a percentage of U.S. GAAP net income. This percentage is finally averaged across all companies in the sample for each category of adjustment. As previously discussed, the inferences made from the companies included in this sample, while informative, should not be considered to have come from a random sample of companies.

¹² In general, many aspects of the treatment of intangibles under IFRS can be found in IAS 36 and IAS 38.

However, it should be noted that during the selection of comparable companies, including the financial data analysis stage of a transfer pricing study, the effects of business combinations, goodwill, and intangibles when converting from U.S. GAAP to IFRS are expected to have limited impact on the transfer pricing analysis. Those line items will typically either be removed from the financial data, or the potentially comparable company with these attributes will be excluded from the set of comparable companies altogether. A much more extensive analysis of how intangibles affect transfer pricing under IFRS and U.S. GAAP can be found in an article written by William F. Finan and Susan Work, from Taj Société d'Avocats, a Deloitte Touche Tohmatsu member firm.¹³

Other differences in how certain items are accounted for under U.S. GAAP and IFRS have the potential to significantly change a PLI for a given company. For example, the differences in the accounting of stock-based compensation under U.S. GAAP net income and IFRS profit, on average across the companies in the survey, accounted for a 5.1 percent change in U.S. GAAP net income. Stock-based compensation directly affects the operating costs of a company in the profit and loss statement, and may therefore affect the calculation of the PLIs that include costs.¹⁴ The same is true for pensions, for which the differences in accounting between U.S. GAAP net income and IFRS profit accounted for a 9.4 percent increase in U.S. GAAP net income. Differences in accounting for property, plant, and equipment caused an average change in U.S. GAAP net income of 4.6 percent. Those differences in property, plant, and equipment will most likely directly affect the calculation of the return on operating assets PLI.

Conclusion

When companies in the United States convert to IFRS, their transfer pricing may be affected in various ways. Some companies may see inconsistencies in the available data of their comparable companies, because some may continue to use U.S. GAAP while others may convert to IFRS. The process of converting could take a decade or longer to complete (taking into consideration non-public companies), and there may be a long period during which different accounting standards may affect transfer pricing analyses. Other companies may see the range of arm's length profits shift due to the use of IFRS, even though the economics of their companies and the economics of the comparable companies did not change. It may be the case that a company whose transfer pricing was within the arm's length range of profitability under U.S. GAAP may find itself outside of the arm's length range of profitability under IFRS.

Some of the effects on transfer pricing analyses due to converting to IFRS may also be more industry dependent, as some changes in the accounting standards may affect companies in a particular industry more than others. Much research still needs to be done to examine how converting to IFRS will affect transfer pricing, both on an individual company basis and in the aggregate.

We have attempted to give a brief description of some of the issues that might affect transfer pricing as companies convert from using U.S. GAAP to IFRS. Depending on each company's individual situation, some or all of these issues may apply. To avoid transfer pricing adjustments and penalties, companies should be especially proactive in reviewing and updating their transfer pricing documentation and intercompany agreements during this transition period.

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¹³ Finan, William F., and Susan Work, "Comparing Valuations of Intangible Assets Performed for Transfer Pricing & Accounting Standards Purposes: Similarities & Potential Differences" *BNA Tax Management Transfer Pricing Special Report*, 17(2), February 5, 2009.

¹⁴ Stock-based compensation is of particular interest to the IRS, as it is specifically mentioned in the recently issued temporary services regulations, the cost sharing regulations, and has further been discussed in the *Xilinx* decision from the United States Court of Appeals for the Ninth Circuit, issued on May 27, 2009.

India's proposed Direct Tax Code 2009 includes sweeping transfer pricing changes

India's Finance Ministry has released a draft Direct Taxes Code to replace the current Income Tax Act, which dates back to 1961. The draft code's aim is to simplify the existing tax structure and pave the way for a single unified taxpayer reporting system. The draft code proposes extensive changes that would affect the taxation of all taxpayers, including major proposed amendments to India's transfer pricing regime.

The draft code was released with a discussion paper. The Finance Minister has invited public comment on both the draft code and the discussion paper. Once finalized, the code will be presented to Parliament in the winter session, 2009, for enactment. It is intended to become effective 1 April 2011.

Advance pricing agreements

The 2009 Direct Tax Code introduces the concept of advance pricing agreements (APAs). Given the numerous transfer pricing cases under dispute, this is expected to considerably alleviate taxpayer uncertainty regarding pricing of international transactions.

Key features

- The Central Board of Direct Taxes would enter into an agreement, with the approval of the central government, with any taxpayer to determine the arm's length price of an international transaction.
- The board would be empowered to make further adjustments to the price determined as it may deem necessary.
- The term of the APA would be limited to five consecutive financial years.
- The APA would be binding only on the taxpayer and the tax authorities, and only for the international transactions for which the agreement is sought.

Definition of "associated enterprise(s)"

The draft code revises various thresholds for an Indian entity to be deemed an associated enterprise. This change is expected to increase the number of taxpayers that fall under the ambit of the Indian transfer pricing regime.

Key features

- The general definition of AE (direct or indirect participation in management, control, or capital) has been omitted.
- Direct or indirect shareholding/voting power has been decreased from the earlier threshold of 26 percent to 10 percent.
- The threshold for loan advances is reduced from 51 percent to 26 percent of the book value of total assets.
- The appointment of board of directors threshold is reduced from one-half to one-third of the governing board.
- The raw materials and consumables threshold is reduced from 90 percent to two-thirds of total supply by one enterprise to the other.

Penalty provisions

The penalty provisions have been modified for various defaults under transfer pricing.

Key features

- The penalty for not filing an Accountant's Report would be INR 0.05 million to INR 0.2 million, rather than the current INR 0.1 million.
- Failure to maintain transfer pricing documentation would incur a penalty of INR 0.05 million to INR 0.2 million, compared to the current 2 percent of the value of the international transaction.
- As a deterrent against noncompliance, prosecution followed by imprisonment and fine is prescribed.

Change in transfer pricing assessment procedure

The transfer pricing assessment procedure has been consolidated to ensure that officers with requisite expertise on the subject address disputes.

Key features

- The accountant's report must be filed with the Transfer Pricing Officer rather than the Assessing Officer. This is contrary to the earlier procedure, whereby the Accountant's report had to be filed with the Assessing Officer.
- The selection of transfer pricing cases for scrutiny is to be based on a risk management strategy as may be framed by the Board. The strategy will not be disclosed to taxpayer or members of the public.
- In line with the Finance Bill 2009, the determination of an arm's length price will be subject to safe harbor rules drafted by the Board.

Dispute Resolution Mechanisms (DRMs)

The draft code makes reference to DRMs to reduce the scope of disputes and minimize litigation.

The dispute resolution mechanism provisions, from a transfer pricing perspective, are similar to those introduced in Finance Bill 2009, except that the proposed variation in the income/loss returned is less than INR 2.5 million.

Change in timelines

The draft code proposes significant changes to the timelines relating to the filing of the accountant's report and assessment proceedings.

Key features

- The accountant's report must be filed by August 31.
- A Transfer Pricing Officer will issue a notice for selection of a case within two months from the end of the financial year in which the accountant's report is filed.
- The Transfer Pricing Officer must issue an order within 42 months from the end of the financial year in which the international transaction is entered into.
- When a matter is not referred to the Dispute Resolution Panel, the Assessing Officer would pass an order within three months in which the order is passed by the Transfer Pricing Officer.

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OECD issues draft of revised transfer pricing guidelines chapters

Following previous discussion drafts on comparability and transactional profits methods, and a public consultation in November 2009, the OECD on September 9 issued draft revised Chapters I-III of the Transfer Pricing Guidelines for a further round of consultation. The revised guidelines propose the elimination of the hierarchy of methods under which the transactional profits methods were considered methods of last resort.

Because the Guidelines provide a framework for the consideration of all transfer prices between associated enterprises, any changes or clarifications are obviously extremely important.

Principal areas subject to current draft

The main areas subject to new guidance are:

- The arm's length principle itself;
- The comparability analysis; and
- The application of transactional net profit methods.

There are also some illustrations of issues concerning the application of transactional net profit methods, together with an example of a working capital adjustment to strengthen comparability.

The arm's length principle

All OECD members have taken the opportunity to reaffirm their belief in the arm's length principle, as opposed to alternative methods, such as global formulary apportionment, for allocating profits.

The OECD emphasizes that Article 9 is the definitive statement governing the arm's length principle, and that transfer pricing involves a review of the conditions – not only price – between the parties and a determination of the profits that would have accrued between them had they been independent enterprises.

The issue of comparability (in essence, finding comparable transactions carried out by comparable entities) remains a cornerstone of transfer pricing. The OECD outlines the concept of reasonably reliable comparables to take into account available information. The five existing comparability factors (characteristics of property or services, functional analysis, contractual terms, economic circumstances, and business strategy) continue to apply; the OECD says the relevant weight of each factor is to be considered in line with the nature of the transaction and the transfer pricing method adopted. The functional analysis remains of key importance. The draft also covers the matter of whether or not a tax administration should recognize the actual transactions undertaken. The text of this section is largely unchanged from the existing Guidelines, but is subject to the outcome of the separate "Business Restructuring" OECD work.

The OECD also considers the matter of transfer pricing methodologies, and which methodologies are preferred. There is a clear change proposed: the transactional profits methods – the profit split and transactional net margin methods – are no longer to be considered "methods of last resort." Based on the experience of OECD members since the last major revision of this part of the Guidelines, those transactional profit methods are in effect to be elevated in status to match the traditional transactional methods – comparable uncontrolled price, resale minus, and cost plus. The proposed change makes it clear that, going forward, the method that is most appropriate to the circumstances of the case can be used.

Comparability analysis

New material is proposed on the issue of comparability, and how comparability is to be determined. A recommended process for the comparability analysis is proposed: in particular, the analysis is to be carried out firmly within the context of the appropriate transfer pricing method.

The OECD recognizes that commercial databases featuring the trading results of companies are useful. The availability of only limited data does not preclude reliance on that data. There is an emphasis on the quality rather than the quantity of data. Further clarifications are presented on the interpretation of the arm's length range of results and the use of multiple-

year data. Thought is given to how to treat situations in which uncertain valuations exist from the outset, and how this might affect pricing between independent enterprises.

Guidance on application of transactional profits methods

The elevation of the status of the existing transactional profits methods has also given the OECD the opportunity to provide further guidance on how those methods should be applied. It is not only choice of method that must be considered – the way the method is applied is also important.

The OECD acknowledges that the transactional profits methods can sometimes result on more reliable answers than the traditional transactional methods, particularly when “below the line” operating expenses reveal functional differences in comparable companies that might not be so apparent when looking at gross margins.

The draft revisions also recognize that it is not compulsory to use a transactional profits method to actually set prices (though it is possible.) The methods can be used after the transactions to analyze what the arm’s length profit would have been. There is an emphasis on examining what third parties would have agreed to. It is important to isolate the results of the transactions under review from other trading results. Product Line Income statements will often prove useful.

For the profit split method, there is new guidance on the use of particular allocation keys – the use of assets and costs is discussed, along with the possibility of other potential keys such as incremental sales achieved, head counts, and time spent by employees.

The new guidance reflects the increased use of the transactional net margin method (TNMM) for transfer pricing purposes. The OECD states that the process for applying TNMM should not be less reliable than for other methods. However, good judgement should be accepted in case of a lack of available information. The OECD emphasizes the importance of considering the facts and circumstances of the case, and gives some examples of what this means.

The OECD also acknowledges the use of Berry ratios in transfer pricing.

Conclusion

The proposed changes will alter the structure of the existing Transfer Pricing Guidelines, as well as provide clarifications and perhaps changes in meaning, the ramifications of which may not be completely clear. Because transfer pricing is a high-risk area for tax administrations, it is vital that taxpayers be aware of the proposed changes and consider them carefully.

The final date for the submission of written representations to the OECD is 9 January 2010. Deloitte will continue to participate in the consultation process – readers are welcome to make their views known to us or directly to the OECD. We will also provide an in-depth analysis of the proposals shortly.

Review the proposed revisions to Chapters I-III of the Transfer Pricing Guidelines.

URL: <http://www.oecd.org/dataoecd/1/57/43655703.pdf>

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Denmark issues guidelines on IP valuation

The Danish tax authorities have published new guidelines on business and intellectual property (IP) valuation for tax purposes. The new guidelines should be seen in the context of the Danish transfer pricing environment, which features detailed documentation requirements and a significant focus by the tax authorities on IP arrangements.

Background

The tax authorities have recently focused their audit activity on IP arrangements, particularly those involving one-time transfers of IP. Historically, the Danish guidance on IP arrangements, including valuation of IP, has been limited to the Danish documentation rules, which are based on the OECD Transfer Pricing Guidelines, as well as a set of fairly crude guidelines for determining goodwill values.

The goodwill guidelines were based on historic financial results, and did not take into account expectations around future returns. Accordingly, Danish taxpayers have been faced with a situation whereby they increasingly found themselves under audit for historic transactions involving IP, while having to rely on very limited guidance on those types of transactions. Further, the experience of many taxpayers has been that, during the audit process, the tax authorities required very detailed analysis and support for those transaction types. This resulted in uncertainty related to both audits and ongoing IP arrangements, for which Danish taxpayers had limited and ambiguous guidance.

Valuation guidelines

The new guidelines intend to cover both transfers of entire businesses and transfers of individual intangible assets. However, the focus of the guidelines is on the transfer of a business, and guidance is limited when it comes to valuation of individual intangible assets.

The guidelines include a summary of historic approaches to valuation for Danish tax purposes, including the goodwill guidelines mentioned above. Based on this summary, the guidelines conclude that an approach to valuation based on historic data should be discarded in favor of approaches based on expected future income. Accordingly, the guidelines describe various forward-looking approaches to valuation, including:

- Cost-based approaches
- Discounted cash flow (DCF) models
- Economic value added (EVA) approaches
- Valuation methods using earnings multiples and
- The relief from royalty method.

This part of the report does not offer any substantial recommendations, but rather serves as a summary of traditional valuation approaches. Further, this part of the report does not put these approaches in the context of the OECD Guidelines nor the Danish documentation rules. The descriptions are fairly typical, but include comments on various topics that may be subject to some controversy within transfer pricing, including:

- Elements in determining a reliable interest rate for discounting purposes
- Buyer versus seller perspective and
- Reliable tax rates for purposes of determining after-tax cash flows.

Although the valuation guidelines mention these and other relevant issues, they do not include any guidance or recommendation. For instance, the issue of asset-specific risk and determination of asset-specific interest rates for DCF purposes is not covered.

In the final part of the report, the tax authorities provide some recommendations in the area of documenting valuations for Danish transfer pricing purposes. These recommendations are very broad and may be considered to significantly increase the documentation requirements for related-party transactions.

Summary

The new guidelines significantly change the generally accepted approaches to valuing individual intangible assets, as well as entire businesses, for Danish transfer pricing purposes. The guidelines focus on forward-looking valuation approaches, which are generally in line with the methodologies followed by most taxpayers. However, the documentation requirements included in the guidelines are broad and extensive and not well-defined. Accordingly, the guidelines should be considered in detail when contemplating IP or business reorganizations involving Danish groups or entities.

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Vietnam reveals use of secret comparables to make deemed tax adjustments

A recently released Official Letter from the Vietnamese General Department of Tax (GDT)-Tax Policy Department, signals the use of secret comparables to make deemed tax adjustments on audit.

In OL No. 4530/TCT-CS, dated 27 November 2008, the GDT instructs the Phu Yen Province Department of Taxation to make a deemed taxable income or deemed tax adjustment to a Vietnamese auto manufacturer and assembler partially owned by a foreign entity. The company under audit imported components from related parties (as broadly defined in the Vietnamese transfer pricing rules) in China and Malaysia to assemble trucks up to seven-tons and vans of up to 16 passengers in Vietnam. To develop the information for the deemed tax adjustment, the GDT requests that several other provincial tax authorities provide information related to revenue and taxable income of similar companies in the automotive industry. The secret comparable information derived from the prior tax audits will be used to develop the ratio of corporate income tax to revenue and then to make a deemed tax adjustment to the company under audit. The sources the GDT could access to collect such information includes, but not limited to:

- Minutes or reports from tax inspections of other companies;
- Tax finalization profile of similar automobile manufacturers and assemblers; and
- Data from the Vietnam Automobile Manufacturers Association (VAMA).

To obtain comparable data from the other provincial tax offices, the national GDT set the following criteria: similar product models (including size, number of seats, price range), using imported material from the same related providers' countries; and similar operational functions (manufacturing and assembling) for similar years.

Tax policy department

The source of the OL is also significant. The Tax Policy Department (TPD) is one of the offices reporting to the director of the GDT. Its mission is studying and proposing the formulation of strategies to reform government policies on taxes, charges, and fees (collectively referred to as taxes), and elaborating, amending, supplementing, or finalizing legal documents on tax policies and administration under assignment from the Vietnamese Minister of Finance. Consequently, TPD is in charge of assisting the Director of the GDT to provide guidance to and direct local tax authorities at all levels in the uniform implementation of Vietnam's tax laws and regulations. OLs issued by the GDT with TPD's support and addressed to all or several relevant local tax departments could be considered a legal supplement to official tax circulars, which provide guidance for implementation of relevant tax decrees promulgated by Vietnamese Prime Minister.

Recommended taxpayer actions

The two OLs released so far, including the one discussed herein, have both dealt with automotive industry suppliers and assemblers. Automotive industry companies should review their transfer pricing policies for purchase of components and for sales of assembled vehicles and review their transfer pricing documentation. Companies in other industries with recurrent losses from transactions with related parties should also increase the attention paid to transfer pricing policies and documentation.

Korean National Tax Services releases second APA annual report

The Korean National Tax Service (NTS) on September 4 released its second annual report on the operations of the NTS's Advance Pricing Agreement (APA) program. The second annual report updates the key statistical information provided in the first annual report, issued in 2008. Taxpayers and tax practitioners can see that the general trend in most of the 2008 program statistics is consistent with the 2007 information. But the second annual report discloses information that was not revealed in the first annual report.

Highlights of the 2008 APA program statistics

Korea concluded its first APA in 1997 with the United States, and by the end of 2008, a total of 106 cases had been concluded. The highlights of the 2008 statistics include the following:

- New statistics have been released for the first time on rollback terms, breakdown of completed cases involving foreign parents versus Korean parents, completed APAs on a counterparty country basis, and cumulative data on key program statistics;
- Thirty-five new applications (13 unilateral, 22 bilateral) were filed and 30 new cases (16 unilateral, 14 bilateral) were completed in 2008;
- The average completion time required for an APA was 18 months for unilateral APAs and 27 months for bilateral APAs;
- The transactional net margin method (TNMM) and operating margin were the overwhelming favorites for methods and profit level indicators used in 2008;
- The majority of unilateral and bilateral APAs closed in 2008 included a five-year term. Of the 30 completed cases in 2008, 25 cases were concluded with a five-year term. Of the total 106 APA requests completed on a cumulative basis, 71 cases were concluded with five-year terms;
- Of the 106 completed cases, 78 cases are for Korean taxpayers with foreign parents or affiliates (inbound) and 28 cases are for Korean parents with foreign subsidiaries (outbound);
- Forty-three percent of APAs (13 out of 30 cases) completed in 2008 were concluded with the United States, but the number of bilateral APA applications with China is growing fast; and
- A China team has been formally established within the APA program.

Application and completion

As shown in Table 1¹⁵, 35 new applications were filed during 2008, the highest number of applications on an annual basis in the Korean APA program's history. Of the 35 new applications, 22 are for bilateral APAs, a significant increase compared to the 10 cases filed on an annual average basis over the 2003-2007 period. However, the number of new applications for unilateral APAs in 2008 decreased from 19 applications in 2007 to 13 applications in 2008. These figures imply two things: first, taxpayers have accumulated enough experience through unilateral APAs and moved on to take more proactive approaches to eliminate double taxation exposures in multiple jurisdictions at the same time. Second, the taxpayers' level of confidence in the NTS capabilities and capacity to handle multiple bilateral APA cases has significantly increased.

¹⁵ Source: NTS 2008 APA Annual Report.

Table 1: Application and completion of APAs

Year	Unilateral APAs		Bilateral APAs		Total	
	Applied	Concluded	Applied	Concluded	Applied	Concluded
2002 and before	9		24	10	33	10
2003	3	2	4	3	7	5
2004	6	7	10	3	16	10
2005	15	4	10	3	25	7
2006	12	8	12	16	24	24
2007	19	13	13	7	32	20
2008	13	16	22	14	35	30
Total	77	50	95	56	172	106

Timeliness

A quick look at Table 2¹⁶ reveals an alarming fact. The average length of time to complete bilateral APAs in 2008 increased to 27 months from 17 months in 2007. This figure could be misleading, unless caution is taken in understanding the numbers. The increase in time to completion is largely due to the fact that a number of pending cases were carried over from 2007 to 2008. In addition, the number of bilateral cases that were completed within 24 months has increased to 25 cases as of the end of 2008, from 14 cases as of 2007 on a cumulative basis. In other words, 11 of the bilateral cases that were concluded in 2008 took less than 24 months from the date of application. Thus, taxpayers should read between the lines, although it appears at first glance that the average completion time for bilateral APAs in 2008 has lengthened substantially.

Table 2: Completion times

	Average time for APAs concluded in 2007	Average time for APAs concluded in 2008	Average time for APAs concluded for all years	Time Taken (from receipt of proposal to conclusion)			
				Total	2 yrs or less	More than 2~years & less than 3 years	More than 3 years
Unilateral APAs	20 months	18 months	20 months	50	50	0	0
Bilateral APAs	17 months	27 months	30 months	56	25	17	14

For unilateral APAs, the time frame allowed under the Law for the Coordination of International Tax Affairs (LCITA) from the date of application to completion of the case is two years. The good news is that the average time to complete a unilateral APA continues to decrease. In 2008, the average time to complete a unilateral APA was 18 months, compared to 20 months in 2007.

In sum, on a cumulative basis, approximately 75 cases of all 106 concluded cases were completed within a 24-month period. All 50 unilateral cases were completed within two years, with no exception. The remaining 31 cases that took more than two years are all bilateral, which requires much more time to exchange information between the competent authorities involved.

¹⁶ Source: NTS 2008 APA Annual Report.

Table 3: Covered transaction

Transaction Type	Tangible Property		Intangible Property		Services ¹⁷	
	2007	2008	2007	2008	2007	2008
Number of APAs	12	20	3	3	5	7
Cumulative Total	77		7		22	

Of the 30 cases concluded in 2008, 20 cases cover taxpayers' tangible property transactions, which top the list of covered transactions. Since the APA program has been in place, 77 cases out of the 106 completed cases have involved the transfer of raw materials, semifinished goods, or finished products between related parties.

The statistics on intangible transactions covered by APAs primarily involve the payment of royalties for the use of technologies, trade names, and trademarks. The 2008 report explains that the intercompany intangible property transactions that are related to more significant tangible property transactions are classified as transfers of tangible property. All three cases concluded in 2008, therefore, cover only the transfer of intangible property.

Of the intercompany services APAs, 12 cases out of all 22 completed cases have been concluded during the 2007-2008 period. According to the 2008 annual report, the seven services cases that were concluded in 2008 involve services related to sales support (before and after sales), management support and consulting, and loan transactions.

Terms and rollbacks

Table 4: Terms (including rollbacks) in the completed APAs

Term in Years	Unilateral		Bilateral		Total		Cumulative Total as of 2008	
	2007	2008	2007	2008	2007	2008	Unilateral	Bilateral
1								
2							1	2
3		1	1	3	1	4	11	8
4	2	1			2	1	1	5
5	4	14	12	11	16	25	37	34
6	1				1			4
7								2
8								1
Total	7	16	13	14	20	30	50	56

Table 5: Rollback years in the completed APAs

Rollback Years	Unilateral 2008	Bilateral 2008	Cumulative Total as of 2008		
			Unilateral	Bilateral	Total
1	6	1	6	1	7
2	3	2	3	2	5
3	4		5		5
4		1		1	1
5		1	5	9	14
6				1	1
Total	13	5	19	14	33

Consistent with prior years, the majority of unilateral and bilateral APAs closed in 2008 included a five-year term. Of the 30 cases concluded in 2008, 25 cases included a five-year term. Of the total 106 APA requests completed on a cumulative basis since the inception of the program, 71 cases have been concluded with five-year terms.

¹⁷ Includes financial transactions.

Rollback data, which were not disclosed in the first annual report, provide useful information regarding the number of APA requests that applied for rollbacks, and the most common rollback terms applied to open tax years. Of the total 106 completed cases, rollbacks were requested for 33 applications. Of the 30 APAs completed in 2008, 18 cases were concluded with rollback terms.

There is an interesting fact to note in the rollback information. Although the information reveals that the requests with rollbacks for five years were the most common on a cumulative basis, this was clearly not the case in 2008. Only one case out of the 18 completed rollback cases included a five-year term. In the absence of detailed guidance or information, it is difficult to speculate on what has happened,. It is worth noting that 19 rollback cases were for unilateral APAs and 14 cases were for bilateral APAs. It is reasonable to think that rollback negotiations would be much easier in unilateral cases than in bilateral cases.

One figure regarding rollbacks in unilateral APAs is misleading. According to Table 4, all 50 completed unilateral APAs were concluded with a five-year term or less, including rollbacks. Table 5 shows, however, that five-year rollbacks were approved for the five unilateral cases. This is not consistent with what the LCITA allows, that is., the maximum three years for rollback for a unilateral APA, although there were a few exceptions. The authors believe the NTS will soon correct this specific figure information in Table 5.

Transfer Pricing Methods and PLIs

Table 6: TPMs in the completed APAs

TPM used	Unilateral		Bilateral		Total		Cumulative Total 2008	
	2007	2008	2007	2008	2007	2008	Unilateral	Bilateral
Comparable Uncontrolled Price								1
Resale Price Method								5
Cost Plus Method	3	1			3	1	4	1
Profit Split Method	1	1			1	1	3	1
Other Reasonable Methods							2	3
Transactional Net Margin Method	9	14	7	14	16	28	41	45

Table 7: PLIs used for TNMM

PLI used	Unilateral		Bilateral		Total		Cumulative Total 2008	
	2007	2008	2007	2008	2007	2008	Unilateral	Bilateral
Operating Margin	2	7	2	6	4	13	18	22
Full Cost Markup	3	2	1	2	4	4	5	4
Value-added Cost			1		1			1
Return on Asset	1			1	1	1	2	1
Berry Ratio	3	5	3	5	6	10	16	17
Total	9	14	7	14	16	28	41	45

The transactional net margin method (TNMM) was the overwhelmingly selected method in 2008. Of the 30 cases completed in 2008, 28 cases (over 93 percent) used the TNMM, One unilateral APA used the cost plus method (CPM) and another unilateral APA used the profit split method (PSM). For the statistics in Table 3 and Table 6 taken together, it might be reasonable to speculate that the TNMM (not the PSM) was also used in at least two of the three completed cases involving the transfer of intangible property in 2008.

Looking at the cumulative data of the APA program, it is clear that the traditional transaction methods were not the favorite choice. For example, the comparable uncontrolled price method (CUP) was, not surprisingly, used only once, most likely due to the lack of reliable third-party information.

Of all profit level indicators (PLIs) used in the application of TNMM, operating margin tops the list in 2008. The 13 TNMM cases were based on operating margin. The Berry ratio, which supported 10 cases, is the second most frequently used PLI. A mark-up on total costs was also used in four cases. It is worth noting that the LCITA no longer recognizes the Berry ratio

as one of the PLIs due to the amendment of the Korean regulations, effective February 4, 2009. Although a bit cautious, the Berry ratio tends to be the favorite PLI for APAs covering services; in fact, the seven completed cases involved intercompany services transactions (See Table 3).

Covered industries

Table 8: Covered industries

Type of Business	Unilateral		Bilateral		Total		Cumulative Total 2008	
	2007	2008	2007	2008	2007	2008	Unilateral	Bilateral
Computer/LCD/Mobile phone	2	1	3	2	5	3	3	10
Automobile/Transportation Equipment	1	1		1	1	2	2	6
Chemicals/ Pharmaceutical	2	2		4	2	6	8	6
Finance/Securities	3	3			3	3	7	
Apparel	1				1	0	1	2
Construction/Plant	1				1	0		
Food & Beverage		3			0	3	4	5
Publishing/ Software				2	0	2		4
Machinery	1	2		1	1	3	6	3
Service		3		1	0	4	8	4
Wholesale	1	1	2	1	3	2	10	5
Semiconductor	1		2	2	3	2	1	11
Total	13	16	7	14	20	30	50	56

The second APA annual report includes a new feature: a list of industries covered in the completed APAs. These include chemicals/pharmaceutical and publishing/software industries for unilateral cases, and food and beverage industry for bilateral cases.

The top six industries in the APA program in 2008 include chemicals/pharmaceutical products with six cases, the services industry with four cases, computer/LCD/mobile phone products with three cases, financial/securities with three cases, the food and beverage industry with three cases, and machinery and equipment with three cases.

The financial and securities sectors have topped the list of unilateral APAs concluded in 2007 and 2008, but no concluded bilateral APAs. One possible reason is that foreign related parties involved in cross-border financial dealings are located in jurisdictions such as Hong Kong that have not entered into tax treaties with the Republic of Korea (South Korea). In addition, because the NTS has been increasingly aggressive in transfer pricing audits in the financial services industry, taxpayers have started to use unilateral APAs to eliminate potential disputes that might arise in the event of an audit.

Foreign vs. Korean parents

Table 9: Ownership type – inbound vs. outbound

Transaction Type	2008			Cumulative Total		
	Unilateral	Bilateral	Total	Unilateral	Bilateral	Total
Inbound: Foreign companies and Korean subsidiaries	15	9	24	48	30	78
Outbound: Korean parents and foreign subsidiaries Foreign Subsidiary(ies)	1	5	6	2	26	28

This information was not disclosed in the first annual report, and is new in the second annual report. Of the 106 completed cases, 78 cases involve Korean taxpayers with foreign parents or affiliates (inbound) and 28 cases involve Korean parents with foreign subsidiaries (outbound). The table shows that the overwhelming majority of outbound cases – 26 out of the 28 cases – were concluded on a bilateral basis. Only a few Korean parents are responsible for almost all outbound bilateral cases. For inbound cases, 48 cases out of the 78 cases are unilateral APAs. This is not surprising, because a unilateral APA is more cost- and time-effective for Korean taxpayers as an audit defense strategy than a bilateral APA.

Counterparty countries

Table 10: Concluded APAs by country as of December 31, 2008

Country	Unilateral	Bilateral	Total	Cumulative Total		
				Unilateral	Bilateral	Total
USA	5	8	13	12	32	44
Japan	1	3	4	10	12	22
China	1		1	2	2	4
U.K	1		1	3	3	6
Singapore	1		1	3		3
Hong Kong	1		1	8		8
Switzerland	3	2	5	4	3	7
Sweden				3		3
Australia					3	3
Others	3	1	4	5	1	6
Total	16	14	30	50	56	106

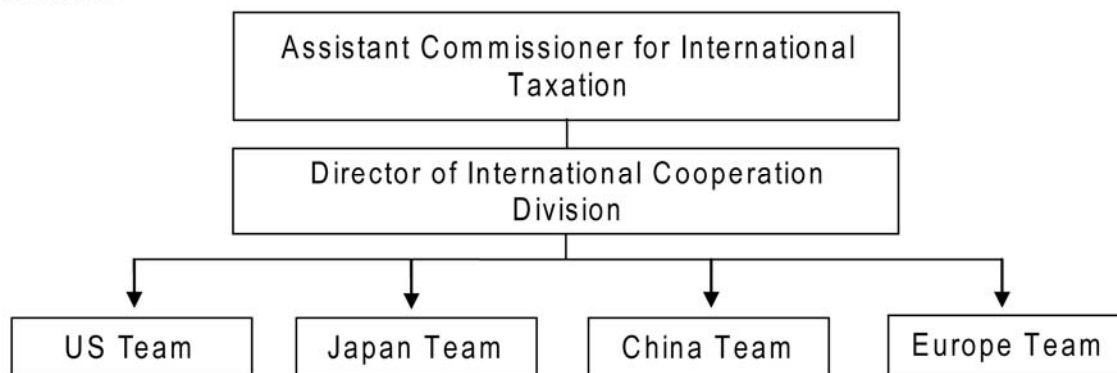
Information regarding counterparty countries was not disclosed in the first annual APA report. A total of 44 cases (12 unilateral and 32 bilateral cases) involved the United States, making it Korea's most frequent APA counterparty. Japan follows the United States, with 10 unilateral and 12 bilateral cases. Taken together, the two countries account for 62 percent of the total 106 cases for all years, and 57 percent (17 cases) in 2008. This is mainly due to the fact that the United States and Japan have long been Korea's major trading partners. A point to note here is that although China, Korea's number one trading partner since 2003, is relatively new to the list, with four cases, China is expected to be one of the leading countries in the list soon. Hong Kong is in third place as of 2008 with 8 unilateral APA cases. These cases primarily involve services transactions dealing with financial products.

Table 11: Pending APAs by country as of December 31, 2008

Country	Unilateral	Bilateral	Total
USA	4	9	13
Japan	7	9	16
China		5	5
France		4	4
Germany	1	5	6
Canada		2	2
U.K	4		4
Singapore	4		4
Switzerland	2	3	5
Others	5	2	7
Total	27	39	66

Not surprisingly, Japan and the United States top the list of countries with pending cases in 2008, but it is notable that China came fourth, with five pending cases for bilateral APAs. It is a bit early to say that this creates a trend for APAs with China, but it becomes clear that Korean parents tend to actively seek bilateral APAs as a strategy to eliminate uncertainties that otherwise lie ahead in transfer pricing audits in China.

APA Team



The International Cooperation Division is responsible for the APA program, as well as for mutual agreement procedures (MAPs). The division consists of four teams, each responsible for a specific country or region: there is a U.S. team, a Japan team, a China team, and a Europe team. Cases for all other countries are assigned to the members of the four teams on a case-by-case basis. In general, the members' industry experience relevant to the cases, as well as their workload, is taken into account in the assignment of cases. Interestingly, the China team was not formally present in the division until the second annual report was released. The official launch of the China team clearly shows the division's country priority from a transfer pricing perspective, given the fast-growing trade and investment flows between the two countries.

Conclusion

The second APA annual report reveals new information, as well as more details on the key APA program statistics. This provides a better picture of the trends in the APA program, and where the program's priorities are and will be in the future.

The TNMM and operating margin are still the overwhelmingly favorite method and PLI, respectively, but the report does not provide statistics on the type of range or point used that would be particularly useful to taxpayers, for example, as to whether full range, interquartile range, floor, or ceiling has been used. As was the case in the first annual report, the second annual report does not offer any information about the number of renewal applications and the amount of time it takes to complete a renewal APA. Nor is there any discussion regarding how differences in functions and risks were adjusted to improve reliability of the analyses in APA applications. Nevertheless, this second annual APA report has clearly left an impression that the NTS is working on providing more detailed information and will bring more useful information in the next report.

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Transfer pricing adjustments in tax holiday years can result in Vietnamese corporate tax liability

Recent official letters (OLs) issued by Vietnam's Ministry of Finance have illustrated the ability of the Vietnamese General Department of Taxation (GDT) to levy corporate income tax on tax adjustments resulting from tax audits of tax holiday and tax incentive years. Although the tax adjustments described in the OLs are not clearly labeled as transfer pricing tax audit adjustments, the principles used to levy tax in such years apply equally to TP adjustments. TP adjustments arising in a tax audit of an incentive tax year will more likely result in tax payable than other typical audit tax adjustments (for instance, denial of deductions for advertising and promotion expenses) due to the potentially large magnitude of TP adjustments. Hence, taxpayers in tax incentive years now risk tax liabilities on TP tax audit adjustments, even if the year is a zero percent tax year under an incentive agreement.

Circular 134/2007/TT-BTC (dated 23 November 2007 and issued by the Ministry of Finance) provides guidelines on implementation of Decree 24/2007/ND-CP, which deals with clawback of underpaid corporate income tax (CIT). Circular 134 provides that when a tax audit of an entity entitled to CIT incentives increases the amount of taxable income, the rate of tax imposed on the taxable income adjustment will be at the overall incentive rate or the full current rate of CIT (28 percent in 2007 and 2008). These provisions apply only for tax years 2007 and 2008 and currently do not apply to any other tax years due to the specific time periods during which the circular was in force.

Official Letter No: 3090/TCT-PC (dated 30 July 2009) does not discuss the nature of the tax audit adjustment involved, but the national office of the GDT instructs the provincial tax authorities to apply the tax law cited above for the years 2007 and 2008. Although a taxpayer was entitled to a CIT reduction or exemption, the provincial tax authority was instructed to levy tax using the overall incentive rate and not the 50 percent reduced rate applicable to the audit year. In addition, the OL states that if tax evasion is involved, penalties of one to three times the amount of tax can be additionally assessed.

Example

A typical tax incentive period in 2007 and 2008 might have been as follows:

- 12 years with an overall incentive rate of 15 percent starting with the first revenue year;
- Three years of complete CIT exemption (zero percent tax rate or 100 percent reduction) starting in the first profit year; and
- 50 percent of the overall incentive rate (that is, 7.5 percent rate) for the following seven years.

For example, assume a company's first revenue year was 2006, and that it had start-up losses in 2006 and 2007, with 2008 as its first profit year based on its returns as filed. The company would have commenced its three years of CIT exemption (zero percent tax rate) in 2008, even though it might have used carryforward tax losses to offset the taxable profit in 2008. A tax audit by the GDT of 2007 and 2008 eliminates the tax losses in those years as a result of TP adjustments and the denial of certain other claimed deductions. The 2007 taxable year is now the first profit year, and the three years of complete CIT exemption now are 2007, 2008, and 2009.

However, under the tax law in effect for 2007 and 2008, the taxable income resulting from the tax audit adjustments, including TP adjustments is *ineligible* for the zero percent tax rate under the tax incentive period and, instead, results in tax payable at the overall 15 percent tax incentive rate. Note that such a company does obtain the zero percent rate for 2009 (which is now the third year of the 100 percent tax holiday) and an audit for 2009 would not result in application of the 15 percent rate to any adjustment, because the circular applies *only* to 2007 and 2008. Any tax audit adjustment for 2009 should be at the zero percent tax rate of the third year of complete CIT exemption, and not result in a tax liability, under the GDT's current approach.

Many companies in Vietnam in tax incentive periods assume that a corporate tax audit will not result in tax payable if an adjustment relates to a CIT exemption year, or a lesser tax payable in the 50% reduction of incentive rate years. Hence, many taxpayers tend to ignore the transfer pricing rules for reporting related-party transactions, and have not undertaken the necessary transfer pricing documentation for such tax years. However, recent tax audit activity as shown in the OLs indicated that for tax years 2007 and 2008 there is a real risk of tax payable at the higher overall incentive rate, rather than at a reduced incentive rate.

Recommended taxpayer actions

Taxpayers in tax incentive periods for the 2007 and 2008 tax years should reassess their transfer pricing and other tax adjustment risks and perform a tax health check for those years. When a real risk of a substantial tax audit adjustment exists, taxpayers should consider preparation of transfer pricing documentation or voluntary disclosure to the GDT prior to the commencement of a tax audit.

U.S. companies subject to FIN 48 procedures for uncertain tax positions should reassess the amount of tax exposure of their Vietnamese operations using the applicable tax incentive rate to quantify the amount that is more likely than not to be paid in the event of a tax audit.

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Belgium introduces new reporting obligations for non-arm's length transactions and off-balance sheet arrangements

Belgium's Royal Decree of 10 August 2009 (published in the Official Gazette of 24 August 2009) requires corporations to report certain non-arm's length transactions in the annexes to their annual accounts. In addition, corporations will have to provide some information regarding their off-balance sheet arrangements.

Non-arm's length transactions

The Royal Decree introduces a requirement for corporations to report non-arm's length transactions with related parties in their annual accounts. This requirement applies only to "material" transactions, although the decree does not provide further guidance as to what constitutes a "material" transaction. For the meaning of the term "related party," reference is made to the definitions in IAS 24, §9 (as imposed by EC Directive 2006/46).

The type of transactions that must be reported depends on the nature of the company. An extensive reporting obligation applies to:

- Corporations listed on a stock exchange;
- Corporations whose shares are traded on a Multilateral Trading Facility; and
- Corporations that meet more than one of the criteria to be considered a large group under article 16, §1 of the Belgian Companies Code.

In principle, these corporations must report all non-arm's length transactions with related parties. However, the Royal Decree provides an exemption for transactions between group members when the subsidiaries involved are wholly owned by a member of that group.

For qualifying transactions, the following information must be reported:

- The amounts involved in the transactions;
- The nature of the relationship with the related parties; and
- All other information needed to ensure an accurate view of the financial position of the corporation.

Corporations that do not meet any of the above criteria are subject to less stringent reporting requirements: they only have to report direct and indirect transactions between the company and its major shareholders and between the company and its leadership (for instance, members of the board).

Off-balance sheet arrangements

The Royal Decree also requires that corporations report the nature and business purpose of off-balance sheet arrangements (such as transactions with special purpose entities) in the annexes to the financial accounts, provided the arrangements are material and the related risks and benefits can influence the assessment of their financial position. In addition, listed corporations, corporations whose shares are traded on a Multilateral Trading Facility, and corporations that meet more than one of the criteria to be considered a large group under article 16, §1 of the Companies Code are required to quantify the financial impact of the off-balance sheet arrangements on their financial position.

Effective date

Both reporting obligations apply to accounting periods starting on 1 September 2008. The obligations imposed by the Royal Decree imply that qualifying corporations should be able to demonstrate to their statutory auditors that they were not involved in any “material” non-arm’s length transactions. Affected corporations should sufficiently document transactions with related parties and off-balance sheet arrangements, because the executives responsible for and involved in the financial accounts may be held liable for non-compliance with the obligations.

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