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Tax
Issue P197/2014 – 29 September 2014

Tax Analysis

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OECD Chapter I Release: Important Guidance on Location-Specific Advantages and Passive Association

The OECD's revised guidance in Chapter VI of the transfer pricing guidelines defines intangibles as assets other than physical or financial assets that are capable of being owned or controlled by a single enterprise. Under this definition, location-specific characteristics and workforce in place are not considered intangibles, because they are not capable of being owned or controlled; rather, they should be considered comparability factors to be taken into account in a transfer pricing analysis. The revisions to Chapter I issued September 16 as part of the release of Base Erosion and Profit Shifting (BEPS) deliverables provide important guidance on location-specific characteristics, workforce-in-place, and synergy benefits as comparability factors.

Location saving

The topic of location savings is discussed in Chapter IX of the transfer pricing guidelines on business restructuring. The additional guidance in Chapter I on location savings generally follows the principles laid out in Chapter IX.

Location savings may be derived by an MNE group that relocates some of its activities to a place where costs (such as labor and real estate costs) are lower than in the location where the activities were initially performed or other locations, considering the possible costs involved in locating or relocating the activities.

To determine how location savings are to be shared between two or more members of an MNE group, the following factors should be considered:

- Whether location savings exist;
- The amount of any location savings;
- The extent to which location savings are either retained by a member of the MNE or are passed on to independent customers or suppliers; and
- Where location savings are not fully passed on to independent customers or suppliers, the manner in which independent enterprises operating under similar conditions would allocate any retained net location savings.

The new guidelines indicate that if reliable local market comparables are available and can be used to determine arm's length prices, specific comparability adjustments for location savings should not be required. However, when reliable local market comparable companies are not present, the guidance suggests that comparability adjustments for location savings should be driven by a full analysis of the underlying facts and circumstances, including the functions performed, risks assumed, and assets deployed by the relevant associated enterprises. Mere differences in salary costs should not be the sole basis for determining the existence or allocation of location savings.

Other local market features

Other local market features that may affect comparability include the following:

- Relevant characteristics of the geographic market in which products are sold;
- Purchasing power and product preferences of local households in that market;
- Whether the market is expanding or contracting;
- Degree of competition in the market;
- Relative availability of infrastructure in the market;
- Relative availability of trained and educated workforce;
- Proximity to profitable markets; and
- Similar features in a geographic market that create market advantages/ disadvantages.

In determining whether comparability adjustments for such local market features are required, the most reliable approach is to examine data on comparable uncontrolled transactions in that geographic market. If the comparable data indicate that transactions are carried out under the same market conditions as the controlled transaction, then the need for making specific adjustments for local market features would not arise.

In cases when reasonably reliable local market comparables cannot be identified, the determination of appropriate comparability adjustments for features of the local market should be based on the underlying facts and circumstances. The same factors for determining the allocation of location savings should be considered.

In some markets, the tax authorities argue that local market comparables do not exist to determine the existence or allocation of location savings or location-specific advantages (LSAs). The absence of comparables may lead to a profit split analysis. The OECD guidance suggests a detailed functional and factual analysis would be required to determine the most appropriate method.

Impact of government licenses on location-specific-advantages

A government-issued license is an intangible. If the license restricts the number of entrants into the market, it may affect how location-specific characteristics are shared. In such a case, it is necessary to determine each affiliated party's contribution to obtaining the license to determine the allocation of the profit attributable to the license intangible. In assessing the impact of the government license, the contribution by the local member of local market intangibles and other group members of intangibles such as skills, experience, and knowledge should be considered, consistent with the guidance under the draft Section B of the proposed new Chapter VI of the OECD guidelines on intangibles.

If the government-issued licenses are readily available to a large number of qualified applicants, then the license requirement would not serve as a deterrent to entry into the local market. Therefore, the possession of that license would not have a material impact on the allocation of location-specific characteristics.

Impact of new guidance on specific countries

This additional guidance on location-specific advantages is likely to affect transfer pricing issues that have emerged in countries like India and China. These countries have specific market features that could potentially impact transfer prices pursuant to the new guidance.

For example, India's 2013 Circular 6 on R&D outlines the appropriate methodology for transfer pricing purposes based on the functional profile of "Indian Development Centers," entities that provide contract R&D services. Different functional profiles may entail different benchmarking methodologies, including a profit split analysis. The new guidance may help provide a clearer and more nuanced framework for discussions between taxpayers and tax authorities, but it is unlikely to reduce the number of instances in which the Indian tax authorities consider comparability adjustments for location-specific characteristics.

In China, the tax authorities believe that Chinese businesses benefit from a number of location-specific advantages, including lower operating costs and unique market features. Chinese tax officials have been pursuing discussions with taxpayers regarding location-specific characteristics, including location savings and market premiums. The OECD's new guidance on location-specific characteristics is likely to increase the number of instances in which comparability adjustments for location-specific characteristics are considered, and may require taxpayers to undertake a more broad-based and exhaustive analysis of the issue.

Group synergies

Current OECD guidelines provide that no compensation should be paid for incidental benefits received by an MNE group member solely because it is a member of the larger MNE group. The new guidance provides additional clarification regarding the concept of group synergies, and provides important examples that apply the principles in the context of intragroup loans and centralized purchasing groups.

The revised guidelines recognize that MNE groups may benefit from group synergies that do not exist for smaller, independent enterprises. These synergies may stem from economies of scale, combined or integrated computer and communication systems, integrated management, and elimination of duplicative expenses. Such synergies are often favorable, but may be unfavorable if they impose bureaucratic impediments that smaller, nimbler enterprises do not face, or as a result of additional burdens and requirements placed on units because they are part of a large organization.

Incidental benefits that arise merely because an associated enterprise is part of a larger group should not require a payment in the absence of "deliberate concerted action" by another member. The term incidental refers to benefits that arise solely from membership in a group, not to the quantum of benefit received.

However, if the benefit arises from the deliberate concerted action of the group, then it is necessary to determine:

- The nature of the advantage or disadvantage;
- The amount of the benefit or detriment; and
- How the benefit or detriment should be allocated among group members.

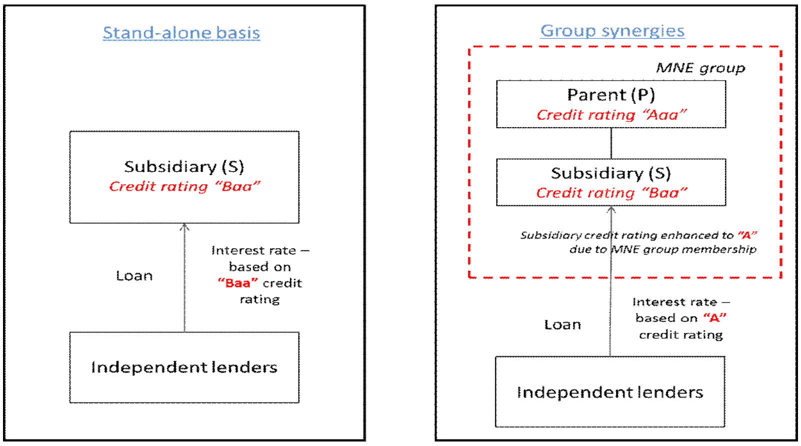
The revised guidelines state that benefits arising from deliberate concerted group actions should be shared in proportion to the members' contribution to the benefit.

Intragroup loans

The guidance on group synergies addresses the issue of passive association/implicit support with respect to financial transactions using two examples.

Example 1 recognizes the impact of group synergies on the credit rating of a subsidiary that is a member of an MNE group. In Example 1, P is the parent company of an MNE group engaged in the financial services business. The strength of the consolidated group's balance sheet enables P to maintain a Aaa credit rating. On a standalone basis, the strength of S's balance sheet would support a credit rating of only Baa. Nevertheless, because of S's membership in the P group, large independent lenders are willing to lend to it at interest rates that would be charged to independent borrowers with an A rating. S borrows simultaneously from a third party lender and P at an interest rate that reflects S enhanced credit rating as part of the P group.

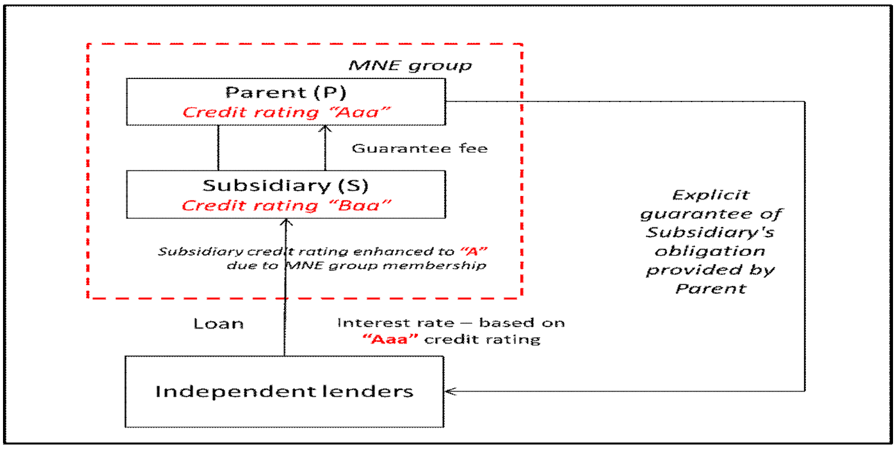
Chart 1 – Illustration of OECD Example 1 – No contractual credit guarantee



The example states that no payment or comparability adjustment is required for the group synergy benefiting S because the benefit arises solely from S's group membership, rather than from any deliberate concerted action of members of the MNE group.

A similar principle is applied in Example 2, which distinguishes between incidental benefit and deliberate concerted action. Example 2 considers a similar situation as Example 1, but the parent company provides an explicit guarantee (legal obligation), an example of a concerted group action. The example concludes that S should be required to pay a guarantee fee, but only on the enhancement of its credit standing from A to AAA, rather than from Baa to AAA, because the leap from Baa to A is attributable to S's passive association in the group, whereas the enhancement from A to AAA is directly attributable to deliberate concerted action – the provision of the guarantee by Parent.

Chart 2 – Illustration of OECD's Example 2 – Contractual guarantee provided by Parent



These examples appear to be premised on a number of facts that may not be present in all situations. The examples conclude that the willingness of the MNE group to provide financial assistance in the future in the event of default is not a "deliberate concerted group action." However, if the parent company undertakes deliberate steps to maintain its credit rating at a certain level to enable it to borrow at a rate lower than its competitors, the examples do not address whether that action constitutes a "deliberate concerted group action" for which S may be required to compensate P.

Similarly, the examples assume that large independent lenders are willing to lend to the subsidiary at an interest rate reflecting a higher credit rating than the subsidiary's standalone rating. This may not be the case in all situations. For example, credit rating agencies consider implicit support only under specified circumstances. The International Basel II framework issued by the Bank for International Settlements Basel Committee on Bank Supervision in assessing a bank's risks generally considers only legally enforceable guarantees, which implicit support would not satisfy. These OECD examples could affect whether a bank would consider implicit support, because implicit support would affect its risk rating. Banks generally do not publish their approach to implicit support, and experience suggests those approaches vary.

Finally, Example 1 assumes that there are no contractual differences between the unrelated-party loan and the related-party loan. Implicit support would not appear to impact loan-specific contractual differences. For example, if the related-party loan were subordinate to third-party creditors, the subordination may affect the standalone credit rating of the specific loan.

Centralized purchasing

The new guidance states that a group that takes affirmative action to centralize purchasing in a single group entity to take advantage of volume discounts has taken deliberate concerted action, which generally requires the members to share the benefits of consolidation regardless of whether the centralized purchasing company buys and resells the purchase items or simply negotiates master purchase contracts for the group. However, no affirmative action occurs if a vendor simply offers an additional discount to a group company in the hope of obtaining additional orders from other group members. In that case, the company receiving the discount is receiving an incidental benefit for being part of the group and should retain the entire benefit.

The guidance contains three examples that illustrate the view that when a centralized purchasing company is able to take advantage of volume discounts, the volume discounts must be shared among the group companies, and the centralized purchasing company is entitled only to a return on the functions it performs and the assets it uses in the purchasing activity. The examples imply that, in those cases, the purchasing activity is a routine activity for which the purchasing entity should receive a routine return. Any benefit received for aggregating the group's purchasing volume should be shared among group members.

The examples appear to be premised on a number of facts that may not be present in all situations. If the centralized purchasing entity engaged in additional functions and employed additional assets or resources, such as by developing a sophisticated software algorithm to track and predict price movements more efficiently, the examples do not appear to dictate that this incremental value attributable to the purchasing services should be shared by the group companies.

Assembled workforce

The additions to Chapter I provide guidance on the potential impact of an assembled workforce in a transfer pricing analysis. The guidance indicates that a uniquely qualified or experienced workforce may be a comparability factor that may impact transfer prices.

An assembled workforce may be transferred as part of a business restructuring. In such a case, the guidance states, the value of the workforce can be estimated by a replacement cost analysis. In some instances, the transfer of an assembled workforce would entail time and cost savings that should be reflected in the arm's length price charged for the transferred assets. Conversely, in some cases, the workforce may come with termination, pension, or other liabilities that would reduce the value of the workforce or even create a negative value. In those cases, the price paid in the restructuring should reflect those potential liabilities. Importantly, the guidance does not suggest that an assembled workforce is an intangible, presumably because it cannot be owned or controlled by a single enterprise.

The guidance indicates that in most situations the mere secondment of an employee would not require any additional compensation other than for the services of the employee.

If the transfer of a workforce or a secondee results in the transfer of valuable know-how, then the transfer of that valuable know-how should be valued in accordance with the guidelines in Chapter VI on intangibles. Similarly, access to a trained and experienced workforce may enhance the value of a transferred intangible, which could affect the value of the intangible or could be a comparability factor affecting the value of the services to be provided by the workforce in the future.

Effective dates

The OECD has not recommended a specific effective date for the changes to Chapter I. The effective date of the changes will depend on the domestic law of the adopting states. Some states have not enacted specific transfer pricing rules, and generally follow the OECD's transfer pricing guidelines. For those countries, the changes to Chapter I will be automatically incorporated into domestic law when final. Conversely, those countries that do have specific transfer pricing legislation, rules or guidance will have to either enact new legislation adopting the rules or formally amend their existing rules or guidance.

Whether the changes to Chapter I will apply prospectively or retroactively will also be determined under local law. It is possible that final agreements at the end of the BEPS project in 2015 could include effective dates for the new OECD guidelines to apply.

Comments from China perspective

On September 17, 2014, the State Administration of Taxation (SAT) issued a press release related to the deliverables of G20 BEPS actions in which it acknowledges BEPS initiatives' unavoidable and practical impacts to tax administration in China and that tax authorities in China will face pressure of fulfilling its corresponding obligation regardless of the final output of the various BEPS actions. In the release, the SAT observes that such global initiatives allow for a more equitable result by aligning taxation with value creation in a fair and transparent way. As such, it concludes that it is important for China to continue to actively participate in this development to ensure a fair transfer pricing enforcement through appropriate legislative and administrative frame work as well as international cooperation.

And then on September 25, 2014, the SAT organized a conference to further discuss its view of BEPS actions with corporate tax payers and advisers. In this conference, the SAT again reiterated its general support for the BEPS initiatives. The SAT also laid out some important upcoming development with respect to BEPS:

- Circular No. 2, Measures of Special Tax Adjustments (Trial), which deals with adjustments under GAAR, transfer pricing, CFCs and thin capitalization, is under revision. The SAT will release a draft for public comments before the end of 2014, and the final rule will likely come out in early 2015.

- The SAT has an internal timetable that corresponds to the OECD timetable. Generally speaking, the SAT should be able to come up with its reaction approximately six to nine months after each OECD recommendations come out.

- The SAT will post on its website a list of what it considers as "unacceptable behaviors" which will be the focus of future transfer pricing audits.

From a technical perspective, the SAT has been increasingly paying attention to LSAs including location savings and market premiums, which has been reflected in the Chapter 10 – Country practices (China) of UN Practical Transfer Pricing Manual for Developing Countries issued in October 2012. In practice, many transfer pricing audits and bilateral advanced pricing agreements cases in China have already included discussions on LSAs. Depending on the specific facts and circumstances of each case, the tax bureaus have requested sometimes substantial amount of additional market and cost data and analyses, as they considered relevant to LSAs. However, we note that in many of these cases, the Profit Split Method was being considered by the tax bureaus. Perhaps this reflects the difficulties to apply comparability adjustments in practice as also noted by the OECD.

For inbound MNEs where there may be perceived or actual LSAs and/or local market features, it is recommended that these are being considered and analyzed when establishing the Group's transfer pricing policy.

For Chinese outbound enterprises with large network of overseas subsidiaries and affiliates, they may also need to consider the impact of LSAs and other local market features.

While the guidance on group synergies addresses the issue of passive association/ implicit support with respect to financial transactions with good examples of dealing with credit enhancement, two practical issues remain in China – controls remain for foreign exchange and interest rates and also the challenges of mapping local rating systems to those of widely used global ones in arriving at the necessary interest spread.

Comments from Hong Kong perspective

While LSA may be the focus of emerging markets, the guidance on passive association may provide valuable clarification for financial transactions and purchasing structures that are common in Hong Kong. The free market nature of Hong Kong's financial markets means that techniques described by the Chapter I Guidance examples can generally be practically applied to intercompany financial transactions. On the other hand, the addition of volume discounts analyses and the potential sharing of resulting benefits amongst group entities mean that groups with significant purchasing value chain should review their transfer pricing policy to ensure these factors have been taken into account.

Conclusion

The additional guidance added to Chapter I regarding location-specific advantages, group synergies, and workforce-in-place provides important new guidance for tax administrators and companies. Companies that have taken positions on these issues should consider this new guidance when analyzing their transfer pricing positions.

Tax Analysis is published for the clients and professionals of the Hong Kong and Chinese Mainland offices of Deloitte China. The contents are of a general nature only. Readers are advised to consult their tax advisors before acting on any information contained in this newsletter. For more information or advice on the above subject or analysis of other tax issues, please contact:

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