Nexia International

Transfer Pricing

Service newsletter

January 2019

Contents:

Introduction

Dear friends,

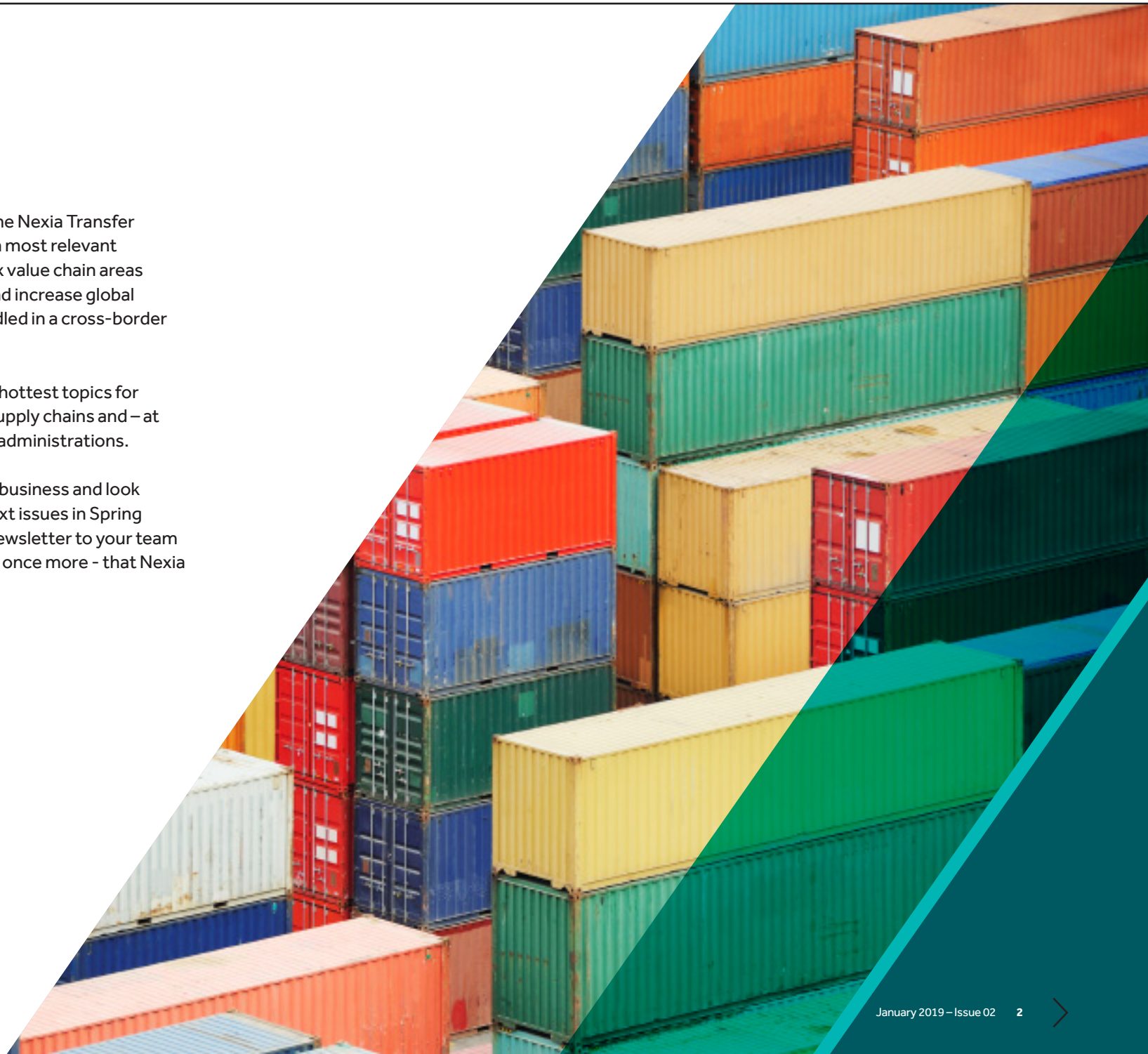
We are now launching the second issue of the Nexia Transfer Pricing Newsletter: it will provide insights on most relevant developments in the transfer pricing and tax value chain areas in the aim of fostering knowledge sharing and increase global view over crucial topics that need to be handled in a cross-border perspective.

Transfer pricing continues to be one of the hottest topics for multinational enterprises to manage their supply chains and – at the same time – their relationships with tax administrations.

We hope this publication will stimulate your business and look forward to receive your contributions for next issues in Spring 2019. We encourage you to distribute this newsletter to your team members as well as your clients to witness - once more - that Nexia is "Closer to you".

Thank you and best regards,

Nexia Transfer Pricing Business Group.



Multilateral Instrument in Australia

On 26 September 2018, Australia ratified the Multilateral Instrument (MLI). The MLI is a multilateral treaty that enables jurisdictions to swiftly modify their bilateral tax treaties to implement measures designed to better address multinational tax avoidance. The MLI will enter into force for Australia on 1 January 2019.

The extent to which the MLI will modify Australia's bilateral tax treaties will depend on the final adoption positions taken by other countries. Some of Australia's key adoption provisions in respect of the MLI have been reproduced on the following table:

Article #	Explanation	Australia's position
3	Transparent entities – Treaty benefits will be granted for income derived through fiscally transparent entities (trusts or partnerships) but only where one of the two countries exercises its taxing rights of that income.	Adopted Article 3 but will preserve existing corresponding bilateral detailed rules where appropriate.
4	Dual Resident Entities – Most of Australia's treaties (31 out of 45) use an entity's place of effective management as the key tiebreaker test determine a dual resident's country of tax residence for treaty purposes. This test will be expanded under the MLI.	Adopted Article 4 but not the rule that would allow the two tax administrations to grant treaty benefits in the absence of such an agreement.
5	Application of methods for elimination of double taxation.	Not adopted Article 5 because all of its treaties apply the credit method in relieving double taxation for Australian residents.
6	Purpose of a Covered Tax Agreement.	Adopted Article 6, including the optional text indicating a desire to further develop its economic relationships with other Parties and enhance cooperation in tax matters.
7	Prevention of treaty abuse.	Adopted Article 7 and only the Principal Purpose Test (PPT), including the discretion not to apply the PPT in certain circumstances.
8	Dividend transfer transactions - Shares will be required to be held for 365 days before any non-portfolio intercorporate dividends payable in respect of those shares become eligible for reduced tax rates under tax treaties.	Adopted Article 8 without reservation.
9	Countries will be able to tax capital gains derived by foreign residents from the disposal of shares or other interests in 'land-rich' entities (where the underlying property is located in that country) if the entity was land-rich at any time during the 365 days preceding the disposal.	Adopted Article 9 but will preserve existing bilateral rules that apply to the disposal of comparable interests (non-share interests) in land-rich entities.
11	Application of tax agreements to restrict a Party's right to tax its own residents.	Adopted Article 11 without reservation.

ATO's Reconstruction Powers

Australian tax legislation was updated in 2013 to provide the ATO with the ability to assess how independent parties would have transacted and re-characterise international related party transactions to be in accordance with the arm's length rate. Whilst to date this has been rarely used in practice, the Australian Deputy Commissioner recently mentioned the ATO's intention to use such powers going forward. In particular, the ATO is likely to focus on taxpayers whose actions which do not appear to make commercial sense and shift value, particularly in the form of IP, out of Australia.

The ATO's recent push is likely to be in part attributable to their recent successful landmark case against Chevron in 2017 which led to a tax bill of approximately A$340 million. Whilst the Chevron case was decided under the previous TP law, the judgement lends support to the view that there is an ability to substitute arm's length conditions as proposed by the ATO.

Diverted Profits Tax (DPT)

The ATO on 26 September 2018 released a Law Companion Ruling (LCR 2018/6) and an accompanying Practical Compliance Guideline (PCG 2018/5) on the DPT.

The DPT rules aim to ensure that significant global entities (broadly members of an accounting group with over A$1 billion worldwide) cannot reduce their Australian tax by diverting profits offshore through arrangements with related parties. Where the rules apply and the ATO decides to make a DPT assessment, tax is imposed at a rate of 40% on the amount of the diverted profit (effectively a 10% penalty rate above the general 30% rate).

The LCR discusses in detail what requirements need to be satisfied before the DPT is triggered. The PCG focuses on the ATO's taxpayer engagement framework and outlines the ATO's approach to risk assessment and compliance activity. Notably the PCG doesn't include any specific record-keeping requirements, however the ATO expects the taxpayer to have kept contemporaneous TP documentation and intercompany agreements and policies regarding such dealings.

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Transfer Pricing in China

As an effort to tackle tax base erosion and profit shifting, the State Administration of Taxation ("SAT") in China issued a series of circulars on transfer pricing ("TP") administration.

On 29 June, 2016, the Bulletin 42 was released as the update of contemporaneous TP documentation and annual reporting of related party transactions. It introduces a three-tier documentation framework, including country-by-country reports ("CBCR"), master file and local file. Besides, the special item file and value chain analysis are all covered by Bulletin 42.

Soon afterwards, SAT issued Circular [2016] No. 64 "Announcement of the SAT on Improvements to Matters Relating to Administration of Advance Pricing Agreement" and Circular [2017] No.6 "Announcement of the SAT on Promulgation of the Administrative Measures on Special Tax Investigation, Adjustment and Mutual Agreement Procedure". The launch of these circulars constructed part of the China's anti tax avoidance system.

PRC - Documentation Request

Master file
Master File requires high level information concerning the MNE global operations and transfer pricing policies.

If the company has cross-border related party transactions, and belongs to a group which has prepared the master file, or the total annual related party transactions amount exceed RMB one billion, it shall prepare a master file.

Local file
Local File should consist of information on the taxpayer specific business operations, financial information and affiliated transactions, including the transfer pricing analysis of the covered related party transactions.

The thresholds are depend on the types of RPTs:

- 200 million RMB for tangible assets transfer;
- 100 million RMB for financial assets transfer;
- 100 million RMB for intangible assets transfer;
- 40 million for other related party transactions in total.

Compared to previous requirements, more information is required to disclose pursuant to Bulletin 42, such as location specific factors, value chain analysis, etc.

- Analysis on location specific factors shall focus on aspects such as labor costs, environmental costs, market size, degree of market competition, consumer purchasing power, substitutability of goods or services, and regulatory controls, and etc.
- Value Chain analysis includes analysis on business flow, logistic flow, cash flow and financial statements of participants in the value chain calculation and allocation of local special factors on enterprise value contribution principle for profit allocation within global value chain and the associated results.

Special item file
The special issue file is required for the taxpayers who are engaged in cost sharing agreement, or fall in the thin capitalization threshold. The disclosure requirements of special issue file are basically similar to the provisions in previous requirements.

Thin Capitalization

- An enterprise with a related party debt-to-equity ratio exceeding the threshold shall prepare a special issue file on thin capitalization to demonstrate its conformity with the arm's length principle.

Cost Sharing Agreement

- This is a mechanism of sharing the costs and risks of the development of intangibles. Through functional analysis, economic analysis and negotiation with tax bureau, CSA can help to mitigate or resolve existing risks such as double taxation, and reduce tax exposure.

Country-by-Country Reporting ("CBCR")
The CBCR Forms are required for the Chinese resident enterprises if it is the ultimate holding company of the group or the consolidated revenues over RMB 5.5 billion or it is nominated as the CBCR entity by the group.

If the multinational enterprise ("MNE") meet one of below requirements, the Chinese tax authorities can ask for CBCR from the Chinese subsidiaries under the following circumstances in the special tax investigation:

- The MNE has not submitted a CBCR to any country;
- The MNE has submitted a CBCR to another country, but China has not established an Information Exchange Mechanism with the country;

The content of the annual CBCR Forms are consistent with those in BEPS Action 13, however, it should be filled in both Chinese and English when submitting together with the annual tax filing. The related 3 CBCR Forms are include in the package of Related Parties Transactions Forms ("RPTF"). Chinese subsidiaries could select whether it is required to fill in CBCR Forms when submitting RPTF.

Advance pricing agreement

China began to practice the administration of APA since the end of the 1990s. Bulletin 64 would prove to be a milestone regulation of Chinese APA practice. The process of APA has been regulated and the administration has been further improved. Major changes are as following:

- Add in the phase "intent for APA";
- Rephrase the "examination and evaluation" to "analyses and evaluation";
- Combine the negotiation and signing arrangement into "negotiations and signing";
- Re-order the "formal filing" after the "analyses and evaluation".

Emphasis of Circular 6

Circular 6 has clarified certain key transfer pricing issues, as well as methodology and procedures for special tax audits and adjustments. Circular 6 puts more emphasis on a risk-oriented tax administration system which expects to improve cooperation between enterprises and tax authorities.

The following are the target enterprises eye-tracked by tax authorities:

- Enterprises with significant amount of related-party transactions or engaged in many types of related-party transactions;
- Enterprises with continuous losses, low profitability or fluctuating profitability;
- Enterprises with profit levels lower than the enterprises in the same industry;
- Enterprises whose profit levels do not match their functions and risks or the shared benefits do not match the allocated costs;
- Enterprises engaged in related party transactions with related parties located at low tax jurisdictions;
- Enterprises not submitting the related party disclosure returns or preparing contemporaneous TP documentation;
- Debt /equity investment ratio exceed the stipulated standards;
- CFCs established in tax jurisdiction with effective tax rate lower than 12.5% and does not distribute profit or distribute minimal profit without reasonable business needs;
- Implements other tax planning or arrangements without reasonable business purposes.

Circular 6 emphasizes that:

- Arm's length principle should be applied for the related party service transactions. It requires that: 1) The services should be beneficial to the service recipient; 2) The fee should be made consistent with arm's length.
- The returns from intangibles should match the business operation and the contribution to the value of intangibles.
- Contribution of "promotion" is newly added compared to BEPS actions.
- If the service fee or royalties are inconsistent with arm's length principle, tax authorities are empowered to make full adjustments.

Conclusion

China tax authorities have been focusing on TP administration by enforcing stringent strong local-flavored TP regulations/rules, imposing detailed compliance requirements and invoking ever-increasing scrutiny on related party transactions. Companies should therefore assess their risks and document their TP policies in their China operations.

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Amendments in Indian Transfer Pricing - ease or burden?

Multi-national enterprises (MNE's) now represent a large proportion of global GDP. Globalisation has resulted in a shift from country-specific operating models to global models. Transfer Pricing (TP) regulations have been at the forefront of corporate headlines over the last few years due to the increasing number of controversies resulting out of tax structuring by multinational companies (MNC's).

The Indian TP regulations and administration have been perceived earlier to be one of the most aggressive regimes in the world.

On Transfer Pricing front, government had come up with few antagonistic amendments in last year which are discussed herein below:

Secondary Adjustment

Finance Act, 2017 inserted section 92CE i.e. secondary adjustment (SA) which provided for adjustment in the books of accounts of the tax payers to reflect actual allocation of profits between the taxpayers and its Associated Enterprise(s) ("AE") in line with the Arm's length price ("ALP") so determined. SA is applicable if there is "primary adjustment" to transfer price. Primary adjustment is nothing but variation in ALP and price of controlled transaction. The Excess money on account of primary adjustment, if not repatriated to India within the prescribed time i.e. 90 days, shall be deemed to be an advance made by the taxpayer to such AE and interest on such advance shall be computed as prescribed in rules.

Here, primary adjustment to transfer price refer to an adjustment made by the assessee in his income return or by the Assessing Officer and has been accepted by the assessee or is determined by an advance pricing agreement (APA) or is made as per the safe harbour rules; or is arising as a result of resolution of an assessment by way of the mutual agreement procedure (MAP) for avoidance of double taxation. Further, SA is not applicable if quantum of primary adjustment does not exceed INR 10 million (USD$ 136,000 approx.) and not applicable in respect of an assessment year commencing on or before 1st April 2016.

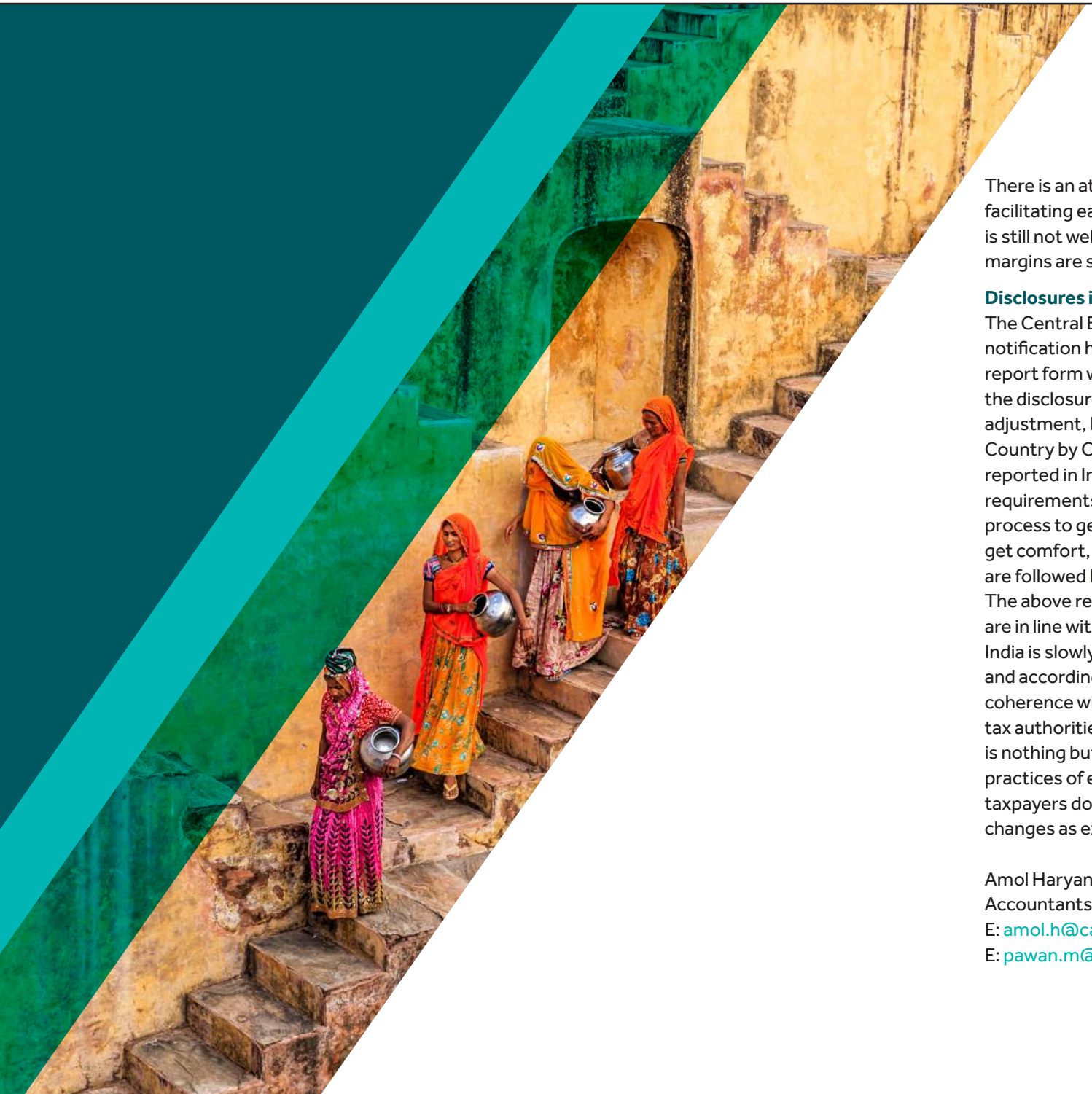
As expressed by Indian taxpayers, this is nothing but burden on AE as well as taxpayers due to repatriation of excess money to India and payment of taxes on primary adjustment. Further, sometimes it is difficult to convince AE (which is considered as AE due to prescribed criteria stated in rules) where there is no actual business control, to repatriate funds.

Limiting interest deduction

In line with Action Plan 4 of OECD Base Erosion & Profit Shifting (BEPS) project, provision related to limiting interest deductions has been introduced with effect from 1st April 2018. It is applicable to an Indian company or a permanent establishment of a foreign company in India. As per the said provision, there is limit set for deduction of interest expense incurred on payment towards debt from non-resident AE. Here also Debt from Non-AE is covered if based on guarantee or matching funds provided by an AE. Disallowance will be lower of total Interest paid/payable above 30% of EBITDA; or Interest paid/payable to AE. The excess Interest disallowed can be carried forward to subsequent years for set off against profits of those years for eight consecutive years immediately succeeding the year. The said amendment is not applicable when amount of interest does not exceed INR 10 Million (USD$ 136,000 approx.)
It deals with limiting base erosion through interest and other financial payments which does not constitute a minimum standard. It requires MNE's to review their financials arrangements to ensure that the arrangement is adhering to BEPS principal.

Safe Harbour Rules

Indian Government has taken several measures to reduce the compliance and litigation burden to taxpayers. The safe harbour rules (SHR) were revised to reduce mark-up/margins for Information Technology (IT) and IT enabled Services (ITeS). There are amendments in other areas of litigation too which includes intra-group financing arrangements.



There is an attempt to reduce TP disputes, bringing certainty and facilitating ease of doing business. However, the said amendment is still not welcomed positively by taxpayers since the safe harbour margins are still higher compared to industry trends.

Disclosures in Tax Audit Report

The Central Board of Direct Taxes (CBDT) in India, vide separate notification has brought about various amendments in tax audit report form which are effective from 20th August 2018. Few of the disclosures are pertaining to TP provisions which Secondary adjustment, Limiting Interest Deductions and Applicability of Country by Country (CbC) Reporting which are required to be reported in Indian tax audit report as per said notification. These requirements signify that, how tax authorities vigorously are in the process to get information through disclosure parts. By doing so, to get comfort, tax auditors are involved to ensure that the provisions are followed by MNE's in a set manner.

The above recent developments in the area of Indian TP regulations are in line with the global practices followed worldwide. Further, India is slowly following recommendation as per BEPS regulations and accordingly, amending the local tax laws to get the same in coherence with the best global practices. The intention of the Indian tax authorities, regarding the above amendments / disclosure is nothing but adherence to TP principals in India and avoiding practices of erosion of domestic tax base. On the other hand, taxpayers do not see things in quite the same way and finds these changes as excessive obligations.

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Singapore: So, do I really need to prepare Transfer Pricing Documentation ("TPD")?

The increased focus on related party transactions, both globally and in Singapore, is apparent. In this age where the amount of cross-border transactions continue to grow and companies continuously look for ways to increase their profits through various means, tax authorities in many countries are keeping up with the trends to ensure that companies are paying the appropriate amount of taxes in their respective territories.

In Singapore, the focus on related party transactions is evident from the increased regulatory compliance requirements. Transfer Pricing (TP) guidelines were first published in 2006, which were subsequently updated in 2015, 2016, 2017 and 2018. Then, starting 2018, Singapore tax payers are required to submit a form for reporting Related Party Transactions (RPT) together with their tax returns if certain requirements are met. Finally, penalties kick in starting 2019 when companies do not prepare TPD if they are required to do so.

At the same time, the IRAS is mindful to not unnecessarily burden Singapore tax payers by requiring TPD to be prepared only if certain thresholds are crossed. The thresholds are carefully calibrated such that most companies in Singapore will not be required to prepare TPD. The RPT form is only required to be completed if the value of RPT as disclosed in the company's financial statements exceed S$15 million for the year. As for TPD, companies must first meet one of these two conditions:

- Gross revenue derived from their trade or business is more than S$10 million for the basis period concerned; or
- TP documentation was required to be prepared for the basis period immediately before the basis period concerned

If one of these two conditions are met, then TPD must be prepared only if the value of the transactions cross a certain threshold – S$15 million for sale / purchase / loans to / loans from and S$1 million for all other types of RPT. Even then, there are certain exemptions which are as follows:

- Related party domestic transactions subject to same tax rate: transactions between related parties in Singapore (excluding related party loans) where both parties are subject to the same Singapore tax rates or exempt from Singapore tax.
- Related party domestic loans: loans provided between related parties in Singapore, and the lender is not in the business of borrowing and lending money.
- Related party loans where the safe harbour interest margin is applied.
- Provision of support services, qualifying as "routine" services on which 5% cost mark-up is applied.
- Related party transactions covered by an Advance Pricing Arrangement ("APA").

Based on the above conditions, most companies do not need to prepare TPD. However, caution should be exercised especially in cases where there are cross-border transactions. This is because even if the IRAS does not require TPD to be prepared, the tax authorities in the other countries may require TPD to be prepared. Further, while TPD may be just a piece of documentation that is prepared for the sake of compliance, there are benefits to preparing TPD – in the course of preparing TPD, companies have to look at their roles, the RPT they have and the margins for the respective RPT. This will enable companies to re-assess their positions to see if they are properly remunerated and spot any issues that may not be apparent at first glance. Also, TPDs generally take 2 months or more to be completed whereas requests from tax authorities may not give the company enough time to properly prepare TPD, creating extra stress and strain on the company's resources and employees.

In conclusion, given the extra focus by the tax authorities on RPT and the benefits of preparing TPD in advance, companies should seriously consider and start preparing TPD for their related party transactions. If you would like us to help you perform a health check on your related party transactions and potential exposure/risk, as well as to help you to prepare TPD, please reach out to us. We look forward to hearing from you!

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CbCR Insights from Germany

Legal framework

The final report on action point 13 of the BEPS action plan defined uniform standards for transfer pricing documentation consisting of three parts: master file, local file and country-by-country reporting (CbCR). All OECD and G-20 states and meanwhile also some other states commit themselves to a CbCR by implementing the regulations into national legislation (in Germany in Sec. 138a General Fiscal Code).

In principle, the domestic parental company is obliged to prepare a CbCR if its consolidated financial statements include at least one foreign company or permanent establishment and if the sales reported in the consolidated financial statements amounted to at least EUR 750 million in the previous fiscal year. Alternatively, the CbCR may also be prepared by a domestic subsidiary if the German tax authorities are not provided with the CbCR of the foreign parent company ("secondary mechanism"). This is relevant where no bilateral agreement on the automatic exchange of CbCR between Germany and the country of the parent company is in place. As Germany and the United States have not yet signed such an agreement, German subsidiaries of US multinationals could have been affected by the secondary mechanism. The competent authorities of Germany and the US have just recently agreed on a spontaneous exchange of CbCR.

In Germany, domestic companies have to state in their tax returns which entity submits the CbCR to which tax authority.

Definition of reported KPIs and open questions

Besides a list of relevant companies and permanent establishments classified by foreign tax jurisdictions (Table 2) the core element of the CbCR is an overview of the allocation of earnings, taxes and business activities in the individual tax jurisdictions by means of selected KPIs (Table 1). The overview includes all affiliated companies that are fully consolidated or proportionately consolidated in the consolidated financial statements.

For the reporting group company difficulties primarily arise in the definition of the KPIs to be disclosed (sales revenues; earnings before tax; income taxes paid; income taxes still to be paid; reported capital; retained earnings; number of employees and tangible assets).

When indicating the sales revenues, it should be considered that pure net sales are to be regarded as a starting point only; e.g., revenues from the sale of fixed assets, interest income and license fees as well as extraordinary income from investment activities and other items have to be added. However, dividends from other group companies are not included.

The indication of the number of employees raises the question whether this is determined by headcount or FTE and whether temporary workers and freelancers are included. While the OECD prefers the number of FTEs, German GAAP require the disclosure of headcount in the notes to the (consolidated) financial statements.

Other KPIs like reported capital or tangible assets also leave room for interpretation. An individually selected definition should be applied consistently for subsequent years and disclosed in the CbCR (Table 3).

Moreover, the availability of all essential data of the affiliated companies raises a great challenge. Centralizing the data ensures an effective control of the group companies and fulfils information obligations. For this reason, an increasing demand for IT solutions enabling an automatic, centralized retrieval of all data can be observed. In any case, the internal CbCR project team should be staffed not only by the tax department, but also include members of the group accounting team.

Technical challenges

The first CbCR for the fiscal year 2016 had to be transmitted to the German Federal Tax Office (Bundeszentralamt für Steuern / BZSt) by 31 December 2017 according to the officially prescribed data format (XML format). Other formats (excel, pdf etc.) are not allowed. Currently the CbCR has to be sent via secured e-mail (De-Mail). Beginning in December 2018, an upload to a specific website via electronic interface will be allowed alternatively and become mandatory from July 2019.

Any company which fails to submit the report at all or completely or in due time may be fined up to EUR 10,000. BZSt is investigating by research in the Federal Gazette (Bundesanzeiger) whether all parent companies have met their obligation to submit the CbCR. The first written contact is likely to be a friendly reminder but might be followed by a threat of fines in case the companies do not submit the CbCR within the additional deadline.

Particularly the requirements of the special format lead to great difficulties in practice. Most companies do not have the relevant software in order to transfer the relevant data into the required XML format. In many cases tax consultants are engaged to verify and to submit the CbCR data to BZSt.

Tax authorities also have to ensure that confidential information from the CbCR are not disclosed to the public. Due to the exchange of information this does not seem to be ensured at any time as some countries allow to easily get access to tax information from individual taxpayers. In addition, the political discussion about a mandatory public CbCR on European level is not yet finalized.

For these reasons the CbCR leads to a considerable additional administrative and time effort for the reporting company. OECD provides useful guidance on the implementation of CbCR (with the latest update in September 2018). But there are challenges remaining and further developments to be looked at carefully.

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Germany adopts Chapter VIII of OECD TP Guidelines 2017 for Cost Contribution Agreements

With their circular dated 5 July 2018 German tax authorities start a new chapter regarding the treatment of Cost Contribution Arrangements (CCA). Effective 1 January 2019 (for CCAs implemented before the publishing date of this circular effective 1 January 2020) German tax authorities will apply Chapter VIII of the OECD TP Guidelines 2017 for assessing CCAs. This means a significant paradigm change since the principle of mutual benefit, which underlies every CCA, is implemented differently in the concept applied by the German tax authorities so far and the new OECD concept.

Comparison of the CCA concepts

The German tax authorities´ CCA concept is based on the principle of cost pooling. The participants of a CCA form an (undisclosed) partnership with the purpose to jointly benefit from activities underlying the costs pooled in the CCA. This partnership carries out functions and bears risks connected with the pooled activities. Consequently, the contributions of the participants are valued with their respective costs. Those costs are allocated to the participants pro rata to their expected benefits from the CCA without mark-ups and form the basis for balancing payments between the participants. This concept applies irrespective of the type of activities pooled in the CCA (provided the preconditions to participate in such a pool are met).

In contrast, the OECD in Chapter VIII of its TP Guidelines 2017 understands a CCA as a performance contribution agreement between members of a pool, which offers simplification for cases of multiple transactions in which each pool participant performs functions while sharing the respective risks with the other participants. Consequently, the contributions of the participants to the CCA are evaluated with their economic value determined under the arm´s length principle. The contributed value, in turn, is allocated to the participants pro rata to their expected benefits and forms the basis for balancing payments.

Regarding the valuation of the contributions, the OECD distinguishes between low-value-adding activity CCAs and other CCAs. In case the activities pooled in a CCA are of low value adding nature (definition no. 7.44 of the OECD TP Guidelines 2017) the OECD for practical reasons states that the contributions may be valued at cost since in such cases the arm's length value of the services are close to the respective costs. Therefore, a mere low value adding activity CCA such as an administrative activity CCA is practically treated equally under the OECD concept and under the (old) German tax authorities´ concept.

For other CCAs - in particular, CCAs concerning R&D activities - the contributions to the CCA cannot be determined on a pure cost base but requires each contribution to be valued in accordance with the arm´s length principle. Even though this approach might be clear in theory, this leaves the taxpayer with a certain amount of insecurity particularly regarding CCAs, which involve functions, tangibles or intangibles which might be hard to value. Thus, we expect a high risk that each tax authority involved in a CCA will assume high value contributions by CCA participants tax resident in their respective country, as those contributions - together with the participants´ benefits - are decisive for determining the arm´s length compensation to be received from other participants under a CCA.

Transfer pricing documentation and recommendations

In principle, in case an international group with group members in Germany has a CCA in place specific documentation needs to be included in the Local and Master File. As the applicable CCA concept will change with effect from 1 January 2019 (for CCAs implemented before the publishing date of the circular with effect from 1 January 2020), it is recommended to review existing CCAs. Focus should be directed to the characteristics of the activities pooled in the CCA.

In case a CCA exclusively includes low value adding services, the application of OECD principles will most likely not have a practical impact, as contributions and balancing payments should be valued at cost base. Still, it is advisable to prepare documentation regarding the characteristics of the activities pooled in the CCA to be able to demonstrate towards the German (and other involved) tax authorities that they are of low value nature only.

If other activities are included in the CCA - particularly R&D activities - it is strongly recommended to review whether a precise determination of the value of the contributions provided by each participant is possible. In case possible, careful documentation is advised for demonstration purposes. Should a precise valuation not be possible, we see significant risks that the balancing payments made under a CCA results in extensive argumentations with the German and international tax authorities. Consequently, in such cases it might be recommendable to evaluate alternative structuring for the activities performed under the CCA.

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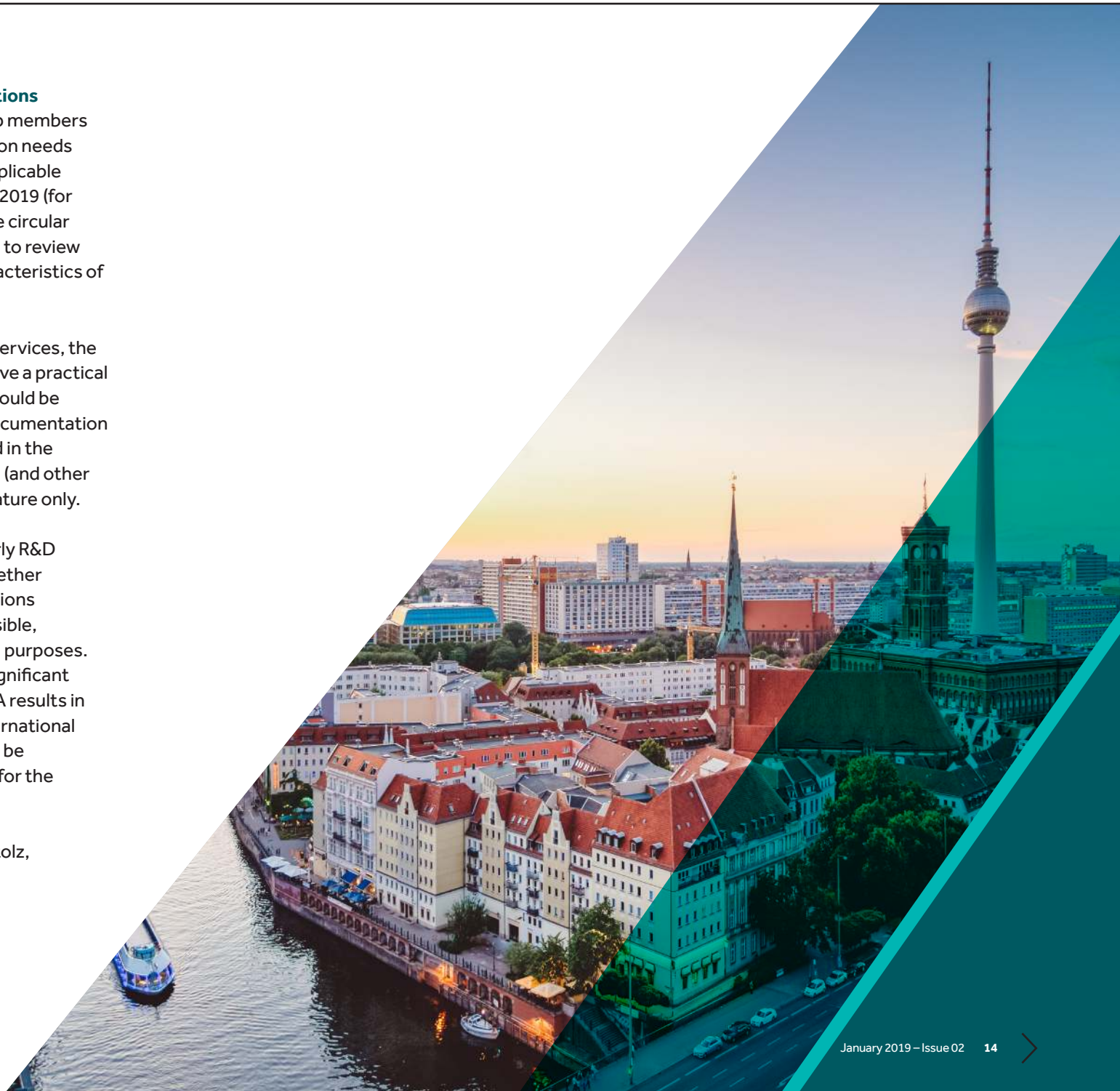


Italy: TP and profit level indicator - A matter of rights

The Italian "Taxpayer Bill of Rights" ("BOR", so called Disposizioni in materia di Statuto dei diritti del contribuente), approved with Law no. 212/2000, recognizes several principles that must be observed by tax administration in its relationship with taxpayers. Among others, it is worth mentioning: the right of information, the right to have clear and justified acts, the safeguard of integrity of property, the principle of cooperation between tax authorities and taxpayers, the right to ask the tax authorities for clarification regarding interpretation and application of law and safeguards during tax inspection.

In particular, article 10 of the BOR provides that the relationship between tax administration and taxpayers should be inspired to good faith and cooperation principles, setting the enhancing the relationship between tax administration and taxpayers in two different ways: first, exempting taxpayers from additional taxes, penalties and interest when they prove to have applied tax authorities' instructions (even if meanwhile they have been changed) or to have behaved in a certain way because of delays, neglects and mistakes of the tax administration. Secondly, prescribing no sanctions when violations don't entail a tax obligation.

In addition, article 12 of the BOR states the invalidity of the tax assessment notified before the term of 60 days from the release of tax audit report (also called Processo Verbale di Constatazione) which summarizes the inspection activities performed by the tax authorities and envisaged challenges), in order to allow the taxpayer to file observations that should be taken into account by the tax administration to possibly revise its position.

Given this framework, the present article summarises first a recent regional tax court case regarding the violation of the aforementioned principles by the tax office in relation to the application of a transfer pricing profit level indicator in the tax assessment different from the one previously leveraged by the same tax office in the audit report.

Decision No. 2629/2018 of the Regional Tax Court of Lombardy

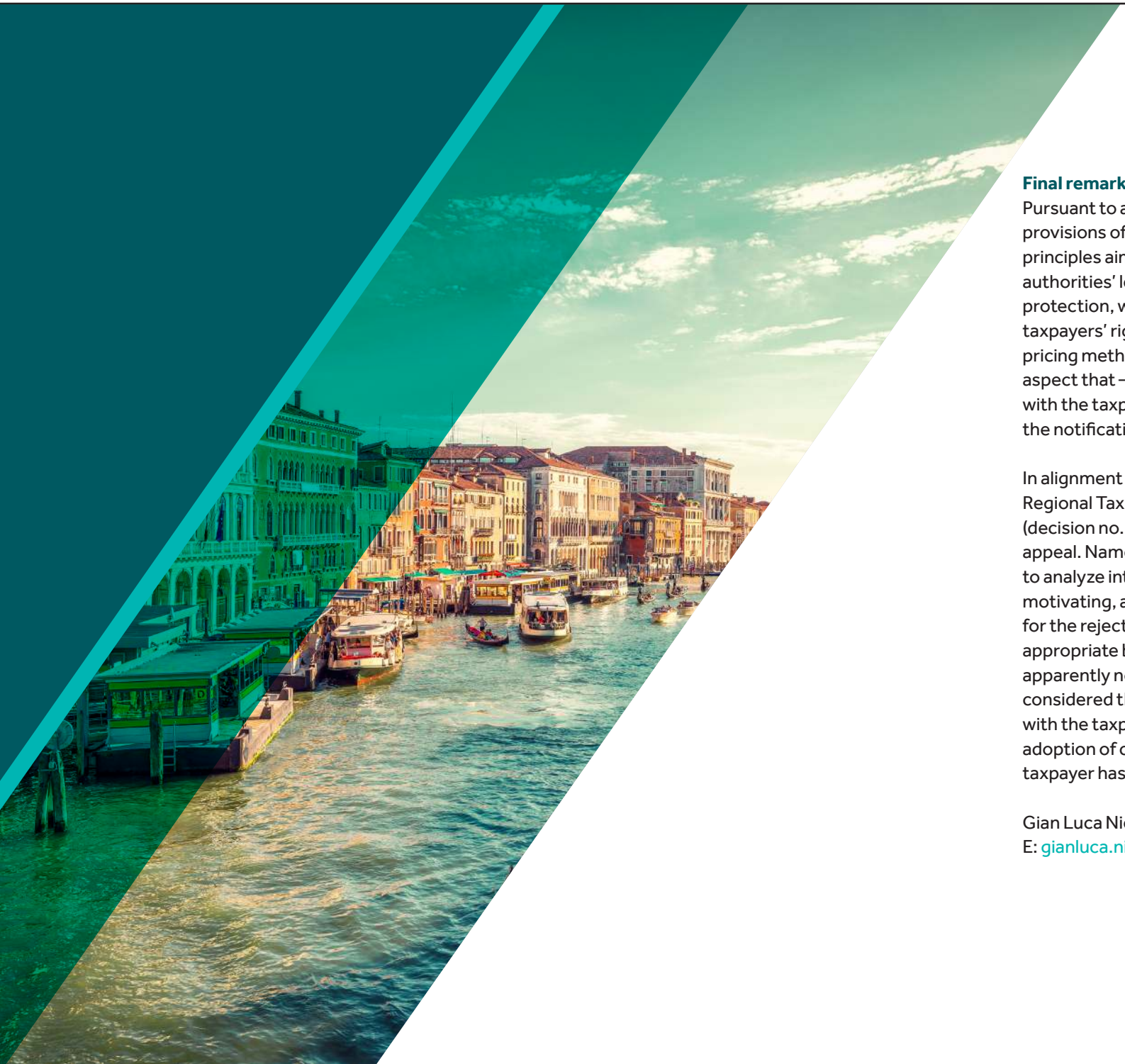
On 7 June 2018, the Regional Court of Lombardy rejected the appeal of the Italian Tax Authorities concerning a transfer pricing assessment. In particular, a company was subject to an assessment for corporate income tax purposes due to a transfer pricing challenge. In this context, Italian Tax Authorities admitted that a wrong profitability ratio (in this case the ROS - Return On Sales) was used in the tax audit report, so switching subsequently to a different one (i.e., ROA – Return on Assets) in the tax assessment.

The company appealed against the tax assessment before the Provincial Tax Court of Milan and succeeded in having its position recognised as correct by the judge that identified the violation of articles 10 and 12 of ITBOR.

In turn, the Italian Tax office appealed before the Regional Tax Court of Lombardy, which confirmed the decision of the Provincial Tax Court. Primarily, the Regional Tax Court argued that a final deed of assessment in which the office admits that a wrong profit level indicator has been used by the tax inspectors in the tax audit report and therefore uses a different ratio for the assessment, is illegitimate. Namely, Italian tax authorities:

- Did not consider the observations presented by the taxpayer vis à vis the tax audit report;
- Did not respect the collaboration principle set forth by the article 10 of BOR;
- Did not allow the taxpayer to present observations and clarification requests concerning the profit level indicator used in the tax assessment (as per the article 12 of the BOR).

As a second instance, the regional tax court definitely recognized the correctness of the technical remarks leveraged by the taxpayers: in fact, the latter pointed out that all steps undergone for the application of the ROA were wrong.



Final remarks

Pursuant to all the above and relying on the aforementioned provisions of articles 10 and 12 of the BOR, they establish principles aiming at setting instruments to balance tax authorities' legitimate power to assess and taxpayer's protection, with a particular focus on an effective taxpayers' right of defence. Consequently, the transfer pricing method used in the tax audit report represents a key aspect that – in the end – needs to be properly discussed with the taxpayer in order to allow a proper defence, before the notification of the final deed of assessment.

In alignment with previous case, the same Lombardy Regional Tax Court decided on another similar case (decision no. 1648/2/2018), accepting the taxpayer's appeal. Namely, the tax office applied a new methodology to analyze intercompany prices without adequately motivating, at the time of the inspection, the reasons for the rejection of the method considered the most appropriate by the taxpayer. The court, ascertaining an apparently non-cooperative attitude of the tax office, considered the change of method (having no discussion with the taxpayer occurred) illegitimate because the adoption of criteria different from those used by the taxpayer has always to be adequately motivated.

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Transfer Pricing regime in Nigeria

The Income Tax (Transfer Pricing) Regulation No.1 2012, released by Nigeria's Federal Inland Revenue Service (FIRS), was Nigeria's first attempt at tackling the issues of tax avoidance and evasion that have stemmed from the absence of guidelines governing transfer pricing. The regulation required connected entities to attach a Transfer Pricing Declaration Form while filing their annual tax returns, in addition to other information as required by the tax authority. Consequently, the revenue service set up a Transfer Pricing (TP) Division in 2013 to deal with the technicalities, implementation and compliance with the newly set-out regulations.

It requires connected entities to prove that a particular transaction is consistent with arm's length principle. In determining whether the result of a transaction is consistent with the arm's length principle, the FIRS will apply one of the following methods:

- The Comparable Uncontrolled Price Method.
- The Resale Price Method.
- The Cost-Plus Method.
- The Transactional Net Margin Method.
- The Transactional Profit Split Method.
- Any other method prescribed by the FIRS from time to time.

Where it is discovered that a transaction fails to comply with the arm's length principle, the FIRS shall make the necessary adjustments using the comparability factors provided in the regulations.

The TP division, in 2014, issued a directive requiring non-resident companies (NRCs) to include with their annual tax returns: audited financial statements and associated computations of income tax and relevant allowances. The rationale for this was to ensure the tax authority have a clearer picture of components of these companies' turnover in order to monitor compliance with the regulation.

Affected taxpayers were required to document their respective TP policies at both group and domestic levels and submit such policy to the FIRS either within 21 days upon request or, if no request is made, at the time of filing their first TP returns. The tax authority also sent out notices to taxpayers, giving them a timeline of 30 days to submit their group and domestic transfer pricing policy.

Many of the affected companies, in the immediate years, after the implementation of the regulation, made efforts to comply despite being faced, at the time, with lack of understanding of how the regulations would be applied, the appropriate TP method, formats of documentation and policies, in addition to new costs associated with hiring TP experts.

Recent developments

The FIRS, on 12 March 2018, introduced the Income Tax (Transfer Pricing) Regulations 2018, which repealed the previous regulations, and is effective from 13 March 2018. Although the 2018 regulations adopted the provisions of the 2012 regulations to a large extent, the following updates are now relevant:

Purpose

The purpose of the regulations was updated to include anti-evasion measures laid out in the Capital Gains Tax Act and Value Added Tax Act, in addition to the Personal Income Tax Act, Company Income Tax Act and Petroleum Profits Tax Act as amended. The objectives broadly remain unchanged.

Connected Persons

The new regulations replaced "connected taxable persons" with "connected persons" broadly defining the relationship between connected persons as a relationship where one person has the ability to influence

or control the other person in making financial, operational and commercial decisions in accordance with the UN and OECD model tax conventions and TP guidelines.

Documentation

The new regulations adopt a "three-tiered approach" for documentation with the introduction of a Master file, a Local file, in addition to country by country reporting (CbCR), which companies are expected to file with the revenue service.

Timeline for submission of documentation

The regulation stipulates different timeline requirements for submission of an entity's Master file and Local file, based on a N300m threshold value of controlled transactions. For amounts at and above the threshold, both files must be given to the FIRS within 21 days of receipt of notice from FIRS requesting documentation. For transactions below the threshold, the timeline is within 90 days of receipt of FIRS notice. The CbCR should however be filed with the FIRS, with or without a notice, not later than 12 months from the accounting year end.

Penalties

In contrast to the old regulation, where the penalties were imposed as per the relevant income tax laws, the latest issue explicitly identifies penalties for TP infractions. These penalties are meant to encourage affected entities to promptly and accurately make TP disclosures. For instance, failure to file TP documentation on request attracts a penalty which is the higher of N10 million or 1% of the value of all the entity's-controlled transaction in addition to N10,000 for every day it fails to file the necessary documentation.

Conclusion

Nigeria has far demonstrated its determination in curbing tax abuses and increasing its tax revenue through the use of TP regulations, given the new and improved release.

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Changes to Polish Transfer Pricing regulations in 2019

The Polish Ministry of Finance issued a bill introducing changes in Transfer Pricing (TP).

According to the Act of 23 October 2018 amendind the Act on personal income tax, Act on corporate income tax, Act - the Tax ordinance and other acts, the regulations are about to come into effect on 1 January 2019 and apply to transactions carried out in the tax year starting after 31 December 2017. The main purposes of the bill are as follows:

1. Simplification of complicated regulations in the TP field and reduction of bureaucratic and administrative burdens related to the preparation of TP documentation, with particular focus on small and medium sized enterprises.
2. Counteracting the processes of understating the tax base and transferring profits abroad with the help of aggressive structures using transfer prices (sealing the system).
3. Adjustment of the regulations in force in Poland regarding TP to the changing legal and economic environment as well as to international regulations.

Primarily, the Legislator indicates three key changes:

Changes in Transfer Pricing limits

New regulations increase documentary thresholds above which there is an obligation to prepare TP documentation in Poland.

Currently, documentation obligation applies to taxpayers with annual revenues or costs of at least EUR2 million. After the change such obligation mostly will depend on value of particular transaction. Legislator claims that the purpose of this change is to reduce the obligations for preparing a TP documentation for most taxpayers, and in particular for micro, small and medium-sized enterprises. The mechanism for defining the documentary threshold will also change (currently each single transaction needs to be verified in view of documentary thresholds) and will be much easier to apply. For this purpose, a division into transaction categories will be introduced and the obligation to prepare TP documentation will arise only when a particular threshold will be achieved, and so:

- Threshold PLN 10 million - for transactions related to tangible assets and financing.
- Threshold PLN 2 million - for all other transations.

Extending the deadlines

Deadline for preparing TP documentation for submitting a statement and information on transfer prices will be extended from three to nine months after the end of the tax year. In turn, the deadline for preparing TP documentation related to a group of entities will be even longer, it will be extended to 12 months after the end of the tax year. Ministry of Finance claims also, that it will be much easier to use documentation prepared by another entity from the group, foreign entity and use its TP documentation prepared in English for Polish documentation purposes.

As a result, taxpayers who receive such documentation will not be obliged to prepare their own documentation in Polish.

Changes in determining the market price

New solutions will be implemented which will help taxpayers to determine prices at market level. In the opinion of the Ministry of Finance, this should provide taxpayers with protection in case of questioning the price by the tax authority and simultaneously reduce the amount of documentation needed to prove the arm's length of prices. The proposed simplifications will affect two types of transactions, i.e. loans and low value-added services.

Furthermore, there will be no obligation to submit CIT / TP and PIT / TP forms. They will be replaced with simpler and more tax friendly transfer pricing reporting in electronic form. This may generate greater efficiency in selecting taxpayers for potential tax controls by the tax authorities.

The Act introducing changes to the currently applicable provisions regarding TP has already been published in the Journal of Laws.

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Spanish Transfer Pricing Obligations

The Spanish Transfer Pricing (TP) obligations in practical terms can by divided into two groups: on one hand, the Group's and Taxpayer's documentation and, on the other hand, the obligation to disclose the related-party transactions.

Reporting obligations:
Reporting obligations follow the OECD three-tiered approach. The obligation to produce one type of TP report does not oblige to nor exempt from the preparation of the others, so it shall be analysed separately what documentation is required to be produced by each taxpayer. The three types of documentation which are due in Spain are summarized below:

The country-by-country report (article 14 of the Corporate Income Tax Regulations)
This shall be applicable to resident enterprises which are the ultimate parent company of a multinational group, whose group's net turnover is at least Euro 750 million. The compliance with this requirement must be met through the filing of Form 231.

The filing of this informative return can be performed over the 12 months following the end of the tax period to which the information refers.

Additionally, resident enterprises and permanent establishments of non-resident companies in Spain belonging to a group which is under the obligation to submit the country-by-country report shall inform to the Spanish Tax Authorities ("STA") both the identification of the parent company and its country of residence before the end of the tax period to which such information refers.

The Group's report (article 15 of the Corporate Income Tax Regulations / "Master File")
This is applicable to enterprises belonging to a group (whose group's net turnover is at least Euro 45 million), carrying out transactions with a related party exceeding Euro 250,000 globally considered.

The Taxpayer's report (article 16 of the Corporate Income Tax Regulations / "Local File")
This is applicable to enterprises carrying out transactions with a related party when the total amount of transactions jointly considered exceeds Euro 250,000 regardless of the group's net turnover. Without prejudice to the foregoing, the group's net turnover shall determine the content of the Local File to be kept available for the Tax Authorities.

Penalties regime applicable to the reporting obligations is tight to the compliance of the documentation requirements as well as to the potential value assessments of the related transactions by the STA:

a. If the tax authorities do not make a TP adjustment, a tax penalty of Euro 1,000 per item of data and Euro 10,000 per group of omitted or misleading documentation may be imposed (with the maximum limit of the lowest of the following amounts:

(i) the one resulting from applying 10% over the whole value of transactions carried out during the tax period;

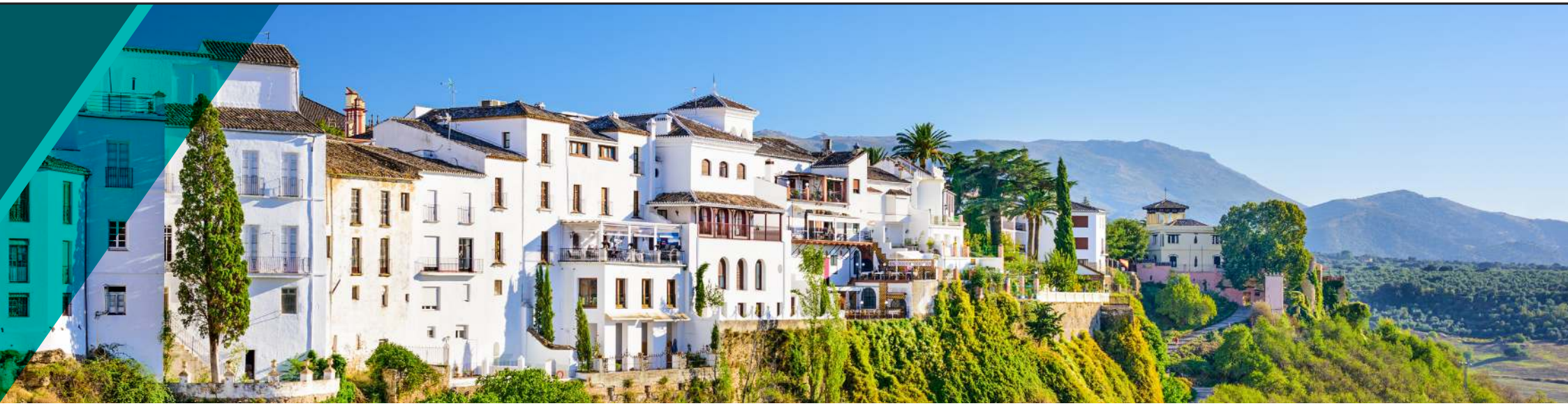
(ii) the one resulting from applying 1% over the net turnover);

b. If the tax authorities do make a tax adjustment, the penalty would be equal to 15% of the adjustment providing that documentation mismatches the one declared in Corporate Income Tax Return or if incomplete, false or no documentation has been made available to STA.

Spanish regulations do not foresee specific penalties for infringement in filling the country-by-country report.

In this respect, it will be necessary to wait until a specific provision is included in the Law or an interpretation is made by the STA considering that the general penalties regime already in place for informative tax returns applies.

In any case, failing to file the country-by-country report when mandatory will probably trigger the attention of the tax authorities.



Disclosing obligation

In addition to the afore-mentioned reporting obligations, taxpayers of Corporate Income Tax and Non-Resident Income Tax carrying out an activity through a permanent establishment, as well as enterprises in income allocation system incorporated abroad with a presence in Spanish territory, shall declare through a specific informative tax return the following transactions with related parties:

a. Transactions carried out with one related individual/ enterprise provided the total amount of transactions carried out during such a tax period exceeds Euro 250,000, as per their market value.

b. Specific transactions providing that the total amount of each type of these transactions for the tax period exceeds Euro 100,000. Those specific transactions are the following:

(i) those carried out by taxpayers of the Personal Income Tax or by their spouses, ancestors or descendants, in the development of an economic activity under the Objective Evaluation System Method, with enterprises upon which they hold a percentage equal or above 25%;

(ii) transfers of business;

(iii) transfers of shares of non-listed enterprises or listed enterprises trading on a stock exchange located in a tax haven;

(iv) transfers of real estate;

(v) transfers or licensing of intangible assets.

c. Regardless of the total amount of the joint transactions carried out with the same related individual or enterprise, there is the obligation to declare transactions of the same kind that, in turn, are assessed by using the same valuation method, providing that the total amount of the joint transactions for the tax period is higher than 50% of enterprise's net turnover.

Compliance with this requirement must be met through the filing of Form 232.

As regards penalties regime for Form 232 is the one applicable for informative tax returns foreseen in the General Taxation Law.

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Current overview of the Brazilian Transfer Pricing environment

Observing the world trend, the Brazilian government incorporated into the tax law specific rules to regulate the prices negotiated in international transactions between companies of the same corporate group[1]. To this end, the Brazilian Congress approved law 9.430/96 which contains specific provisions namely for dealing with Transfer Price. This law completed Brazil's transition to the tax system on a universal basis.

Brazil is not a member of OECD and, unlike the existing rules in most other countries with this type of legislation, Brazilian rules for Transfer Price differ significantly from the international guidelines, especially those established by the OECD.

Despite being inspired by the OECD model, Brazil does not follow principle of arm's length, since the main method consists in the use of objective calculation formulas, with fixed,

1 Brazilian legislation requires the calculation of Transfer Price, including for operations with companies domiciled in tax havens. Tax heaven is where tax income is not levied, or tax is levied at a maximum rate below than 17% (seventeen percent).

preestablished profit margins and, mainly, wavering any need for economic analysis of risk, functions or (tangible or intangible) assets used.
In general, in the case of imports subject to Transfer Price, the main Brazilian method is to verify that, in the fiscal year, the imported[2] products used for resale or as inputs were sold by applying a minimum fixed profit margin (only the difference between the cost price and net revenue) of 20%, 30% or 40%, according to the industries' economic activity, as shown:

1. 40% (forty percent) for the sectors of:
   a. pharmachemicals or pharmaceutical products;
   b. tobacco products;
   c. optical, photographic and cinematographic instruments and equipment;
   d. machinery, appliances and equipment for dental-medical and hospital use;
   e. extraction of petroleum and natural gas; and
   f. petroleum by-products;
2. 30% (thirty percent) for the sectors of:
   a. chemical products;
   b. glasses and glass byproducts;
   c. pulp, paper and paper products; and
   d. metallurgy; and
3. 20% (twenty percent) for the other sectors.

2 PRL Method (Resale Price Less Profit) - Brazilian law requires that calculation is made by product, considering the weighted average of purchase and sales prices. The calculation provides for several adjustments established in Normative Instruction n. 1312. It should be noted that Brazilian legislation uses several other methods: PIC, CPL, PVEX, CAP, PVV and PVA that will not be analyzed in this article.

In view of the foregoing, the application of fixed margins in Brazil is severely criticized by OECD member countries, which use the arm's length principle, since this method corresponds to an assumption or fiction and may result in double taxation or double non-taxation.

Another criticism is that once the minimum profit margin is established and known, companies can price their products within the limits established by law and allocate profit in the country where it is most favorable. On the Brazilian side, the authorities strongly defend these methods as they believe they have greater objectivity and transparency and they push away the subjectivities of the arm's length principle and avoid profit shifting.

It is the understanding of the Brazilian authorities that the BEPS Project (action 8-10) evidences all vulnerabilities at arm's length and proposes that other countries should seriously consider applying the fixed margins.

Another aspect that is very relevant in the Brazilian legal system, which diverges sharply from global practices and is widely discussed in the context of the BEPS Project (Action 01, 08-10), corresponds to the treatment related to intangibles. This divergence occurs simply because Brazil does not apply Transfer Pricing rules to payments of royalties abroad.

This posture does not mean that the country is subject to aggressive tax planning involving intangibles, on the contrary, Brazil uses general rules of limit of deductibility for the payment of royalties.

Although controversial and subject to disputes, the former legislation[3], which is still in force, establishes the limits of deductibility of expenses for the purpose of Income Tax, according to the corporate group and types of royalties. For example; expenses with royalties for the use of industry and trade brands, or commercial names, in any type of production or activity, have their deductibility limited to 1% of the income arising from the use of the brand.

The Brazilian tax administration further understands that its rules do not diverge from OECD principles and maintains its application, including in transactions with countries which signed double taxation avoidance agreements[4].

Another peculiarity of Brazil subject to criticism, is its position in not responding, for several years, the requirements of friendly negotiations of several countries with which the country has an agreement and that does not comply with the Brazilian TP methods.

In response to this global criticism, and in line with the pressure of the BEPS Project (Action 14), Brazil has finally issued a legal standard[5] containing all procedures necessary for the Mutual Agreement Procedure (MAP), including instructions for divergences related to Transfer Price methods.

3 Article 436/58, dated 12-30-58, as amended by Ordinances N° 113/59 and GB-314/70.
4 The Federal Revenue Service of Brazil has manifested itself to this effect through Consultation Process N° 12/00, as follows:
"SUBJECT: Corporate Income Tax - IRPJ
Menu: Adjustments established by law n° 9,430, of December 27, 1996, regarding Transfer Price. There is no prevalence of international treaties on domestic legislation. There is no contradiction between article 9 of the articles of the model convention with respect to taxes on income and on capital - which deals with transfer price in the conventions - and Articles 18 to 24 of law 9.430/96, which includes Transfer Price in Brazilian tax legislation".
5 See Normative Instruction n. 1.669/2016.

The Brazilian MAP standard is extremely clear and details all the procedures that need to be observed in order for countries to find solutions to divergences in the use of tax rules, however, Brazil does not accept to participate in tax arbitration in any way, nor does legislation set a deadline for the resolution of the conflict, which puts the whole process at risk.

Although this standard was published in 2016 and represents a new hope for Brazilian taxpayers to rule out possible instances of double taxation involving divergences of Transfer Price rules, the Brazilian tax authorities did not disclose the results of occasional friendly negotiation procedures required by the companies and thus, it is not yet possible to assess and conclude as to its effectiveness.

It should be noted that recently membership of the OECD was formally requested and, as a consequence, it is likely that increased pressure towards Brazil's compliance with arm's length and OECD standards related to Transfer Pricing, plus other topics relating to international tax policy, that Brazil should wish to be accepted into this select group.

However, due to the current political environment at the moment (elections for executive and legislative positions), it is not possible to conclude whether Brazil will accept any demand for changes to its rules, nor is it possible to affirm that the same interest of being a member of the OECD is maintained.

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Recent Developments: U.S. Transfer Pricing

U.S. companies and multinational companies with U.S. operations are reassessing their transfer pricing policies and structures following the enactment of the Tax Cuts and Jobs Act ("the Act") signed into law on 22nd December 2017.

Most notably, the Tax Act permanently reduced the corporate tax rate from 35% to 21% effective for tax years beginning after 31st December 2017. Furthermore, the Act introduced sweeping changes to U.S. international tax law, and the Transfer Pricing (TP) impacts of which are still being assimilated, examined and modeled by domestic, international and some individual clients.

The Act's tax law changes that directly or indirectly impact transfer pricing practices are:

Base Erosion Anti-Abuse Tax ("BEAT")
The Act introduced a new tax that is applicable to large-size businesses having average annual gross receipts for the three-taxable-year period ending with the preceding taxable year of at least US$ 500 million. BEAT will apply when such company has significant amounts of related-party payments.

Foreign Derived Intangible Income ("FDII") and Global Intangible Low-Taxed Income ("GILTI")
Mostly applicable to corporations, these two provisions aim to prevent the shifting of profits to foreign tax havens. FDII stimulates companies to create and keep intellectual property ("IP") in the U.S. as it creates an export incentive. Essentially, FDII incentivizes IP within the U.S by providing for a reduced rate on income associated with certain exports. While, GILTI imposes a penalty on companies by subjecting foreign income derived from IP in low tax jurisdictions to current U.S. taxation, eliminating the previously available deferral regime.

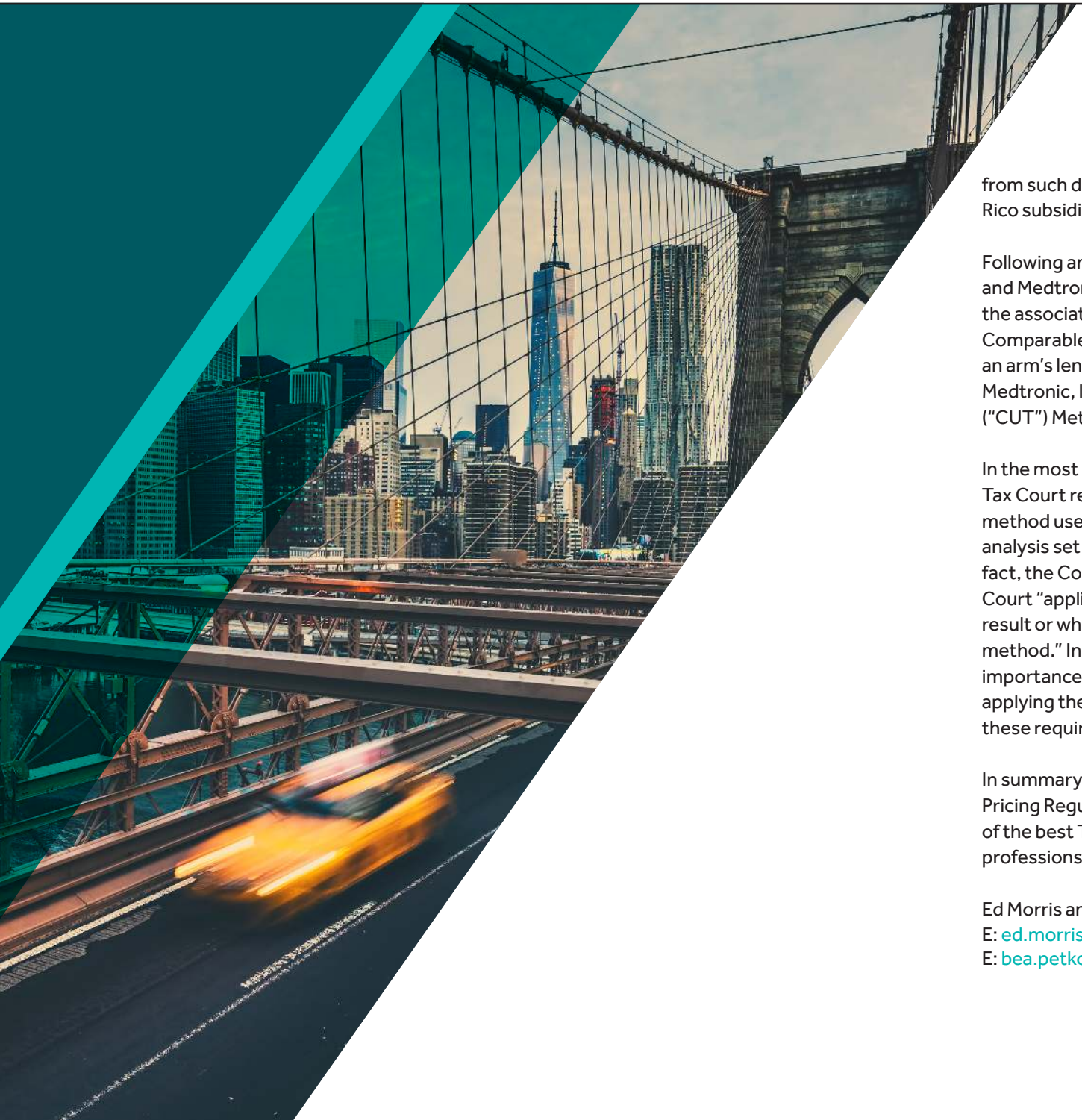
Intellectual Property Transfer Limitations
Code Section 936(h)(3)(b) was amended to change the definition of an intangible asset which now includes any goodwill, going concern value, workforce in place, and any other item in which the value or potential value is not attributable to tangible property. This change aims to prevent transfers of value without compensation. As the definition of IP now includes goodwill, going concern, workforce in place, the Comparable Uncontrolled Method ("CUT") could become less reliable of a method with transactions involving IP. This being the case because such definition change potentially makes the IP of a given company more complex and less likely to be comparable to another company's IP.

Due to the complexity of the Act's imposed changes to the U.S. tax law, companies should be assessing the case-specific tax implications to their tax structures. Based on the discussed changes, multinational and U.S. companies should be more aware and readier for an increased audit risk with respect to their U.S. international tax structure and transfer pricing practices. Companies can achieve this goal by being more proactive about their planning and compliance. The Internal Revenue Service ("IRS") and many non-U.S. tax authorities have expressed their intent of heightened compliance and transparency requirements of businesses of all sizes with international operational structures. Up until now it was mostly large-size businesses that have been proactive about their international tax and TP policies, however, the compliance risk now extends to the small and mid-sized companies.

Becoming better equipped for scrutiny by tax authorities will not only be beneficial to the companies that been historically proactive about their international organization structure, but also to those companies that have not.

Transfer Pricing Case Law Update: Medtronic, Inc. & Consolidated Subsidiaries v. Commissioner, United States Court of Appeals for the Eighth Circuit
On 16th August 2018, the Court of Appeals issued an opinion reversing the Tax Court's decision that had previously rejected the TP method applied by the Internal Revenue Service ("IRS") in a high-profile TP case. In addition, the Court of Appeals has remanded the case for further consideration by the Tax Court.

The key dispute in this Case consists of opposing views on proper TP methodology and allocation of income relative to intercompany licensing of intangible property between Medtronic, Inc. and its Puerto Rican subsidiary. Medtronic, Inc. is a U.S. company that owns a Puerto Rican subsidiary which functions as a medical device manufacturer. Medtronic, Inc. allocates the profit earned



from such devices and leads between Medtronic, Inc. and the Puerto Rico subsidiary through an intercompany licensing agreement.

Following an IRS audit covering tax years 2005 and 2006, the IRS and Medtronic, Inc. did not reach an agreement on how to allocate the associated royalty income. In its arguments, the IRS applied the Comparable Profits Method ("CPM") as the best method to determine an arm's length price for the intercompany royalty agreement whereas Medtronic, Inc. applied the Comparable Uncontrolled Transaction ("CUT") Method.

In the most recent development, the Court of Appeals held that the Tax Court rejected the IRS' CPM TP method and adopted the CUT method used by the taxpayer without applying the comprehensive analysis set forth in the U.S. Transfer Pricing Regulations. Due to this fact, the Court of Appeals was not able to establish whether the Tax Court "applied the best TP method for calculating an arm's length result or whether it made proper adjustments under its chosen method." In its issued opinion, the Court of Appeals highlighted the importance of meeting the strict comparability requirements when applying the CUT method, whereas the Tax Court had failed to apply these requirements properly in its analysis.

In summary, the Medtronic case highlights the fact that the Transfer Pricing Regulations must be thoroughly followed in the application of the best TP method by companies, the tax authority, and TP professions.

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