

7th Perm Economic Forum

RUSSIA 1990-2000-2010. HOW TO MOVE ON ?

Transfer taxation: problems and prospects for development

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Programme

- ✓ Introductory remarks on transfer pricing
- ✓ EU developments
- ✓ Transfer pricing news in Italy
- ✓ Cost sharing and the Motorola case

Introductory remarks on transfer pricing (1)

- ✓ Transfer pricing is not an exact science (para 1.45 OECD)
- ✓ Macro-economy and micro-economy
- ✓ It requires a deep knowledge of the structure and functioning of the enterprise
- ✓ It is an anti-avoidance legislation
- ✓ Significant increasing number of tax litigations (also domestic TP)

Introductory remarks on transfer pricing (2)

- ✓ To avoid currency rules
- ✓ To show lower or higher profits so to manage employment issues
- ✓ To transfer more easily profits with no timing and formal constraints
- ✓ To remunerate the investments by the parent company

Introductory remarks on transfer pricing (3)

Transfer pricing around the world

- ✓ applicable to any kind of transaction with non-residents (e.g. Austria, Belgium, Finland, France, Germany, Italy, Japan, Korea, Mexico, Norway, Sweden, UK, US; However: DK, IT, UK)
- ✓ only for specific type of transactions (e.g. Argentina, Brasil)
- ✓ There is no specific legislation but transfer pricing is countered through other anti-avoidance rules (e.g. the Netherlands fraud legis, in Switzerland hidden distribution of profits)
- ✓ Only for direct taxes

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EU developments

- I. General presentation of the EU Joint Transfer Pricing Forum (« JTPF »)
- II. Code of conduct on the Arbitration Convention
- III. Code of conduct on the EU Transfer Pricing Documentation
- IV. Guidelines on advance pricing agreements

I. General presentation of the JTPF

Background

- The Commission proposed in its Communication of 23 October 2001 to establish a EU Joint Transfer Pricing Forum (« JTPF »).
- The General Affairs Council of 11 March 2002 adopted Council Conclusions welcoming the initiative to set up the JTPF.
- Initially, the JTPF had a two-year mandate. In December 2004, the Commission extended this mandate for another two years (from January 2005 to December 2006). In December 2006, the Commission extended again for four years (from March 2007 to March 2011).
- The overall objective of the JTPF is a more uniform application of transfer pricing tax rules within the EU.

Participants to the JTPF

—The following members of the JTPF were appointed for a renewable period of two years:

- A chairman.
- Representatives of the Member States.
- 10 experts from business, increased to 15 for the second renewal.

—Representatives of the OECD.

Functioning and outcome

- There were two to four meetings a year (first meeting in October 2002).
- The JTPF aims at working on the basis of consensus.
- The outcome must be pragmatic, non-legislative solutions within the framework of the OECD Guidelines to the practical problems posed by transfer pricing practices in the EU.
- The result of the work undertaken by the JTPF is transmitted on a regular basis to the Commission and then to the Council which assess the need for appropriate action.

Results up to now

— As regards the Arbitration Convention:

- Report adopted in December 2003 on Arbitration Convention.
- Communication of the Commission of 23 April 2004 endorsing the report and proposal for a Code of Conduct.
- Code of Conduct approved by ECOFIN of 7 December 2004.

— As regards the EU Transfer Pricing Documentation (« EU TPD »)

- Report on EU TPD approved at the meeting of 16-17 March 2005.
- Proposal for a Code of Conduct adopted by the Commission on 10 November 2005.
- Code of conduct approved by ECOFIN of 27 June 2006.

— As regards APA

- Report adopted at the meeting of September 2006.
- Communication of the Commission of 26 February 2007 proposing guidelines on APA.
- Approved by ECOFIN of 5 June 2007

II. Code of conduct on the Arbitration Convention

The Arbitration Convention

- This treaty was signed by Member States in 1990 and entered into force on 1 January 1995. It terminated on 31 December 1999 and re-entered into force on 1 November 2004.
- The Convention of 21 December 1995 concerning the accession of Austria, Finland and Sweden to the Arbitration Convention entered into force on 1 April 2005.
- A convention aiming at extending the scope of the Arbitration Convention to the 10 new Member States must be signed and ratified by all 25 Member States.

The Arbitration Convention

- This procedure is dedicated to transfer pricing disputes.
- The Arbitration Convention guarantees the elimination of double taxation within three years:
 - competent authorities (« CAs ») have two years to find a solution in the context of a mutual agreement procedure;
 - in the absence of agreement, the case is submitted to an advisory commission. The commission must issue an advice within 6 months;
 - this advice is not binding on the CAs; however, if they do not find an agreement within an additional 6-month delay, the CAs are bound by the advice.

The Arbitration Convention

- On 31 December 2005, 161 procedures were engaged.
- 2 advisory commissions met: (i) one involving France and Italy, (ii) the other one involving France and Germany.

Result of the works performed by the JTPF

—Improvements were adopted on the following points:

- Transitional issues.
- Starting point of the three-year period (deadline for a company suffering double taxation to present its case to the relevant CA);
- Starting point of the two-year period during which the CAs must attempt to reach an agreement to eliminate double taxation;
- Arrangements to be followed during this mutual agreement procedure (the practical operation of the procedure, transparency and taxpayer participation);
- Establishment and functioning of the advisory commission that must then arbitrate in the case);
- Suspension of tax collection during the procedure.

III. The EU Transfer Pricing Documentation (« EU TPD »)

Documentation requirements

a) Masterfile and country specific documentation

- The EU Transfer Pricing Documentation (« EU TPD »)

Findings and approach

- Documentation requirements in the EU have increased and there are significant differences in documentation requirements between Member States.
- The existence of different sets of documentation requirements in the internal market places a burden on a company in one Member State that wants to set up and/or conduct business with an affiliated company in another Member State.
- The JTPF identified different approaches to documentation requirements and, in the light of their pros and cons, in particular in terms of legal certainty and flexibility, decided to pursue the concept of standardized EU TPD.

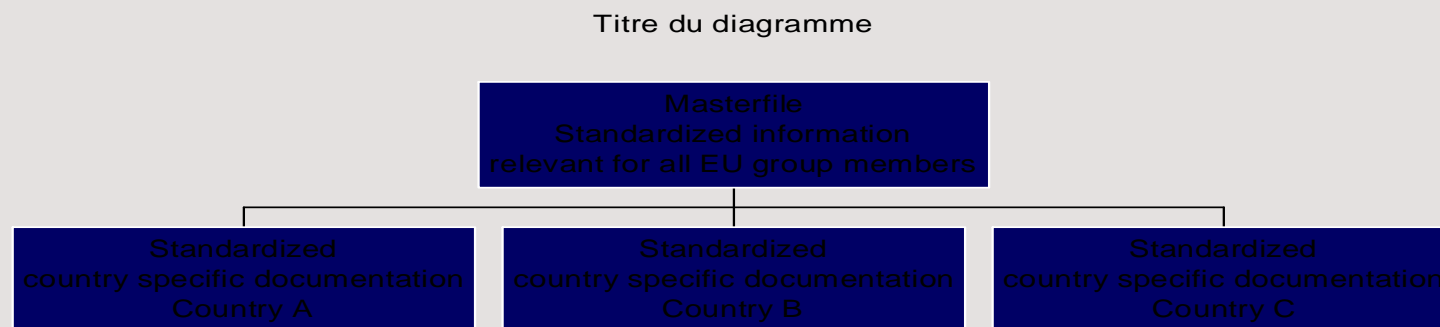
Main features of the EU TPD

- Standardisation of the documentation requirements necessary for a tax administration as a risk assessment tool and to obtain sufficient information for the assessment of the group's transfer prices;
- The possibility for centralisation of the core part of the documentation (« Masterfile ») at group level; and
- Availability to all EU Member States concerned of common standardised transfer pricing information relevant for all EU affiliates of a multinational enterprise.

Main features of the EU TPD

—The EU TPD would consist of two main parts:

- one set of standardized and consistent documentation relevant for all EU group members of a multinational enterprise (Masterfile), and
- several sets of standardized documentation each containing country specific information that fit together with the Masterfile.



Content of the Masterfile

- A general description of the business and business strategy including changes in the business strategy compared to the previous tax year;
- A general description of the group's organisational, legal and operational structure;
- A general identification of the associated enterprises engaged in controlled transactions involving enterprises in the EU;
- A general description of the controlled transactions involving enterprises in the EU;
- A general description of functions performed and risks assumed and a description of changes in respect of functions and risks compared to the previous tax year;

Content of the Masterfile (cont 'd)

- The ownership of intangibles (patents, trademarks, brand names, know how etc.) and royalties paid or received;
- The group's inter-company transfer pricing policy;
- A list of Cost Contribution Agreements, APAs and Rulings covering transfer pricing aspects as far as group members in the EU are affected; and
- An undertaking by the taxpayer to provide supplementary information upon request and within a reasonable time frame according to national rules .

Content of the country specific documentation

- In order to meet the EU TPD requirements, a country specific documentation should contain, in addition to the content of the Masterfile, the following items:
- A detailed description of the taxpayer's business and business strategy including changes in the business strategy compared to the previous tax year;
 - Information, i.e. description and explanation, on country specific controlled transactions; including (i) flows of transactions (tangible and intangible assets, services, financial); (ii) invoice flows; and (iii) amounts of transaction flows;
 - A comparability analysis, i.e. (i) characteristics of property and services; (ii) functional analysis (functions performed, assets used, risks assumed); (iii) contractual terms; (iv) economic circumstances; and (v) specific business strategies;

Content of the country specific documentation (cont 'd)

- An explanation about the selection and application of the transfer pricing method[s];
- Relevant information on internal and/or external comparables, if available; and
- A description of the implementation and application of the group's inter-company transfer pricing policy.

Benefits of the EU TPD

- All tax administrations involved would have access to the same common documentation and information in the masterfile element.
- Standardized and - to the extent possible - centralised documentation could substantially reduce a taxpayer's compliance costs.
- Tax administrations should not impose documentation related penalties on a taxpayer acting in good faith and complying with the EU TPD by providing in a timely manner appropriate documentation and properly applying his documentation to determine the arm's length transfer prices.
- The EU TPD should allow Member States to: (i) have more information about intra-group transactions that are relevant for the Member States concerned; (ii) more effectively perform their risk assessment; (iii) reduce administrative costs; and (iv) assess the transfer prices of the inter-company transactions.

Use of database searches for comparables

- Preference is given to local comparables but in general, regional or pan-European comparables are accepted in so far as they respect the comparability factors and/or the results do not show any significant differences from the rest of a set of comparables.
- The position of Member States is consequently that, for example, comparables found in pan-European databases should not be rejected automatically.

IV. Guidelines on APA

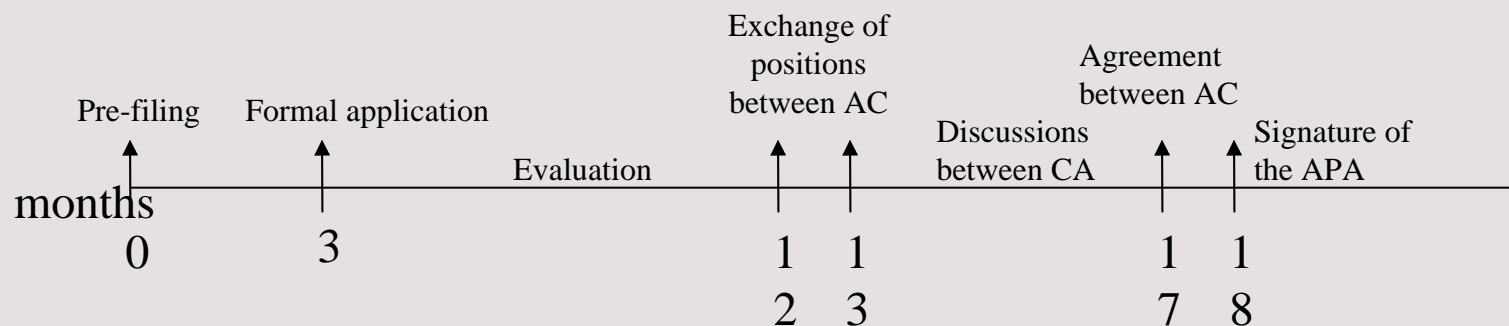
Preliminary comments

- Legal framework.
- Organization of APA procedures in Member States.
- Entry to the APA programme.

Conduct of the APA process

- Pre-filing.
- Formal application.
- Evaluation and negotiation.
- Formal agreement.

Time frame



Documentation

- Names and addresses of all associated enterprises in the APA.
- A group structure showing all entities involved in the trade of the enterprises in the APA.
- An analysis of industry and market trends which are expected to affect the business.
- The period for which the taxpayer desires that the APA should apply, including any request for rollback.
- A functional analysis of the parties and transactions to be covered by the APA.
- The reason why the taxpayer feels an APA is appropriate for these particular transactions.

Documentation

- The critical assumptions integral to the APA.
- Details of the proposed methodology for the covered transactions and evidences for the view that this procedures results consistent with the arm's length principle.
- A list of any APA already entered into by any of the associated enterprises involved in the APA which relate to the same or similar transactions if not already available to the tax authorities.
- Details of financial information of the entities in the APA for the three years prior to the APA.
- A list of any legal agreements between any associated enterprises which affect the transactions in the APA.
- For any years where a rollback is requested – where possible in domestic law – details of the tax position of each entity involved for these years.

Clarifications

- Rollback.
- Unilateral APA.
- APA for SME.

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Transfer pricing news in Italy

- ✓ new documentation requirements
- ✓ advance pricing agreements (APAs)

New documentation requirements

—Art. 26 of the 2010 anti-deficit package (Law Decree No. 78 of 31 May 2010 converted by the Law No. 122 of 30 July 2010) provides that, in case of a transfer pricing assessment, no penalties will be levied in case the taxpayer:

- complies with specific documentation requirements, and
- makes a specific communication to the Italian tax authorities.

New documentation requirements

- Administrative penalties range from 100% to 200% of the higher tax to be applied on the adjusted prices.
- Criminal penalties ?

New documentation requirements

- The documentation requirements and the content and terms of the communication will be set forth by the Italian Revenue Agency (within 60 days from the entrance into force of the converting law, i.e. within 29 September 2010).

New documentation requirements

- The regime is applicable also to previous tax periods.
- In this case the communication has to be made within 90 days from the publication of the above mentioned regulation of the Italian Revenue Agency (i.e. maximum 30 July 2010 + 60 + 90: end of 2010).

APAs – Overview

- The international ruling procedure is addressed to companies with international activity that intend to agree in advance with the Italian tax authorities:
- the transfer pricing methodology applicable to transactions carried on with related parties in the form of unilateral APAs;
 - the application of tax treaties distributive rules to specific cases;
 - the attribution of profits to permanent establishments (hereinafter “PE” or “PEs”).

APAs – Overview

—Access to the international ruling procedure is made, on a voluntary basis and free of any charge, by mean of an application sent to the International Ruling Office – International Division – Central Directorate for Tax Assessment of the Revenue Agency, which is organized into two branches based in Rome and Milan.

APAs – Overview

- Within 30 days from the receipt of the application, the International Ruling Office schedules a first meeting with the taxpayer in order to define the terms and developments of the procedure. The procedure follows with several meetings during which further documentation may be required and visits to the premises where the business is actually carried on may be organized in order, for the Italian tax authorities, to obtain direct knowledge of the circumstances represented in the application.

APAs – Overview

- The procedure should be completed within 180 days from the date in which the application is filed. Nevertheless, as this term is merely formal, according to circumstances, the parties may agree to extend the procedure.

APAs – Overview

- The procedure ends up, possibly but not mandatorily, with a 3 years binding agreement between the taxpayer and the Italian tax authorities which sets out the criteria and methods for calculating the normal value of the transactions to which the application refers to, or, in other cases, the criteria for application of the concerned legislation.

APAs – Overview

—During the 3 years period the Revenue Agency, and more specifically the International Ruling Office, verifies that the terms of the agreement are complied with and also ascertains whether any changes have occurred to the *de facto* or *de jure* conditions which constitute the assumptions on which the clauses of the agreement are based. This activity is carried out also by means of one or more agreed visits to the premises where the enterprise carries on business.

APAs – Overview

—At the end of the 3 year period of validity, and at least 90 days before it expires, the taxpayer may submit an application for renewal. Starting from 2008, 4 agreements have been renewed.

APAs – Inputs from statistics

—A bulletin released on 21 April 2010 summarizes, for the first time, for statistical purposes and anonymously, the outcome of the requests for the international ruling procedure made under Italian tax law.

APAs – Inputs from statistics

—The data provided in Table 1 shows that 52 applications have been submitted in the period 2005-2009 with an average of 10 per year. However, out of the 45 out applications not rejected only 19 ended up in a binding agreement between the taxpayer and the Italian tax authorities with an average of 4 per year.

APAs – Inputs from statistics

Table 1

Applications for the international ruling procedure in 2004-2009

Applications submitted	52
International ruling granted	19
Procedures in process as at December 31, 2009	17
Applications rejected due to the lack of subjective or objective elements	7
Applications withdrawn	9

APAs – Inputs from statistics

- Table 2 shows the procedures concluded in relation to the number of months necessary to be signed.
- The duration has been calculated as the difference between the date of signature of the agreement and the date of submission of the application. Calculation of this difference excludes any suspension periods due to the lack of essential elements to reach the agreement. Instead, the duration of the procedure includes periods of inactivity or delay in providing documentation or information from the taxpayer.
- The average time, approximately 20 months, is calculated as a simple average of the total number of months necessary to sign the agreements.

APAs – Inputs from statistics

Table 2

International ruling procedure completion time

months	number of agreements signed
1-6	2
7-12	3
13-18	5
19-24	4
25-30	2
31-36	2
37 or more	1

APAs – Inputs from statistics

- Table 3 shows the methods used in determining APAs.
- It is split in two parts, the first one relevant to traditional methods and the second one relevant to alternative methods.
- Surprisingly, alternative methods have been very much adopted.

APAs – Inputs from statistics

Table 3.1

Traditional methods used for determining APAs

CUP - Internal comparables	1
CUP - External comparables	0
Cost Plus - Internal comparables	2
Cost Plus - External comparables	1
Resale Price - Internal comparables	0
Resale Price - External comparables	0

APAs – Inputs from statistics

Table 3.2

Alternative methods used for determining APAs

TNMM – mark up on total cost	7
TNMM – return on sales	3
Profit Split – contribution analysis	0
Profit Split – residual analysis	5

APAs – Inputs from statistics

—Table 4 shows data relating to taxpayers, divided into classes according to turnover, who signed an agreement or whose procedure was still pending as of 31 December 2009. The data shows that the majority of taxpayers submitting applications (approximately 52%) have a turnover of more than 100 million Euro, and 37% of these fall into the class of taxpayers with turnover of more than 300 million Euro.

APAs – Inputs from statistics

Table 4

Classes of taxpayers by turnover

Taxpayers' turnover	Number of taxpayers	%
< 100 MEuro	13	48,15%
from 100 to 300 MEuro	4	14,81%
> 300 MEuro	10	37,04%

APAs – Inputs from statistics

- Table 5 highlights the ruling procedures which were concluded with an agreement distinguished on the basis of the relationships between the associated parties.
- It shows roughly the same number of companies which are controlled by non-resident subjects and companies which carry out transactions with subsidiary companies abroad.
- The total number of agreements given in Table 5 does not coincide with the number of ruling agreements concluded during the 2004-2009 period as the scope of an agreement may also include more than one kind of relationships between related parties.
- The concept of control within the context in question includes both direct and indirect control.

APAs – Inputs from statistics

Table 5

Relationships between associated parties

Non-resident parent company – Italian subsidiary	9
Italian parent company – non-resident subsidiary	8
Italian related company – non-resident related company	6
Italian PE – non resident head office	2
Non-resident PE – Italian head office	0

APAs – Inputs from statistics

- Table 6 highlights the ruling procedures which were concluded with an agreement distinguished on the basis of the type of transactions covered by ruling agreements.
- It shows a predominance of agreements concerning the sale of tangible goods from Italy (50% of total transactions).
- The total number of agreements given in Table 6 does not coincide with the number of Ruling agreements concluded during the 2004-2009 period as per Table 1, since an agreement may also include more than one kind of transactions between related parties.

APAs – Inputs from statistics

Table 6

Cases of transactions in the agreement signed

Sale of tangible property into Italy	11
Purchase of foreign goods	4
Performance of services by Italian entity	3
Performance of services by non-Italian entity	0
Cost sharing agreements	1
Transactions involving intangible property	1
Attribution of profits to a PE	2

Programme

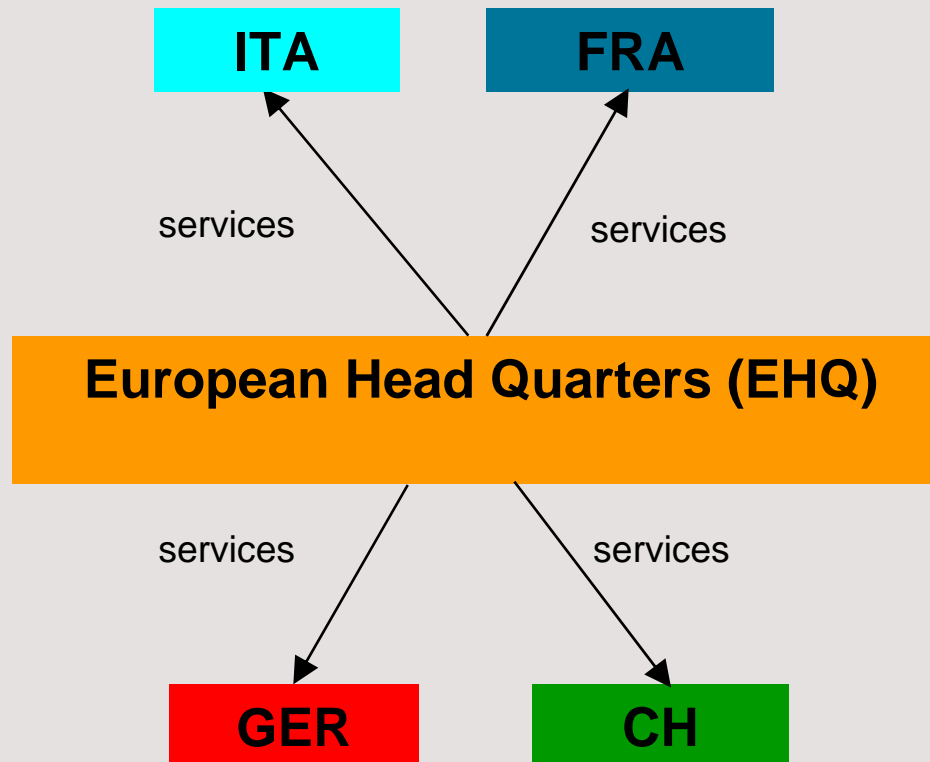
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Documentation for cost sharing agreements

The Motorola case

- ✓ six years litigation
- ✓ More than 30 tax litigation briefs
- ✓ Thousands of documents
- ✓ 80 M € taxes for non deductible costs

The *cost sharing agreement* of the Group



Position of the TA

1. Are the services effectively received ?
2. What are the advantages ?
3. Duplication of some services (legal and tax)
4. Shareholder costs
5. Rejection of the documentation submitted (late and in English)
6. Rejection of the auditing company declaration

Our arguments

1. Functional organization of the Group
2. *Ratio* for centralizing services
3. Denied deduction of all intra-group costs
4. Lack of use exchange of info rules
5. Criminal law proceedings closed in favour of the company
6. To allow documentation in English

The documentation filed by us:

- Contracts with categories and sub-categories of services (MSA and Addendum);
- Name list of all employees of the EHQ;
- Accounting data for the overall costs and their allocation among the various companies (man working hours);
- Sample invoices to justify sample services with specific description of the services and of the benefits;
- Certification by the auditing company.

Other documentation

1. Group structure and functional analysis of each company's activity;
2. Documentation before CCA showing costs and benefits of the CCA;
3. Documents showing the reduction of the costs and the increase of the proceeds from the CCA;
4. Eventual APA – reassessments – sentences.