



# Insights: Transfer Pricing

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## Trends in transfer pricing in 2012 and looking ahead to 2013

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As the global economy continues to suffer from recession and sluggish growth, countries are looking for ways to increase tax revenues. So it is no surprise that in 2012 transfer pricing remained a hot topic of conversation as government officials publicly condemned the tax practices of many large multinational corporations, including Amazon, Apple, Facebook, Google, Hewlett Packard, Microsoft, and Starbucks.<sup>1</sup> Notable headlines include “British lawmakers slam Amazon, Google, Starbucks for ‘immoral’ tax avoidance schemes”<sup>2</sup> and “How Apple Sidesteps Billions in Taxes.”<sup>3</sup> While government officials admitted that many of these companies are complying

with the letter of the law, they say corporations are abusing the spirit of the law. What follows is a brief summary of the trends in transfer pricing with a focus on: (i) the United States (US), (ii) the United Kingdom (UK), and (iii) the Organisation for Economic Co-operation and Development (OECD).

### United States

#### Senate subcommittee hearing on “offshore profit shifting and the US tax code”

In September of 2012, the Permanent Subcommittee on Investigations held a hearing on “Offshore Profit Shifting and the US Tax Code.” The hearing was conducted by Senator Carl Levin (D-MI) and Senator Tom Coburn (R-OK). During the hearing, Senator Levin facilitated testimonies and discussions from transfer pricing professionals, Microsoft and Hewlett-Packard (HP) management, and Ernst and Young (E&Y). The hearing focused on three particular areas:

1. The alternating loan structure used by HP.
2. E&Y’s role as an auditor and adviser for HP, which potentially compromises independence.
3. Microsoft’s intellectual property (IP) licensing structure.

In addition, the Senate interviewed representatives from the Financial Accounting Standards Board (FASB) and the Internal Revenue Service (IRS) in an attempt to find ways to curb situations where

<sup>1</sup> Janet Novack, “Senate Report Details HP & Microsoft Tax Ploys,” *Forbes*, September 20, 2012; AP Exchange, “Europe takes on tech giants and their tax havens,” *Starherald.com*, December 4, 2012.

<sup>2</sup> Jill Lawless, “British lawmakers slam Amazon, Google, Starbucks for ‘immoral’ tax avoidance schemes,” *Associated Press*, December 3, 2012.

<sup>3</sup> Charles Duhigg and David Kocieniewski, “How Apple Sidesteps Billions in Taxes,” *The New York Times*, April 28, 2012.

the Senate believes some companies are abusing current transfer pricing rules. In our opinion, neither the FASB nor the IRS's representatives provided much in the way of potential "fixes." While the long-term impact of this hearing remains to be seen, its occurrence highlights the fact that transfer pricing remains a topic of much debate within the legislature.

For CRA's article summarizing the Senate subcommittee hearing, [click here](#).

### **Discussions of a territorial tax system**

On February 22, 2012, the Obama Administration released a proposal to revise the US corporate tax system. Much of the proposal touched on multinational transfer pricing. Along with reducing the corporate income tax from 35.0 percent to 28.0 percent, the White House proposed a minimum tax on US multinationals' foreign profits.<sup>4</sup>

The Senate Republican Policy Committee countered President Obama's proposed corporate tax system in a congressional news release on September 19, 2012. In this report, the Republicans advocated for shifting the current US worldwide tax system to a territorial tax system. Unlike the proposed corporate tax system advocated by the White House, this tax system would keep the US corporate tax rate at 35.0 percent but allow for the tax-free repatriation of foreign profits.<sup>5</sup> These proposals are not expected to result in immediate reforms, but it is a debate that will continue to take place in 2013.

### **Changing climate for advanced pricing agreements (APAs)**

On February 27, 2012, it was announced that the IRS had completed the merger of the APA and competent authority functions. The resulting Advance Pricing and Mutual Agreement Program (APMA) falls under the authority of the Large Business and International (LB&I) division of the IRS. Samuel M. Maruca, the director of transfer pricing operations for the IRS, stated that the goal of this merger was to create a team that could take an APA case from start to finish.<sup>6</sup>

Shortly after the creation of the APMA, Richard McAlonan was named director. Prior to this role, he was a director of Ernst & Young LLP's national transfer pricing controversy group. So far, it appears that Mr. McAlonan has been able to make the APA application process much more efficient as evidenced by the increasing number of APA approvals. Within four months of his confirmation as director of the APMA, the number of APAs signed reached 46, a larger number than what was passed in all of 2011.<sup>7</sup>

Through both the creation of the APMA and the appointment of Richard McAlonan, it appears as if the IRS would like to expand the use of APAs in transfer pricing transactions. While APAs could prove to be a good option for those wanting to obtain certainty regarding their transfer pricing practices, the Eaton Corp. case that is currently being heard by the tax court underlines the uncertainty that still exists with respect to this payment structure.

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<sup>4</sup> Jackie Calmes and John Cushman, "Obama Unveils Proposal to Cut Corporate Tax Rate," *The New York Times*, February 22, 2012.

<sup>5</sup> "Senate Republicans Say Territorial Tax System Would Increase Competitiveness," *Tax Analysts*, September 19, 2012.

<sup>6</sup> Dolores W. Gregory, "Maruca Says APMA Launched Feb 27, Describes Plans for Case Development," *BNA*, March 3, 2012.

<sup>7</sup> Molly Moses, "McAlonan Says 46 APAs Completed So Far in 2012, Exceeding 2011 Levels," *BNA*, August 2, 2012.

In December 2011, the IRS canceled two unilateral APAs that Eaton Corp. had previously put in place with its manufacturing subsidiaries. The IRS then issued transfer pricing adjustments totaling \$368.6. These adjustments resulted in a tax assessment of \$75 million and penalties of \$52 million.<sup>8</sup> The ruling will set a precedent regarding the finality of APAs going forward.

### **What to expect in the United States in 2013**

The number of transfer pricing audits rose notably in 2012 partly due to increased recruitment of transfer pricing professionals by the IRS.<sup>9</sup> As there is typically a six- to eight-month lag between new hiring and increased audits, we can expect the number of transfer pricing audits in 2013 to increase or, at the very least, remain at a similar level to 2012.<sup>10</sup> Additionally, it is believed that in 2013 the IRS will be taking a more strategic approach, targeting audits at particular industries with special emphasis on the technology sector.<sup>11</sup> One of the most politically charged issues is “offshoring” IP. We expect to see the IRS continue to focus on IP issues, specifically IP migration and imputing IP value to US operations where they are deemed routine by the taxpayer.

With the successful restructuring of the APA and competent authority functions, the number of completed APA cases in 2013 is expected to increase compared to 2012. The head of the newly formed APMA predicts that as many as 150 to 200 APA cases could be completed each year.<sup>12</sup> Additionally, 2013 should provide clarity regarding the ability of the IRS to re-examine APAs if the pending Eaton Corp. case is resolved. Furthermore, CRA is aware of a company that is currently applying for an APA to cover an IP migration transaction under the new cost sharing regulations. If approved, this APA could set a precedent for future IP royalty structures and audit positions.

On July 30, 2012, the IRS published Notice 2013-39, which provides guidance to section 367(d) of the Internal Revenue Code with the intention of closing loopholes that previously allowed multinationals to repatriate cash tax-free.<sup>13</sup> In 2013, expect to see continued scrutiny in the press and pressure from government officials for tax reform to close loopholes in an attempt to increase revenues.

## **United Kingdom**

Next year promises to be a very important one for transfer pricing in the UK. The following is a brief outline of the main trends in the UK from Paul Wilmshurst, a principal in CRA’s London office.

### **Controversy**

Events in 2012 brought about a dramatic increase in public and political awareness of multinationals’ transfer pricing practices. Much of this resulted from the Public Accounts Committee’s annual review of Her Majesty’s Revenue and Customs’ (HMRC) accounts, which led to the public questioning of representatives from Starbucks, Amazon, and Google. They were challenged on the relatively small amounts of corporate tax the multinationals pay compared to the revenues they generate from the UK, despite having significant operations there.

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<sup>8</sup> “IRS Attacks Eaton’s Claim that Contract Law Requires It Show Cause for Canceling APAs,” BNA, October 23, 2012.

<sup>9</sup> Sophie Ashley, “Silicon Valley must prepare defense against IRS attack,” *TP Week*, October 16, 2012.

<sup>10</sup> Ibid.

<sup>11</sup> John Letzing, “US Transfer Pricing Brings Tax Troubles to Tech Giants,” Dow Jones, April 4, 2012.

<sup>12</sup> “New APMA Director Sets Ambitious Goals, Ultimately Hopes to Move 150 Cases Yearly,” BNA, July 28 2012.

<sup>13</sup> Alison Bennett, “Coming 367(d) Rules to Contain Sizeable Transfer Pricing Components,” BNA, September 21, 2012.

The Committee's report, released in early December, did not pull any punches. It described this situation as "outrageous" and stated that the "evidence we took from large corporations was unconvincing and, in some cases, evasive."<sup>14</sup>

Moreover, it called for a change in mindset at the HMRC, which must be "more aggressive in policing and prosecuting companies that paid too little tax."<sup>15</sup> Also, "HMRC needs to be seen to challenge practices to prevent the abuse of transfer pricing, royalty payments, intellectual property pricing, and interest payments."<sup>16</sup>

In the same week, the government announced increased funding for transfer pricing enforcement and re-doubled the government's commitment to international efforts to combat tax avoidance. Also Starbucks, in an unprecedented move, announced that it wanted to voluntarily pay more tax in the UK by not claiming deductions for intra-group charges.

These developments are worrying for multinationals and from the perspective of UK tax competitiveness. The political and media attention will undoubtedly continue into 2013 and we will also begin to understand how HMRC will react in practice.

### **UK Patent Box**

The UK Patent Box will come into force on April 1, 2013. This will provide a means for UK companies, including subsidiaries of foreign groups, to benefit from a reduced corporation tax rate on relevant profits that will be less than half of the headline rate.

The reduced rate will be phased in over several years, down to 10 percent from April 2017. This compares to the main rate of UK corporation tax effective on April 2013 of 23 percent, which falls to 21 percent from April 2014.

Companies can qualify either by owning a qualifying patent or certain other narrow categories of IP or via an exclusive license to use a qualifying patent. The company itself will need to meet certain criteria regarding the development and management of the IP embodied in the patent, with some special conditions applying to group companies.

There are a number of steps involved in determining the relevant income for the UK Patent Box and then in calculating the relevant profits, which include applying transfer pricing principles to some elements. They include:

- The company must first identify its qualifying income—for example, worldwide sales of any products incorporating a patented item; license fees and royalties, or the proceeds from selling qualifying IP. Additionally, if the company's patent-related income does not fall within the definitions (e.g., where it uses a patented invention to provide a service) a "notional royalty" can be determined based on transfer pricing principles.
- The relevant profits are then determined either through a simple allocation or by "streaming" the company's income and allocating its expenses in a reasonable way.

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<sup>14</sup> House of Commons Committee of Public Accounts, "HM Revenue & Customs: Annual Report and Accounts 2011–12: Nineteenth Report of Session 2012–13" accessed December 3, 2012, <http://www.publications.parliament.uk/pa/cm201213/cmselect/cmpublicacc/716/716.pdf>.

<sup>15</sup> Ibid.

<sup>16</sup> Ibid.

- Certain deductions then need to be made from the profits calculated, potentially including a notional, arm's length, and marketing royalty in relation to profit attributable to a brand.

Evaluating and then implementing the UK Patent Box can require addressing a number of challenging economics and transfer pricing issues, including assessing the qualification criteria and completing the arm's length benchmarking and profit segmentation work.

Companies wishing to complete the necessary preparations in advance of April 2013 are advised to begin in earnest in the new year if they have not already done so.

### **UK CFC rules**

The new UK Controlled Foreign Company (CFC) rules come into effect for accounting periods starting on or after January 1, 2013. Significant aspects of these rules require the application of transfer pricing concepts.

The rules set out four "Gateway" conditions. If one or more of these are met then the CFC's profits remain outside the scope of the CFC charge. One of these conditions asks whether the CFC has any assets or risks for which key management activities are in the UK. This requires an arm's length evaluation of the management and control of the relevant assets and risks within the group.

If none of the Gateway conditions are met, the steps to be taken to determine any UK taxable profits then follow the OECD's 2010 Report on the Attribution of Profits to PEs. The familiar first step hypothesizes the PE as a separate enterprise with its own assets and risks based on the results of a functional analysis; the second step then prices the "dealings" between the PE and other parts of the enterprise on an arm's length basis.

HMRC's draft CFC guidance<sup>17</sup> notes that the content and form of the records that a business is expected to be able to make available follow the same principles as for transfer pricing. A group's existing transfer pricing documentation will therefore provide an important starting point for a CFC analysis under the new rules.

The draft CFC guidance indicates that the transfer pricing rules are the UK's "primary defense" and HMRC should apply these first, though applying the new CFC rules may be necessary since profit may still be artificially separated from UK activity even though individual transactions are correctly priced. It is interesting to consider whether the economic substance principles set out in the current OECD interim draft on intangibles would, if finalized, bring the UK transfer pricing rules up to the level of the new CFC rules in this respect.

### **OECD**

This past year has been a busy one in the international transfer pricing arena, both within the OECD and with other international organizations focusing their attention on transfer pricing matters. In particular, the United Nations published their "Transfer Pricing Manual" in October.

CRA has been following these developments closely. In particular, Alberto Pluviano, a principal in CRA's Paris office, has contributed on the intangibles project and participated in the OECD public consultation in November. Mr. Pluviano is involved through the OECD's Business and Industry

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<sup>17</sup> HMRC, "Controlled Foreign Companies (CFCs) and permanent establishments—draft guidance," May 16, 2012.

Advisory Committee (BIAC), an independent international business association that advises government policymakers at the OECD. The following is a summary of Mr. Pluviano's key takeaways regarding the OECD's transfer pricing developments in 2012.

The main focus of the OECD involves revising Chapter VI of the OECD Transfer Pricing Guidelines on intangibles. The intangibles project, started in 2010, has moved exceptionally fast (compared to previous projects, especially considering its complexity) with the publication of an interim draft in early June 2012.<sup>18</sup> At the same time, the OECD has published two discussion drafts on "Safe Harbors"<sup>19</sup> and "Timing Issues"<sup>20</sup> as part of a parallel project on simplifying certain aspects of transfer pricing administration.

By mid-September, the OECD had received more than 130 comment letters from business representatives on the three drafts, totaling a record level of almost 1,400 pages of comments. Following the letters, a three-day public consultation took place in mid-November at the OECD where transfer pricing experts from various governments met with more than 100 private sector representatives.

The UN Manual, published in October, is mainly focused on providing practical guidance to developing countries and generally reflects the OECD principles.<sup>21</sup> It currently does not include a chapter on intangibles and there are uncertainties on its future steps.

Finally, the G20 and various governments have urged the OECD to intensify its work on "Base Erosion and Profit Shifting." In a release published at the end of November, the OECD quotes, among other key areas: "transfer pricing, in particular in relation to the shifting of risks and intangibles, the artificial splitting of ownership of assets between legal entities within a group, and transactions between such entities that would rarely take place between independents."<sup>22</sup> A progress report to the G20 is planned to be issued in early 2013.

CRA very closely follows these developments, including through its direct participation to the Tax Committees of: (i) BIAC, (ii) the International Chamber of Commerce (ICC), and (iii) the United States Council for International Business (USCIB).

The main concerns expressed by the business community in relation to 2012 developments tend to focus on the OECD intangibles project and encompass:

- The clear orientation of the project toward focusing on values rather than definitions despite the pressure exercised by the business community in favor of a clearer set of definitions that would improve certainty and prevent double taxation;
- The perceived "anti-abuse" flavor of certain sections of the draft;

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<sup>18</sup> OECD, "OECD Working Party No. 6 releases a discussion draft on the Transfer Pricing Aspect Aspects of Intangibles," June 6, 2012.

<sup>19</sup> OECD, "OECD Working Party No. 6 releases a discussion draft on the revision of the Safe Harbours section the Transfer Pricing Guidelines," June 6, 2012.

<sup>20</sup> OECD, "Draft on Timing Issues Relating to Transfer Pricing," June 6, 2012.

<sup>21</sup> Committee of Experts on International Cooperation in Tax Matters, United Nations, "Practical Manual On Transfer Pricing For Developing Countries," October 15–19, 2012.

<sup>22</sup> OECD, "The OECD Work on Base Erosion and Profit Shifting," November 20, 2012.

- The emphasis on functions and the relative downplaying of legal ownership in the identification of the parties entitled to intangible related returns;
- Significant uncertainties about how the treatment of goodwill and workforce in place will be addressed;
- The constraints posed to utilizing the comparable uncontrolled price (CUP) method and the perceived preference for the profit split method in many cases; and
- The likely expansion of the use of valuation techniques for valuing intangibles and how prescriptive should the OECD guidelines be on this subject.

### **What to expect from the OECD next year**

Next year could be seen as a transition year in the sense that none of the current OECD projects are likely to convert into a final document before 2014. In practice, we expect 2013 to be a challenging year characterized by new issues, some of them going beyond the traditional technical complexities of transfer pricing. They include:

- A growing focus of tax authorities on transfers of intangibles, in particular in cases of “business restructurings” (we have already seen in 2012 some tax authorities utilizing concepts taken from the OECD draft during tax audits);
- An increasing number of cases where tax inspectors will utilize valuation methods (normally a discounted cash flow approach) to reassess the transfer pricing of intangibles;
- Pressure from tax authorities to settle transfer pricing disputes instead of going through lengthy processes in courts or in competent authorities’ procedures;
- In general, a shift of attention from preventing “double-taxation” to preventing double “non-taxation;”
- More companies hitting the news headlines in case of tax adjustments and press campaigns against multinationals not paying their fair share of local taxes; and
- OECD’s focus on actions to prevent “Base Erosion and Profit Shifting” and growing attention on the subject from the G20, governments, NGOs, and the press.

Multinationals should consider adopting a proactive approach to face the likely challenges by reviewing their potential exposures, in particular those linked with current intangibles policies (including location, pricing, and value) and the evolution of business structures and trends. This type of internal checkup, followed by the development of a strategic action plan, could significantly improve the chances of a multinational group to be successful in facing new challenges that could go well beyond the traditional boundaries of taxation issues.

### **Other expectations for 2013**

The following summarizes other noteworthy changes that will take place around the globe in the upcoming year.

- On March 29, 2012, the Canadian Minister of Finance proposed significant changes to Canada’s transfer pricing in the government budget including: (i) clarifying the treatment of transfer pricing secondary adjustments, (ii) changing thin capitalization rules, and (iii) implementing a measure to curtail foreign affiliate “dumping” transactions.

- The Brazilian National Congress is currently reviewing a change to re-establish the country's safe harbor for inbound intercompany loans and interest rate specifications. The change would reverse previous rules that were set to apply on January 1, 2013.<sup>23</sup>
- German tax authorities plan to enact an amended law to implement the Authorized OECD Approach for permanent establishments (PEs) starting in 2013. Along with this change in the regulation, the tax authorities will enact an ordinance to provide further details in early 2013 and publish administrative guidelines shortly thereafter.<sup>24</sup>
- The Irish tax authority announced on November 26, 2012 that it is going to select large companies across a range of industries on which to conduct transfer pricing compliance reviews (TPCRs). Selected companies will have three months to conduct their transfer pricing review and to provide information on their business structures, related-party transactions, and transfer pricing methods.<sup>25</sup>
- Japan is expected to introduce earnings stripping rules in April 2013 to prevent companies from taking too much profit and loss out of foreign-related parties through interest expenses.<sup>26</sup>
- Vietnam's National Assembly has approved legislation that established an APA program effective July 1, 2013.<sup>27</sup>
- Ukraine is expected to launch its APA program in 2013.<sup>28</sup>
- Australia released draft transfer pricing legislation incorporating OECD comparability factors on November 22, 2012. Comments regarding the draft legislation are due December 20, 2012. Expect to hear more dialogue in 2013 regarding the draft legislation in response to the comments received.<sup>29</sup>

## Conclusion

This past year we have witnessed increased scrutiny of multinational corporations' transfer pricing policies by both government stakeholders and the general media. In an attempt to get multinational corporations' transfer pricing policies to conform more with the substance of the law, many countries have engaged in more aggressive auditing activities and passed legislation to close existing loopholes. However, despite the changing landscape, transfer pricing remains the same at its core. Ultimately, transfer pricing is still examined through the prism of the arm's length principle—evaluating intercompany transactions by looking at what third parties would charge in a similar arrangement. In summary, with the understanding that tax authorities around the world are increasingly looking to transfer pricing as a potential source of revenues, taxpayers should ensure that they have the best protection available through proper documentation. Taxpayers can no longer wait until audit to prepare comprehensive defensive positions on their global transfer pricing policies. Proactive analysis and documents will save time and money upon audit.

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<sup>23</sup> Alex M. Parker, "Brazil to Reopen Intercompany Loan Safe Harbor, Tweak Interest Rates," BNA, November 29, 2012.

<sup>24</sup> Michael Jakob, "Expected changes in German transfer pricing regulations," *TP Week*, October 2, 2012.

<sup>25</sup> Kevin A. Bell, "Ireland Launches Compliance Program; Revenue to Conduct Risk Assessments," BNA, November 30, 2012.

<sup>26</sup> Yuriko Nagano, "Japan Expected to Introduce Earnings Stripping Rules Next Year," BNA, September 27, 2012.

<sup>27</sup> Kevin A. Bell, "Vietnam's National Assembly Approved Advance Pricing Agreement Program," BNA, December 4, 2012.

<sup>28</sup> Sophie Ashley, "Getting the most from the Ukrainian APA programme," *TP Week*, September 18, 2012.

<sup>29</sup> Kevin A. Bell, "Australia: Australia's Draft Legislation Would Adopt OECD Comparability Factors," BNA, September 29, 2012.

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