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Plenary 5: Future of Transfer Pricing—Moving towards Profit Split?

Panelists

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We speak in our personal capacities. None of the statements should be relied upon without consulting lawyers or other professionals.

Outline

- Transfer pricing now
- Moving towards Profit Splits?
  - European Union: ongoing discussion on Common Corporate Tax Base (CCTB)
  - On 22 June 2017, OECD releases a public discussion draft “Revised Guidance on Profit Splits,” and the release of a formal Guidance may be as early as the end of April 2018.
  - Perspectives from jurisdictions
- Future of transfer pricing

Transfer Pricing Now

Transfer pricing now - **Taiwan**

- In 1971, the Income Tax Act §43-1 was put into force
  - If price or result of the transaction between affiliated enterprises does not conform to arm's length principles (ALPs) and results in reduction of their tax liabilities in Taiwan,
  - The tax authority may make an adjustment in accordance with ALPs after the case is reported to and approved by the Ministry of Finance.

Transfer pricing now - **Taiwan**

- The Regulations Governing Assessment of Profit-Seeking Enterprise Income Tax on Non-Arm's Length Transfer Pricing (TP Regulations)
  - In 2004, the regulations were promulgated by reference to the OECD Transfer Pricing Guidelines for Multinational Enterprises (MNEs) and Tax Administrations.
  - Under the regulations, MNEs are required to prepare a TP report (i.e., local file)
  - In 2017, we introduced the master file and country-by-country report (CbCR) and completed the three-tiered TP documentation after referring to the recommendations in the final report of OECD BEPS Action 13.

Australian Regime: Division 815

- Adopts the arm's length principle
  - 815-A intended to legislate Article 9 of DTC
  - 815-B - 'arm's length conditions' should be substituted for 'actual conditions' where a taxpayer obtains a 'transfer pricing benefit‘
- OECD Transfer Pricing Guidelines
  - Must identify arm's length conditions to best achieve consistency with OECD TP Guidelines (as prescribed by regulations)

Australian Regime: Division 815

- Reconstruction under 815-B
  - Arm's length conditions may be determined based on alternative 'commercial and financial relations' in certain situations
    - Where substance does not match the form
    - Where independent entities would have entered into different commercial and financial relations
    - Where independent entities would not have entered into any commercial and financial relations
- *Chevron Australia Holdings Pty Ltd v FC of T* [2017] FCAFC 62
  - Reconstruction may be possible without the use of the specific reconstruction provisions based on definition of 'conditions'

Australia Tax Office (ATO) Position and Compliance

- Financing
  - ATO expect cost of financing for subsidiary to be the same as cost for parent - aggressive application of principle of parental affiliation
- Centralised operating models
  - ATO guidance that offshore marketing hubs are only 'low risk' if profit less than or equal to 100% mark-up on costs (costs exclude cost of commodity / shipping)
- Master-file/local-file and compliance
  - Australian local file significantly more onerous than OECD guidance on local files
- Documentation penalty requirements
  - Taxpayer will not have a 'reasonably arguable position' if documentation that meets legislated requirements is not prepared

United States Transfer Pricing

- Arm's length standard
- Impact of OECD Guidelines
- Form and Substance
- Changing landscape

Transfer pricing now in **Korea**

- Korean TP regulation
  - Adjustment of International Taxes Act (AITA)
  - AITA Enforcement Decree (AITA -ED)
  - Based on Arm's Length Principle
  - Consistent with the OECD Guidelines

- Transfer Pricing Methods (TPM)
  - Comparable Uncontrolled Price (CUP), Resale Price (RP), Cost Plus (CP), Profit Split Method (PSM), Transactional Net Margin Method (TNMM)
  - Domestic comparables are preferred to Foreign comparables

Transfer pricing now in **Korea**

- Intangibles
  - No detailed regulations for Intangibles
  - Relatively detailed regulations for CCA (cost contribution arrangement)
  - OECD guidelines apply unless they conflict with AITA(-ED)
  - "Hard to Value Intangible" not introduced
- Intragroup services (ART. 6-2 AITA-ED)
  - Low value adding intragroup services not introduced
- 3-tiered documentation (Master, Local, CBCR)
  - Currently in force
  - 1st CBCR EOI : June 2018

Transfer pricing now in **Indonesia**

- The arm's length principle is regulated in Art.18(3) Income Tax Law
  - In line with Art.9 of DTC
- 5 methods – as in the OECD Guidelines
  - The most appropriate methods
- Documentation requirements
  - MF, LF, CbCR: started from FYE 2016

Moving Towards Profit Splits?

Moving towards profit splits?

- European Union: ongoing discussion on Common Corporate Tax Base (CCTB)
  - On March 15, the European Parliament approved it by a 438-145 vote, with 69 abstentions.
  - The next step, the European Council, however, requires unanimity, while Ireland and the Netherlands have voiced concerns.
- On 22 June 2017, OECD releases a public discussion draft “Revised Guidance on Profit Splits”.
  - On April 12, Jefferson VanderWolk said Working Party 6 made significant progress on developing consensus, and a profit-split guidance may be published as early as this month.

Moving towards profit splits?

- Please describe your views on, or reactions to, the OECD's discussion draft on the Revised Guidance on Profit Splits.
  - Will the transaction profit split method improve transfer pricing practice (or auditing)?
  - How (Through which TP method) is a highly integrated operation (such as the global trading of financial instruments by associated enterprises) taxed in your jurisdiction?
  - What profit splitting factors should be used? How should they be measured? How should weights be attached to such factors?
  - At the end of the discussion draft are a few examples. What are your views on these examples?

In **Australia**: Increased use of the profit split

- Profit splits used and accepted for many years in Australia
  - No case law on point, but accepted in practice and in ATO guidance (TR 97/20, TR 98/11, TR 2001/11)
- Subdivision 815-B
  - Identification of arm's length conditions by selection of most appropriate and reliable method, and to best achieve consistency with the OECD Transfer Pricing Guidelines
- Reconstruction
  - Before selection of profit split method:
    - Substance must match form
    - Would independent entities have structured in this way?

In **Australia**: Increased use of the profit split

- When and how is the profit split method applied in Australia?
  - Residual profit split is most common use of profit split
  - Profit split often used for intangibles
    - Royalty or license fee
  - May be used for service fee where the entities are both contributing economically significant functions, assets or risks
    - Example: outsourcing of trading services to quarantine risks in separate entities, both entities bearing economically significant risk and holding assets
  - Attribution of profit to PE's would often use the profit split method

In **Australia**: Increased use of the profit split

- What profit splitting factors should be used? How should they be measured? How should weights be attached to such factors?
  - External data: most reliable, but most difficult to identify, useful particularly in a residual profit split
  - Internal data (asset based factors / cost based factors): ideal where there is a correlation between costs or assets and profit, but this is not often the case
  - Other:
    - "Value drivers" for the business may be identified and weighted
    - Each entity’s relative contribution to the value drivers will then determine the split of profit
    - Example: business process analysis of outsourced trading services

In **Australia**: Increased use of the profit split

- At the end of the discussion draft are a few examples. What are your views on, or reactions to, these examples?
  - Generally consistent with Australian application of the profit split method
  - We see less examples of the sharing of economically significant risks / highly integrated businesses in Australia
    - often have one simpler entity that can be remunerated at least to a certain extent using another method with external comparable data

Indonesia: Moving towards Profit Splits?

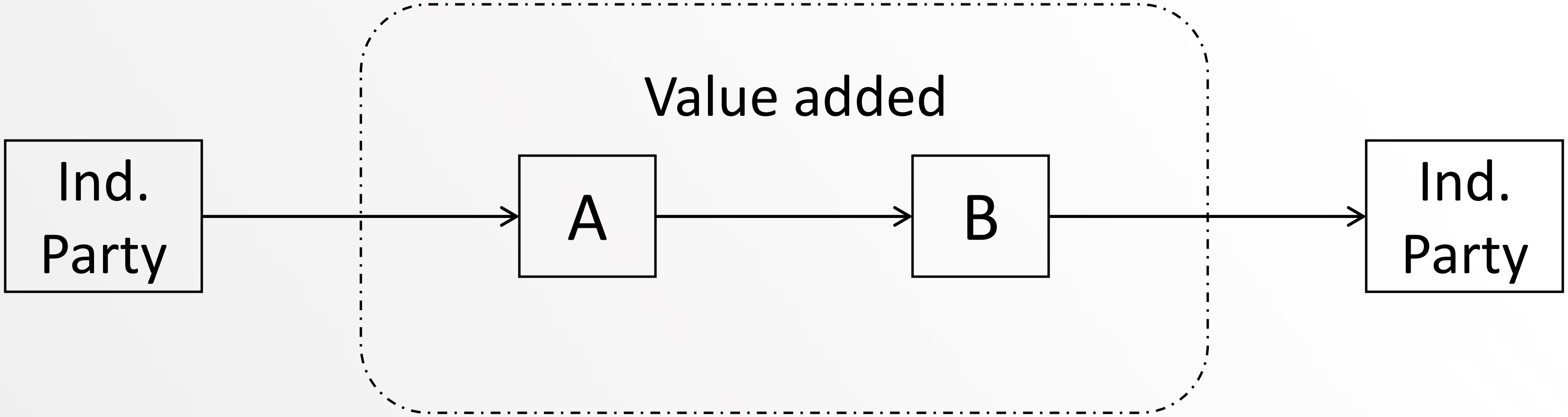
- Profit split is not yet widely applied in Indonesia
- Over use of TNMM
- Multinational groups tend to treat Indonesian entity as doing routine and less complex functions
  - Including the case of global trading
- R&D activities by Indonesian entity is often treated as supporting and remunerated based on cost
- Indonesian Tax Office (ITO) is getting more commonly to use PSM

Indonesia: Moving towards Profit Splits?

- In many cases:
  - Routine functions of a party (usually located in net capital importing countries) are treated to have very low value (excessively undervalued)
  - It is always claimed that the biggest value creation is laid on IPs owned by entities in net capital exporting countries

Indonesia: Moving towards Profit Splits?

A Simple Scheme of Related Parties Transaction



- A and B are related parties, and viewed as ONE entity.
- The combined profits of A and B signify the total value added by the group.
- How each of A and B should be remunerated?

Indonesia: Moving towards Profit Splits?

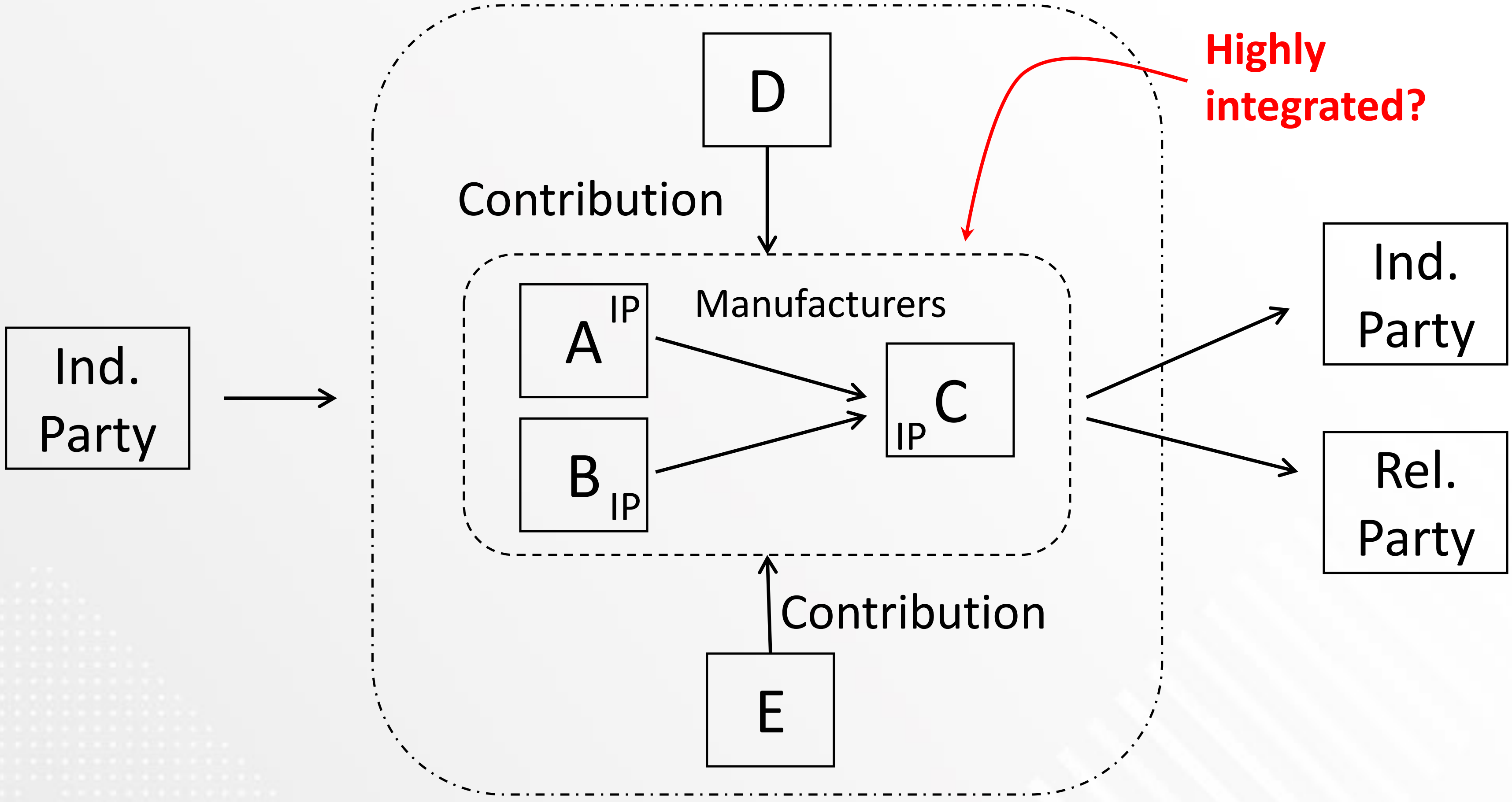
- Defining and valuing contributions
  - A lot of contributions are difficult to quantify
- Defining routine, non routine, and intangible
  - Understanding on the industry will be critical
- Defining combined profits can also be a problem
  - Profits from other transactions
  - Accounting issues (treatment, timing, recognition)
  - Currency
- Determining splitting factors:
  - Asset or capital based, cost based
  - Employee based (compensation, headcount)
  - Others

Indonesia: Moving towards Profit Splits?

- In digital economy
  - Digital dealing and digital business
  - More advanced ICT (information and communication technology) → more and more new business arrangements
  - Contributions will be more difficult to identify and to value

Indonesia: Moving towards Profit Splits?

A More Complex Scheme of Related Parties Transaction



Q: How to remunerate each party in the group? How to split profits?

Comments on the examples in the proposed OECD Discussion Draft
-- from Indonesia

- Not much talking about splitting factors
- None of the examples gives guidance on how to value or to quantify contributions
- Most of the examples involve only two parties → tend to be a simple business arrangements

United States Views on Profit Splits

- PSM in general
- OECD revised guidance on PSM
- Future of PSM

Korea: Moving towards profit splits

- More detailed OECD guidelines on profit split method (PSM)
  - Lack of comparables
  - Unique and valuable contributions
  - Highly integrated operation

- Korean tax audits
  - Often adopt PSM in case of the global trading of Financial Instruments
  - Profit splitting factors : wages, relative contributions

Korea: Moving towards profit splits

- Difficulty in the application
  - Measuring combined profits on a consistent standard
  - Identifying objective profit splitting factors
  - The disputes on the standard, factors, etc.
  - Mutual Agreement Procedure (MAP) case, difficulty in agreeing to any solutions
  - PSM could be abused

Taiwan: Application of Profit Split Method

- The premise of the application of the PSM in Taiwan：
  - The activities of the participants of the controlled transactions are highly integrated so that the profit or losses cannot be measured individually; or
  - Each participant makes unique and valuable contributions
- Residual analysis only
- PSM practice in Taiwan
  - PSM is rarely used
  - The cases using PSM
    - Each of the participants has intangibles and makes unique and valuable contributions to the controlled transaction
    - Allocation keys: cost-based or function weight

Application of Profit Split Method in **Taiwan**

- Statistics of the PSM used in Taiwan

unit：case,US dollar

Audit year	2004-2005 (1st Project)	2006-2007 (2nd Project)	2008-2010 (3rd Project)	2013 (4th Project)
No. of cases using PSM	**1**	**1**	**2**	**2**
No. of cases using PSM/ No. of Total TP audit cases	**5%**	**3.45%**	**7.41%**	**10.00%**
Amount adjusted by PSM	**2,135,820**	**517,036**	**19,159,136**	**2,590,971**
Amount adjusted by PSM / Reported income before adjustment by PSM	**1.6%**	**15.17%**	**26.08%**	**76.72%**
Amount adjusted by PSM / Total adjusted amount for all TP audit cases	**4.38%**	**0.53%**	**16.66%**	**7.17%**

Future of Profit Split Method in **Taiwan**

- Taiwanese enterprises' related parties outside Taiwan
  - Also perform R&D or marketing activities
  - May develop intangibles and make unique and valuable contributions
  - Expect that PSM will become more and more important in the future
- The challenge of applying PSM
  - How to allocate the residual profits?
  - How to decide the most suitable allocation keys ?
- Audit on cases in the optical industry --using PSM
  - Allocation key in one case: Contribution to the yield rate
  - Other potential allocation keys for different industries

Future of Transfer Pricing

A perspective from **Australia**

- Practical concerns regarding profit splits
  - Uncertainty / subjectivity
    - Profit splits can be difficult to tie to external data or even internal data
  - Residual profit split
    - can be helpful to mitigate subjectivity, as at least the routine portion of an entities return can be priced based on external data
  - Double taxation
    - Arbitrariness or uncertainty mean the application of the profit split may result in double taxation
  - MAP
    - Increased use of the profit split method may therefore result in additional reliance on MAP to resolve double taxation
    - MAP can be drawn out, time consuming and resource intensive

A perspective from **Australia**

- Increase in disputes between jurisdictions
  - Action 13 and information sharing increases visibility of global value chain
  - Reconstruction increases likelihood of double taxation
  - Use of profit splits increases uncertainty and likelihood of double taxation
  - US tax reform - Base Erosion and Anti-Abuse Tax
  - EU tax reform - Digital PE concept and Common Corporate Tax Base rules may create a mismatch with non-EU jurisdictions
  - OECD can be slow to move and guidance is not definitive
- Examples: increased disagreement between ATO and IRAS

A perspective from **Indonesia**

- Implementing PSM
  - What creates value? Profit driver?
  - Information contained in Master File would be helpful in determining relevant splitting factors.
  - In case of MAP, it shoud be considered that PSM is the only method used.

A perspective from **Korea**

- Hard To Value Intangible (HTVI), Low Value Adding Infra Group Services (LVAIGS)
  - Internal legislation for implementation
- 3-tiered document Provide more information
  - Compliance with TP regulations
  - Expected more verification on TP in progress
  - Increasing number of TP disputes expected
- Commercial database and its limits
  - Developed database cures the lack of appropriate comps.
  - Nevertheless, peculiarities of controlled transactions ➔ demand for PSM

A perspective from **Korea**
Comparison of two methods

PSM	TNMM
Lack of Comparables	Commercial Database Developed & Sophisticated
Peculiarities	

There is a need to prevent disputes

stemming from PSM application.

A perspective from **United States**

- U.S. tax reform
- Future of transfer pricing

A perspective from **Taiwan**

- Selection of audit cases
  - Using master file and CbCR
- Regulations
  - Drafting regulations by reference to the final reports of BEPS Actions 8-10
- Audit of TP
  - Using the three-tiered TP documentation and DEMPE (**D**evelopment, **E**nhancement, **M**aintenance, **P**rotection and **E**xploitation) to emphasize the audit of intangible transactions
- Following up
  - Attending international conferences or trainings to learn experiences of utilizing three-tiered TP documentation and PSM

Concluding Thoughts

- Professionals should share the experiences with one another.
- Professionals should cooperate to deal with "tough" issues.