

ASIA PACIFIC REGIONAL TAX CONFERENCE

“GLOBALISATION OF TAX RULES IN A DE-GLOBALISING WORLD”

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Attribution of profits to PEs

The Asia Pacific Transfer Pricing perspective

IFA Asia Pacific TP Panelists



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Agenda

1. TP consequences of the shifting of global business models
2. Attribution of profits or TP adjustments?
3. APA or BAPA
4. TP adjustments- Settle or fight?
5. Preparing for more controversy?
6. Expectations going forward: Less aggressive planning, but more aggressive tax authorities?



1. TP consequences of shifting of global business models

2. Attribution of profits or TP adjustments?

Attribution of profits

A Singapore perspective

- PEs are treated as separate and distinct persons.
- Arm's length principle applies when attributing profits to the PE in Singapore.
- No further attribution of profits to Singapore PE:
 - Where activities performed by Singapore company for overseas related party result in PE in Singapore
 - The Singapore company receives an arm's length fee from the overseas company that is commensurate with the FAR assumed by the Singapore company
 - The fee paid by the overseas company to the Singapore company is supported by adequate TPD to demonstrate compliance with the ALP; and
 - The overseas company does not perform any functions, use any assets or assume any risks in Singapore, other than those arising from the activities carried out by the Singapore company under the inter-company service arrangement.



Attribution of profits

A China perspective

Under the current China regulations

In principle, taxable income of the PE will be subject to 25% PRC CIT, if revenue and costs can be clearly accounted for.

The “**Deemed Profit Method**” will apply, if PE financials are not available.

The typical deemed profit rate:

- Engineering operations, design, and consulting services – 15% to 30%
- Management services – 30% to 50%
- Other labor services or business activities – not less than 15%

Our observation

The “**Deemed Profit Method**” is

- by nature an arbitrary profit allocation method;
- commonly used against identified Pes

The solution is more TP based:

- Adjustment of function and risks allocation
- “*Taxable income of PE*” included in TP compensation to the relevant China entity



Attribution of profits

A Japan perspective

Effectively same as TP Analysis and TP Documentation

- Description of Functions, Risks and Assets
- Selection of most appropriate transfer pricing method

Branch PE: Functional Analysis

- Branch PE: Functional analysis
- PE does not include “*the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character*”, Article 5(4)(e) of Singapore - Japan DTT

Agency PE

- “*where a person -- other than an agent of an independent status to whom the provisions of paragraph 6 apply -- is acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise*”, that enterprise shall be a PE – Article 5 of Singapore - Japan DTT



Attribution of profits

A Japan perspective

1. PE Adjustment on Amazon US in 2009

- Japanese affiliates found to constitute a (either branch or agency) PE
 - (1) Amazon US's assets (computers) were used in Japan
 - (2) Japanese employees were instructed by Amazon US, and
 - (3) the Japanese affiliates functioned as more than mere logistics providers for Amazon US.
- But, MAP resulted in no significant tax expense for Amazon US in 2010.

2. PE Adjustment on a US online car-parts vendor (in 2016)

- US resident rented an apartment and a warehouse in Japan for car-parts
- Finding: activities in Japan were "essential and material", beyond those of a "preparatory or auxiliary" character

3. HK company found to be an agency PE (in 2013 – ex-amendment)

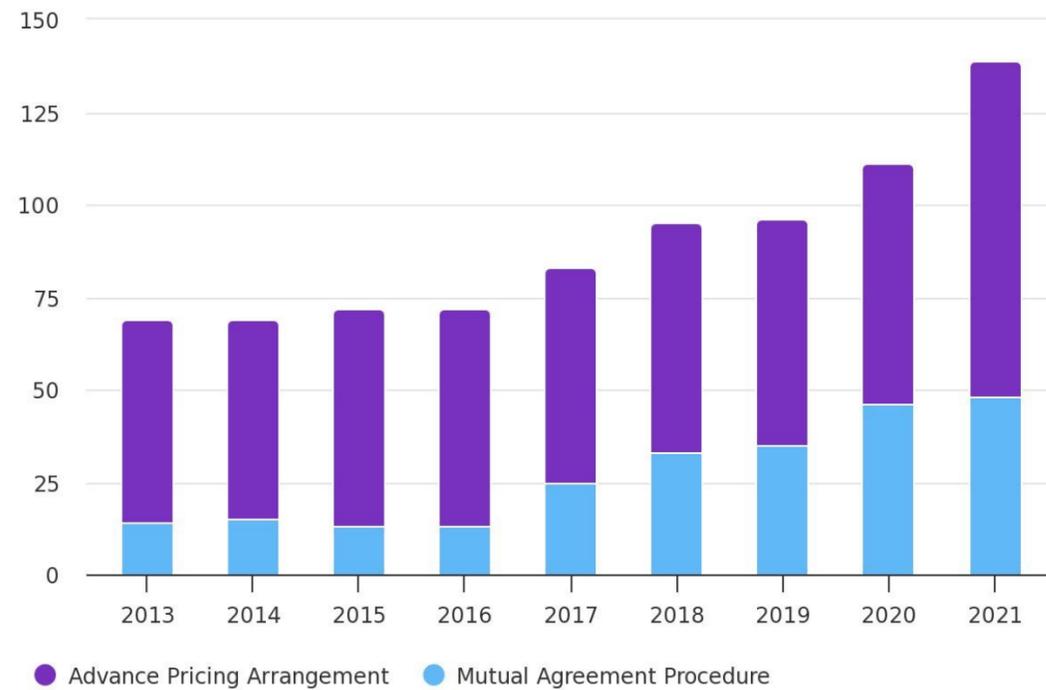
- HK company sold goods through a Japanese affiliate company
- The Japanese affiliate company performed "material" functions in taking orders, which was "viewed as equivalent to" and "directly connected to" the concluding contracts with customers for HK company



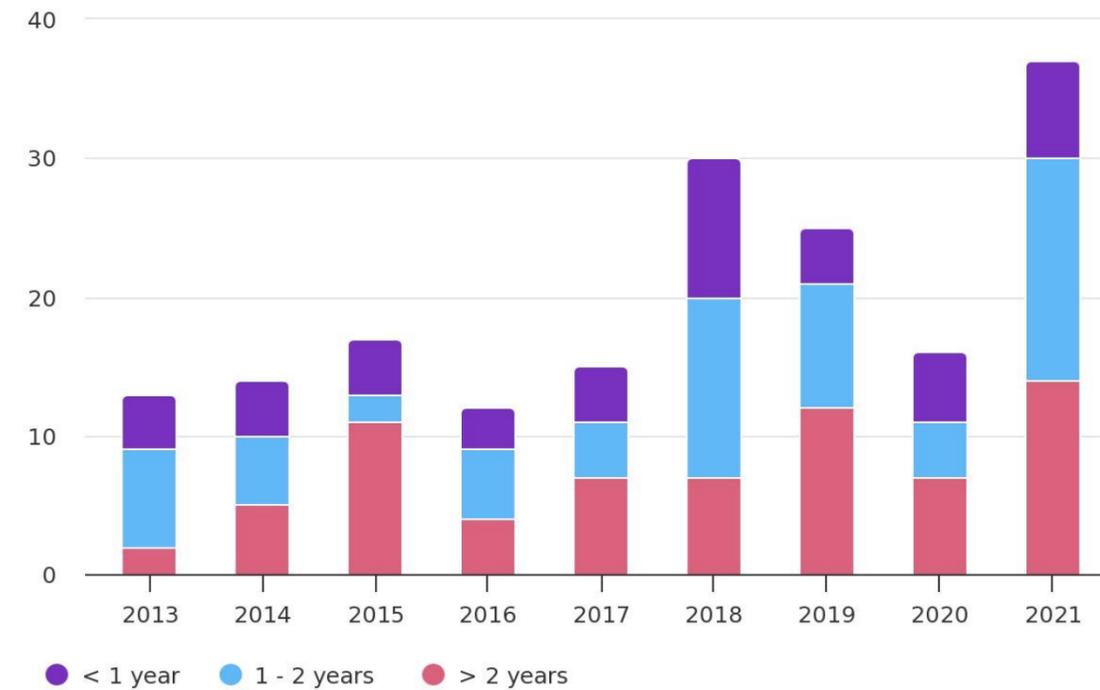
3. APA or BAPA?

A Singapore perspective

Caseload

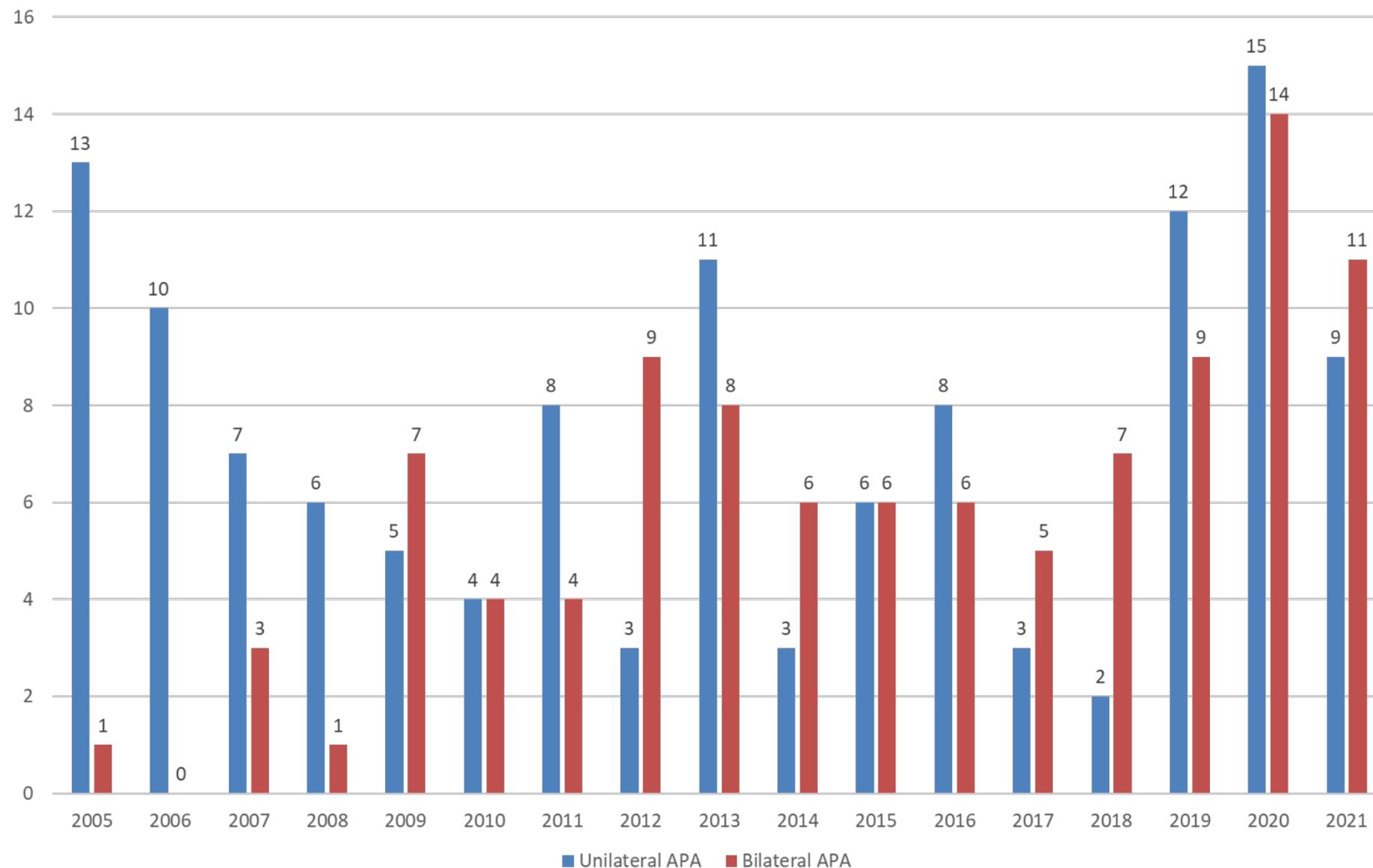


Cases concluded



A China perspective

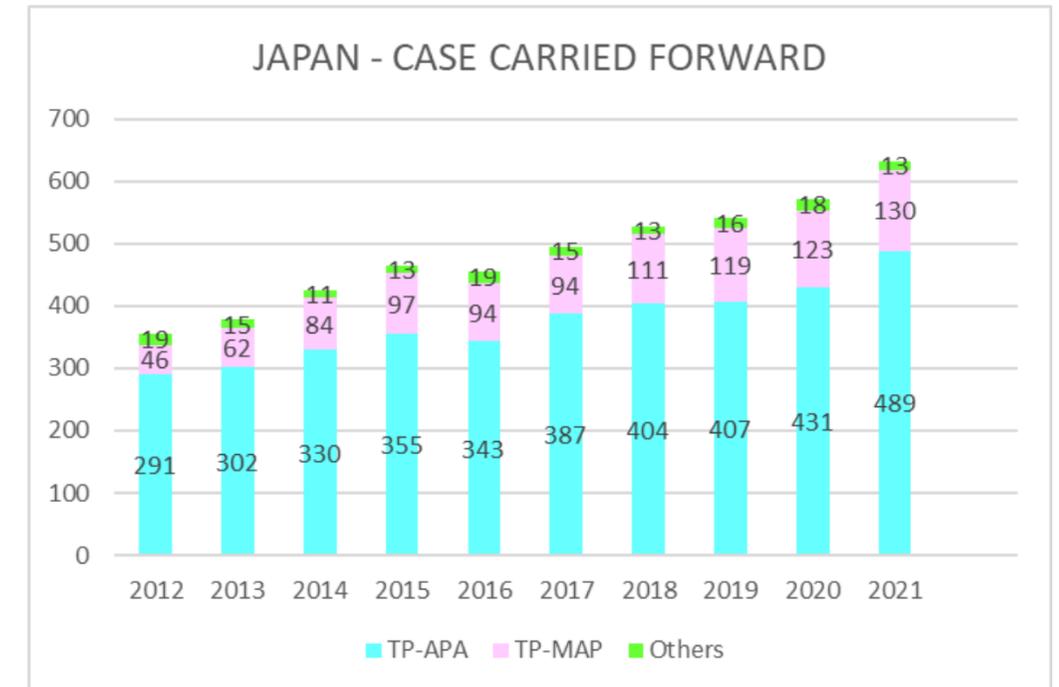
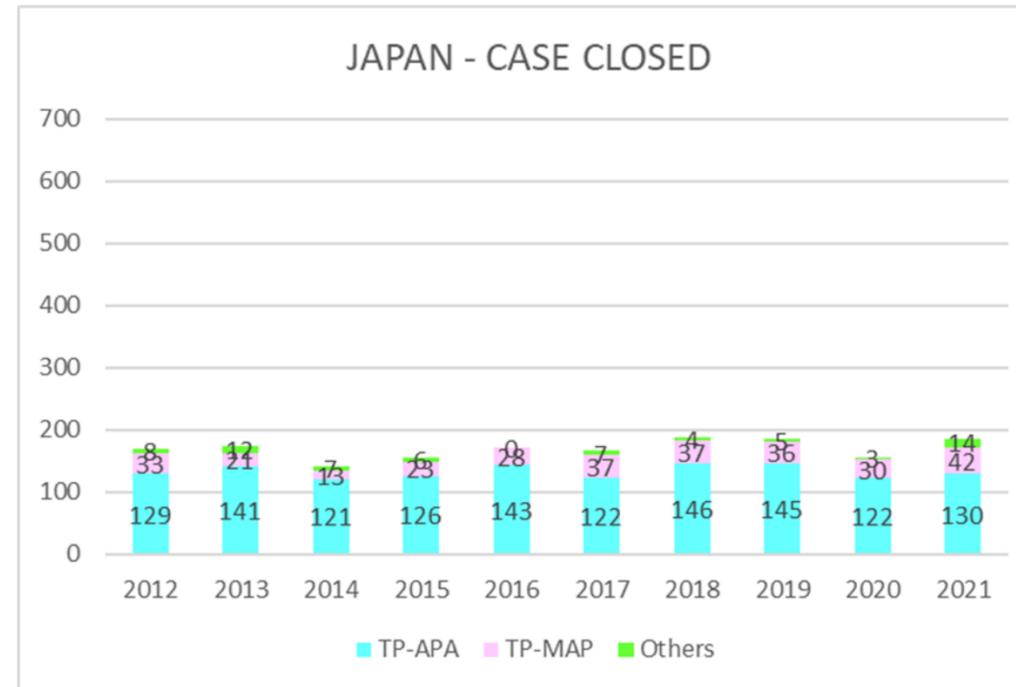
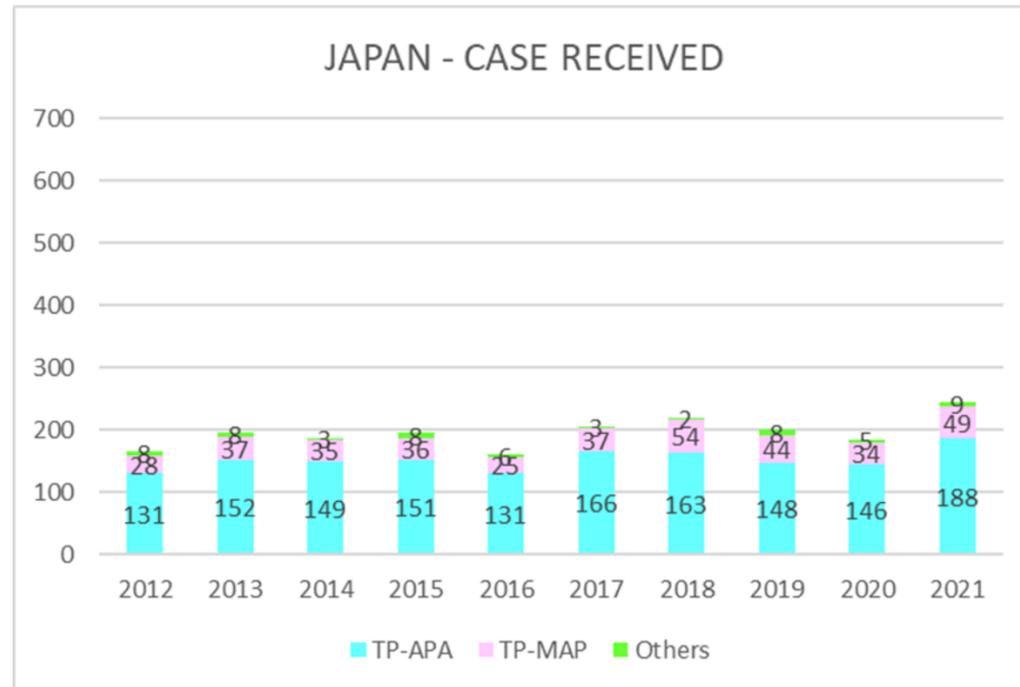
Number of APAs Concluded by State Administration of Taxation
(2005 to 2021)



- Efficiency in 2021
- 7/9 unilateral APA < 24 months
- 9/11 > 24 months
- The effect of 2021 Simplified UAPA procedure?
- The trend - Increase or decrease?
- Customs & Tax Authority TP Coordination in Shenzhen
- APA in the pipeline
- UAPA – 14 application + 125 in negotiation
- BAPA – 100 application + 101 in negotiation



A Japan perspective



4. TP adjustments- Settle of fight?

A Singapore perspective

- Defend if you believe in your position.
- Settle if you have doubts about your position.
- Surcharge applicable since YA2019 – lower the surcharge as much as possible
 - Lower the primary adjustment
 - Possibility of (partial) remission – cooperative, contemporaneous TP documentation, good tax compliance record



A China perspective

- The three typical scenarios
 - Voluntary adjustment before formal TP audit
 - Negotiated adjustment at the end of TP audit
 - Administrative appeal and court after TP audit
- Most cases are settled, but fight usually will be pick when:
 - information are available and transparent
 - With a strong technical base
 - cannot find a balanced point for settlement

2002 Reports on the Development of a Rule of Law Government		
	Administrative Appeal	Court Litigation
Entire Nation	2088	1174 *
Beijing (municipal level)	138	10
Shanghai	38	25
Tianjin	62	?
Shenzhen	192	?
Ningbo	17	14
Zhejiang Province	18	3

* Reportedly, less than 50% of the court cases are concluded with a verdict, while most cases are ended with a ruling.



A Japan perspective

1. Settlement – Not an easy option

- Tax authority invests significant time and resources in TP audits
- No “settlement” policy – Strict compliance with law
- Defense strictly in accordance with law

2. Options after TP Adjustments

(1) BAPA / MAP

- With OECD countries – viable
- With non-OECD countries – less viable

(2) Litigation

- Administrative appeal, followed by court litigation
- 2-3 years for administrative appeal and 4-5 years for court litigation
- Issues
 - Intangible: Most appropriate method - TNMM or Profit Split
 - Comparability: “*one country, one market*” principle
 - Functional analysis is a key



5. Preparing for more controversy?

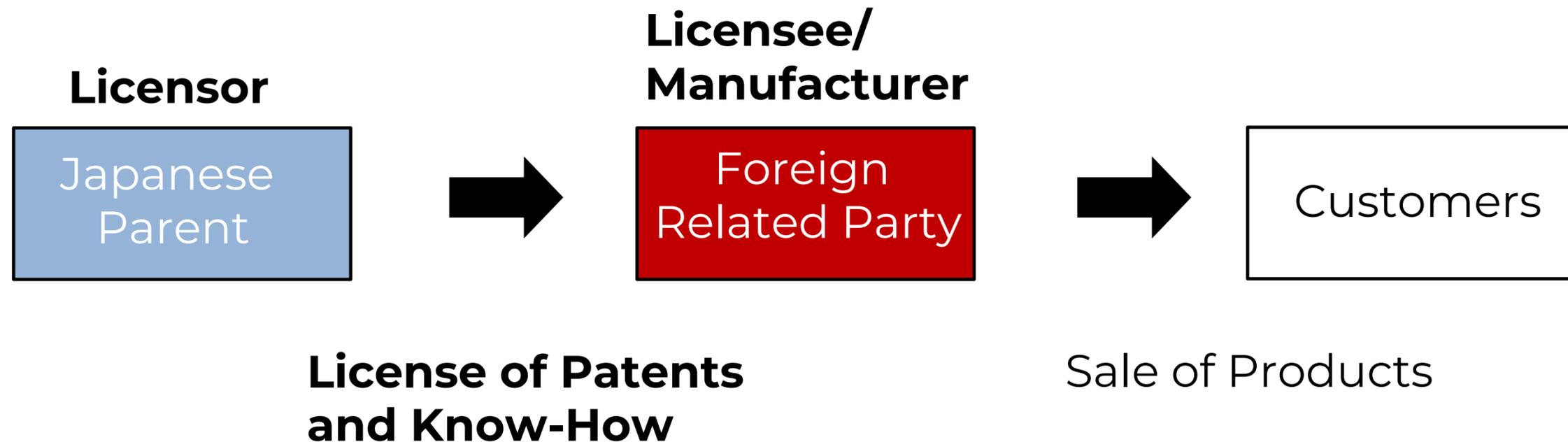
A Japan perspective

- NGK Insulators Ltd. Case Insulators Ltd. Case (Tokyo High Court, March 10, 2022)
- The Japanese tax authority made an adjustment in the amount of JPY 5.8 billion (USD 40 million) applying a Residual Profit Split Method (RPSM), using R&D expenses spent by the Japanese Parent and its Polish Subsidiary, respectively, claiming that the Parent should have recognized a vast majority of the combined profits due to its far larger R&D expenses.
- The Court disagreed with the tax authority:
 - *“The excess profits were attributed to (a) high demands of the products (Diesel Particulate Filter; DPF) caused by EU exhaust gas regulations, and to (b) high profitability earned by the capital-intensive cost structure, which realized economy of scale and built a high entry barrier against competitors”*
- “The contributions by the Polish Subsidiary was thus estimated not only by its R&D expenses, but also by 'excess depreciation expenses', which were the depreciation expenses in excess of the average depreciation expenses spent by comparable companies.”



A Japan perspective

NGK Insulators Ltd. Case (Tokyo High Court, March 10, 2022)



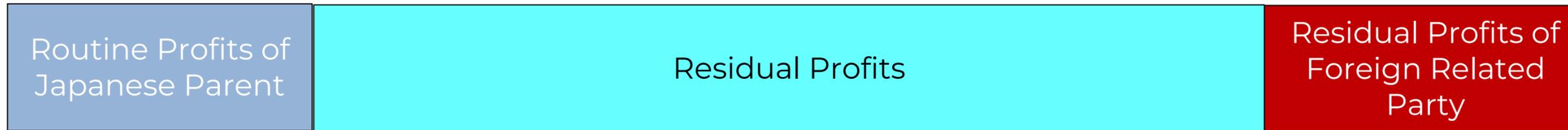
License Fees; Royalties



1. Combined Profits



2. Allocation of Routine Profits



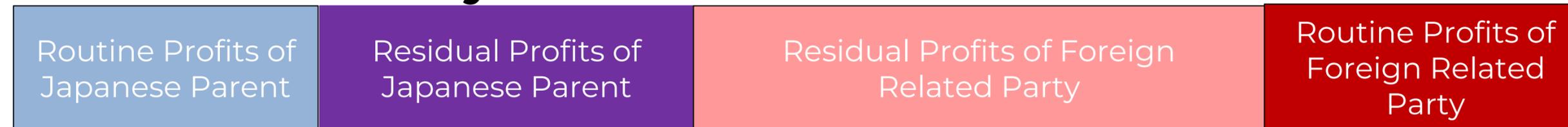
3. Division of Residual Profits



A. Cancellation by Court: Denial of Comparability

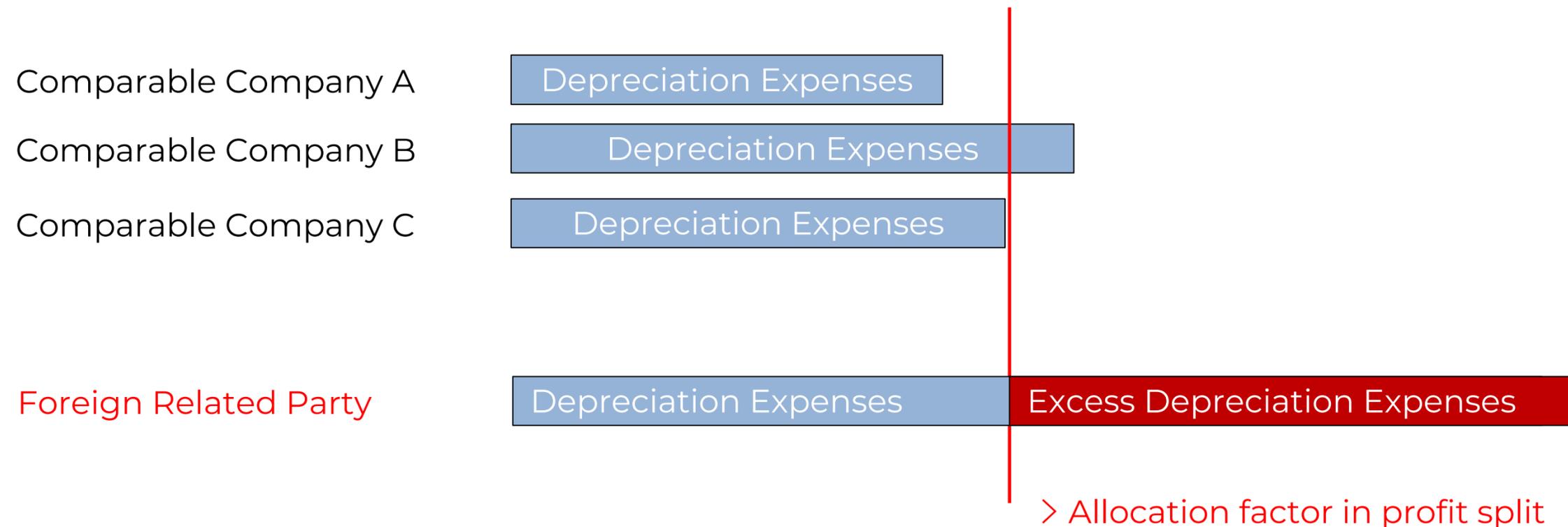


B. Cancellation by Court: Denial of Allocation of Residual Profits



A Japan perspective

- NGK Insulators Ltd. Case (Tokyo High Court, March 10, 2022)
- *“high profitability earned by the capital-intensive cost structure, which realized economy of scale and built a high entry barrier against competitors”*
- 'excess depreciation expenses', which were the depreciation expenses in excess of the average depreciation expenses spent by comparable companies.”



5. Expectations going forward

THANK YOU

