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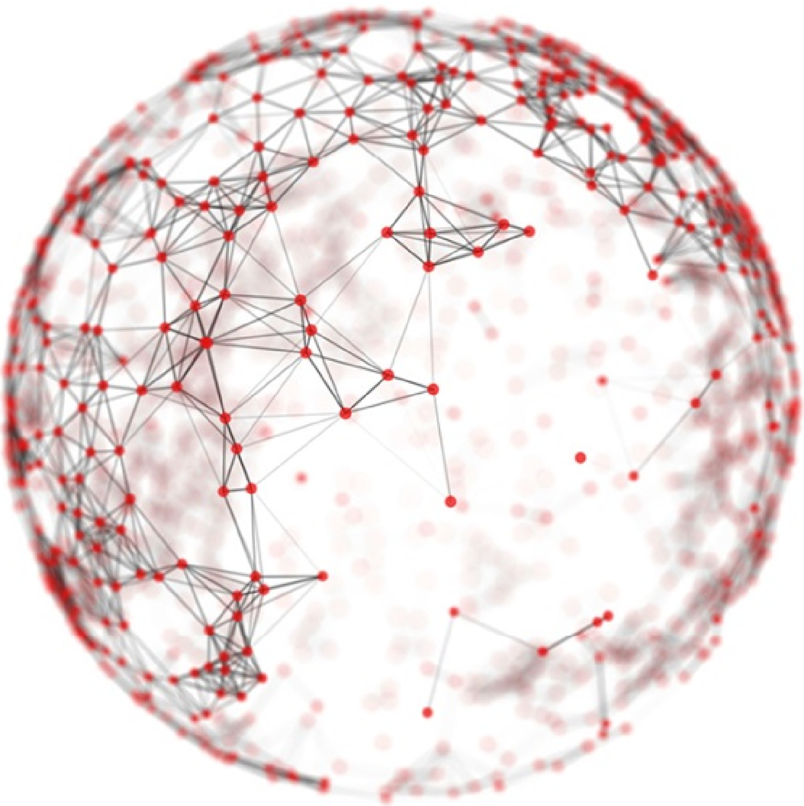
Transfer Pricing Newsletter



MAY 2015

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Introduction

Practical consequences of not having a transfer pricing documentation

While transfer pricing documentation requirement is not a new issue, it remains more than ever topical. Over the last years, many countries introduced more stringent regulations in that framework. Furthermore, Action 13 of BEPS is about re-examining transfer pricing documentation. Action 13 aims at developing rules regarding transfer pricing documentation to enhance transparency for tax administrations.

In this context which claims for increased documentation obligations, practical consequences of not having a transfer pricing documentation are described for several jurisdictions.

CMS Transfer Pricing Team

Focus

France - Practical consequences of not having a transfer pricing documentation

Since 2010, legal entities established in France and belonging to a large group are subject to the obligation to prepare a transfer pricing documentation that must be remitted to the French tax authorities ("FTA") at the beginning of a tax audit (in the following, the "Full TP Documentation")[1] [2]. This requirement mainly concerns companies (i) which have an annual turnover (taxes excluded), or gross balance sheet asset value of at least EUR 400 million, or (ii) which control or are controlled by, directly or indirectly, an entity exceeding these thresholds.

This obligation is codified under art. L13 AA and L13 AB of the French Tax Procedure Code (*Livre des Procédures Fiscales*, "FTPC"). Under article L 13 AA[3], the “standard” content of the Full TP Documentation encompasses the two levels of documentation proposed by the Code of Conduct drawn up by the EU Joint Transfer Pricing Forum, namely: (i) general information concerning the group of associated enterprises (the concept of a masterfile under the Code of Conduct); and (ii) specific information concerning the associated enterprise subject to a tax audit (the concept of country-specific documentation under the Code of Conduct). The Finance Bill for 2014 has expanded the list of information to provide: in addition to the elements listed above, a Full TP Documentation should include a copy of the rulings obtained from foreign tax authorities by associated enterprises. This new rule applies to Full TP Documentations relating to tax years closed after 1 January 2014.

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[1] Entities subject to the Full TP Documentation requirement must also file with the FTA, within six months following the deadline for filing their annual income tax return, a document which must contain some of the elements included in the Full TP Documentation.

[2] For entities outside of the scope of this legislation, there is no formal transfer pricing documentation requirement. However, under article L13 B of the FTPC, if the FTA gather elements, in the course of a tax audit, which tend to indicate that the enterprise in question has made an indirect transfer of profits to a related non-French entity, they may require that certain documents and information be produced. The taxpayer then has a maximum of three months to provide the information required. In order to comply with this time frame, French companies (not subject to the documentation requirement) whose transactions with foreign associated companies are significant generally document their transfer pricing policy in advance.

[3] Under article L 13 AB of the FTPC, “additional” documentation must be provided where transactions are undertaken with one or more associated enterprise(s) established in a non-cooperative State or territory (within the meaning of article 238-0 A of the FTC; the list of such States or territories is updated on a yearly basis). The “additional” documentation should include, for each associated enterprise, all documents required from companies which are subject to corporate income tax, including the balance sheet and profit and loss account drawn up in accordance with French GAAP (as provided for by the French CFC rules - article 209 B of the FTC).

From a practical standpoint, the absence of Full TP Documentation can (i) first have procedural consequences on the tax audit and trigger the application of penalties for the absence of transfer pricing documentation and (ii) in addition, render the FTA more suspicious and less flexible, both on transfer pricing issues and other aspects reviewed during the tax audit of the company.

Timing to provide the Full TP Documentation – Penalties in case of non-compliance

The Full TP Documentation must be made available to the FTA on the date the tax audit of the French entity begins, i.e. on the date of the first on-site arrival of the tax inspector as mentioned in the notification of tax audit.

Where the audited enterprise does not provide the Full TP Documentation, or where it provides incomplete documentation, the FTA must send a notice to provide or, as the case may be, complete the documentation, within a 30-day period. This notice must specify the documents or complementary information required and the penalties applicable in case of non-compliance.

It should be noted that the Finance Bill for 2015 has modified and potentially increased the penalty applicable in case of non-compliance with this obligation (article 1735 ter of the FTC): if the audited enterprise does not provide the Full TP Documentation timely to the FTA (or if it provides incomplete documentation within the period mentioned above) and depending on the seriousness of the non-compliance, the enterprise is liable to a penalty that can reach the highest of the following amounts:

- 0.5% of the amount of the transactions for which the documentation was missing or incomplete,
- 5% of the transfer pricing reassessment made by the FTA to the transactions for which the documentation was missing or incomplete, or
- EUR 10,000.

Other practical consequences of the absence of Full TP Documentation

Obviously, the absence of Full TP Documentation is likely to increase the suspicion of the FTA vis-à-vis the audited enterprise. This may trigger:

- A more thorough review of the transfer pricing policy of the taxpayer: in particular, via long list of questions in relation to transfer pricing matters, the FTA may somehow "force" the taxpayer to provide during the audit most of the information that should have been included in the Full TP Documentation.
- A higher risk that the FTA perform a reassessment in relation to the transfer pricing policy of the taxpayer.
- More generally, a higher risk that the FTA, also for other tax matters, review more thoroughly the positions taken by the taxpayer and perform reassessments.

In such a context, there is also a higher risk that, in addition to the documentation-related penalties above, the FTA apply so-called "bad faith" penalties amounting to 40% of the additional tax due upon the reassessments made. In principle, the application of such penalty would prevent the taxpayer from engaging – as the case may be – mutual agreement or arbitration procedures allowing to cancel the double taxation resulting from a transfer pricing reassessment.

Nowadays, in nearly all tax audits, the FTA request their Full TP Documentation to taxpayers. The recent extension of the list of information to provide and changes to the penalties applicable also show the interest of the FTA for this documentation. Because of the potential direct and indirect consequences described above, it is clearly advisable to prepare a Full TP Documentation sufficiently in advance so as to have it ready at the starting date of the tax audit. Such preparation can also be an opportunity to review and render more robust a transfer pricing policy.

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Germany - Practical consequences of not having any transfer pricing documentation

1. Submission of transfer pricing documentation based on German tax law

Based on German tax law, firms have to submit appropriate transfer pricing documentation, which in essence must not be unusable, within sixty days upon the tax auditor's request during a tax audit. In many cases, such a request is expressed at the very beginning of the tax audit. Therefore, in contrast to many other countries, in Germany it is not required to have transfer pricing documentation already available when the tax returns of the fiscal year in question are submitted to the tax authorities. However, the sixty days' time frame is generally too short to set up appropriate transfer pricing documentation. From a practical point of view, it is advisable to produce appropriate transfer pricing documentation when tax balance sheets and tax returns are prepared.

Furthermore, the time frame of sixty days is reduced to thirty days for extraordinary business transactions (e.g. restructuring or change of sales systems) or similar matters of major importance.

An extension of the above-mentioned time frames may only be granted upon application and the presentation of good reasons.

2. No clear definition for minimum requirements of transfer pricing documentation

In practice, it is still not quite clear when documentation is 'in essence unusable'. An official interpretation by the German tax authorities is not available. In order to determine what kind of documentation is necessary, it has been suggested to distinguish between the documentation required by law (section 90 paragraph 3 German General Tax Code – *Abgabenordnung*) and the more extensive documentation requirements included in the regulations of 13 November 2003 (BStBl I, 2003, 2296). As a consequence, there should be good reasons to limit the volume of documentation, which is needed for reasonable documentation (i.e. not being in essence unusable) to those requirements explicitly mentioned by law (but not by the regulations). Furthermore, different approaches have been taken in literature and different percentages have been suggested in order to determine what 'in essence unusable' could mean. One such approach that has been taken to describe the minimum transfer pricing documentation necessary is as follows:

- The overview of inter-company transactions needs to include about 50% of all cross-border transactions with related parties.
- With respect to each cross-border transaction or each kind of such transaction, a function and risk analysis has to be provided (generally only) for the German taxpayer.
- An explanation on how transfer prices were determined, including an explanation on the choice of transfer pricing methods, has to be available.

- Documentation should show serious efforts for determining appropriate transfer prices.

Based on this view in literature, transfer pricing documentation should qualify as being sufficient, if the above-mentioned requirements are fulfilled; thus, penalties should be avoided. However, the German tax authorities have not yet accepted any of these criteria. Therefore, a substantial risk remains in order to define the minimum requirement for a (still) acceptable transfer pricing documentation, and a case-by-case approach has to be taken.

3. Potential income adjustments and tax assessments in case of not having appropriate transfer pricing documentation available

If the taxpayer does not produce transfer pricing documentation, or the transfer pricing documentation is in essence unusable, or if it is recognized that the transfer pricing documentation has not been created in due time as required by law, it will be assumed that the income of the taxpayer is higher than reported. Thus, if the documentation is insufficient, the burden of proof is shifted to the taxpayer.

The taxpayer is permitted to rebut this legal presumption. If the taxpayer cannot provide proof to the contrary, the tax authorities are allowed to estimate or to increase the tax basis in line with section 162 paragraph 3 sentence 2 German General Tax Code (Abgabenordnung). In this respect, the tax authorities are allowed to carry out their own calculations. If there is a range of prices, the tax authorities may choose the point of the price range that is most disadvantageous to the taxpayer. Thus, the tax basis may be increased up to the upper range of possible results (to the burden of the taxpayer), resulting in 15.825% corporation tax including solidarity surcharge and about 7-17.15% local trade tax.

Generally, an income increase may be based on different legal grounds:

- ***Hidden profit distribution (constructive dividend)***

In case of a hidden profit distribution, the income of the German corporation would be increased. A hidden profit distribution is defined as a decrease of assets or a prevented increase of assets of a corporation which is caused by the relation of the company to its shareholder and the decrease or prevented increase affects the corporation's income. A decrease or prevented increase of profits is based on the relationship of the shareholder to the corporation, if a prudent and diligent managing director, under the same facts and circumstances, would not have accepted the decrease or prevented increase of assets vis-à-vis a person who is not a shareholder.

Furthermore, a hidden profit distribution generally triggers withholding tax on dividends, similar to an ordinary profit distribution. The local withholding tax (currently 25% plus 5.5% solidarity surcharge thereon, i.e. combined 26.375%) applies, unless a certificate is available, stating a lower rate based on a double tax treaty or the 0% EU withholding tax rate on dividends. If no double tax treaty applies or the EU parent-subsidiary directive is not applicable, the withholding tax may be reduced down to 15% plus a 5.5% solidarity surcharge thereon (combined 15.825%) for foreign parent corporations. To apply for any such certificate or reduction, the taxpayer has to demonstrate sufficient substance within the meaning of section 50d paragraph 3 German Income Tax Act (Einkommensteuergesetz), if the shareholder was not directly entitled to such relief, and has to deliver several other information.

- ***Adjustment in line with the arm's -length principle in accordance with section 1 paragraph 1 German Foreign Tax Act (Außensteuergesetz)***

The tax authorities have the right to adjust a German taxpayer's taxable income from cross-border transactions with related parties based on section 1 paragraph 1 German Foreign Tax Act (Außensteuergesetz), if the transactions were not at arm's length and do not qualify as a hidden profit distribution (e.g. granting of interest-free loans to a foreign subsidiary). Such an adjustment does not result in any withholding taxes. However, the assessment of a hidden profit distribution prevails over any adjustment based on section 1 paragraph 1 German Foreign Tax Act (Außensteuergesetz).

4. Transfer Pricing Penalty Framework

In addition to the above-mentioned income increase (and additional taxes), the German tax authorities are allowed to assess penalties according to section 162 paragraph 4 German General Tax Code (*Abgabenordnung*), if the documentation requirements are not fulfilled. Such penalties are treated as non-deductible expenses for tax purposes.

The taxpayer has to pay a penalty of at least EUR 5,000 if the documentation has not been produced or if the documentation is materially unusable. However, the penalty has to be in the range of 5 10% of the additional income that is assessed as a result of the non-production of the documentation, if this amount exceeds EUR 5,000.

If the documentation is produced after the sixty-day period or the thirty-day period, a minimum penalty of EUR 100 per day will be due, with a cap at EUR 1 million.

The following table provides an overview of the penalties that can be assessed:

Issue	Penalty
No or unusable documents were provided	5%-10% of the income increase, at least EUR 5,000
Late filing of useful documents	at least EUR 100 per day of delay, max. EUR 1 million

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Italy - Practical consequences of not having any transfer pricing documentation

In accordance with Art. 26 of Law Decree No. 78 of 31 May 2010 (converted into Law No. 122 of 30 July 2010), Art. 1 of Legislative Decree No. 471 of 18 December 1997 has been amended through the addition of a new paragraph (2-ter) stating that " *In case of adjustments under the arm's length principle of the transfer prices applied with regard to transactions falling within the scope of Art. 110, paragraph 7, of Presidential Decree no. 917 of 22 December 1986, if a higher tax or a difference in the tax credit is determined, penalties pursuant to paragraph 2 do not apply if during access, audit or verification or other investigation the taxpayer delivers to the Tax Administration the documentation specified in the corresponding Provision of the Revenue Agency Director allowing to control that the transfer prices charged are consistent with the arm's length principle". The law also states that "taxpayers holding documentation specified by the aforementioned provision must notify the Financial Administration of said occurrence within the procedures and terms there specified* " and that "in case of default of said communication, paragraph 2 shall apply" (i.e. penalties ranging from 100% to 200% of the additional tax are applicable).

In short, the aforementioned provision specifies that administrative penalties shall not apply if the taxpayer subject to tax audit submits appropriate documentation in order to assess the compliance of the transfer prices applied to the arm' s length principle as specified by the Provision of the Revenue Agency Director issued on 29 September 2010 (so-called "penalty protection regime").

Please note that:

•appropriate documentation should not be sent in advance to the revenue Agency but only filed upon request;

•the existence of appropriate documentation should however be disclosed to the Revenue Agency through a specific communication (to be made inside the annual income tax return);

- if the penalty protection regime has been properly applied but the Revenue Agency does not agree with the transfer pricing policies applied by the taxpayer, an assessment may be issued but penalties may not be requested;
- if the penalty protection regime has not been applied and the Revenue Agency does not agree with the transfer pricing policies applied by the taxpayer, an assessment may be issued and penalties may be requested;
- the application by the taxpayer of the penalty protection regime is not compulsory, thus no penalty may be requested by the Revenue Agency to the taxpayer merely for the fact that appropriate documentation is not available or its existence has not been disclosed in the annual tax return;
- however, penalties may be applied if the taxpayer communicates in the annual tax return that appropriate documentation is available but, upon request form the Revenue Agency, is not able to provide such documentation in due time (10 days); this circumstance may also determine negative consequences during the audit since the Revenue Agency could doubt of the taxpayer's good faith.

From a practical point of view, the absence of appropriate documentation makes much more difficult for the Revenue Agency to challenge the transfer pricing policies applied by the taxpayer. In fact, the Revenue Agency may not limit its activity to questioning taxpayers' policies but needs to run the analysis from scratch. However, in these situations the Revenue Agency has the right to ask to the taxpayer information and details on the structure of the group, on the adopted business model, on the participants to the supply chain and, more specifically, on the functions performed, asset used and risks assumed by the taxpayer. The latter is usually requested to provide these information and details in writing. As a result, the additional activity left to the Revenue Agency is actually "limited" to the search of comparable prices.

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Romania - Practical consequences of not having transfer pricing documentation

Over the last year there has been an increase in transfer pricing resources available to the central tax authorities and a corresponding increase in transfer pricing-related audits conducted by the Romanian tax authorities. As one could expect, these increases have also triggered a rise in the number of transfer pricing controversy cases in Romania.

The Romanian transfer pricing legislation follows the Organisation for Economic Co-Operation and Development (OECD) Guidelines and requires that transactions between related parties be carried out at market value.

Taxpayers engaged in related party transactions are required to prepare a transfer pricing documentation file ("TP documentation file") that must be presented, upon request of the tax authorities, during a tax audit. Transactions with both non-resident related parties and domestic related parties should be documented in the TP documentation file. The deadline for presenting the TP documentation file is of maximum three months from the date of receiving the formal written request, with the possibility of a single extension equal to the term initially established. The tax audit may be suspended until the TP documentation file is made available.

Local requirements specify the sections which must be included in the TP documentation file, including: information on the group and the local company; functional analysis; and economic analysis. The local TP requirements are in line with the EU Code of Conduct on TP documentation.

Transfer prices are subject to investigation by the tax authorities during the general tax audit or during audits for reimbursement of taxes, with the most common audits being for VAT reimbursement.

In practice, the investigation of transfer prices frequently proves to be a lengthy and complex process leading to the suspension and extension of tax audits as well as to numerous extensive information requests from the tax authorities.

Practice has also shown that the approaches in investigating transfer prices vary from one tax inspector to another. For example there were situations where the tax authorities took aggressive approaches which required: manual verification of the companies included in the benchmarking studies; analysis of the losses incurred and requests for detailed information on why losses were generated; detailed analysis of the cost base for the provision of intra-group services; and additional tests to analyze the profitability of the main competitors of the audited company.

1. Risks of non-compliance and transfer pricing adjustments

Failure to present the TP documentation file by the requested deadline will result in fines ranging from approximately EUR 2,700 to EUR 3,100. If the taxpayer does not present the TP documentation file at the tax authorities' first request or presents an incomplete file, the tax authorities will make a second request for the file. The taxpayer can be fined again for failing to comply with the second TP documentation file request. Failure to present the complete TP documentation file after two consecutive requests entitles the tax authorities to estimate the transfer prices that should have been used by the taxpayer in the transactions with the related parties.

The procedure for estimating the transfer prices requires the tax authorities to identify three similar transactions based on generally available information and to calculate the arithmetic mean of the prices used in these transactions. This procedure is not in line with the OECD TP Guidelines as the tax authorities use information which is known only to them in estimating the transfer prices. Also, in practice, the tax authorities apply the procedure to estimate the transfer prices without considering the particularities of the intra-group transactions or the functional and risk profiles of the audited company. The procedure applied by the tax authorities for estimating the transfer prices may lead to significant adjustments of the transfer prices used in transactions with related parties. The additional taxable profits resulting from this estimation or any transfer pricing adjustments are subject to the general 16% corporate income tax rate and related late payment interest and penalties (currently approx. 18% per year).

Transfer pricing adjustments can also be performed for transactions between domestic related parties. In such situations double taxation of the same revenue/taxable profit can arise. Romanian legislation contains provisions to avoid such double taxation, allowing the other Romanian related party to decrease its tax result with the amount corresponding to the transfer pricing adjustment for the audited company. If for example, Company A (Romanian entity) provided and invoiced services to Company B (also a Romanian entity) and further to a tax audit, Company A suffers a transfer pricing adjustment by assessment of additional service revenues estimated by the tax authorities, Company B would be able to adjust its taxable result by deducting additional expenses of the same amount.

In practice, the legal provisions for avoiding domestic double taxation are difficult to apply, due to the following situations:

- the decision for the transfer pricing adjustment issued by the tax authorities to the audited company is often not communicated to the other Romanian related party;
- the audited company may challenge the transfer pricing adjustment decision in which case no corresponding adjustment can be performed until the administrative and legal procedures are finalized; and
- the statute of limitation may elapse before the other Romanian related party performs the corresponding adjustment.

2. Latest developments in transfer pricing regulations in Romania

There are ongoing discussions for amendment of the Romanian transfer pricing regulations. Proposed changes include the introduction of a contemporaneous documentation requirement. However, it is not yet known if the amendments will be approved in their current form. It is expected that the changes will be approved in 2015 with applicability starting 1 January 2016.

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Spain - The importance of documentation of transactions between related parties

Regulation applies to all multinationals with subsidiaries or permanent establishments in Spain that perform intra-group transactions

A little effort on time may bring about significant cost savings in penalties imposed by the Spanish Tax Administration. Thus, it is important to recall that the preparation of a specific Spanish country-file of related party transactions by multinational group subsidiaries or permanent establishments in Spain is an obligation required by Spanish transfer pricing rules contained in the Corporate Income Tax Act. In this regard, the "Spanishfication" of the master-file of the Group’s headquarters is a type of work that, prepared in due time and form, would avoid serious tax violations, which entail penalties that can be considerable.

In this regard, the Spanish Tax Administration has recently focused its efforts in the routine monitoring of the correct application of transfer pricing rules by multinational groups with a presence in Spain - and all indications are that this line of action will be strengthened in the immediate future. Thus, making properly prepared documentation of related parties’ transactions available to the Spanish Tax Administration is the first line of defense of the application of arm’s length principles and will produce, in either case, cost savings by way of avoiding penalties.

It is also hereby informed that the recent tax reform in Spain, which, among other things, has meant the approval of a new Corporate Income Tax Act with effect from January 1st, provides in certain specific cases the simplification of the documentation requirements. Additionally, the new Law sets forth as well a slight reduction of the penalties regime for formal infringements such as lack of documentation, incomplete or false information (from 1,500 Euros to 1,000 Euros for each piece of data missing and from 15,000 Euros to 10,000 Euros for set of data). Further, in case of adjustment by the Tax Administration, the lack of properly prepared transfer pricing documentation triggers a 15% penalty on the adjusted value.

In spite of the foregoing, or, probably because of this, the Spanish Tax Administration closely monitors that related party transactions are duly backed by transfer pricing documentation (also in the context of the BEPS project driven by the OECD on transfer pricing documentation with which the Spanish Tax Administration is aligned unconditionally). Therefore, an adequate preparation of such documentation is highly recommended.

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Hot topics

Africa - Africa and Transfer Pricing: an ongoing construction

The growth of foreign investments in Africa comes with a growing number of flows among companies incorporated in Africa and associated enterprises established in other continents or other African countries.

Thus, pricing of these intragroup flows, whatever their nature, also known as "transfer pricing", has become a major issue for many African tax administrations: taxable profit will partly derive from transfer pricing.

1. Involvement of regional organizations

Creation of the African Tax Administration Forum (ATAF) in 2009 illustrates the will of African States to have a better understanding of international tax issues. It represents a breakthrough in the Pan African tax construction. Since 2013, transfer pricing issues have been among the top priorities of ATAF.

ATAF and the Organization for Economic Cooperation and Development (OECD) concluded in late 2012 a cooperation agreement. In the context of the Base Erosion and Profit Shifting (BEPS) Action Plan, regular consultations include African tax representatives to enable African countries to express their concerns in this respect.

In addition, ATAF[4] , and the Conference and Research Center of Tax Administration Representatives[5] , a network of French speaking African countries, have highlighted among other issues the need to tailor transfer pricing guidelines. Recent OECD calls for public comments specifically focused on intragroup transactions which often involve companies located in Africa. A draft report on transfer pricing matters related to cross-border commodity transactions was issued on 16 December 2014 by the OECD for comments by interested parties[6] . Furthermore, after months of work, the Economic and Social Council of the United Nations released in May 2013, the "*United Nations Practical Transfer Pricing Manual for Developing Countries*". The manual is consistent with the OECD guidelines which remain the international standard for transfer pricing. Thus, it recommends the use of the arm's length principle for determining transfer prices. The Manual is intended to provide guidelines regarding the practical implementation of the OECD principles within developing countries, taking into account their own priorities and realities.

Considering all of this, the ground was prepared for further transfer pricing regulations in Africa. If regulations have been enacted for many years, this trend has been confirmed over the past years, especially in 2014.

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[4] 18-19 March 2014, Johannesburg, ATAF consultation, available on the OECD website

[5] 25 March 2014 Paris, CREDAF consultation, available on the OECD website

[6] CMS comments are available on the OECD website

2. Fast changing environment: the CEMAC countries example

Many African states had already enacted domestic rules similar to the article 57 of the French Tax Code so as to tax profits shifted abroad. More recently, many African states within the Central Africa Economic and Monetary Community ("CEMAC" which members are: Cameroun, Central African Republic, Congo, Gabon, Equatorial Guinea and Chad) have required documentation, more or less extended depending on the country, for supporting transfer pricing policies.

Certain jurisdictions, such as Congo, have adopted specific legislation on transfer pricing[7] . More stringent documentation obligations were introduced. The largest companies are thus required to prepare transfer pricing documentation. Transfer pricing documentation must be delivered on first demand during the tax audit. For smaller companies which are not in the scope of the formal documentation requirement, the law provides that, if the tax administration, during a tax audit, finds elements which lead it to believe that the audited entity has been shifting profits from Congo, it may then request further specific information. In practice, the tax payer will have to disclose information comparable to the one contained in a Transfer Pricing documentation.

In Cameroon, companies depending on the Large Enterprise Division and belonging to international groups must spontaneously submit their transfer pricing documentation at the beginning of a tax audit. In addition, the Finance Act for 2014 introduced another requirement for these companies. They must attach to their tax return, each year, no later than 15 March, a detailed statement of intra-group transactions[8].

In Gabon, a documentation requirement[9] was enacted recently as well as an annual filing requirement[10].

As a conclusion, a significant trend towards the increase of documents to be made available to local tax administrations is observed as well as thorough transfer prices review in the framework of tax audits.

Hence, MNEs should pay special attention to domestic rules and tax specificities when planning their global transfer pricing policies. Consequently, be it regarding transfer pricing method selection or specific local tax regulatory framework, MNEs should adopt a combined approach (both national and international) in order to limit the risk of double taxation, which would be difficult to eliminate in practice, even if the transfer pricing policy was complying with the arm's length principle.

With the growth of their investments in Africa, MNEs will have to take particular care of the structuring and justification of their transfer prices. It is also important because the efficiency of bilateral agreements for the elimination of double taxation remains uncertain at the moment.

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[7] Congolese Tax Code, sections 120 et seq., Amended Finance Act for 2012

[8] Cameroonian Tax Procedure Code, section L19 bis

[9] Gabonese Tax Code, sect. P831 bis

[10] Gabonese Tax Code, sect. P831

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Germany - New German regulations on the allocation of profits to permanent establishments

1. Application and background

The final version of the regulations on the application of the arm's length principle to profit allocations between head office and permanent establishments (PE Regulation) is in force since 18 October 2014 and will have to be applied for fiscal years starting after 31 December 2014. In particular, the new regulations should be of interest to foreign companies having permanent establishments in Germany.

The PE Regulation has the status of a law and is binding on taxpayers, the tax authorities and tax courts. The PE Regulation includes a range of detailed rules on the application of the Authorized OECD Approach (AOA) in Germany, which was incorporated into German tax law in 2013. Thus, more than 4 years after the OECD provided its 2010 Update on the Model Convention and a modified version of Article 7, the German legislator has now finalized regulations for implementing the AOA into national tax law.

2. Brief summary of the PE Regulation

Based on the AOA, permanent establishments are to be treated as if they were (nearly) fully independent and separate legal entities for tax purposes. Therefore, the arm's length principle has to be applied to internal dealings between the permanent establishment and its head office as well as between different permanent establishments of the same group.

The PE Regulation mainly includes the following topics:

- Principles on identifying significant people functions
- Principles on the attribution of (tangible and intangible) assets, risks and liabilities to permanent establishments
- Branch capital allocation
- Principles regarding the determination of internal dealings ("assumed contractual relationships")
- Obligation to set up ancillary accounts for each permanent establishment in order to determine its income
- Specific regulations concerning the application of the AOA to banks, insurance companies, building & construction companies and exploitation sites
- Specific rules for dependent agents

In line with the PE Report of the OECD, the German PE Regulation takes a two-step approach. In the first step, the people functions performed by the permanent establishment are identified based on the activities of locally employed personnel (including seconded personnel). However, the PE Regulation includes the exemption that no people functions are to be assigned to a permanent establishment, if those functions are only performed in that location for less than 30 days.

In a next step, the assets used and risks assumed are to be attributed, in line with the associated people functions. Finally, the branch capital has to be determined, considering the functions performed and risks assumed by the permanent establishment.

Based on these attributions, the internal dealings are to be identified, and an arm's length remuneration is to be determined. This also includes economic activities for which unrelated parties would have concluded a contract (e.g. internal services). However, concerning financing activities, the PE Regulation only accepts a cost-based allocation of financing costs, unless the permanent establishment has taken over the financing function for the group or is providing excessive liquidity for a special-purpose financing.

Although the German rules generally follow the guidance on AOA provided by the OECD, in some cases the German PE Regulation is more detailed than the OECD guidelines and reduces the range of alternative approaches. In particular, this is the case regarding branch capital allocations as well as regarding specific rules for construction and exploitation sites (e.g. profit allocation to the site only if also relevant people functions are carried out at that location). Furthermore, the different treatment of domestic and foreign permanent establishments, for example the asymmetric approach of allocating the branch capital for industrial companies, banks and insurance companies, appears highly questionable from an EU law perspective.

It should be noted that the German PE Regulation requires the preparation of a separate balance sheet and profit & loss statement for the permanent establishment. Therefore, taxpayers must open the auxiliary calculation at the beginning of each fiscal year, must record all transactions during that year, and then close it at the end of the fiscal year. The auxiliary calculation has to be prepared at the latest when the permanent establishment's tax return is filed for the relevant year. Additionally, the taxpayer must be able to provide transfer pricing documentation for its inter-company transactions (including the reasoning for the asset attribution and the identification of internal dealings) within 60 days of the request by a tax auditor for avoiding penalties and income adjustments.

3. Consequences in practice

Taxpayers should take the opportunity to decide on the nature of the activity they want to have between head office and permanent establishments (or between different permanent establishments), and should implement and document this. Furthermore, the PE Regulation requires that assets used in different permanent establishments be allocated based on their "predominant use". People functions relevant for a specific transaction, but carried out at different locations, require an assessment based on the criteria "major importance", resulting in a relating profit allocation. These criteria may leave open some room for interpretation and planning opportunities, but, unfortunately, most likely also for some controversial discussions with the tax authorities.

If taxpayers do not document their position, it cannot be excluded that the German tax authorities will take their own views and tax the German part of the transaction accordingly. Therefore, it is recommendable that taxpayers prepare for such discussions in future tax audits.

As the PE Regulation is applicable for fiscal years starting after 31 December 2014, it has to be expected that a tax auditor will try to assess income adjustments and penalties, if the transfer pricing documentation does not cover the allocation of people functions, assets, dealings etc., or is not submitted on time. It can also not be excluded that a future tax auditor may request such documentation for fiscal years before 2015. However, in such case, it should be noted that the PE Regulation is not legally binding for fiscal years starting before 1 January 2015. If necessary, taxpayers should take appropriate actions in order to defend their position.

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Italy - Hot topics on transfer pricing

1. Supreme Court – Decision No. 27087 of 19 December 2014

The decision concerns the application of transfer pricing rules to interest income.

A company resident in Italy granted interest free loans to its Luxembourg and USA subsidiaries. The Italian Revenue Agency questioned the fact that interest were not charged to the non-resident borrowers and, invoking transfer pricing rules, adjusted the IRES (Corporate Income Tax, or *Imposta sul Reddito delle Società* in Italian) taxable base declared by the resident lender. The Supreme Court stated that the Revenue Agency was not allowed to make the said adjustment.

In particular, the Supreme Court concluded that an interest free loan granted by the controlling company to the controlled company is not subject to adjustment due to the fact that the controlling company is resident in Italy and the controlled companies are resident abroad, being the absence of remuneration not contrary to transfer pricing rules since the latter are applicable only when the company derives a positive or negative item of income from a transaction. To that end the Supreme Court pointed out that interest free loans are valid transactions from a legal perspective, that the lender – being the controlling party of the borrower – may be motivated by sound business purposes, that a valid alternative for the lender would have been to execute an equity contribution where interest would have been absent as well and that the presumption to generate interest is applicable only when the parties have not specified which is the remuneration due while in an interest free loan the parties clearly specify that no interest is due.

The Supreme Court stated, however, that in case of interest free loans the Revenue Agency is allowed to adjust the declared income of the lender if there is fraud, simulation or avoidance, to be demonstrated on a case by case basis.

2. Provincial Tax Court of Reggio Emilia – Decision No. 510 of 19 November 2014

The decision concerns the application of transfer pricing rules to IRAP (Regional Tax on Productive Activities).

Until 2007 IRAP taxable base had to be determined taking into account IRES adjustments including those deriving from the application of transfer pricing (i.e. Art. 110, paragraph 7, of the Income Tax Code). Starting from 2008 (as a consequence of the abrogation of article 11-bis of Legislative Decree No. 446/97) IRAP taxable base had to be determined in accordance with the principle of direct derivation from financial statement results.

However, the position of the Revenue Agency was to consider transfer pricing rules still valid even for IRAP purposes. In order to solve this issue Art. 1, paragraph 281, of Law No. 147/2013 stated, retroactively, that transfer pricing rules are applicable to IRAP also for tax periods subsequent to 2007.

With the decision in question the Provincial Tax Court of Reggio Emilia established that the above mentioned provision of the Law No. 147/2013 is applicable only starting form 2014. The Court has denied the retroactive effect of the new provision considering that it is detrimental to the principles contained in the Statute of Taxpayer's Rights (Law No. 212/2000). To that end, the Court also referred to the

Supreme Court's most recent positions on retroactivity.

The Provincial Tax Court of Reggio Emilia concluded by asserting how the said provision "may only be deemed applicable in the future", or rather, for tax years subsequent to 2013, given that, if the provision were to be deemed applicable to tax years before 2014, it would "violate the constitutional principle of entrustment and of good faith in Tax Authorities-taxpayer relations". Therefore, the provision is to be construed, if its constitutional lawfulness is to be preserved, as if its applicability were provided strictly for tax years subsequent to 2013.

3. Regional Tax Court of Milan – Decision No. 4287 of 5 August 2014

The decision concerns the application of transfer pricing rules to royalties.

A company resident in Italy licensed some patents to its Polish and Chinese subsidiaries. The Italian Revenue Agency questioned the fact that royalties were not charged to the non resident licensees and, invoking transfer pricing rules, adjusted the IRES taxable base declared by the resident licensor. The Regional Tax Court stated that the Revenue Agency was allowed to make the said adjustment.

The following principles stated by the Court should be taken into account:

- the Revenue Agency does not have to demonstrate the tax saving of the taxpayer;
- the royalty calculation provided by the Revenue Agency in the assessment should have been opposed by the taxpayer through an alternative calculation; this does not result in an inversion of the burden of proof;
- the methodology adopted by the Revenue Agency to determine the royalty, consisting in the average value (i.e. 3.5%) between the minimum (i.e. 2%) and maximum (i.e. 5%) royalty values provided for by the Ministry of Finance in its Circular No. 32/9/2267 of 22 September 1980.

4. Supreme Court – Decision No. 8849 of 16 April 2014

The decision concerns the application of transfer pricing rules to domestic transactions.

Italian tax law explicitly provides the application of the arm's length principle only to cross border transactions between related parties. However, the possibility to apply such principle also to domestic transactions between related parties is a much debated issue.

In the above mentioned decision the Supreme Court takes the position that not only cross border transactions but also domestic transactions are subject to the arm's length principle if they involve related parties (thus confirming the previous decision No. 17955 of 24 July 2013). This principle – based on the Supreme Court view – represents an anti-avoidance rule, deriving from the general prohibition to abuse of the law in tax matters, and has been considered applicable to a situation where the tax base was shifted to a company with a favorable tax regime without any sound business purpose (in particular, prices charged to the parent company were subject to a 1.2% increase with respect to prices charged to unrelated parties and such increase was considered not deductible for the parent company).

In this context the Supreme Court has also stated that the burden of proof is on the taxpayers, i.e. the taxpayer – following ordinary rules set forth by Art. 2697 of the Civil Code – has to provide the evidence of the fact that the transactions were in line with the arm’s length principle.

5. Cooperation program on transfer pricing between Italy and Albania

Within the framework of the OECD project “Tax Inspectors Without Borders” (TIWB), the Italian Revenue Agency will cooperate with the Albanian Tax Administration with regard to transfer pricing matters. The program has been launched on 11 February 2015 and implies the secondment of Italian officers to Albania for six months to support Albanian officers.

TIWB enables the transfer of tax audit knowledge and skills to tax administrations in developing countries through a real time, “learning by doing” approach. Experts – currently serving or recently retired tax officials – are deployed to work directly with local tax officials on current audits and audit-related issues concerning international tax matters, and to share general audit practices. The project concept has received the strong support of the G20 Leaders in their August 2013 St Petersburg Declaration including in the Tax Annex, and from the G8 Leaders at their summit in June 2013 (Lough Erne Communiqué).

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Switzerland - Safe harbour interest rates on down-stream intra-group loans 2015

As every February, the Swiss Federal Tax Administration has published its current safe harbour interest rates on intra-group loans. Apart from the rates themselves there are some other aspects that have been adjusted. Generally, it has to be differentiated between a down-stream loan, an up-stream loan or a group cash pooling system. Also, the currency of the loan has to be taken into account.

The following deals with **down-stream loans to a Swiss subsidiary** which is the main tax risk area when a non-Swiss shareholder (or a non-Swiss FinanceCo of a Group) grants a loan to its Swiss affiliate. In that scenario, the determination of tax deductible intra-group interest payments is a two-tier calculation:

- 1.Calculation of admissible interest bearing intra-group debt
- 2.Calculation of the maximum interest payable on the respective debt

The calculation of the admissible interest bearing intra-group debt amount is based on the Swiss thin capitalisation guidelines which were published by the Federal Tax Administration in circular no 6 in 1997 and has not changed since. This calculation is based on the asset structure of a company and certain maximum debt ratios per asset category (e.g. maximum debt financing of 85% on receivables, 85% on stock, 70% on participations, 70-80% on real estate etc.). To the extent the total debt to asset ratio exceeds the maximum ratio calculated, any excessive intra-group debt is considered so-called hidden equity and must not bear interest. Any interest paid on such hidden equity is not tax deductible (and consequently considered a hidden profit distribution subject to dividend withholding tax). Actual third party debt is not affected by these Swiss thin capitalisation guidelines.

The maximum interest rate on the admissible intra-group debt is based on the annual circular letter of the Federal Tax Administration. The 2015 version was published on 12 February 2015. The maximum interest rates depend on the reason for the financing, the business of the subsidiary and – newly – the loan amount:

a) Financing of real estate

a.1) Residential properties and farm land: 1% on 2/3 of the property value; 1.75% on the rest of the loan (up to the admissible 70% debt financing)

a.2) Property for commerce and industry: 1.5% on 2/3 of the property value; 2.5% on the rest of the loan (up to the admissible 70-80% debt financing)

b) Financing of operations

b.1) Commerce and industry: 3% on the first CHF 1m; 1% on debt exceeding CHF 1m

b.2) Holding and investment management: 2.5% on the first CHF 1m; 0.75% on debt exceeding CHF 1m

The CHF 1m threshold refers to the total intra-group debt not to single loan agreements. This threshold rule has only been introduced in 2015.

These maximum interest rates generally refer to CHF loans. The Federal Tax

Administration also publishes safe harbour rates in connection with other currencies.

Any intra-group interest paid in excess of these calculations can be deemed as hidden profit distribution, i.e. would not be tax deductible for profit tax purposes and could be subject to dividend withholding tax. All calculations are based on safe harbour rules. Higher debt ratios or higher interest rates might be accepted based on proof of at-arms-length dealings. It has to be noted, though, that any underlying comparable facts would need to refer to the Swiss finance market in order to be accepted by the tax authorities.

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Annexes

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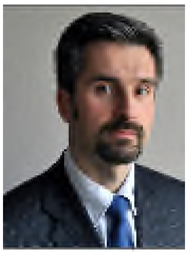

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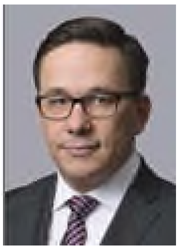

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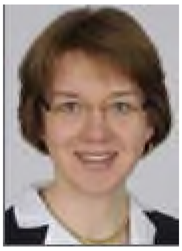

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