

The Arm's Length Standard

*Global Transfer Pricing Developments
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Italy's Internal Revenue Agency Issues First Transfer Pricing Ruling

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Italy's Taxpayer's Bill of Right, which entered into force on August 1, 2000, represents a milestone in the history of the often-troubled relationship between Italian taxpayers and their tax authorities.

Among the provisions set forth in the Bill, article 11 (Taxpayer Ruling Request) is of particular interest, because for the first time taxpayers were granted the right to request the tax authorities' opinion on the application of a tax law or regulation. However, a taxpayer's request may only be accepted provided it is about an actual case and the taxpayer claims the applicable law is unclear.

The latter condition cast doubts on the coverage provided by article 11 on transfer pricing issues, because the Italian Tax Regulations on intercompany transfer prices did not seem to be either particularly unclear or uncertain. Essentially, the Income Tax Code requires intercompany transfer prices to be at arm's length, and the Ministry of Finance's Circular Letter n.32/80 clearly lists and describes the methods to be used in evaluating compliance with the arm's length standard.

All doubt regarding the applicability of article 11 to transfer pricing has been removed by a recent resolution of the Internal Revenue Agency which, for the first time since the entry into force of Law n.212/2000, explicitly ruled on a transfer pricing issue. The agency rendered an opinion regarding the possibility of using a variant of the resale price minus method in establishing intercompany prices in a distribution business.

The content of the ruling, which provides interesting tax planning

hints, is discussed below, but the fact itself that the ruling request has been accepted is of the greatest significance, because it clearly confirms the possibility for taxpayers to address the tax authorities on transfer pricing issues, even though only within the limitations set forth in the law with reference to addressable issues.

Unfortunately, the Internal Revenue Agency is unlikely to publish the ruling, because of the peculiar topic it addresses. The main drawback of lack of publication is that it would prevent taxpayers, other than the one that received the ruling, from officially making reference to the latter when establishing their transfer pricing, while the tax authorities remain completely free to change their mind on the next case. As a result, every taxpayer would have to file its own tax ruling request to get assurance from the tax authorities, the result of which will remain uncertain.

The Ruling

The ruling request was filed by the Italian distribution subsidiary of a multinational group operating in the field of technical and IT solutions. The subsidiary's main business activity is distributing on the Italian market products manufactured by foreign related companies.

To rationalize the functions carried out by the different companies in the group, a model was developed for setting the transfer prices of the products to be sold to the distribution companies, aimed at standardizing the commercial relationships between the latter and the manufacturing companies. Under this model, the

price of the products would be set according to what can be seen as a variant of the resale price minus (RPM) method. The RPM method is among those clearly accepted by the Italian tax authorities when dealing with transfer pricing to distributors; thus, no uncertainty should arise regarding its use. Nonetheless, the company was unsure whether its "reengineered" methodology would be deemed to comply with the transfer pricing rules, and it filed a ruling request.

The tax authorities answered within the time period provided by the law, stating that "[...] in principle, the correctness of the method the taxpayer plans to implement cannot be denied." Of course, the fact that the proposed method is deemed acceptable in principle does not mean that the tax authorities will not check to verify whether the actual intercompany prices are at arm's length, nor will it prevent them from assessing additional taxable income (and imposing the relevant penalties), should they determine that the implementation of the transfer pricing system was different from

that described in the ruling request and/or otherwise incorrect.

In fact, the tax authorities have set a number of conditions and requisites to be met, for the aforementioned conclusions to be deemed fully applicable.

Conclusion

The acceptance by the Internal Revenue Agency of a ruling request like the one submitted in the case above is per se an important confirmation that taxpayers may now ask for assurance about the correctness of their transfer pricing prior to implementation, albeit only with respect to methodology, not actual prices.

Regarding the content of the ruling, the proposed transfer pricing method - a kind of mix of an "indirect RPM" method and a transactional net margin method -- has been accepted by the tax authorities, thus offering tax planning opportunities, even though the implementation of the system has been clearly deemed critical. Should a tax audit reveal that the limitations and recommendations in the ruling were not respected, the protection granted by the ruling itself will be lost.

Transfer Pricing v. Customs -- Different Paths to the Same Goal

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Transfer pricing and customs duty issues are two of the most important issues facing multinational corporations that import goods into the United States. While transfer pricing and customs rules both have the same goal of determining the arm's-length price for imported goods, the U.S. Internal Revenue Service and the Customs Service employ different methodologies. That may result in importers being whipsawed if the IRS claims that the importer paid too much and Customs claims that the importer paid too little.

Recognizing that their actions may result in undue hardship for importers, the IRS and Customs have been working with importers and their advisors to address the problem. The early results of that collaboration are two rulings that allow importers to coordinate their transfer pricing and Customs compliance efforts.

Although the IRS and the Customs Service are both agencies in the

Department of Treasury, their jurisdictions conflict. Transfer pricing and customs regulations seek to determine an arm's-length price for imported goods; however, the IRS and the Customs Service apply different substantive legal requirements to achieve that goal. The IRS applies section 482 to determine an importer's income, whereas Customs applies the Customs statute to determine the value of imported goods.

The IRS bases its enforcement efforts on information reported on the importer's tax return, which may be filed up to 8-1/2 months after the close of the tax year. Transfer pricing penalties are equal to 20 percent or 40 percent of the underpaid tax, depending on the amount of the transfer pricing adjustment.

Conversely, in its enforcement efforts, Customs seek to determine the correct appraised value on the date of entry. Customs penalties may range from the

lesser of 200 percent of the underpaid duty or 20 percent of the dutiable value, to as high as the dutiable value of the imported goods.

Section 1059A -- Some Convergence

Under IRC section 1059A, the inventory basis of imported merchandise cannot exceed the declared Customs value, with minor adjustments for costs, including international freight and insurance.

Therefore, taxpayers must reconcile two distinct goals: declaring a low value for imported goods and not running afoul of section 1059A. However, for section 1059A, importers would compute a high inventory basis to obtain the largest deduction on their corporate income tax return.

Because taxpayers often determine the appropriate intercompany pricing based solely on section 482, without regard to the section 1059A "cap," they inadvertently increase their Customs exposure and run the risk of increased examinations, adjustments, and penalties.

Innovative Customs Rulings

In a step towards resolving the jurisdictional conflict, Customs issued a landmark ruling on 30 August 2000 (HQ Ruling 546979). The ruling allows an importer that purchases merchandise from its foreign related parties to declare values for the imported goods based on prices established in a bilateral advance pricing agreement.

The case involved a bilateral APA requested by a large Japanese multinational corporation and its U.S. subsidiary. The U.S. subsidiary was a distributor, in the North American market, for consumer durable goods manufactured by the Japanese parent. All product design and development, as well as manufacturing, was done by the Japanese parent.

The taxpayers, assisted by Deloitte & Touche, conducted a transfer pricing study based on the comparable profits method (CPM). The CPM set an interquartile profitability range with considerations for results yielded by another transfer pricing approach, the

profit-split method. The importer also applied to Japan and the United States for a bilateral APA.

While the APA was being negotiated, the U.S. subsidiary filed a customs ruling request seeking to validate the declared values using the transfer prices developed under the bilateral APA. A Customs representative participated in the APA negotiation process, at the request of the U.S. importer. That participation during the actual APA negotiations played a central role in Customs' analysis and made it easier for the agency to issue a favorable ruling.

In the ruling, Customs stated that product, imported by a U.S. distributor from its Japanese parent into the United States, is generally appraised under section 402 of the Tariff Act of 1930. Customs found that the information submitted during the series of APA negotiations constituted a basis for the U.S. distributor to demonstrate that the circumstances of sales (COS) did not influence the price, and that the import values were, thus, arm's-length.

The ruling was a breakthrough for multinational corporations striving to achieve certainty on both their transfer pricing and customs valuations. Customs accepted the CPM result in the bilateral APA, and did not require any further breakdown of product line profitability.

However, Customs specifically noted in the ruling that the bilateral nature of the APA was persuasive in satisfying the COS test. In other words, Customs found that the National Tax Administration of Japan represented Customs' position in the APA negotiations. Because the bilateral APA resulted from negotiations between two competing foreign authorities, Customs accepted the result under the transfer pricing methodology, rather than a pure Customs valuation application.

Customs issued another innovative ruling (HQ Ruling 547382) on 14 February 2002. In that ruling, Deloitte & Touche helped a multinational corporation obtain a "first sale" Customs ruling based on section 482

methodology. Customs accepted the section 482 methodology, even though no foreign tax authority was involved nor was there any outstanding transfer pricing issue.

The Customs ruling involved the sale of products manufactured by a U.K. manufacturer. The U.K. manufacturer sold the products to a U.S. importer through a U.K. related party. The U.K. related party was responsible for marketing, operations, product distribution, sales, and some product design and development of the products. Under the sale terms, the U.K. related party maintained title until all the payments were made.

Customs accepted that an arm's-length transaction had taken place for Customs valuation purposes, on the basis of a section 482 transfer pricing documentation study. Specifically, Customs found the COS demonstrated that the relationship

between the parties did not influence the first sale price, and that the price was supported by the transfer pricing study based on the IRS's standards in section 482.

In ruling that the first sale price could serve as the basis for the appraisal of the imported goods, Customs relied on: a comparables study based on a functional analysis; financial statements for the U.K. related party, showing its profit and loss information for the U.K. manufacturer; and a capital adjusted interquartile profitability range for independent U.K. comparable companies.

Conclusion

The two new Customs rulings represent the first steps toward ameliorating transfer pricing and Customs headaches for importers, and may open the door to additional coordination of transfer pricing and Customs enforcement efforts.

Venezuela Issues Rules on Reporting Related-Party Transactions

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Venezuela's tax administration recently issued Administrative Resolution #1,158 on the Form, Conditions, Requisites and Instructions for filing the "Informative Return on Transactions with Foreign Related Parties." The resolution was published in Venezuela's Official Gazette # 37,508 on August 19, 2002, and became effective on that date.

Venezuelan taxpayers engaged in transactions with foreign related parties must file Form PT-99 in the month of June following the close of their fiscal year. In this form they must list their related-party transactions and include details such as amounts, dates, applicable exchange rates, and name and country of residence of the related parties.

To file Form PT-99, taxpayers must follow the instructions set forth in the form. In accordance with article 169 of the Venezuelan Income Tax Law, Form PT-99 must include the following information, which should also be available from the taxpayer in the event of an audit:

- Description of the operations carried out with related entities, with dates, amounts and currency used;
- Organizational structure of the company and/or group, and functional information on the departments or units involved;
- Full name, business or trade name, taxpayer identification number (RIF N°) and tax domicile of the taxpayer and its related entities;
- Risks inherent to the business activity engaged in;
- The taxpayer's financial statements for the fiscal year, prepared in accordance with generally accepted accounting principles, and balance sheets, income statements, and statements of movement of shareholder's equity and cash flows;
- Agreements executed between the taxpayer and related parties abroad (such as distribution, sales, loan, license, know-how, use of trademarks, copyright, and intellectual property agreements);
- Information related to business strategies; volume of operations, etc.;
- Method(s) used to determine transfer prices, indicating the basis used to determine the most appropriate method;

The Temperature Heats Up on Transfer Pricing and Customs Issues in China

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- Information on the transactions of comparable companies, including a description of the items and amounts compared;
- Information on the functional analysis and calculation of the transfer prices; and
- Any other information considered relevant or that may be required by the tax administration.

Article 4 of the resolution states that taxpayers whose fiscal year begins

Chinese tax and customs authorities have stepped up activity in an apparent attempt to restore falling government revenues. The increase in activity appears to be a result of the government's budget deficit. The deficit is partly due to the government's efforts to maintain a minimum 7 percent annual economic growth rate. To this end, public spending has been significantly increased to stimulate consumption. At the same time, social security payments have been rising rapidly, as more and more workers at state-owned enterprises have been thrown out of work.

On the revenue side, China is experiencing a drop in tariff income due to the introduction of lower custom duty rates, a requirement of entry into the WTO. It is estimated that the drop in tariff revenue could be as high as RMB 60 billion (approximately \$7.2 billion) in the first two years.

The government, however, cannot expect much, if any, increased tax revenues from state-owned businesses. Many of these have been losing money due to fierce competition and/or inefficiency. Consequently, foreign companies and high-income individuals have become targets in the government's attempt to raise much-needed revenues.

Many foreign owned or foreign invested businesses in China are now increasingly moving into a tax paying position. Initial tax breaks have allowed tax holidays for many such businesses, with zero tax to pay in the first two profitable years and 50 percent rates for three years after

between January 1 and December 31, 2002, must file their informative return within 90 continuous days from the date of publication of the resolution -- August 19, 2002 - that is, by November 19, 2002.

Article 2 of the resolution provides that taxpayer noncompliance could be subject to a fine between 300 and 500 tax units (each tax unit's current value is Bs. 14,800 - approximately \$10) as provided in Venezuela's Organic Tax Code.

that. As those relief periods run out and the tax take begins to increase, it is perhaps inevitable that the tax authorities will start to take a closer look at the tax returns being submitted.

Transfer pricing is clearly becoming a major issue. For example, in August, the Shenzhen Local Tax Bureau issued a notice requiring all Foreign Investment Enterprises (FIEs) and Foreign Enterprises (FEs) located in Shenzhen to file annual disclosure forms on related-party transactions. This is viewed as only the beginning of recent efforts on a national basis by the State Administration of Taxation (SAT) to ensure more transfer pricing compliance. There is a clear intention to crack down on tax evasion through inappropriate transfer pricing arrangements.

Under the current system operating in China in the transfer pricing area, tax officials are evaluated by how many foreign companies they investigate and audit every year, and to a lesser extent, how much additional tax revenue resulting from such investigations and audits they collect. Customs, on the other hand, are evaluated largely by whether they meet the tariff revenue goal every year. With duty rates dropping, their only recourse is to seek to increase values on which duty is charged. It has long been the case that the Tax and Customs authorities do not have much incentive to communicate and coordinate with each other.

Now bound by WTO rules, Customs officials have started to pay more attention to intercompany transactions. In the past, most foreign

companies imported raw materials and/or intermediate goods into China for production and reexport. They were --and still are -- able to do so without paying customs duty. However, due to the rapid economic growth in the past few years and China's recent entry into the WTO, many foreign companies are significantly expanding their sales in the Chinese marketplace. Imports of raw materials, intermediate and/or finished goods for such sales are now being more closely scrutinized by Customs. In the past few months, Deloitte Touche Tohmatsu has become aware that Customs officials have increased their valuation enquiries and are majoring on intercompany pricing policies. They are now often asking for transfer pricing documents or other documents supporting intercompany transfer pricing policies, a totally new approach.

From meetings we have had with them, we are aware that Customs are also becoming more interested in royalty payments for intangible assets, *i.e.*, technology, know-how, brand name, etc., by foreign companies on domestic sales in the Chinese market.

In challenging declared import values, Customs have advised us that they would take any supportive evidence, *e.g.*, well-developed transfer pricing documents, into account in their evaluation. They are also addressing intercompany transaction issues in drafting implementation rules for new Customs law and regulations.

It is now apparent that Customs and transfer pricing planning is becoming crucial in the China context. For customs purposes, if a foreign company is investigated, it will generally have a very short time period to justify its claimed transaction value. Challenges at this stage are crucial. If Customs succeed in lifting import values, the format will be used well into the future, directly affecting bottom-line profit figures. Because Customs and the tax authorities have a low level of communication, there is also the inevitable potential consequence of a "double hit" on both fronts unless defensible structures are in place.

Unlike in the U.S., there is no customs trial reconciliation program in China. In this respect, if a foreign company gets an upward transfer pricing adjustment that lowers the transaction value for customs purposes, the company will not have an opportunity to make corresponding adjustments.

The message is clear: importers into China should look closely at and properly document their transfer pricing strategy. There needs to be a supportable compatibility between tax and customs values. Those actions need to be taken and systems need to be put in place in advance of enquiries by the authorities. It is far better to demonstrate at the outset that the issues have been addressed and the rules complied with, than to fight a rearguard action trying to defend an arbitrary pricing structure.

IRS Issues Proposed Regs Requiring Inclusion of Stock-Based Compensation In Cost Sharing Arrangement Cost Pools

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On July 25, 2002, the IRS released proposed regulations that substantially revise Treas. Reg. § 1.482-7 to require stock-based compensation to be included in the cost pools of qualified cost sharing arrangements. The proposed regulations, which were included on the Treasury-IRS Priority Guidance Plan for 2002-2003, expand upon an IRS LMSB Industry Directive on Stock Options and Cost Sharing Arrangements issued on January 25, 2002. The proposed regulations also revise Treas. Reg. § 1.482-5 to address the

effect of stock-based compensation on comparability.

A summary of the proposed regulation follows.

Inclusion of Stock-Based Compensation in Intangible Development Costs -- The proposed regulations amend Treas. Reg. § 1.482-7(d) (defining intangible development costs) to require that all costs attributable to stock-based compensation be taken into account in determining the controlled participant's operating expenses. The proposed regulations define stock-

based compensation as any compensation provided by a controlled participant, whether to an employee or independent contractor, in the form of equity instruments, options to acquire stock, or rights with respect to (or determined by reference to) equity instruments or stock options regardless of whether ultimately settled in the form of cash, stock, or other property. The preamble to the proposed regulations states that stock-based compensation includes: restricted stock, statutory and non-statutory stock options, stock appreciation rights, and phantom stock.

Identification Rules -- To be included in the cost pool, the stock-based compensation must be related to the development of intangibles covered by the qualified cost sharing arrangement. The proposed regulations state that this determination is to be made as of the date that the stock-based compensation is granted, rather than the vesting date. For example, the preamble to the proposed regulation describes a simple situation in which stock-based compensation is granted to an employee who, at the time of the grant, is performing research services related to the cost sharing arrangement.

Measurement of Operating Expenses Attributable to Stock-Based Compensation -- The proposed regulations contain a general measurement rule requiring that stock-based compensation be taken into account in the year in which the controlled participant is allowed a deduction and in the amount allowed as a deduction. If stock options that were related to the development of intangibles covered by a cost sharing arrangement are repriced or otherwise modified, and the new grant of stock options is not related to the development of intangibles covered by the cost sharing arrangement, the existing stock options will be treated as being exercised immediately before the modification, provided they are substantially vested within the meaning of IRC Section 83.

Solely for purposes of applying the measurement rule, IRC section 421

(which generally disallows compensation deductions when statutory stock options are exercised, except in limited situations) is disregarded. In addition, an amount is treated as deductible by a foreign controlled participant under the above principles even if it would not otherwise be allowed a deduction under U.S. tax law.

Expiration or Termination of the Cost Sharing Arrangement -- The proposed regulations provide that all vested, unexecuted "in-the-money" stock options are treated as being exercised upon the expiration or termination of a cost sharing arrangement.

Special Rule for Options for Publicly Traded Stock -- The proposed regulations also permit an elective method of measurement and timing for options on publicly traded stock of companies subject to financial reporting under U.S. GAAP, provided the stock is traded on a U.S. securities market. Under this election, stock-based compensation would be taken into account for cost sharing purposes at the time the fair market value is reflected as a charge against income in audited financial statements or disclosed in footnotes to such financial statements. This election may be made: (1) in a new cost sharing arrangement by explicit reference to this election, (2) for existing cost sharing arrangements by written amendment no later than the latest tax return due date (without regard to extensions) of any controlled participant, or (3) with the consent of the IRS.

Consistency Rules for Options for Publicly Traded Stock -- The proposed regulations contain consistency rules to ensure that all controlled participants in a qualified cost sharing arrangement use the same method of measurement and timing for all options on publicly traded stock with respect to that arrangement. Once a method of measurement has been adopted, this method may not be changed for these options. Changes in the method of measurement after the effective date of these regulations can be made only with the consent of the IRS.

Effect on Comparable Profits Method --
The treatment of stock-based compensation as a cost or operating expenses for purposes of the transfer pricing of services and for purposes of applying the comparable profits method will be considered in a separate regulation project. As a result, these regulations do not propose amendments to the definitions of cost or operating expenses in Treas. Reg. §1.482-2(b) or §1.482-5(d)(3). However, the proposed regulations clarify that in applying the comparable profits method, material differences among the tested party and the uncontrolled

comparables regarding the utilization or treatment of stock-based compensation may be an appropriate basis for comparability adjustments.

It is unclear why the IRS released these proposed regulations at this time, given that its position on the issue has already been discussed publicly. Further revisions to these proposed regulations will likely result from the outcome of the *Xylinx* Tax Court case.

The IRS is seeking public comments on the proposed regulations. The deadline to file comments is tentatively set for October 28, 2002.

PATA Documentation Proposal Does Not Provide Relief, Says Deloitte Coalition

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The recent proposal by Australia, Canada, Japan and the United States to harmonize transfer pricing documentation requirements would not ease taxpayers' compliance burdens, according to a coalition of multinational corporations represented by Deloitte Touche Tohmatsu. In fact, according to the coalition, the proposal may even increase such burdens and exacerbate existing problems.

The coalition, which incorporated the views of Deloitte's Global Transfer Pricing Team in Australia, Canada, Japan and the United States, as well as 11 multinationals, addressed the Pacific Association of Tax Administration's proposed uniform transfer pricing documentation proposal (the PATA Package). All four PATA member jurisdictions had issued the proposal jointly on June 17 and requested the submission of comments by July 31.

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