

Border Crossing

Welcome to the fourth edition of Border Crossing - the electronic newsletter from RSM International covering technical developments in global taxation.

In this issue:

Implications of a transfer pricing audit

French Tax Alert

EU dividends exempt from taxation



Implications of a Transfer Pricing Audit

By Jennifer Rhee, RSM International, Canada

With contributions from RSM International experts in Australia, Hong Kong, Singapore, US, Germany and UK

In many countries, transfer pricing adjustments have become a popular means of raising tax revenues especially in the last decade. For tax administrations they offer a politically correct way of increasing tax revenues without raising tax rates. For the tax auditors, such reassessments present “low-hanging fruit” because unlike traditional tax issues, that have the benefit of numerous interpretations in applying tax law (whether by way of tax rulings, administrative positions or jurisprudence) transfer pricing is relatively in its infancy as far as the application of those principles and the auditors have a wide berth in assessing whether they believe transactions meet the arm’s length standard. This, and the subjective nature of transfer pricing issues means tax auditors often issue tax reassessments that reflect their uncertainty in these matters and their lack of sophistication and understanding of not only transfer pricing principles but business practices.

Unfortunately, unlike other tax issues, transfer pricing issues are not confined to the tax realm. The impacts of a transfer pricing reassessment, or threat

of one, are far-reaching. From cash flow concerns in paying a reassessment that results in double tax (at least temporarily until relief is obtained), to prolonged and on-going negotiations with or among tax authorities for resolution, to impacts on financial reporting and disclosure and finally, to the very core of the international business operations.

In this backdrop, many businesses are faced with unprecedented uncertainty, not only in their fiscal planning, but very simply, right down to the basics of operating their business because transfer pricing issues do not arise only as a result of fiscal planning or tax minimisation strategies - they exist the minute a company expands its operations in another jurisdiction whether or not that move is tax driven.

Operational Implications

When a transfer pricing adjustment is proposed, there are well-known concerns regarding the risk of double taxation, cash flow concerns, possible customs duties and goods and sales tax implications and the uncertainty regarding the length of time for resolution. However, in addition to these issues, there are implications to the fundamental transfer pricing infrastructure used by the taxpayer.





Take for example a multinational enterprise (“MNE”) that has subsidiaries around the world.

Typically, in these situations, the MNE parent company implements the same transfer pricing model for all of its subsidiaries for a number of reasons; one can only imagine the amount of work and manual intervention that would be required if every transaction with every subsidiary was based on a different transfer pricing model. As such, for practical reasons and ease of implementation, the MNE centralises and standardises its transfer pricing model. This also limits potential challenges by various tax administrations if different models are used for the same type of transaction.

However, where a transfer pricing reassessment is raised by one jurisdiction, this puts at jeopardy the standardisation of the transfer pricing model for the MNE group. For example, assume MNE charges a royalty to its subsidiaries under a licensed distribution arrangement and the tax authorities of Country X challenge the royalty payment and argue that the royalty component is already built into the price of the tangible goods transferred between MNE parent and Subsidiary X. Whether or not such adjustment is merited or technically justified, the reality is that unless Subsidiary X successfully overturns the reassessment, it is faced with the prospect of changing the transfer pricing model for subsequent years to eliminate the royalty (and perhaps adjust the transfer price of the goods accordingly) or it will be confronted with a recurring transfer pricing adjustment.

Under the first possibility, MNE will be required to create a different transfer pricing model and pricing structure only for Subsidiary X, especially if other taxing jurisdictions have accepted the original transfer pricing model with the royalty charge. Alternatively, Subsidiary X can take its chances on the next audit and whether or not the same adjustment will be proposed. If an adjustment is proposed, Subsidiary X may incur penalties and interest along with that adjustment.

Financial Reporting Implications

Another emerging area of concern that may impact a transfer pricing audit surrounds financial reporting. There have been a number of developments in the US regarding measurement and reporting of contingencies that affect both the current and future tax provisions. In Canada, as well as many other countries around the world, what happens in the US may reflect a trend that will be followed shortly thereafter.

- The US Financial Accounting Standards Board (“FASB”) Statement No. 5, Accounting for Contingencies, clarifies that recognition of a tax return benefit must be “probable” of being sustained before being recognised in the financial statements. It goes further to state that the difference between the “probable tax basis” and the returns “as filed” should be recorded as a current liability, not a deferred liability.
- In July 2005, the US issued an exposure draft proposing to modify FAS 109, reporting for future income taxes. The exposure draft proposes that companies measure and recognise the impact of “uncertain tax positions” on future income tax assets. The same concept of “probable” tax benefit is applied, that the benefits of an “uncertain tax position” must be probable of being sustained. More importantly is the lack of definition to the term “uncertain tax position”. A FASB meeting held in November 2005 reaffirmed the decision not to define “uncertain tax position” and indicated that this term would likely apply to “all tax positions taken by an enterprise”. An uncertain tax position will be question of fact and “should be based upon the manner in which the enterprise supports and documents its tax return and the level at which issues are addressed with taxing authorities.” Finally, there is a presumption that all tax positions will be examined by tax authorities and therefore, “consideration of the risk of examination is not appropriate”.





Let's put these changes into a transfer pricing context. Most US practitioners believe that tax minimisation strategies, using transfer pricing practices, should not be considered an "uncertain tax position" if appropriate documentation is available to support the transfer pricing model (e.g. moving IP offshore to a lower tax jurisdiction and licensing such rights to entities in higher tax jurisdictions).

However, consider this situation as an example: the Competent Authorities of the Canada Revenue Agency ("CRA") and the Internal Revenue Service ("IRS") have a number of issues on which they fundamentally disagree. One of these is the appropriate methodology to compute the return that should be earned by a consignment manufacturer. The two approaches result in a very wide discrepancy in what the consignment manufacturer should be paid for its services. Now assume that the MNE is a US company that engages its subsidiary, located in Canada, to perform consignment manufacturing services on its behalf and the income and tax result is reported based on the US methodology of computing the transfer price for the manufacturing service. Despite the documentation to back up the computation and methodology, if MNE is aware of the Canadian authorities' position on the preferred computation methodology, it would appear that MNE has an "uncertain tax position" which they must report. The recognition of such contingencies may, as a result, adversely affect the company's financial position, share price or financing ratios and covenants that may exist.

A transfer pricing audit does not end with a reassessment; the resolution may be prolonged, the issues are grey and the future may be uncertain. MNEs must be aware of the transfer pricing environment in the countries where they conduct business. They must be sensitive to the issues of concern of each jurisdiction and they need to be flexible and pro-active in addressing these issues and thereby better manage the associated transfer pricing risks.

Taking the temperature of the transfer pricing climate around the world

Below is a synopsis of the transfer pricing environment in selected jurisdictions.

Canada

There has been a noticeable increase in the transfer pricing audit activity in the last 2-3 years. From a procedural point of view, the CRA is issuing, as standard practice, formal requests that require the taxpayer to supply transfer pricing documentation within 3 months of the date of the request. Recently, the CRA has significantly increased its resources, by hiring 15 additional economists to support the field auditors.

There have also been numerous files referred to the newly formed Transfer Pricing Review Committee, a committee of various CRA officials whose mission is ostensibly to ensure the consistent and fair application of transfer pricing penalties and the "re-characterisation" provision. The CRA appears to be targeting specific industries (pharmaceutical, automotive, call centres) and types of businesses (limited risk distributors, contract manufacturers). The most troublesome trend appears to be a prevailing attitude by the CRA that an adjustment must be found. Even where a taxpayer's transfer pricing model and methodology appear to be reasonable, the CRA does not respect the taxpayer's position, but rather creates its own scenario to justify increased profits to be attributed to the Canadian entity.





United States

The level of transfer pricing audit activity in the United States has increased significantly over the past few years.

To identify transfer pricing exposures, the IRS will review prior year tax filings, focusing on either Form 5471 "Information Return of US Persons With Respect to Certain Foreign Corporations" or Form 5472 "Information Return of a 25% Foreign-Owned US Corporation or a Foreign Corporation Engaged in a US Trade or Business". While all inter-company transactions are being scrutinized, the IRS is paying particular attention to inter-company services and cost sharing arrangements, both of which have been the subject of recent proposed regulations.

Due to corporate downsizing, many experienced tax practitioners have recently joined the IRS to become International Examiners. Transfer pricing economists are assigned to geographic regions. Economists from the IRS' National Office in Washington, DC are highly skilled and such economists are typically brought into an audit where significant amounts of proposed tax adjustments appear to exist.

United Kingdom

There has always been questions raised on transfer pricing and cross border transactions and since 1 April 2004 this has extended to solely UK/UK transactions. In particular, since 1 April 2004, there has been more emphasis on thin capitalisation issues, especially where borrowings are at a subsidiary level and not the UK parent company. The use of parent company guarantees is also under scrutiny.

More recently, the emphasis seems to be shifting to accounting principles and provisions. Although the provisions may be acceptable under a true and fair view for accounting purposes, HM Revenue & Customs ("HMRC") are questioning the exact make up of the provisions and seeking adjustments for those that cannot be supported adequately for tax purposes.

The focus on transfer pricing audits in the past has been, and continues to be, on the pharmaceutical and motor industries but any large companies that are foreign owned face increased scrutiny. There is also increasing interest in how the boardrooms of large companies deal with tax risk. There are a number of HMRC initiatives in this area including discussions with chairmen and CEO's on whether they have a tax risk policy and their views on corporate responsibilities to society. In addition, the Large Business Service of HMRC is developing an operating model to understand businesses, risk factors, use of client relationship managers, and actions to counter non-compliance. A project team comprising representatives of HMRC and business is expected to report with recommendations for improvement later this year. This might lead to a reduction in audit activity, as it would be replaced with more dialogue on a regular basis.

This is supported by the recent disclosure rules under which details of certain tax planning arrangements are disclosed to HMRC, within a short time frame, enabling them to act quickly and introduce immediate legislation where there is perceived abuse.

Germany

During a landmark court case in 2001, the Federal Fiscal Supreme court stated that a taxpayer is not obliged to provide documentation of transfer prices. Following this, legislation was then introduced regarding transfer pricing documentation requirements concerning business transactions of closely related persons or companies.





Since 2003 transfer pricing documentation has to be made available on request of a tax auditor within 60 days. Furthermore, extraordinary events and transactions (e.g. conclusion of new long-term contracts, changes in transactions, strategy, risks and functions, transfer of assets during reorganizations) have to be documented within 6 months. The documentation requirements include, a presentation of organisational structure, a functional and risk analysis, the disclosure of applied transfer pricing methods and detailed calculations.

As a result of these legal changes, transfer pricing has become a more important field for tax auditors. After a wide introduction of auditing software, tax auditors have the technical possibilities to analyse extensive calculation data as well as to examine and compare transfer prices on basis of databases and statistical tests.

Australia

The Australian Taxation Office (“ATO”) has in recent years increased its compliance focus on the area of transfer pricing. In the year to 30 June 2005 the ATO completed 87 transfer pricing risk reviews in the large business sector with 26 audits being conducted. While in the small to medium business sector they carried out 101 transfer pricing risk reviews identifying significant compliance issues and leading to audits on 23 of the highest risk cases. The ATO’s transfer pricing compliance focus is to increase in the 2005-2006 year.

The risk of an ATO audit is increased where a business conducts extensive international related party transactions, or has been consistently returning losses or below industry average profits. The main areas that the ATO appear to be focusing on are transactions involving the transfer of intangibles (including trade names, business models and manufacturing know-how), services, financing, management fees, situations where high value functions, assets or risks have been moved offshore and multinationals headquartered in Australia that provide services to offshore related parties.

China

Upon accession to the World Trade Organisation, China moves further towards a global manufacturing base and there is significant growth in international trade and investment. As a result, Chinese tax authorities have been strengthening the enforcement of disclosure requirements for such cross border related party transactions and have also launched nation-wide transfer pricing audits.

The State Administration of Taxation identifies transfer pricing investigation/audit targets; these targets include enterprises whose operational and management decisions are controlled by associated enterprises, companies that have incurred losses for over two years, businesses that have reported only marginal profits while expanding or those that show drastically reduced profits after the expiration of tax holidays.

In addition, the tax bureau will consider the quality of the taxpayer’s processes, the existence and quality of transfer pricing documentation and whether related party transactions result in “commercially realistic” profits, in determining whether to proceed with a tax audit.

Because of the absence of reliable public company data in the People’s Republic of China (“PRC”), the tax authorities will in practice use their “internal” comparables based on a compilation of a nation wide anti-avoidance database containing relevant taxpayer information.

Precaution is better than cure for managing transfer pricing risk. The advisable practice is to display a consistent and defensible internal transfer pricing policy that reflects a good understanding of the critical functions and relative added value of the underlying transactions, all of which is supported by appropriate comparable benchmarking.





Hong Kong

Hong Kong is a special administration region of the People's Republic of China. The tax system of Hong Kong is independent and separated from Mainland China. Transfer pricing is not a major concern of the Hong Kong Inland Revenue Department ("IRD") as the corporate income tax rate of Hong Kong (currently 17.5%) is considered the lowest among the Asia Pacific region.

In Hong Kong, transactions entered into between Hong Kong residents and closely connected non-Hong Kong residents are required to be disclosed when the company files its annual profits tax return. The Hong Kong IRD may enquire into details regarding the business operations of the company, and details of related party transactions to ascertain if they are conducted at arm's length on a commercially justifiable basis, especially for non-Hong Kong residents located in the tax haven countries (eg British Virgin Islands, Cayman Islands, etc).

The IRD has not issued any specific regulations or rules on transfer pricing. The focus of the IRD on transactions with non-residents is to make sure that transfer pricing policies are commercially justifiable and it seldom carries out audits on transfer pricing issues.

Singapore

Due to the relatively low corporate tax rate of 20%, transfer pricing had not been a significant focus for the tax authorities. However, with the increased focus on transfer pricing issues by other countries and given that Singapore is often a regional hub to many MNEs, the Singapore government issued its first ever circular on transfer pricing guidelines in February 2006 providing practical guidance on applying the arm's length principle. The circular also sets out procedures for applying for Mutual Agreement Procedure and Advance Pricing Arrangement.

For further information please contact the RSM expert in:

Canada: Jennifer Rhee
jrhee@rsmrichter.com

United States: Mark Kral
Mark.kral@rsmi.com

United Kingdom: Les Secular
Les.Secular@rsmi.co.uk

Germany: Florian Eisele
florian.eisele@haarmannhemmelrath.com

Australia: Rob Mander
rob.mander@rsmi.com.au

China and Hong Kong: Dicky To
dickyto@rsmnelsonwheeler.com

Singapore: Lim Lee Meng
lmlim@rsmchiolim.com.sg

References

¹An increase in income in one jurisdiction should be offset by a corresponding deduction in the other country. However, this may not always occur if the revenue authorities, the "Competent Authorities" do not come to a resolution or to the extent that the tax rates are different or for example if the offsetting jurisdiction is in a loss position.

² A consignment manufacturer is similar to a contract manufacturer (a company, separate from the entrepreneur, that provides manufacturing services) except that it does not hold title to the work in process or the finished goods.

³ This is a specific provision which allows CRA to disregard the transaction as it was entered into and structured by the taxpayer and to re-characterize it to conform with what CRA believes to be the economic substance of the transaction.

⁴ A transfer pricing risk review involves the ATO reviewing transfer pricing documentation and interviewing a business to evaluate the quality of processes, documentation and the commercial realism of the business's dealings with related parties. If the review shows there is a risk to the revenue, the ATO may consider it appropriate to proceed to a transfer pricing audit.

French Tax Alert

Pending modification of the DTT France-Luxembourg, action is advised for real estate properties and real estate companies held through a Luxembourg company.

The French and Luxembourg tax authorities have agreed upon a draft modification of the France-Luxembourg double tax treaty ("DTT"). The change is expected to enter into force as soon as 1 January 2007. This is particularly important for foreign investors, who typically hold French real estate properties via a Luxembourg SOPARFI. Below is a summary of the major propositions of the intended modification and action points for foreign investors.

Double Exemption due to DTT

Pursuant to Article 3 of the DTT, in force since 1958, real estate income shall be taxed according to the location of the property. Regular income and capital gains derived by an investor resident of one country from real estate located in the other country is taxed in this other country.

Other double tax treaties and the OECD Model convention provides for the application of this rule also when the income is derived by a business (Art. 6 section 4 OECD Model convention). This rule aims at ensuring that real estate income of a company is taxed in the source country even if the company is resident in another country and has no permanent establishment in the country where the property is located. The DTT between France and Luxembourg does not include such a clause.

French Tax Courts have stated that Art. 3 of DTT does not give France the right to tax income derived from French real estate owned by a Luxembourg company. According to the French Judges, the right to tax would result from Art. 4 of DTT, which would suppose that the Luxembourg company has a permanent establishment in France. The French High Court has ruled that the mere possession of a property in France does not qualify as a permanent establishment (Conseil d'Etat, 18 March 1994, "Société d'investissement Agricole et Forestier").

On the other hand Luxembourg Courts deny Luxembourg any right to tax French-sourced real estate income (Luxembourg High Court 2 February 2002).

This situation leads to a tax loophole, as neither country can tax French real estate income derived by a Luxembourg company. This double exemption is applicable to regular income as well as to capital gains on the disposal of French real estate properties.

The Luxembourg High Court has, however, now ruled that income from the disposal of interests in a French real estate company (société civile immobilière) by a Luxembourg SOPARFI is subject to tax in Luxembourg. In its decision of 16 January 2006, the High Court ruled that according to Art. 19 section 2 of DTT income derived from partnerships is taxable according to Luxembourg tax law, notwithstanding the other DTT provisions. With this new ruling the Luxembourg High Court closed the tax loophole in certain limited cases, however under banning of the French right to tax.





Intended modification of the DTT

The modification of Art. 3 of DTT would comply with the regulations of the OECD Model Convention. The country of source would hence have the right to tax real estate income and capital gains even if they are received by a company resident of another country with no permanent establishment in the source country.

Furthermore, it is planned that this provision would also be applicable if the real estate income or capital gains are received by a transparent entity which is not subject to tax at its level. These provisions should not affect Art. 4 of DTT relating to the taxation of business income.

The planned modification has an impact on international real estate investments insofar as rental income and capital gains from French properties received by a Luxembourg SOPARFI or another entity should now be taxable in France.

Conclusion

Future real estate investments in France, particularly real estate funds, should take the planned DTT modification in to account.

Existing real estate investments still profiting from the double tax exemption on French-sourced rental income and capital gains should consider a restructuring of their investment in order to cash in on the existing tax benefit.

Before entering into force, the DTT modification should be signed and ratified by the French and Luxembourg authorities. No political obstructions are expected and therefore investors should anticipate the new provisions entering into place as early as 1 January 2007.

For further information please contact the RSM expert:

Frankfurt (French Desk)/Paris

Jacques-Henry de Bourmont

T: +49 69 153 480 186 (Frankfurt)

T: +33 1 53 53 02 80 (Paris)

E: jh.debourmont@haarmannhempelrath.com

Guillaume Rubechi

T: +49 69 153 480 186 (Frankfurt)

T: +33 1 53 53 02 80 (Paris)

E: guillaume.rubechi@haarmannhempelrath.com

Luxembourg

Laurent Heiliger

T: +352 26 97 97 1

E: laurent.heiliger@rsm.lu



EU dividends exempt from taxation

On 6 April 2006, the Advocate General ruled in the FII Group litigation case (of which BAT Group was the main test claimant) that exempting UK dividends received by UK companies from taxation while taxing the receipt of EU dividends (albeit with credit in part for overseas taxes) is contrary to EU law.

While the FII Group litigation case dealt with a number of complex and interconnected issues surrounding the now defunct advance corporation tax (ACT) and the foreign investment income regime, the headline point made by the Advocate General was that by applying an exemption system to UK dividends but a credit system for EU dividends, the UK tax system treats EU dividends received less favorably and hence is contrary to the freedom of establishment and free movement of capital within the EU.

Advance corporation tax was considered by the Advocate General to be unlawful, unrelievable double taxation of foreign profits. Claimants were therefore entitled to recovery of charges unlawfully levied. The UK government submitted that the potential value of claims for refunds could be of the order of £7bn but was unable to substantiate the number. Most taxpayers and advisers believe that the order of magnitude is likely to be significantly less at £500m to £1bn because of the complexity of the claims and various restrictions on what can and cannot be claimed.

The opinion, which is not binding on the European Court of Justice but likely to be followed in due course, was long and extensive and dealt with a number of issues including:

- The unlawful discrimination against portfolio holdings (of less than 10%) where no relief for foreign taxes was allowed;
- EU dividends always suffered 30% UK tax whereas UK dividends did not necessarily;
- EU dividends could never constitute Franked Investment Income (which allowed recipient companies to pay (frank) dividends without accounting for ACT);
- UK law denied the recovery of ACT where foreign tax had been incurred on the profits out of which the dividends were paid and illegally required double taxation relief to be taken into account before ACT could be offset against main stream corporation tax in the UK;
- The requirement for upfront payment of ACT under the FID regime (albeit with subsequent recovery) introduced in 1994 to ameliorate the negative effects of the build up of surplus ACT in a number of companies, breached EU law;
- As did the fact FIDs could not constitute Franked Investment Income and so could not frank the payment of ordinary dividends to shareholders;
- However the Advocate General was not convinced that companies themselves had necessarily suffered where they paid enhanced FID dividends to shareholders to compensate them for the loss of the refundable tax credit on UK dividends; but did leave it open to shareholders to consider this point.



EU dividends exempt from taxation

➤ The Advocate General also covered the issue of remedies, stating that it was up to national courts to characterise and classify the type of claims for breach of EU law but there must be an effective remedy for reimbursement or reparation of all financial loss sustained by a taxpayer.

The UK Government sought to limit the time for claims and the Advocate General accepted that a time limit might be appropriate where there was a risk of serious economic repercussions and that the failure to comply with EU law resulted from uncertainties that had in some way been contributed to by the Commission of other member states. However he felt the UK had not been able to substantiate this and should have been aware of the dangers following earlier EU case law.

Summary

Assuming the European Court of Justice follows the Advocate General's reasoning, then:

- EU dividends received by UK companies should be exempt regardless of the tax paid elsewhere;
- Companies may therefore want to review their overseas holding structures and consider repatriation of accumulated overseas earnings tax free;
- The Cadbury Schweppes and Vodafone 2 cases to be heard later this year on the legitimacy of the UK's controlled foreign companies legislation may have very significant ramifications for the competitiveness of the UK tax system if companies seek to maximize lower tax rate opportunities and incentives offered by other Member States and can now remit these profits back tax free to the UK;

- This may invoke a wholesale review of the UK tax system with the UK Government possibly looking to restrict the relief of interest against UK profits of overseas activities;
- Companies should consider whether they need to make claims for UK tax illegally paid on portfolio holdings, additional UK tax paid on any overseas remittances, ACT unnecessarily paid or suffered and/or unrecovered whether absolutely or in cash flow terms as a result of the payment of dividends to shareholders in whole or part out of foreign profits restitution for financial loss may be due.

For further information please contact the RSM expert:

London

Lynne Patmore

T: +44 (0)20 7865 2551

E: lynne.patmore@rsmi.co.uk



The next issue:

The next newsletter will be published in 3rd quarter 2006.

Editor

Gillian Hawkes

PR & Communications

RSM International

Executive Office

T: +44 (0)20 7601 1080

E: gillian.hawkes@rsmi.com

The opinions expressed in these articles are the personal views of RSM International and are not intended as specific business advice. Readers of this material are recommended to seek professional advice before making any business decisions.

RSM International is an affiliation of independently owned and managed member firms. RSM International and each of its member firms are separate and independent legal entities as are RSM International Limited and RSM International Association. RSM International, RSM International Limited and RSM International Association do not practice public accounting or consulting.

© RSM International, 2006

RSM International

www.rsmi.com

