

# Global Tax Report

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### Editor's Note

The White & Case GLOBAL TAX REPORT is prepared for the general information of our clients and other interested persons. It should not be acted upon in any specific situation without appropriate legal advice.

## Indonesia Issues Strict New Rules for Claiming Treaty Relief Effective January 1, 2010

The Indonesian Director General of Taxation (DGT) on November 5, 2009, issued two new regulations setting out strict requirements that nonresident persons must meet in order to claim reduced Indonesian withholding tax rates under Indonesia's tax treaties. (See DGT Regulation No. PER-61/PJ./2009, "Procedure for Implementation of Double Taxation Agreements" (Regulation 61), and DGT Regulation No. PER-62/PJ./2009, "Prevention of Tax Treaty Abuse" (Regulation 62)).

### Conditions for Treaty Relief

Under Regulation 61, a withholding tax agent should withhold tax in accordance with the provisions of an applicable tax treaty (i.e., apply a reduced treaty withholding tax rate or exemption), if the following conditions are met:

- The income recipient is not an Indonesian resident tax subject.
- The administrative conditions for applying the provisions of the tax treaty have been fulfilled.
- There is no "abuse" of the tax treaty by the foreign taxpayer as contemplated in provisions regarding the prevention of tax treaty abuse.

If the above three conditions are not all met, the withholding tax agent must withhold or collect the tax payable in accordance with Indonesian domestic tax law, which is 20 percent in the case of interest, dividends and royalties.

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Regulation 62 provides that “abuse” of a tax treaty occurs if:

- A transaction that has no economic substance is carried out using a certain structure/scheme solely in order to obtain a benefit from a tax treaty.
- A transaction has a structure/scheme whose legal form is different from its economic substance and is solely in order to obtain a benefit from a tax treaty.
- The income recipient is not the real owner of the economic benefit of the income (the beneficial owner). For this purpose, the real owner of the economic benefit of the income is an income recipient who is not acting as an agent or a nominee, and is not a conduit company.

The new regulations specifically provide instances where tax treaty “abuse” is not deemed to occur. They are:

- An individual who does not act as an agent or a nominee.
- An organization whose name is mentioned in the tax treaty or has been agreed by the competent authority of Indonesia and the competent authority of the tax treaty partner.
- A foreign taxpayer who receives or earns income through a custodian from a transfer of shares or bonds traded on the Indonesian Stock Exchange, other than interest and dividends, where the foreign taxpayer is not acting as an agent or as a nominee.
- A company whose shares are listed on a stock exchange and traded regularly.
- A bank.
- A company that meets the following conditions:
  - The company is established in the tax treaty partner country or has a structure/scheme transaction arrangement that is not solely intended to take advantage of a tax treaty benefit.
  - The company’s operation is managed by the management itself who has sufficient authority to enter into transactions.
  - The company has employees.
  - The company has activities or an active business.
  - The Indonesia-source income is subject to tax in the recipient country.
  - The company does not use more than 50 percent of its total income to fulfill its obligations to other parties in the form of interest, royalties or other types of compensation (the 50% Test).

These tests relating to a company are quite stringent and are not clear, particularly the 50% Test. For example, if a company has significant bank debt which is totally unrelated to its investment in Indonesia, but the bank debt results in a company paying more than 50 percent of its total income to the bank, does this mean that the company is denied tax treaty benefits? This is not the intent of the new rules, but could technically be the correct result. Hopefully, the Indonesia Tax Department will provide some clarification.

## **Certificate of Domicile**

### **General Income Recipients (Form-DGT 1)**

The Regulations generally require all nonresident persons, other than banks, to provide a "Certificate of Domicile of Non Resident for Indonesia Tax Withholding" (COD) on Form—DGT 1 to the payer of the income, acting as a withholding tax agent, in order to claim treaty relief from Indonesian withholding tax on Indonesia-source income (such as dividends, interest, royalties and income from rendering services).

The income recipient must complete Form—DGT 1 and make a declaration that the information provided is true, correct and complete. It must provide detailed information regarding itself, including whether it has its own management to conduct the business and such management has independent discretion, whether it employs sufficient qualified personnel and whether it engages in the active conduct of a trade or business. It must also provide information regarding the income in respect of which treaty relief is being claimed and, in the case of services, the terms of the engagement. This latter requirement will prove burdensome to professional service firms (e.g., management consulting firms and international law firms).

In addition, the competent authority of the country of residence of the income recipient (the tax treaty partner country) must confirm and certify that, for purposes of tax relief concerning the types of income mentioned in the form, the income recipient is a resident in the tax treaty partner country within the meaning of the tax treaty. The competent authority or his authorized representative must sign the COD and affix its official stamp, if any.

The income recipient apparently is required to provide a separate Form—DGT 1 for each payment of income for which treaty relief is being claimed. The income recipient must submit the COD to the withholding tax agent before the deadline for filing its monthly tax return for the period in which the income is paid (i.e., by the 20th of the following month).

This is a radical departure from prior practice where a COD was only required to be given to an Indonesian withholding agent once a year and, thus, the new requirement will prove to be very burdensome for foreign investors.

# When Transfer Pricing Meets Custom Valuation



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For multinational companies, dealing with either tax authorities or customs administrations can be a major headache. So how about serving two masters at the same time? Surely it would not be easy. In the cross-border business environment, it is not uncommon to see multinational companies struggling with the conflicting demands from tax authorities and customs administrations. Indeed, the conflict between transfer pricing and customs valuation is attracting attention from various stakeholders, including tax practitioners in the game. The solution to this conflict varies with countries.

In China, the transfer pricing issues are administered by the State Administration of Taxation (SAT) and its local branches, while the customs issues fall into the jurisdiction of the General Administration of Customs (GAC). The SAT and the GAC are two separate governmental agencies at the national level. China's customs valuation rules and transfer pricing rules are similar on some basic principles, such as the arm's length principle applicable to the transactions between two related entities. Nevertheless, there are some differences and conflicts between the two.

This article discusses the interaction of transfer pricing and customs valuation in China. The first part will explain a variety of potential conflicts between transfer pricing and customs valuation. To a certain extent, the conflicts are rooted in the divergent purposes of the SAT and the GAC. The second part is to explore possible reconciliation measures to resolve the conflicts. The documentation requirement in recent tax regulations could be helpful to customs valuation. The third part will provide a brief conclusion to the discussion.

## 1. Conflicts between Transfer Pricing and Customs Valuation

While it is the objective of both the SAT and the GAC to ensure that related parties are transacting with each other on an arm's length basis, as in other countries, there is a natural tendency for the two different authorities to pursue potential adjustments in opposing directions. For example, when a Chinese company imports goods from an overseas company, the SAT would scrutinize whether the transaction value is so high that it could increase the cost of goods and reduce the taxable income from a corporate income tax perspective. Conversely, the GAC would examine whether the transaction value is too low and thereby would result in underpayment of customs duties. Setting prices that will satisfy the requirements of both the SAT and the GAC can pose a challenge for companies.

The conflicts between the two systems can materialize in the following main areas.

### 1.1 Target of Investigation and Valuation

Although the GAC has the right to investigate the valuation of prior transactions, it tends to focus more on transactions currently undergoing the customs declaration process. Normally the customs process does not focus on a preselected target company, but rather on a transaction-by-transaction approach. In practice, however, the GAC has developed a risk analysis system that it applies during the entry declaration review process by which it identifies goods and companies that present risks of noncompliance.

From a transfer pricing perspective, investigations generally will more often target historical transactions rather than ongoing transactions. The objective of a transfer pricing investigation is to review whether transactions of a selected target taxpayer in a certain past period are in accordance with the arm's length principle and to make adjustment if the taxable amount in such a period is affected by a violation of the arm's length principle. The SAT will consider the taxable income and profitability of an entity as a whole over a period of time, whereas the GAC focuses on examining the dutiable value of imported goods on a transaction-by-transaction basis. Unlike the customs valuation, the transfer pricing investigations do not commonly apply to general enterprises but to a particular target enterprise selected by the tax authorities.

### 1.2 Pricing Methods and Priority

The Chinese transfer pricing rules prescribe five main transfer pricing methods, including: (1) comparable uncontrolled price (CUP) method; (2) resale price method; (3) cost plus method; (4) transactional net margin method and (5) profit split method. There is no priority to these methods.

The Chinese customs valuation rules prescribe that four main methods can be used for valuation purposes. In preferred sequential order they are (1) transaction value of the identical goods method (similar to the CUP method); (2) transaction value of the similar goods method (similar to the CUP method); (3) deductive value method (similar to the resale price method) and (4) computed value method (similar to the cost plus method).

In comparison, the transfer pricing rules have more valuation methods (i.e., transactional net margin method and profit split method) than the customs. Further, no priority exists in transfer pricing methods, whereas customs valuation methods follow a sequential order. These differences may result in a company having difficulty structuring its pricing methodology to satisfy the requirements of both the tax authorities and the customs

authorities. Accordingly, even if a company sets its transaction price in compliance with transfer pricing rules, it may still face a challenge and a price adjustment from the customs authorities employing a different pricing methodology, or vice versa.

### 1.3 Focus of Investigation

The main objective of customs valuation is to determine a reasonable dutiable value for each import transaction. The GAC normally focuses on the factors and details that may affect prices. However, the objective of transfer pricing investigations is to determine a reasonable distribution of profits earned in controlled transactions between related parties consistent with the arm's length principle. Although the SAT also looks at the factors that may affect prices, it focuses more on the functions performed and the risks borne by related parties.

### 1.4 Price Comparable Selection

When the GAC applies the transaction value the identical goods method or transaction value the similar goods method, assuming multiple identical or similar transaction values, it shall select the lowest one as the basis for customs valuation under the relevant rules. Nevertheless, when the SAT applies the CUP method, multiple comparable uncontrolled prices will be considered in determining a reasonable price range. As long as the transfer price is within this reasonable price range, the SAT normally will not challenge it. If the profit level of the taxpayer is lower than the median, the SAT will make an adjustment by raising it to the median or higher.

### 1.5 Conflict on License Fees

Cross-border license fees are normally subject to Chinese withholding tax and business tax. Under current customs rules, however, certain license fees must be included in the customs value of the relevant goods and thus subject to customs duty. Due to a lack of necessary cooperation and information sharing, the decision made by the GAC may not necessarily be acceptable to the SAT. As such, the same license fees could be separately taxed by the SAT and the GAC, thus resulting in an issue of double taxation.

### 1.6 Conflict on Price Adjustments

Periodic price adjustments for transfer pricing purposes are common in China. In other words, related parties can adjust their transfer prices over a period of time to ensure transactions as a whole reflect the arm's length principle. Nevertheless, the GAC normally does not accept periodic adjustments. Its focus is to compare the value of related party transactions to those of similar transactions between unrelated parties.

## 2. Reconciliation Measures

The SAT and the GAC generally focus on different aspects of related party transactions. When it comes to import/export pricing, however, they both require that all pricing information that parties submit must be objective, authentic and accurate. If both authorities were to coordinate their efforts and share information and experience, they should be able to operate more efficiently and reduce the rate of conflicting outcomes.

So far, there has been no Chinese law or regulation expressly addressing the reconciliation between transfer pricing and customs valuation. There is also no reporting of any joint audit case. Due to the lack of regulations that require the coordination and cooperation between these two government bodies, the SAT and the GAC do not have a formal system in place for cooperation and information sharing. A resulting problem is that the two authorities may make overlapping or duplicative information requests in connection with the same import or export transaction based on their respective focus. Subsequently, they could arrive at different conclusions regarding the responding company's transfer pricing policy. As a result, taxpayers not only have to spend significant amounts of time and effort to prepare documentation based on the different requirements of the two authorities, but also need to deal with additional risks arising from the lack of cooperation between the two authorities, e.g., the conflict that arises when one authority's final conclusion is not recognized by the other.

This may change soon, however, in connection with the SAT's issuance of the *Administration Measures of Special Tax Adjustments (Trial)*, which included a long-awaited contemporaneous documentation requirement. Many expect the GAC to cooperate closely with the SAT moving forward as SAT implements these measures. In addition, GAC officials reportedly have been studying the OECD transfer pricing guidelines and may introduce some of the same principles into their valuation system.

The expectation is that there will be more information exchanges between the SAT and the GAC. For example, the new, related party disclosure forms in the transfer pricing rules may address the treatment of intangibles. Intangibles such as royalties for the use of trademarks are often dutiable for customs purposes, but importers often fail to declare them properly for valuation purposes. Going forward, the GAC will be likely to ask for a copy of these tax disclosure forms when conducting valuation audits. Companies should therefore ensure consistency in documentation exists in terms of what is presented to the SAT and the GAC.

## 3. Conclusion

In China, the interaction of transfer pricing and customs valuation remains to be an interesting subject for multinational companies and tax practitioners. The tax and customs authorities continue to maintain divergent purposes and interests. In many areas, the conflicts could cause significant financial and compliance burdens on multinational companies without any realistic relief. It is still largely unclear how the tax and customs authorities would work to solve potential conflicting positions on the same issue. The contemporaneous documentation required by the tax authorities could be a good starting point for the customs administrations to come up with some positive steps in the direction of reconciliation.

# France Ready to Take a Tougher Stand to Combat Tax Havens



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Efforts by the G20 on an international level to combat tax evasion have accelerated the conclusion of bilateral tax treaties. Concerning uncooperative countries that refuse to comply with international standards for the exchange of information, the revised French tax legislation (to be adopted by the end of 2009) will launch an attack by proposing tax provisions that will make relationships with those countries unattractive.

The reform promoted by the revised 2009 tax legislation would introduce the definition of "noncooperative countries." A country may be designated as noncooperative if (i) it is a nonmember of the European Union; (ii) it has signed less than twelve bilateral tax treaties containing a clause providing for administrative assistance allowing the exchange of information and (iii) it has not signed a similar tax treaty with France. The list of the noncooperative countries would be published every year.

Several measures are proposed:

- The French participations exemption on dividends received by a French parent company currently applies regardless of where the subsidiary is incorporated. The reform would deny this benefit for distributions received by a French parent company from subsidiaries that are established in noncooperative countries.
- French withholding taxes levied on payments made to a noncooperative country would increase to 50 percent. This higher rate of withholding tax would cover payments made to persons established in noncooperative countries as well as to a bank account based in such country, regardless of the domiciliation of the beneficiary (an amendment would maintain the benefit of the current tax exemption on interest due for loans granted before January 1, 2010). The reform would also include a general exemption of withholding tax on interest, except for interest payments to individuals or entities located in a noncooperative country.
- The current condition under French law for the deduction of expenses paid or accrued to individuals or entities established in a tax haven requires proof that the expenses correspond to actual services and that there is no overpayment. The revised tax legislation would introduce a new requirement for payments made to an individual or entity established in a noncooperative country, namely that the French payor demonstrates that the main purpose of the payment is not to locate profits in a noncooperative country.
- The French CFC rules would be toughened. Current CFC rules trigger a French tax on income realized by a foreign entity which benefits a favorable tax regime and is controlled by a French corporation, unless the foreign company performs an industrial or commercial activity locally and the revenue from this activity exceeds certain thresholds. Under the new proposals, this exemption for local activity would no longer apply to companies established in a noncooperative country.
- Profits realized by a company located in a tax haven are taxable in France when a French resident individual holds ten percent or more of the share capital. The reform would introduce an assumption that this threshold is met if the French resident individual has transferred goods, rights or receivables to the foreign company.
- A French company would have to provide specific documentation on transfer pricing to the French tax authorities, if its annual turnover or the amount of its assets (or those of its controlling parent or controlled subsidiaries) exceed €400 million. Where transactions are realized with companies established in a noncooperative country, standard information on the activity, chart, relationship with the foreign entities would be required and the balance sheet and income statement of those companies would have to be disclosed. A failure to produce this documentation would be subject to a penalty of the greater of €10,000 or five percent of the profits transferred to a tax haven.

A temporary list of approximately twenty countries that could be regarded as noncooperative on January 1, 2009 has been prepared by the French authorities; it includes only countries appearing on the grey list of the OECD, but a more aggressive approach could be taken in the future, with France reserving the right to include any country that has signed tax treaties but has

not in practice implemented its commitments to exchange information (or countries that have refused a proposal to sign a tax treaty with France). To our knowledge, the first version of the list should include Chili, Uruguay, Guatemala, Philippines, Costa Rica, Panama, Liberia, Brunei, Belize and several islands in the Antilles and in the Pacific area.

## Risk of Double Taxation is Increasing



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The German Legislature has not worked out the fine details of the provisions governing a shift of functions. The term “function” is not yet clearly defined. Andreas Knebel—head of the German Tax Practice Group at White & Case and an authority in the field of German and international tax law—warns that the continuing risks regarding tax treatment will have a negative impact on entrepreneurial activity in Germany, especially now, during a global economic crisis.

Transfer pricing is a subject that becomes increasingly important for multinationals in the context of the continuing globalization, as a result of the sharp increase in competition. Given this development, new provisions were enacted in Germany on January 1, 2008, regulating business restructurings by way of a shift of functions (§1(3) sentence 9 of the German Foreign Transactions Tax Act—AStG). According to these new provisions, a shift of function occurs when a company transfers or leases assets or other benefits to a related company enabling such other company to exercise a function previously exercised by the transferring company. Thus, German law defines for the first time what the term “shift of function” means and how the transfer prices to be charged in this respect shall be determined. Germany has taken a go-it-alone approach and it is not clear whether and when other countries will follow its lead. At the most recent conference of the Organization for Economic Cooperation and Development (OECD) at the end of September 2009 in Paris, some observers commented as to whether OECD member countries may oppose adopting positions consistent with the German approach.

### Criticism of Germany’s Go-it-alone Approach

Thus, German companies are faced with significant uncertainties regarding the tax implications of a shift of functions, both with respect to the interpretation of the new tax rules in German law and—for an unforeseeable period of time—how foreign countries will treat such a shift of functions as a principle of law currently not embedded in their national legal systems. The German fiscal authorities have made every effort to resolve uncertainties relating to interpretation of the new rules in German law. In addition to the regulation issued on August 12, 2008 with respect to transfer pricing, a 72-page draft has been prepared as well and, although this draft of July 17, 2009 leaves many questions unanswered, legal certainty at the national level has significantly increased. However, whether or not this will be of any value depends largely on how other countries will react towards Germany’s go-it-alone approach.

### Treaty-Based Mutual Agreement Procedure May Be of Limited Assistance

In the event that the German tax authority imposes tax on a transferred package, the risk of double taxation arises depending upon whether the other country accepts this approach. At present, an apparent significant difference with the OECD principles is that the OECD focuses on the pricing of individual assets, rather than a “transferred package” that includes profit potential. Without a common approach, competent authorities in a mutual agreement procedure to avoid double taxation under a tax treaty may have great difficulty reaching a solution.

## Contrary to EU Law?

The focus of tax audits of multinationals is more and more on transfer pricing given the stricter obligations regarding documentation, thus involving the risk of a reassessment of taxable profits, penalties and evidentiary disadvantages. Moreover, the question of whether the German tax rules are compatible with EU law remains unanswered. According to the decisions of the European Court of Justice (ECJ), tax rules which are likely to prevent, hamper or make less attractive the transfer of nonmonetary or monetary capital or the establishment of a branch office restrict the freedom of establishment and the free movement of capital. Under this aspect the German tax rules would present a problem.

## Requests for Advance Pricing Agreements will Increase

It appears unlikely, particularly after the last OECD conference, that the OECD would quickly follow Germany's lead and establish legal certainty any time soon (an idea which may have been entertained by the federal fiscal authority as well as German companies). Rather, the previously existing consensus among OECD countries at the international level seems to be put at risk by the tendency towards more detailed requirements and the need for coordination.

Thus, it can be safely predicted that companies will increasingly rely on advance pricing agreements. These agreements are made between tax authority and taxpayer; their purpose is to establish, prior to transactions, certain criteria for determining transfer prices. The tax authorities are legally bound by these agreements. It should, however, be noted that even today it takes, on average, 27 months to obtain an advance pricing agreement from the tax authorities, time which some companies simply do not have.

# Hong Kong's Court of Final Appeal Decides Transfer Pricing Case

**Linda Ng**

In *Ngai Lik Electronics Company Limited v. the Commissioner of Inland Revenue*, FACV No. 29 of 2008 (2009), the Hong Kong Court of Final Appeal (the CFA) affirmed the applicability of the arm's length principle in a cross-border transfer pricing case.

## Facts

The taxpayer, a Hong Kong company, belongs to a group whose business was the design, manufacture, and trading of electronic audio products. The taxpayer subcontracted the production to two unincorporated businesses that belonged to the same group, Din Wai Company and Shing Wai Company.

In 1987, the group relocated all of its production facilities from Hong Kong to mainland China. Din Wai Company and Shing Wai Company subcontracted the production to parties in China.

In 1991 and 1992, the group was reorganized. A Bermuda company was incorporated in 1992 to act as the holding company of the group, including the taxpayer, three BVI companies (DWE which took over the business of Din Wai Company from 1991, NWP and SWL), and a Hong Kong company that took over the business of Shing Wai Company (SW(HK)). SWL later took over the assets and liabilities of SW(HK).

After the reorganization, customers placed orders for audio products with the taxpayer in Hong Kong. The taxpayer would in turn order such products from DWE on the terms that the taxpayer would have the right to refuse to take delivery if the landed cost of DWE's products should exceed by more than ten percent the cost of goods from the cheapest alternative supplier. DWE would then order the necessary components for the products from companies in China, including its affiliates. The taxpayer performed sourcing, agency and other ancillary activities for SWL, NWP, and DWE under a cost plus five percent arrangement.

In practice, however, sales and purchases of goods between the taxpayer and DWE were recorded in terms of quantities only. The price of such goods was not set at the time the orders were placed, but was decided later by the taxpayer's accounts department on an annual basis.

The Board of Review found that the practical or commercial end result was that:

- the mode of operation of the group had not changed after the reorganization;
- while the taxpayer's turnover represented the group's turnover, the taxpayer's profits dropped and its contribution to the profits of the group dropped from 31.19 percent in 1991/92 to 7.19 percent in 1995/96 and
- the taxpayer's drop in profitability was offset by the profitability of the three BVI companies and SW(HK), which operated offshore.

The Commissioner took the view that the arrangement involving SW(HK) (replaced by SWL from 1993/94 onwards), DWE and NWP and the inter-company pricing operation were schemes entered into for the sole or dominant purpose of obtaining a tax benefit and raised additional assessments on the taxpayer pursuant to section 61A of the IRO. That was done by treating the whole of the profits shown in the accounts of SW(HK) (and as from 1993/94 SWL), NWP and DWE as the taxpayer's assessable profits. The assessor subsequently reduced each of the additional assessments by half. The Board of Review upheld the additional profits tax assessments against the taxpayer. The taxpayer lost its appeals to the Court of First Instance and the Court of Appeal. It then appealed to the CFA.

### Court of Final Appeal's Decision

The CFA allowed the taxpayer's appeal. The Court annulled the additional assessments and ordered the case to be remitted with a direction that fresh additional assessments be raised for three of the five years of assessment at issue.

The CFA held that the price-fixing arrangement between the taxpayer and DWE had the effect of conferring on the taxpayer a tax benefit involving a reduction of its assessable profits by transferring them to DWE. That was done with the dominant purpose of obtaining a tax benefit for the taxpayer. Therefore, the general anti-avoidance provisions in section 61A of the IRO applied to the years of assessment 1993/94, 1994/95 and 1995/96.

The CFA further held that the Commissioner must exercise her power under section 61A(2)(b) of the IRO on the basis of a reasonably postulated hypothetical transaction that produces an assessment designed rationally to counteract the tax benefit. In this case, a reasonable approach would have been to raise an assessment on the profits that would hypothetically have been earned if the taxpayer had purchased the goods at arm's length prices from its affiliated supplier DWE, instead of the prices the taxpayer actually paid pursuant to the price-fixing arrangement. The assessment cannot be raised in some arbitrary amount or be arrived at upon some basis that is unreasonable or not rationally related to the tax benefit in question.

### Observations

The CFA's decision in the *Ngai Lik* case provides authority for the applicability of the arm's length principle in a cross-border transfer pricing case. The CFA also makes it clear that the Commissioner does not have unfettered discretion when invoking section 61A of the IRO. If the Commissioner raises an assessment under section 61A, it must be justifiable as a reasonable and proper exercise of her power.

Interestingly, the CFA mentioned in dicta that sections 16(1) and 17(1)(b) of the IRO do not require the Commissioner to compare the purchase prices deducted against market prices and to disallow deductions considered excessive. However, until the point is authoritatively determined after proper argument, in cases where the Commissioner seeks to challenge excessive expenditure resulting in reduced assessable profits, she should mount the challenge on alternative bases under sections 16, 17, 60 and 61A of the IRO insofar as these provisions may be applicable.

# New CFC Regime in Hungary



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The great budgetary difficulties faced by governments globally made the efforts to crack down on tax avoidance schemes stronger than ever, reaching out for means that may bring in the hidden revenues. Hungary has been no exception, and the effort to broaden the income tax net has induced some sweeping changes in the tax regime. After a long, ongoing lawmaking process and several fine-tuning proposals, the Parliament has finally laid down the cornerstones of the new controlled foreign company (CFC) regime, that will bring about a whole new era for out-bound Hungarian investments.

Historically, Hungary has always had an interesting approach to the CFC concept. Despite the many back and forth changes in the definition of CFCs in terms of the necessary “substance requirement” and its permissive attitude towards EU and OECD locations, it has been uniquely consistent in catching not only controlled businesses, but also those low-taxed businesses, not controlled by the investor group, if a related party of the Hungarian company held some interest (no matter how insignificant) in the foreign company. The CFC regime, although barring the application of certain tax benefits with respect to investments caught by it, overall has been less dominant in Hungary in setting the tax climate than in other countries. Establishing a more substantial CFC regime is one of the major new forces put in place to crack down on tax avoidance. Therefore, it came as little surprise that this time, as of January 2010, we are facing a brand new CFC definition along with rules which capture and tax CFC profits in Hungary in an unprecedented way at the level of both corporate and individual investors.

From January 1, 2010 a foreign company which either (i) has a beneficial owner who is a Hungarian tax resident private individual holding a ten percent interest during the majority of the tax year or (ii) derives the majority of its income from Hungarian sources, will be treated as a CFC, provided that it does not meet the comparable taxes requirement, and it does not have real economic presence and tax residence in an OECD or treaty country.

Comparable taxes mean that the company in the given tax year pays or is required to pay taxes at the effective tax rate not lower than 12.67 percent. In case of results being zero or negative, the statutory income tax rate of the foreign country must reach this threshold. In practice this means that entities, not only in low tax countries but in countries providing significant tax benefits with an otherwise high statutory rate, may also be caught by the definition.

Even if the comparable taxes test is not met, a foreign company with real economic presence in an OECD or treaty country will not be considered a CFC. Real economic presence means that at least 50 percent of revenues are derived either from manufacturing, processing, agricultural, service, investment or commercial activity using its own equipment and employees within a given country. Although holding and financing are explicitly listed in the law as activities securing substance, collecting royalties has not been mentioned as such, which raises the question of whether the popular tax efficient royalty regimes such as the “Dutch patent box” may also be caught. The substance of this test, clearly, remains open to interpretation, which will surely be frequently on the agenda of both the legislator and the authorities.

But how does the CFC regime operate? As mentioned above, the CFC regime, although its framework is set out in the Act on corporate income tax, affects both corporate and individual taxpayers. We have outlined the most important points to remember below.

- Hungarian corporate taxpayers with at least 25 percent of voting rights or shareholding, or controlling interest in a CFC that has no direct or indirect individual shareholders, should include the part of the non-distributed positive after-tax profit of the CFC that is proportionate to their interest in the CFC in their profits subject to corporate tax.

- Furthermore, as an adverse impact for corporate taxpayers, considerations paid to CFCs are deemed to be expenditures that do not occur in the course of furtherance of trading activity, unless proved to the contrary by the taxpayer. Therefore, these expenses are not deductible by default, for corporate tax purposes. There is no room to eliminate the same presumption with respect to grants and aids provided without the obligation of repayment, funds or assets transferred permanently or liabilities undertaken without consideration during the tax year and any value added taxes accounted for as expenditures in relation to these allowances. None of these items are considered to be business expenses, and therefore are not deductible expenditures for corporate income tax purposes.
- Dividend income received from a CFC is taxable income of the corporate taxpayer as opposed to dividends received from other entities. Under the participation exemption rule of reported shares, capital gains realized on shares are not taxable for corporate income tax purposes, provided that the shareholder (i) acquires at least 30 percent shareholding, (ii) reports the acquisition to the tax authority within 30 days and (iii) holds those shares for at least one year. This tax benefit is not applicable to participations in CFCs.
- Private individual members of a CFC, who directly or indirectly alone or together with their close relatives hold at least 25 percent of the shares or voting rights of the CFC, are subject to personal income tax on that part of the undistributed taxed profit of the CFC that is proportionate to their interest.

The introduction of the concept that levying personal income tax on undistributed profits of CFCs most probably puts an end to the era of the popular Cypriot professional service companies held by Hungarian individuals, with no local employees engaged. It will no longer be a viable option to earn and accumulate revenues by a Cypriot company with the view to finance investments in the future. The undistributed taxed profit of the company will be subject to the hefty Hungarian personal income tax and social security contribution charges.

Also, given that the comparable taxes test threshold applies to the effective tax rate of the foreign entity, many entities, registered in European jurisdictions with high standard tax rates, may still be regarded as CFCs, should tax refund, tax credit or preferential rates be applied to them. As an example, we may take again the Dutch Patent Box regime, under which Dutch entities with income realized from intangible assets, are taxed at a reduced rate of ten percent, up to a set threshold. In this case, irrespective of the standard corporate income tax rate of 25.5 percent in the Netherlands, the Dutch entity will become a CFC.

Similarly, the application of the tax refund system and the foreign tax credit administration in Malta, and the taxation of certain passive income in Ireland, result in effective tax rates being lower than 12.67 percent, which under the new Hungarian CFC rules will surely adversely influence the outbound investment spirit on passive activities, other than holding or financing functions.

Practitioners are facing a challenging time in the application of the new CFC regulations in practice, particularly given that it is not yet clear how widely the authorities and legislators are going to interpret the law and whether the original intention was indeed to capture such a wide scope of entities and activities.

# Proposed Transfer Pricing Documentation Requirements and Impact on Taxpayers



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## 2010 Tax Reform Proposals

On December 22, 2009, the Government Tax Commission issued its "Outline of 2010 Tax Reforms" ("2010 Outline"). One of the proposals concerns potential transfer pricing documentation requirements.

Japan presently does not impose such documentation requirements or assess penalties for a failure to provide prescribed documentation. The National Tax Agency (NTA) has issued a directive to its examiners indicating what information they should obtain and review during a transfer pricing audit. The only sanction for a taxpayer's failure to provide documentation is the application of the so-called "presumptive taxation" rules, which would raise several serious concerns for taxpayers, as described further below and, consequently, constitute a kind of penalty.

In early December, the Ministry of Finance (MOF) had proposed to the Commission the need to clarify the documentation requirements under the existing presumptive taxation rules. Under these rules, the tax authorities can "presume" certain prices to be arm's length prices when a taxpayer does not present documentation which is considered to be "necessary to determine arm's length prices." However, at present, there is no clear guidance in the law or related orders as to what documentation is "necessary" in order to avoid presumptive taxation.

The 2010 Outline explains that the "necessary" documentation will be clarified, based upon (a) "documents stating the contents of the foreign related transactions" and (b) "documents pertaining to the arm's length prices determined by the taxpayer with regard to those transactions." It is not clear how this will be done, but observers suggest that this may be accomplished through an amendment to the relevant ministerial order or possibly through a change in the NTA's transfer pricing directive.

## Potential Documentation Requirements

The 2010 Outline itself does not provide any further details as to the documentation which may be required. However, the NTA's directive sets forth a list of documents to be reviewed by examiners, including "documents stating the contents of the foreign related transactions" and "documents pertaining to the arm's length prices determined by the taxpayer with regard to those transactions." The OECD Transfer Pricing Guidelines may be taken into account. It is also possible that reference may be made to the criteria set forth in the Bilateral Advance Pricing Arrangement (BAPA) Operational Guidance for Member Countries of the Pacific Association of Tax Administrators (PATA).

Of particular concern to foreign-based taxpayers is the possibility that the necessary documentation will include segmented profit-and-loss information of all foreign related parties involved (directly or indirectly) in the foreign related transactions with the Japanese taxpayer. At present, the statute requires that taxpayers only "endeavor" to obtain documentation held by foreign related parties but it imposes no obligation to obtain such information.

## Implications for Taxpayers

If documentation requirements are imposed, taxpayers who have not prepared documentation should do so in accordance with the applicable Japanese requirements. This may require modifying or supplementing standard documentation prepared for use around the world. Furthermore, in any event, it is always prudent to consider whether such standard documentation is appropriate for use "as is" in a Japanese transfer pricing audit.

In addition, if the proposed 2010 changes do result in the requirement to disclose foreign segment profit-and-loss information, taxpayers will have to weigh the burdens and risks of preparing and disclosing such information against the risk of application of the presumptive taxation method.

The burden of preparing such information will likely depend upon whether the taxpayer has accounting systems in place to create the required segment data up through the chain of transactions which ultimately ends in Japan. The risk of providing such information lies in the possible use of certain profit split methods by the Japanese tax authorities to allocate excessive profits to Japan, based upon, for example, their positions concerning the economic ownership in Japan of intangibles and use of allocation factors which ignore the value of intangibles created, owned and controlled by foreign related parties.

The presumptive taxation risks, on the other hand, include (i) shifting of the burden of proof to the taxpayer, (ii) the application of transfer pricing methodologies which are significantly relaxed in favor of the tax examiners and (iii) in the opinion of the tax authorities, both the potential use of related party transactions as comparable transactions and the lack of any requirement to make adjustments for differences.

### **Burden of Proof**

If the presumptive taxation rules are applied, then, in the event of a subsequent appeal or litigation, the arm's length price determined by the tax examiners is "presumed" to be correct. The taxpayer can rebut this presumption only by affirmatively proving that its prices are arm's length pursuant to a normal transfer pricing method. If the taxpayer cannot do so, then the prices determined by the tax authorities are to be accepted.

The shifting of the burden of proof to the taxpayer may become a more critical objective of the Japanese tax authorities in audits going forward. In the Adobe Case in late 2008, the Tokyo High Court concluded that the NTA had not met its burden of proof in connection with the method used as the basis for an assessment. Consequently, there is now an increased concern that NTA examiners will aggressively exploit the presumptive taxation rules, which would dramatically lower the burden upon them to establish an arm's length price for an assessment.

### **"Relaxed" Transfer Pricing Methodologies**

Under the presumptive taxation rules, the examiner is permitted to make an assessment by presuming that the arm's length price is an amount which is computed in accordance with certain specified methods that are based upon (but not identical to) the resale price method, the cost plus method, profit split methods or transactional net margin methods. A review of the detailed requirements in the statute and related orders suggests that these specified methods are considerably relaxed as compared with the normal transfer pricing methods.

### **Use of Related Party Transactions**

The provisions in the law and orders setting forth the various comparative methods under the presumptive taxation rules refer only to the requirement for the tax examiners to identify a "similar business activity" conducted on a similar scale and whose other circumstances are similar to those of the corporation subject to presumptive taxation. These provisions do not explicitly require that this business activity be conducted with unrelated parties. Consequently, the NTA believes that related party transactions may be used.

### **Adjustments for Differences**

Unlike the normal resale price method, cost-plus method or transactional net margin method, the provisions describing the methodologies to be used under the presumption taxation rules contain no explicit language requiring that the margins applied as comparable margins have been adjusted for differences. Japanese tax examiners have indicated that only the minimal tests ("similar business," "similar scale" and "other similar details") explicitly prescribed in the presumptive taxation rules need be applied.

### **Path Forward**

The next steps in the legislative process should be the release of a tax reform bill in late January or early February, deliberations and passage in the National Diet in February or March, and then the publication of the amended law and the related cabinet and ministerial orders by April. It is not yet clear what effective date may be applied for new documentation requirements.

## Polish Investment Funds Increasingly Used in International Tax Planning



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Recently, Polish investment funds have become more frequently used in international tax planning. Pursuant to Article 6.1.10 of the 1992 Polish Corporate Income Tax Law, all investment funds established and operating based upon the 2004 Investment Funds Law are fully exempt from corporate income tax. Such an exemption is consistent with the general idea of an investment fund being a “tax-neutral” entity, which does not create any additional layer of taxation. Thus, income of any kind, including dividends or capital gains, is not taxable at the fund’s level. Such income would become taxable only at the investor’s level, i.e., owner of the participation units in open-ended investment funds or investment certificates in closed-ended funds.

From this perspective an interesting feature is a closed-ended fund (so-called FIZ), which issues investment certificates. Income from redemption or sale of such investment certificates constitutes capital gain. Pursuant to Article 13 of a typical bilateral double taxation treaty, based upon the OECD Model Convention on

Income and on Capital, capital gains shall be taxable, with some minor exceptions regarding capital gains made on disposition of real estate; movable property of a permanent establishment, or vehicles operated in international transport, shall be taxable only in the state of residency of the seller. As a consequence, a diligent selection of a jurisdiction in which an investor in a closed-ended fund is located may result in a significant reduction or full elimination of income taxation. This might be particularly interesting in cases in which the shareholding of a non-Polish investor in a Polish target company is lower than the minimum threshold required under the EU Parent-Subsidiary Directive for a full exemption from withholding tax on dividends in the source country. A direct payment of dividends from a Polish target to such investor would not qualify for an exemption from withholding tax, otherwise levied at a 19 percent rate (or at a lower rate resulting from a respective bilateral double taxation treaty), while a diligent use of a residence jurisdiction and Polish closed-ended investment funds may result in a full exemption.

## Singapore Transfer Pricing Developments

Linda Ng

### Arm’s Length Principle

A new section 34D of the Singapore Income Tax Act clearly stipulates the arm’s length principle. Previously, there was no explicit statutory provision, although the Inland Revenue Authority of Singapore (IRAS) published transfer pricing guidelines concerning the application of the arm’s length principle.

Section 34D provides that if two persons are related parties and conditions are made or imposed between the two persons in their commercial or financial relations that differ from those that would be made if they were not related parties, then any profits that would, but for those conditions, have accrued to one of the

persons, and, by reason of those conditions, have not so accrued, may be included in the profits of that person for income tax purposes. Section 34D also provides that if a person carries on business through a permanent establishment, the section shall apply as if the person and the permanent establishment are two separate and distinct persons.

For purposes of section 34D, the term “related party,” in relation to a person, means any other person who, directly or indirectly, controls that person, or is controlled, directly or indirectly, by that person, or if he and that other person, directly or indirectly, are under the control of a common person.

## Related-Party Loans

The IRAS on February 23, 2009 published a supplementary tax guide that provides transfer pricing guidelines for related-party loans and related-party services.

A related-party loan can arise in the following situations:

- A domestic entity lends to, or borrows from, a related domestic entity (a related domestic loan). For that purpose, a domestic entity means any business entity that is incorporated or registered in Singapore and is carrying on a business in Singapore.
- A domestic entity lends to, or borrows from, a related foreign entity (a related cross-border loan).

Under the arm's length principle, an entity that makes a loan to, or otherwise becomes a creditor (e.g., through intercompany credit balances arising from sales or the provision of services) of, another related entity should charge the related entity an arm's length rate of interest for the use of the funds.

In the case of related domestic loans, however, IRAS will allow taxpayers to continue the common practice of extending or receiving interest-free loans or interest bearing-loans at rates that are not supported by a transfer pricing analysis to or from other related entities, provided that the lender is not in the business of borrowing and lending funds (such as banks or other financial institutions, finance and treasury centers). The IRAS will restrict the amount of any interest expense claimed by the lender on such loans, if applicable.

In the case of related cross-border loans, taxpayers should adopt the arm's length methodology. To give domestic lenders time to restructure their loans, IRAS will continue applying interest adjustments to them on such loans for a transition period of two years starting from January 1, 2009. From January 1, 2011, all cross-border loan arrangements should be arm's length. Guidance on the determination of an arm's length interest rate can be found in the supplementary tax guide.

## Related-Party Services

The supplementary tax guide also provides transfer pricing guidelines for related-party services (also commonly known as intra-group services). Examples are administrative, technical, financial, commercial, management, coordination and control functions.

Service providers can adopt a direct charge method or an indirect charge method. They should adopt the direct charge method in charging for related-party services, whenever possible. The direct charge method is appropriate for specific services (such as

conducting a market survey for a particular new product developed by a related party) rendered to related parties, where the beneficiary of the services and the costs incurred for the performance of the services are usually clearly identifiable.

Indirect charge methods involve the use of an appropriate apportionment basis or allocation keys to charge/bill for the service provided, such as gross sales, income or receipts, loans and deposits, staff numbers, floor area and asset size. Generally, the most appropriate allocation key is one that most accurately reflects the share of benefits received or is expected to be received by the beneficiaries. IRAS will accept the allocation key adopted by the taxpayer as long as it is reasonable, founded on sound accounting principles and has been consistently applied year-to-year throughout the group, unless there are very good reasons for failing to do so.

The remuneration for related-party services should be in accordance with the arm's length principle. According to the IRAS's transfer pricing guidelines, the Comparable Uncontrolled Price Method and the Cost-Plus Method are often the most appropriate choices for determining the arm's length fee for related-party services.

IRAS will accept a five percent mark-up on costs for certain routine support activities as a reasonable arm's length charge for such services, provided that the routine support activities that the service provider offers to its related party are not also provided to an unrelated party. The supplementary tax guide provides a list of services that IRAS will accept as routine support services, such as accounting, payroll and certain other management or administrative functions. However, if a service provider has performed a detailed transfer pricing analysis that supports charging for services at a mark-up different from five percent, the mark-up should be adopted. Once an arm's length mark-up has been adopted, it should be applied consistently year after year throughout the group, until there are any material changes to the circumstances or services provided.

The supplementary tax guide also provides transfer pricing guidelines for services provided on a cost-pooling basis and for strict pass-through costs.

# Requesting US Competent Authority Assistance to Resolve Transfer Pricing Disputes



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The United States has concluded bilateral tax treaties with over 60 states around the world.<sup>1</sup> These treaties typically include an administrative provision called the Mutual Agreement Procedure (MAP), through which the competent authorities of the two treaty partners may consult together to mutually resolve differences in interpretation or application of the treaty and to prevent double taxation of the residents or nationals that are covered by the treaty.<sup>2</sup> The United States Competent Authority (USCA) is the Internal Revenue Service (IRS) LMSB Deputy Commissioner (International). Regular meetings are conducted between the USCA and the competent authorities of Canada, France, Germany, India, Japan, Korea, Mexico, the Netherlands, and the United Kingdom. Meetings with the competent authorities of other countries are scheduled as needed.

A US taxpayer may request the assistance of the USCA whenever the taxpayer believes the actions of either treaty partner will result in double taxation in violation of the terms of the treaty, and the MAP option exists “irrespective of the remedies provided by the domestic law” of the treaty partners.<sup>3</sup> As a result, a US taxpayer confronted with a transfer pricing adjustment (either US- or foreign-initiated), is equipped with an additional tool for obtaining a favorable resolution. This article will focus on US-initiated transfer pricing adjustments and discuss the benefits (and costs) of involving the USCA in the dispute resolution process.

## Traditional Administrative Avenues and Litigation

As an initial matter, a US taxpayer seeking the assistance of the USCA is still entitled to all of the avenues of dispute resolution ordinarily afforded to taxpayers, including (1) disputing the adjustment with the IRS Compliance Team (Compliance) that is performing the audit; (2) protesting the adjustment with the IRS Office of Appeals (Appeals) and (3) challenging the assessment in US Tax Court or seeking a refund in US District Court or the Court of Federal Claims. However, the complexities of a transfer pricing dispute and, more importantly, the possibility of double taxation inherent in transfer pricing disputes,<sup>4</sup> can make it challenging for a US taxpayer to achieve a favorable resolution in an efficient manner.

A transfer pricing question may be a novelty for Compliance or even a seasoned Appeals officer. Compliance must focus solely on US tax law and has no room to negotiate a settlement, let alone consider the issue of potential double taxation or the international implications of its proposed adjustment. While the mission of Appeals is to reach a settlement with the taxpayer, settlements in Appeals are primarily based upon the litigating hazards of the case; the risk of double taxation by a foreign tax authority may not be factored into the equation.

1 For example, if a US taxpayer performs services for a foreign affiliate and the IRS asserts that the US taxpayer should be paid US\$120 per hour as opposed to the US\$100 per hour that was actually charged, the US and foreign taxpayer face the risk of both taxing authorities imposing tax on the US\$20 per hour.

2 US Internal Revenue Code of 1986, as amended (IRC).

3 *Eli Lilly & Co. v. Comm’r*, 84 T.C. 996, 1131 (1985), *aff’d in part, rev’d in part, and remanded* 856 F.2d 855 (7th Cir. 1988).

Litigating a transfer pricing case involves similar challenges. Transfer pricing cases may involve extremely complicated facts and this will add to the complexity and cost of litigation. Expert witnesses are often required to provide economic analyses of the transactions at issue. Moreover, a taxpayer litigating a transfer pricing dispute faces a high burden of proof. Section 482 of the Internal Revenue Code<sup>5</sup> provides that “the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances...if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of such organizations;” and thus grants the IRS broad discretion. As a result, the taxpayer has the burden of proving both that the adjustment proposed by the Internal Revenue Service is “arbitrary, capricious, or unreasonable;”<sup>6</sup> and that the transaction at issue satisfies the arm’s length standard of Treasury Regulation Section 1.482-1(b).<sup>7</sup>

### Benefits of Seeking Competent Authority Assistance

The USCA functions as an advocate for both the United States and US taxpayers, and its mandate is to endeavor to avoid double taxation in the jurisdictions involved. The USCA has extensive institutional expertise in transfer pricing issues, with a substantial portion of its case load comprised of transfer pricing disputes and the negotiation of Advance Pricing Agreements (APAs). Additionally, the USCA, as a result of its ongoing discussions with treaty partners, is cognizant of developments outside of the United States and how the positions and concerns of treaty partners can shape US transfer pricing issues and policies. The APA process in particular has fostered a mutually beneficial working relationship between the USCA and competent authorities around the world, who have grown accustomed to cooperating to resolve transfer pricing matters.

A taxpayer challenging a US-initiated adjustment has the option to seek USCA relief either after participation in the Appeals process or concurrent with Appeals by initiating a Simultaneous Appeals Procedure (SAP) in conjunction with its request for USCA

assistance. In a SAP, an Appeals officer assigned to the case will work with the taxpayer and the USCA to resolve un-agreed issues before the USCA presents its position to the foreign competent authority.<sup>8</sup> Any agreement reached with Appeals through the SAP will be non-binding, and the terms of that tentative agreement will serve as the basis for the USCA’s negotiating position in the MAP process. The SAP process permits the taxpayer to negotiate directly with an Appeals officer while still taking advantage of the added benefits of the USCA’s unique expertise and international perspective.

If the taxpayer requests the assistance of the USCA after participating in Appeals, the MAP options may be more limited. The stated primary mission of the USCA is to seek a correlative adjustment on behalf of the taxpayer.<sup>9</sup> However, as long as the case has not reached a final resolution, the USCA is not precluded from granting unilateral relief. In fact, if the IRS’s asserted transfer pricing adjustment is inconsistent with US transfer pricing principles, it is unlikely the USCA would advocate such a position to its treaty partners in an effort to obtain correlative relief. A hallmark of a MAP, and, indeed, of tax treaties, is comity and the USCA can, where necessary to avoid an unjust result, reject an IRS-initiated adjustment to avoid double taxation.

If, however, the taxpayer has executed a closing agreement with Appeals or reached a final determination through litigation (including a settlement), the USCA may only seek a correlative adjustment from the treaty partner.<sup>10</sup> This means the USCA will only attempt to elicit a corresponding adjustment from the foreign tax authority in the same amount.

The USCA is extremely successful in resolving transfer pricing disputes, whether initiated by the US or foreign tax authorities. Over the past five years, cases that have been fully considered by the USCA resulted in 49 percent of adjustments being withdrawn and correlative adjustments equaling 41 percent of the total proposed amounts being received. A mere ten percent of adjustments were afforded only partial (4.45 percent) or no relief (5.36 percent) after full participation in the competent authority process.

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4 *Eli Lilly & Co. v. Comm’r*, 856 F.2d 855, 860 (7th Cir. 1988).

5 Rev. Proc. 2006-54, §§ 8.01, 8.05. A SAP request can be made after a request for competent authority consideration is made.

6 Rev. Proc. 2006-54, § 12.07. Using the example in footnote 4, the USCA would seek to convince the foreign tax authority to provide the foreign entity with a deduction to reflect the additional US\$20 per hour proposed by the IRS.

7 Rev. Proc. 2006-54, § 7.05.

8 Rev. Proc. 2006-54, §§ 4.05, 4.07.

9 Foreign-initiated cases that closed in 2008 had been pending for an average of 791 days.

10 Rev. Proc. 2006-54, § 7.05.

## **Burdens of Requesting Competent Authority Consideration**

Participation in the mutual agreement procedure comes at a price, as taxpayers who seek competent authority assistance are required to disclose substantial information on their business operations and on the terms of the transactions at issue.<sup>11</sup> The USCA, in the course of seeking correlative relief from the foreign tax authority, will serve, in a sense, as the representative of the US taxpayer's interest. While the taxpayer participates directly in meetings with the USCA and can also participate directly in meetings with the foreign competent authority, the taxpayer may not participate in the formal meetings between the two competent authorities. Thus, it is the taxpayer's obligation to provide the USCA with sufficient information to allow the USCA to be fully informed during its meetings with the foreign competent authority. The amount of such information typically exceeds what a taxpayer would be required to disclose during an IRS audit.

In addition, while any adversarial proceeding takes time, the USCA meets with the competent authorities of its treaty partners relatively infrequently, and this can result in a significantly drawn out process. There is also a sizable backlog of cases pending USCA consideration. In 2008, for example, the USCA received 308 new cases, disposed of 230, and ended the year with a 578-case inventory, and the US-initiated cases that closed last year had been pending for an average of 424 days.<sup>12</sup>

However, there may be a silver lining for taxpayers willing to expend the necessary time and effort to go through the competent authority process: the information provided by the taxpayer, the USCA's position paper and any mutual agreement reached by the treaty partners can cumulatively provide a strong basis for the conclusion of an Advance Pricing Agreement that will govern the terms of the transactions at issue going forward. Thus, in addition to obtaining resolution of the disputed issue for the years under audit, the taxpayer may be able to obtain certainty on these transactions for future years.

The Mutual Agreement Procedures available under bilateral tax treaties provide taxpayers with many unique benefits, one of which is the ability to obtain the assistance of USCA in US-initiated transfer pricing adjustments. Similar benefits are afforded with respect to foreign-initiated transfer pricing adjustments, as well as in several other areas of international taxation including questions of residency and determinations as to the existence of a permanent establishment. It is important that multinational companies understand fully the benefits available to them under the vast network of tax treaties.

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<sup>11</sup> Rev. Proc. 2006-54, §§ 4.05, 4.07.

<sup>12</sup> Foreign-initiated cases that closed in 2008 had been pending for an average of 791 days.

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We welcome your comments and suggestions. If you have any questions or would like a copy of this issue, please contact:

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