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TRANSFER PRICING NEWS

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INTRODUCTION

Transfer pricing is increasingly influencing significant changes in tax legislation around the world. This 21st issue of BDO's Transfer Pricing Newsletter focuses on recent developments in the field of transfer pricing in Austria, China, Luxembourg, Russia, the United Kingdom and the United States. As you can read, the ongoing work on OECD's BEPS project results in changing and new legislation around the world.

We are very pleased to bring you this issue of BDO's Transfer Pricing News, which we were able to produce in close co-operation with our colleagues from the above-mentioned countries. We trust that you will find it useful and informative. If you would like more information on any of the items featured, or would like to discuss their implications for your business, please contact the person named under the item(s). The material discussed in this newsletter is intended to provide general information only, and should not be acted upon without first obtaining professional advice tailored to your particular needs.

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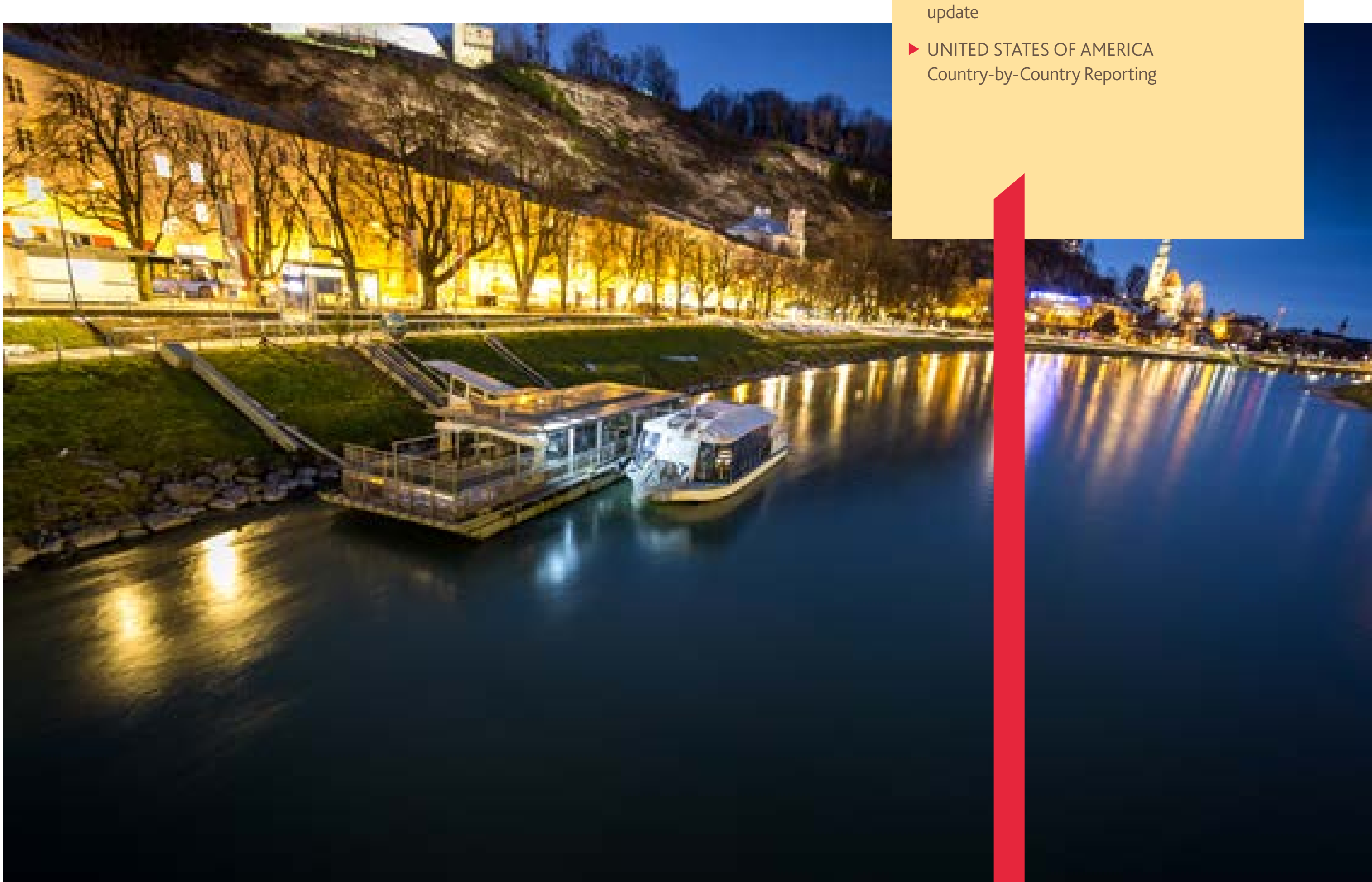

AUSTRIA

AUSTRIA TIGHTENS REQUIREMENTS REGARDING TRANSFER PRICING DOCUMENTATION – EU-TAX CODE AMENDMENT ACT 2016

Overview

The Transfer Pricing Documentation Act (TPDA) was passed by the Austrian Parliament on 6 July 2016.

The TPDA is based on the Base Erosion and Profit Shifting (BEPS) Action 13 of the Organisation for Economic Co-operation and Development (OECD) and significantly increases the documentation burden for multinationals with entities in Austria.

Accordingly, Austrian entities have to prepare a Master and Local file where sales exceeded EUR 50 million in the two previous years. Also a Country-by-Country Report has to be prepared for Multinational Entities (MNEs) generating more than EUR 750 million consolidated sales. Non-filing incurs a penalty of up to EUR 50,000.

This new law will be effective for FY commencing 1 January 2016.

Full details

BEPS (Base Erosion and Profit Shifting) is a keyword not only dealt with quite often in the media these days, but is now actually affecting the Austrian tax law landscape. The OECD recently started focusing on this topic and prepared action plans on how to tackle the issue of base erosion and profit shifting in the international tax landscape. One of these has now been incorporated by adopting the **Transfer Pricing Documentation Act (TPDA)**.

The TPDA obliges multinational companies to prepare a three-tiered Transfer Pricing Documentation comprising a Master File, a Local File as well as a Country-by-Country Report (CbCR).

Master File

The Master File should contain comprehensive overall information on the whole multinational group, mainly comprising the following:

- Organisational structure;
- Description of the business activity;
- Intangibles;
- Financing activities within the group;
- Financial and tax position.

Local File

The Local File must contain specific information regarding the business transactions of the respective entity, in particular information about financial transactions as well as the comparability analysis. The content of both documents is also specified in more detail in the TPDA regulations.

Austrian companies have to prepare a Master File and Local File if sales exceed EUR 50m in the two previous fiscal years. The TPDA does not only oblige separate legal entities to set up both documentation parts, but dictates the same obligation also for permanent establishments (PEs) under specific circumstances which will mostly be fulfilled. However, an Austrian entity (separate company or PE) will only be covered by the TPDA if it is part of a multinational group of companies, i.e. apart from a local Austrian entity another entity has to exist abroad.

Country-by-Country Reporting

Groups of companies that exceeded consolidated sales of EUR 750 million in the previous fiscal year additionally have to prepare a Country-by-Country Report. This third part of the Transfer Pricing Documentation is supposed to provide a standardised overview of how the sales, earnings before tax, taxes paid, number of employees, material assets and separate business activities are distributed globally. This report must be filed in Austria if:

- The parent company is an Austrian resident company;
- The parent company does not have to file the CbCR in the respective other country;
- No qualified agreement regarding the exchange of the CbCR exists; or
- Such a qualified agreement exists, but the automatic exchange was suspended or failed during a prolonged period.

Coming into force

The three-tiered Transfer Pricing Documentation has to be prepared for fiscal years commencing 1 January 2016. The CbCR has to be filed electronically via FinanzOnline no later than 12 months after the last day of the fiscal year. The Master File and Local File have to be available at the moment of filing the tax returns, as these have to be presented to the fiscal authorities within 30 days upon request. Generally, it is possible to prepare the Transfer Pricing Documentation in English.

Penalties

In addition to the administrative burden imposed by the TPDA, taxpayers also now face specific penalties. Companies which deliberately refrain from filing the CbCR on time, file incorrectly or not at all face penalties of up to EUR 50,000. Gross negligence is also punished in this context, with penalties up to EUR 25,000.

Summary

In short, it can be concluded that the TPDA will lead to significant additional efforts and costs for multinational entities. According to the preamble of the initial draft of the TPDA, the Austrian legislator estimates the one-off costs for setting up the CbCR at approximately EUR 200,000 and those for preparing the Master File and Local File at about EUR 400,000.

In this context it also seems important to mention that changes to the EU accounting guidelines are currently being discussed. These changes intend to oblige multinational enterprises (the sales of which globally exceed EUR 750 million) to publish a separate income tax information report ("Ertragsteuerinformationsbericht"). The content of this audited report mostly coincides with the CbCR. However, whereas the CbCR has to be provided to the fiscal authorities only, the income tax information report should be made publicly available.

Effective support by BDO

The transfer pricing team of BDO Austria GmbH will gladly assist companies in planning and implementing a transfer pricing system and meeting their statutory obligations regarding Transfer Pricing Documentations. Should the need arise, we will involve colleagues from other service lines, e.g. if IT systems have to be adjusted or compliance structures need to be set up within the company. If necessary, we are also able to involve colleagues from our international network, which is active in more than 150 countries across the globe.

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CHINA

UPDATE ON RECENT TRANSFER PRICING DEVELOPMENTS

Overview

Ever since the initiation of the Base Erosion and Profit Shifting ("BEPS") project by the Organisation for Economic Co-operation and Development ("OECD"), China has been closely following the BEPS Action Plan in fighting global anti-tax avoidance. As a commitment to the BEPS Action Plan, China has recently signed the OECD's Multilateral Competent Authority Agreement ("MCAA") for the Automatic Exchange of Country-by-Country Reports ("CbCR"). In addition, China has updated the Chinese transfer pricing regulations and requirements to align the rules for related-party transactions reporting and preparation of contemporaneous documentation with the requirements in Action 13 of the BEPS Action Plan.

Automatic exchange of Country-by-Country Reports ("CbCR")

On 11 May 2016, the heads of 44 tax administrations met in Beijing for the 10th Meeting of the OECD Forum on Tax Administration ("FTA").

During the FTA Meeting, China recorded tremendous progress in tax co-operation and tax transparency. One of the key highlights is that on 12 May 2016, China signed the OECD's MCAA for the Automatic Exchange of CbCR, joining a group of 38 other signatories.

China's signing of the MCAA presents a commitment to localise and implement Action 13 of the G20/OECD BEPS Project. China-based multinational enterprises ("MNEs") with significant global revenues are to be required to file CbCR in which high level information of the group and the affiliates should be disclosed on a tax jurisdiction basis. Similarly, China will be granted the right to access and analyse CbCR filed by foreign-based MNEs that have operations in China.

Release of new regulations on transfer pricing compliance

The signing of MCAA to automatically exchange CbCR will definitely expedite the release of China's domestic regulations on the CbCR. On 29 June 2016, the State Administration of Taxation ("SAT") issued new regulations to improve the related-party transactions reporting and contemporaneous documentation (SAT Bulletin [2016] No. 42, "Bulletin 42"). Bulletin 42 updates the chapters of related-party transactions reporting and contemporaneous documentation in the existing "Implementation Measures of Special Tax Adjustment (Provisional)" (Guoshuifa [2009] No. 2, "Circular 2"). Note that Circular 2 is still partly in effect. Only the applicable sections in the Circular 2, i.e., Chapter 2 and 3, Article 74 and 89, and the current Annual Related-party Transactions Reporting Forms (Guoshuifa [2008] No. 114) have been repealed. It is predictable that SAT will further promulgate announcements to regulate other matters in Circular 2, such as intangible assets and anti-avoidance.

Highlights of Bulletin 42

Bulletin 42 sets out more detailed regulations on related-party transactions reporting, definition of related-party relationship, types of related-party transactions, reporting party and content for CbCR, and types, contents, thresholds and submission of contemporaneous documentation.

Update of Annual Related-party Transactions Reporting Forms

Bulletin 42 attaches a FY2016 version of Annual Related-party Transactions Reporting Forms of the People's Republic of China, with detailed filing instructions. FY2016 RPT Reporting Forms increase the total number of forms from 9 to 22, with a major increase in information disclosure of CbCR. Taxpayers that are required to file CbCR should complete the forms in both English and Chinese.

CbCR forms an important part of BEPS Action 13. Bulletin 42 included the CbCR as part of Annual Related-party Transactions Reporting Forms in the annual corporate income tax filing, and it requires taxpayers who meet one of the following circumstances to submit the CbCR:

- The taxpayer is the ultimate holding company of a MNE, with consolidated revenues greater than CNY 5.5 billion in the precedent fiscal year; or
- The taxpayer is nominated by its MNE group as the reporting entity.

The ultimate holding company refers to the entity with the ability to consolidate financials of all other member entities within the group, and its financials cannot be consolidated by any other member entity.

In addition, Bulletin 42 specifies that Chinese tax authorities have the right to request taxpayers to provide the CbCR under any of the following circumstances:

- MNEs that have not submitted the CbCR in any countries;
- MNEs that have submitted CbCR in other countries, but China has not established the information exchange regime with the other countries; or
- MNEs that have submitted CbCR in other countries and China has established the information exchange regime with those countries, but the Chinese tax authorities have not obtained the CbCR.

Improvement of the contemporaneous documentation management

Bulletin 42 modifies the detailed requirements of contemporaneous documentation reports, including the structure, content, thresholds of the transactions and submission deadlines. Compared with Circular 2 that is currently in force, Bulletin 42 implements a three-tiered framework for Transfer Pricing Documentation, i.e., master file, local file and special issue file, according to Action 13 of BEPS Action Plan.

The following table summarises the requirements and exemption of preparing contemporaneous documentation report and the submission deadlines set out in Bulletin 42.

Item	Bulletin 42
Documentation type	Master file, local file and special issue file.
Preparation requirements	Master file should be prepared: – Where the taxpayer has related-party transactions with overseas related parties during the year, and the taxpayer's ultimate holding company, which consolidates the financial statements of the taxpayer, has prepared a master file; or – Where the annual amount of related-party transactions conducted by the taxpayer exceeds CNY 1 billion.
	Local file should be prepared: – Where the amount of purchase/sales of tangible assets is more than CNY 200 million (for toll manufacturing activities, the amount is calculated based on the import/export customs declaration prices); – Where the amount of transfer of financial assets is more than CNY 100 million; – Where the amount of transfer of intangible assets is more than RMB CNY million; or – Where the amount of other related-party transactions is more than CNY 40 million.
	Special issue file should be prepared: – Where the taxpayer enters or implements cost sharing agreements; – Where the taxpayer violates the thin capitalisation rules for thresholds (non-financial institutions – 2:1, financial institutions – 5:1).
Exempt from preparation	– Taxpayers with an Advanced Pricing Arrangement ("APA") are exempted from the preparation of a local file and special issue file if the related-party transactions are covered in the APA; – The taxpayer is exempted from the preparation of a master file, local file and special issue file if its related-party transactions are conducted with domestic related parties only.
Deadline for preparation	– Master file should be completed within 12 months of the fiscal year end of the group's ultimate holding company; – Local file and special issue file should be completed by 30 June of the following year.
Deadline for submission	Within 30 days of the request from the tax authorities.

Since the master file aims at large-scale enterprises with tremendous amounts of related-party transactions, the disclosure requirements focus more on the group information, such as the global shareholding structure, group business description, group strategic plan for intangible assets, group financing arrangement and group financial and tax information.

As for the local file, Bulletin 42 makes revisions based on Circular 2 by including value chain analysis which requires taxpayers to disclose the allocation principles and actual allocation results of group's value chain from research and development to after-sales services, as well as the impact of location specific factors on the pricing of transactions, and the portion of value creation from location specific factors shared by taxpayers. In addition, Bulletin 42 adds the disclosure requirements for overseas investment and related-party equity transfers. Compared to Circular 2, Bulletin 42 places more emphasis on related-party services transactions, including the methodology of the determination of service costs, allocation standards, calculation process, as well as information on any same or similar service transactions that the taxpayer and its group enters into with third parties.

The disclosure requirements of the special issue file for cost sharing agreements and thin capitalisation in Bulletin 42 are mostly the same as those in Circular 2.

BDO China comment

The release of Bulletin 42 enables the Chinese Tax Authorities to obtain more comprehensive information on taxpayers so that the selection of transfer pricing audit targets will be more precise. The implementation of Bulletin 42 signals the determination of the Chinese tax authorities in strengthening international tax cooperation and combating tax evasion by actively participating in the BEPS Project.

Bulletin 42 sets higher requirements for disclosing information in contemporaneous documentation. It requires more resources for MNEs with large amounts of related-party transactions to prepare master files. To most Chinese subsidiaries of MNEs, the most significant impact is the additional scope for preparing a local file, especially the disclosure of value chain analysis and related-party service transactions. We expect many taxpayers will have difficulties in information collection, analysis and integration when preparing the master file or local file for the first year.

It is noted that following CbCR and other related-party information required to be disclosed in the related-party transactions reporting, and new requirements set out for the three-tiered Transfer Pricing Documentation Reports, Bulletin 42 not only improves the transparency of taxpayer's information, but also increases the compliance cost of taxpayers. Bulletin 42 is applicable to contemporaneous documentation and related-party reporting in year 2016 and after. To avoid the hassles in reporting related-party information and preparing the contemporaneous documentation report in year 2017, it is recommended that taxpayers, especially large MNEs that are required to prepare a master file and local file, should communicate with global headquarters to start the information collection and preparation process as early as possible in order to ensure the consistency in the disclosure of transfer pricing arrangements on a global scale. If taxpayers experience uncertainty in information disclosure or difficulty in information preparation, it is suggested that they consult professional firms for advice, and perform a health check on current transfer pricing arrangements to better cope with and manage transfer pricing risks.

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LUXEMBOURG

IMPLEMENTATION STATUS OF OECD GUIDELINES AND EU DIRECTIVES

Like many other countries, Luxembourg is progressing with the transposition of the OECD recommendations developed under the OECD/G20 BEPS-Project for increasing the transparency of cross-border tax arrangements, and of EU initiatives aiming for the same. Furthermore, the government has taken another step forward to supplement the existing transfer pricing regulations with regard to the application of the arm's length principle.

Exchange of information about Advance Tax Rulings and Advance Pricing Agreements

In the final report on item 5 of the OECD/G20 BEPS-Project, a framework is recommended where a spontaneous exchange of information about Advance Tax Rulings ('ATR') and Advance Pricing Agreements ('APA') takes place amongst the jurisdictions affected.

The EU has launched a similar initiative, which resulted in the third modification of the EU Directive on Administrative Cooperation ('DAC3') via Council Directive (EU) 2015/2376 of 8 December 2015. According to DAC3, the exchange of information between EU Member States is mandatory and automatic.

In order to transpose DAC3 into Luxembourg law, the Parliament approved on 23 July 2016 draft law no. 6972, amending the law of 29 March 2013 on administrative cooperation in taxation matters. The law will apply from 1 January 2017, but it also covers ATRs/APAs that:

- Were issued, amended or renewed between 1 January 2012 and 31 December 2013, under the condition that the ATR/APA was still valid on 1 January 2014;
- Were issued or will be issued, amended or renewed between 1 January 2014 and 31 December 2016, irrespective of whether they are still valid.

Excluded from the exchange of information are ATRs/APAs that:

- Were issued, amended or renewed before 1 April 2016 on behalf of enterprises with an annual net turnover of less than EUR 40 million (or the equivalent in another currency) in the fiscal year before the ATR/APA has been issued and do not relate to financial or investment activities;
- Relate solely to Luxembourg tax or transfer pricing matters;
- Are issued to individuals.

Already since 1 January 2016, the Luxembourg tax administration grants new ATRs/APAs only if the relevant information is provided by the taxpayer via Form 777 (mandatory to be prepared in English). Information about ATRs/APAs granted previously is currently collected via the same form, also covering those issued or modified already on or after 1 January 2010, which is the timeline recommended by the OECD.

It is worth noting that some of the ATRs/APAs granted in the past will not be subject to the exchange due to their limitation on Luxembourg tax matters.

Country-by-Country Reporting

The Country-by-Country Report ('CbCR') as one of three tiers of Transfer Pricing Documentation recommended by the OECD has been adopted by the EU via the fourth modification of the EU Directive on Administrative Cooperation ('DAC4'), Council Directive (EU) 2016/881 of 25 May 2016.

The transposition of DAC4 into Luxembourg law progresses as well, with draft law no. 7031 submitted to the parliament for approval on 2 August 2016.

The provisions of the law will come into force starting 1 January 2016 and the CbCR must be filed within 12 months after a respective financial year has expired. The content to be provided exactly follows DAC4.

Making CbCR available to the public, as advocated especially by some EU Member States, is not foreseen in the draft law.

If the taxpayer fails to comply with the CbCR requirements, either by filing incompletely, incorrectly or with delay, the tax administration will be entitled to impose a penalty of up to EUR 250,000.

Master file and Local file Documentation

Luxembourg introduced Transfer Pricing Documentation requirements effective 1 January 2015, and the Luxembourg tax administration is increasingly reviewing whether taxpayers comply with the rules. For example, it has become common practice that the administration requests from taxpayers the submission of such documentation in the context of annual tax assessments, if international structures have been newly set up or been modified significantly or if the numbers presented in the annual tax returns raise questions about the adequacy of the transfer price setting.

The existing documentation requirements provided for by the law are based on the general requirement to explain and evidence transactions that are relevant from a tax point of view. A specification of the rules with regard to content and structure of Transfer Pricing Documentation does not yet exist.

Given the OECD's recommendation for a three-tiered set of Transfer Pricing Documentation and the current lack of specific guidance in Luxembourg, a legislative initiative to make the preparation of master file and local file mandatory appears likely. However, such an initiative has not been addressed to the public yet.

Application of the Arm's Length Principle

As of now, the only legal basis for applying the arm's length principle is article 56 of the Luxembourg Income Tax Law, which mirrors article 9 para. 1 of the OECD model tax convention. No further guidance exists yet on how to apply the arm's length principle in practice, apart from circular L.I.R. no. 164/2 that applies solely to intra-group financing transactions.

As part of the 2017 budget and respective draft law no. 7050 that has been presented by the government on 12 October, the Luxembourg transfer pricing regulations will be further specified by the introduction of new article 56bis into the Luxembourg Income Tax Law. Article 56bis, as currently drafted, makes specific reference to chapters I to III of the OECD Transfer Pricing Guidelines and to items 8-10 of the OECD/G20 BEPS-Project.

Emphasis is put in the draft of article 56bis on explaining the importance of a comparability analysis. Chapters II and III of the OECD Guidelines are declared directly applicable as part of Luxembourg laws.

The draft of article 56bis ends with mentioning the possibility of disregarding intra-group transactions if the actual conduct lacks economic rationale (c. 1.122-1.125 OCED Guidelines).

Closing remarks

The taxpayer is well advised not to be passive, but to take ownership to the largest degree possible regarding type and content of the information exchanged between tax authorities regarding ATRs/APAs and under CbCR.

Even though not yet formally required in Luxembourg, preparing Transfer Pricing Documentation in line with the OECD's master file/local file approach is permitted and will be recommended.

The recent legislative measures and current practice of the Luxembourg tax authorities in reviewing transfer pricing cases demonstrate that multinationals need to be fully compliant with the arm's length principle in relation to their intra-group transactions affecting Luxembourg.

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RUSSIA

REVIEW OF THE RESULTS OF TRANSFER PRICING AUDITS

In the Russian Federation Transfer Pricing (TP) rules that are generally in compliance with the OECD TP Guidelines entered into force as far back as 2012.

Under the Russian Tax Code only the Federal Tax Service is entitled to conduct TP audits. A TP audit cannot be part of standard tax audits conducted by local tax inspections.

A TP audit of a taxpayer is conducted for a separate reporting year and must be started by the Federal Tax Service no later than two years from receiving a notification on controllable transactions from the taxpayer or information from the local tax authority on controllable transactions undisclosed by the taxpayer.

Brief review of the TP audit measures taken by the Federal Tax Service of the RF to date

All the TP audit measures known to date were reported in March 2016[1].

TP audits

As reported, only 16 TP audits for 2012 were completed and respective audit reports were delivered to three of six taxpayers. Export deliveries of crude oil and refined products as well as metallurgic products were audited. Just seven TP audits for 2013 were started for six taxpayers in respect of deliveries of metallurgic products and mineral fertilisers.

At present no results of such TP audits are known.

Self-assessment TP adjustments

Some Russian taxpayers have also made TP adjustments on a self-assessment basis for more than RUB 30 billion.

TP notifications

Local tax inspections have checked 11,800 TP notifications filed by Russian taxpayers and revealed different violations, mostly in relation to non-compliance with deadlines.

[1] *The Report on the RF FTS 2015 plan execution, signed by the Minister of Finance of the RF, 25.03.2016, p. 1.1.39.*

TP check procedures within common tax audits

The last time the Russian tax authorities tried to conduct TP check procedures within common tax audits carried out by local tax inspections in respect of non-controllable transactions. Such an approach is justified by the fact that local tax inspections are entitled to reveal any activity of the taxpayers aimed at an unjustified tax benefit using price manipulation.

In particular, 195 decisions were issued upon common tax audits for 2015 in the above cases.

Recent law enforcement practice shows that such decisions were often considered in court, generally resulting in rulings for taxpayers.

The following main questions were examined in lawsuits:

Is a local tax inspection entitled to perform the transfer pricing control within the common tax audit?

Such a question arises from some provisions that are envisaged by the Russian Tax Code relating to TP audit procedure. First of all the special TP audit can be conducted exclusively by the Federal Tax Service rather than by local tax inspections.

Moreover, by virtue of an express statutory bar, common tax audits conducted by local tax inspections cannot involve transfer pricing control procedures for the controllable transactions.

Pursuant to the abovementioned provisions, the Russian courts often decide that local tax inspections go beyond legislative powers when adjusting prices in the controllable transactions for tax purposes.

What conditions must be observed by the local tax inspection to have powers for the transfer pricing control?

As far back as 2012 the Russian Ministry of Finance issued explanations on how to interpret the above-mentioned provisions. In its explanations the Ministry actually confirmed the ability of local tax inspections to perform transfer pricing control within common tax audits, but only for non-controllable transactions[2]. Moreover, the Ministry has limited such cases by the following conditions:

1. There are cases where the tax base is accrued based on some specific legislative provisions that require transfer pricing rules to be directly applied irrespective of whether the transaction is controllable, including but not limited to following types of transactions:
   a) Barter transactions;
   b) Donations;
   c) Granting a pledge to the pledge holder in default of the secured obligation; or
   d) Transactions within a truck system.
2. If the first condition is not met, the local tax inspection must prove within the common tax audit that the taxpayer reaped an unjustified tax benefit due to price manipulation.

The "unjustified tax benefit" concept was defined by the Plenum of the Supreme Arbitration Court of the RF in 2006[3]. The Supreme Arbitration Court noted, *inter alia*, that the mere relationship of parties to the transaction cannot prove the tax benefit is unjustified.

Last but not least, the Russian tax courts also sought to prevent local tax inspections from performing transfer pricing control where the inspection affirmed an unjustified tax benefit based only on the relationship of parties to the transaction.

What approaches and what information must be applied by the local tax inspection for the transfer pricing control?

Among all the types of transactions so far leases and interest-free loans were generally subject to court proceedings regarding the powers of local tax inspections to perform transfer pricing control. In all cases the courts examined in depth whether the approach applied by the local tax inspection within transfer pricing control was in compliance with the transfer pricing rules provided by the Russian Tax Code.

In their analysis the courts typically paid attention to the following issues:

a) Did the local tax inspection ascertain any comparable transactions (or the lack of them) before estimating market price of the transaction under review;
b) Whether the conditions of the transactions considered by the local tax inspection to be comparable with the transaction under review were actually similar to the conditions of the transaction under review;
c) What information on comparable transactions was applied to calculate the market range.

In many cases where interest-free loans were considered, local tax inspections sought to define market interest rate using a database on bank deposits taken by the Russian banks. Such an approach was rejected by courts that classified bank deposits as non-comparable with loans between non-banking companies. Other reasons for refusal involved the nature of data used. As it was established in the course of proceedings, the above mentioned database contains data on a quarterly weighted average yield over bank deposits (broken down by banks) rather than on specific deposit transactions.

Everything mentioned above brings us to the conclusion that the law enforcement practice with respect to the transfer pricing rules and TP audits in Russia is in its infancy and has not yet showed any clear trends.

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[2] *Letter of the Ministry of Finance of the RF of 18.10.2012 N 03-01-18/8-145.*
[3] *Ruling of the Plenum of the Supreme Arbitration Court of the RF of 12.10.2006 N 53.*

UNITED KINGDOM

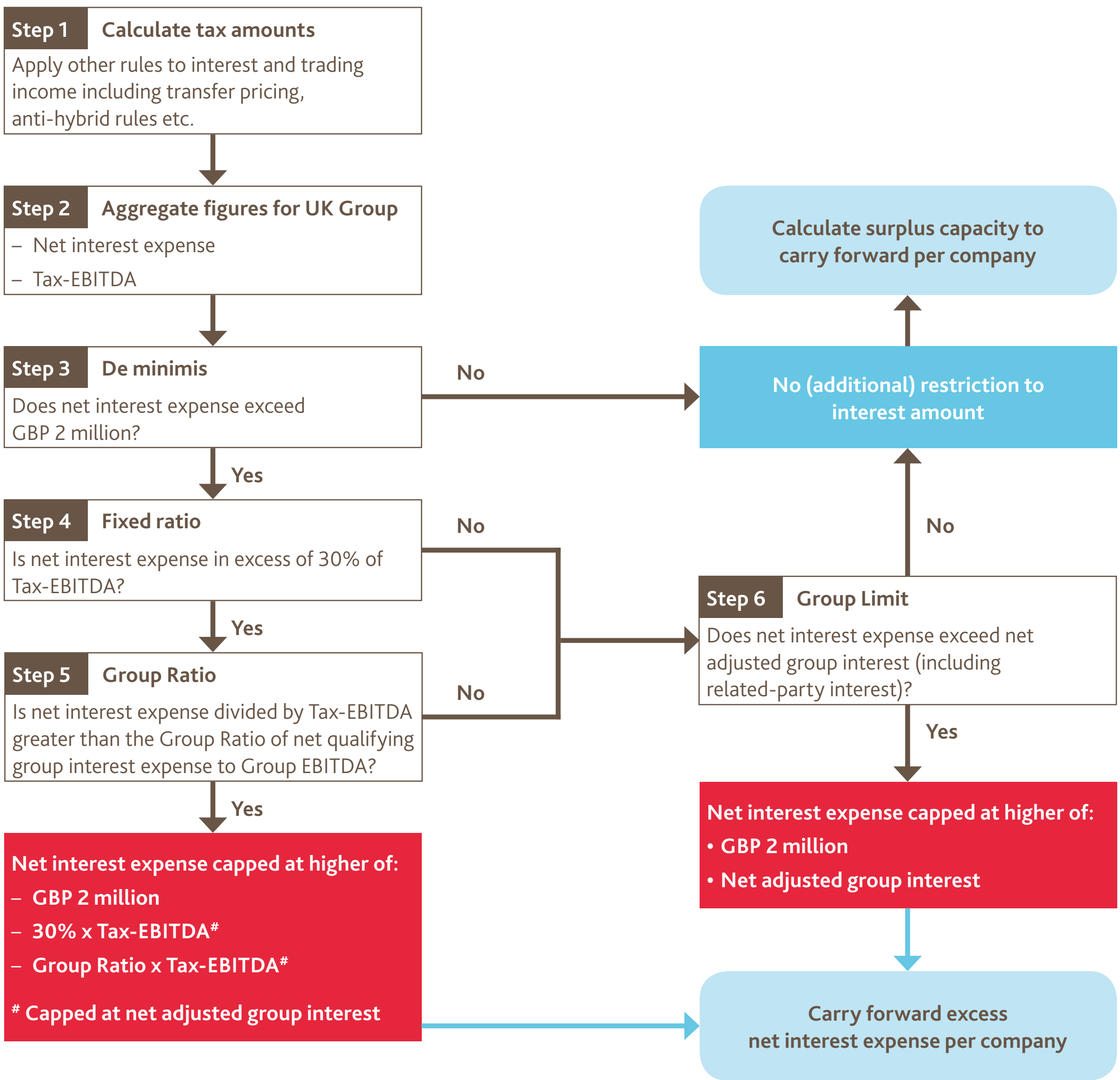
INTEREST DEDUCTIBILITY AND DIVERTED PROFITS TAX UPDATE

Interest deductibility

Following the OECD's recommendation in respect of Action 4 of its BEPS programme, which was published in October 2015, the UK is introducing a new limitation on corporate interest deductions that will come into effect from April 2017.

The second consultation on the new limitation closed on 4 August 2016. This is expected to be the final stage of formal consultation before draft legislation appears later in the year.

The rules can be summarised as follows:



Notes

1. Figures will be aggregated for all UK members of a 'group'.
2. Interest is calculated including capitalised interest and after other limitations such as transfer pricing, anti-hybrid and unallowable purpose tests. Foreign exchange movements will be excluded.
3. Tax-EBITDA is PCTCT before interest, capital allowances, IFAs and capital losses (not gains).
4. A de minimis of GBP 2 million in total will be allowed for the UK group members.
5. A fixed ratio of 30%, or if higher Group Ratio, of 'Tax-EBITDA' will be allowed.
6. The ratio test, but not the de minimis amount, will be subject to a cap based on overall net group interest expense (replacing the Worldwide Debt Cap).
7. Interest disallowed under this rule can be allocated at will to specific companies.
8. Disallowed interest will be carried forward indefinitely, to be allowed in years when there is sufficient capacity.
9. Surplus capacity may be carried forward up to three years within a specific company, allowing additional relief in later periods.
10. Interest deductions from before 1 April 2017 (e.g. under late paid interest) will not be affected.

Related-party interest

The Group Ratio rule will be restricted by excluding related-party interest amounts from the group's total qualifying interest amount. This is aimed at private equity investments and owner-managed businesses. The Government does not intend to capture genuine lenders, even where a small equity stake is held, but the detail of how these objectives will be reconciled is yet to be seen.

Conversely, related-party interest will not be excluded from the broad interest cap, keeping the effect in line with the Worldwide Debt Cap.

On-going consultation

While there is a reasonable amount of clarity over how the main rules are intended to operate, there are a number of questions outstanding, some more substantive than others.

One of the main issues seen currently is the interaction of the cap based on overall net group interest expense and the carry forward of restricted interest. Currently it is easy to make examples where restricted interest will never be allowable (as the maximum capacity is limited to current year interest).

An exemption will be made available for public benefit projects (applying to third party interest only) but the topic of what businesses qualify is the subject of much discussion.

EU impact

The EU Anti Tax Avoidance Directive permits the currently proposed UK rules, and is more lenient in several aspects such as the application to singleton companies.

The recent referendum vote in the UK reduces the significance of the EU's directive; however it has also led to some renewed calls for the interest limitation to be scrapped in order to show the UK is still 'open for business'. We consider this is unlikely given the anti-avoidance rhetoric that has been followed in the UK over a number of years, making it politically awkward to abandon plans. It is more likely the rule could be deferred.

Diverted Profits Tax update

The UK Diverted Profits Tax (DPT) came into force from 1 April 2015, with the ability to apply a 25% tax on profits diverted from the UK either by transaction structures lacking sufficient substance or through artificial avoidance of a UK permanent establishment.

Unlike the majority of UK taxes, the DPT is not self-assessed by taxpayers and relies on notification and then action by HMRC. The first notifications, for companies with year ends up to April 2016, were due by 30 June 2016.

HMRC has a task force of approximately 40, led out of the transfer pricing unit that is examining scenarios that potentially give rise to a loss of tax on international transactions, including withholding tax. The task force is expected to consider a wide range of sources to identify and score risks.

The DPT can apply in situations where an insufficient transfer pricing adjustment has been made, which could include cases where a taxpayer has been in dispute with HMRC, and therefore is a potentially powerful threat against arrangements that have any doubt over substance or commercial purpose.

Taxpayers and advisers alike will be waiting with interest to see the level of activity by HMRC using the DPT and how cases progress.

We are aware of companies having received DPT assessments already, although the full extent of activity or total tax assessed will not be known for some time as HMRC has a two-year window to raise assessments for each period.

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UNITED STATES OF AMERICA

COUNTRY-BY-COUNTRY REPORTING

In October 2015, the Organisation for Economic Co-operation and Development ("OECD") released its final reports on base erosion and profit shifting ("BEPS"), including Action Item 13, which addresses Transfer Pricing Documentation[4]. To further the BEPS goal of standardised transfer pricing reporting, Action Item 13 calls on member states to require multi-national entities ("MNEs") to maintain and submit three "tiers" of documentation: (i) a master file, (ii) a local file, and (iii) a Country-by-Country ("CbC") Report. Action Item 13's revised Chapter V of the *OECD Guidelines* declares it "essential" that its guidance "be implemented effectively and consistently." Since the announcement of the new reporting regime, many OECD Member States have adopted the complete reporting package. Affected MNEs are revamping their Transfer Pricing Documentation to align with the new approach.

The United States has formally committed to adoption of all BEPS action items. Yet the Treasury Department and Internal Revenue Service ("IRS") now require only one of three Action Item 13 documents – the CbC Report – from US-resident MNEs. Regulations finalised on 29 June 2016 (T.D. 9773) require larger US-resident parents of MNEs to file CbC Reports with their annual US income tax returns[5]. The CbC requirement supplements Transfer Pricing Documentation requirements, but does not otherwise change the current IRS reporting scheme.

Reporting threshold and contents of CbC Reports

The IRS CbC requirement follows OECD recommendations in many respects. The OECD would require CbC Reports from MNEs with worldwide revenue of at least EUR 750 million in the immediately preceding accounting period. The US CbC requirement approximates to the OECD threshold by applying the requirement to US-resident parents of MNEs with worldwide revenue of at least USD 850 million.

The IRS also requires much the same information as the OECD. US CbC Reports must identify each "constituent entity" of the MNE group by legal name, tax jurisdiction of residence, jurisdiction of organisation or incorporation, tax identification number, and principal business activities. For each tax jurisdiction in which a constituent entity resides, the reporting taxpayer must provide:

- Revenues from intercompany transactions;
- Revenues from third party transactions;
- Pre-tax profit or loss;
- Income and withholding taxes paid;
- Accrued tax expense in the current period;
- Stated capital;
- Accumulated earnings;
- Number of full-time equivalent employees; and
- Net book value of tangible assets.

This financial information must be aggregated by jurisdiction. For example, a CbC Report for a tax jurisdiction in which two constituent entities reside will provide only one revenue figure for intercompany transactions. The regulations further define each of the key terms included in the CbC Report.

Differences in documentation requirements

While the IRS CbC plan resembles the OECD's, the Treasury Department's decision to maintain existing reporting requirements leaves the US standing apart from other OECD Member States. Master files and local files respectively offer support for the MNE's worldwide transfer pricing policies and the application of those policies to local entities. The OECD recommends that MNEs deliver master files and local files directly to tax administrations and that master files be shared freely among them.

By contrast, the IRS requires all US resident taxpayers with intercompany transactions subject to the arm's length principle to maintain, but not to file, Transfer Pricing Documentation to avoid transfer pricing penalties. Taxpayers must complete the documentation by the time the return is filed, and must provide it to the IRS on 30 days' notice. Missing or improper documentation invites penalties up to 40% of any increase in tax resulting from a transfer pricing adjustment.

A US tax examiner reviewing a local file modelled on OECD standards would likely find much of the same information and analysis that appear in a US Transfer Pricing Documentation Report. Nevertheless, a local file that accords with the OECD approach may not protect a US MNE member from US transfer pricing penalties. Only a report prepared in accordance with the penalty avoidance guidelines appearing in Section 1.6662-6 of the US Treasury Regulations will afford protection.

Similarly, while US-resident parents of MNE groups that meet the income threshold must file a CbC Report, the US does not require any master file setting forth worldwide transfer pricing policies. Since many other tax jurisdictions will expect master files to be available, such US entities should obviously consider having them on hand.

[4] OECD. (2015). *Transfer Pricing Documentation and Country-by-Country Reporting, Action 13 – 2015 Final Report,* OECD Publishing, Paris. http://www.oecd.org/tax/transfer-pricing-documentation-and-country-by-country-reporting-action-13-2015-final-report-9789264241480-en.htm

[5] US Departments of the Treasury. Internal Revenue Service. (2016). *T.D. 9773, Country-by-Country Reporting.* https://www.irs.gov/irb/2016-29_IRB/ar05.html

Exchange of CbC Reports

The OECD's vision of a single transfer pricing reporting system includes automatic annual exchange of CbC Reports among competent authorities. The OECD has developed, and at least 44 countries have signed, the Multilateral Competent Authority Agreement on the Exchange of Country-by-Country Reports[6]. The US has no plan to sign any multilateral tax agreement. Instead, the preamble to the IRS CbC regulations promises that the United States will "enter into competent authority arrangements for the automatic exchange of CbC [Reports] with jurisdictions with which the United States has an income tax treaty or tax information exchange agreement ['TIEA']." It remains to be seen whether existing US treaty and TIEA partners will embrace this bilateral approach in addition to multilateral arrangements they have already entered into.

Timing of CbC implementation

The OECD recommended that the CbC reporting would commence for taxpayers whose annual accounting periods began on or after 1 January 2016. US CbC regulations are effective for reporting periods beginning on or after 1 July 2016. The timing difference may create a "gap period" in which US-parented MNEs would have to file a CbC Report in a foreign jurisdiction even though US requirements were not yet effective. The Final Regulations allow US parent entities to file CbC Reports voluntarily during the six-month gap. The IRS plans to issue further guidance on how to accommodate voluntary CbC filers.

Conclusion

While a majority of OECD and G-20 countries have implemented the complete OECD framework for MNEs to file a master file and local file, the US requires only the CbC Report. Regardless, many US entities may have foreign parents in jurisdictions that require filing of all three documents, and must be aware of when and how to implement the new regulations.

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[6] OECD. (2016). *Signatories of the Multilateral Competent Authority Agreement on the Exchange of Country-by-Country Reports.* https://www.oecd.org/tax/automatic-exchange/about-automatic-exchange/CbC-MCAA-Signatories.pdf

CURRENCY COMPARISON TABLE

The table below shows comparative exchange rates against the euro and the US dollar for the currencies mentioned in this issue, as at 8 November 2016.

Currency unit	Value in euros (EUR)	Value in US dollars (USD)
British Pound (GBP)	1.12318	1.24308
Chinese Yuan (CNY)	0.13319	0.14742
Euro (EUR)	1.00000	1.10665
Russian Rouble (RUB)	0.01412	0.01563
US Dollar (USD)	0.90348	1.00000

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