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Be prepared: BEPS is coming

This year’s TP supplement focuses on the developments that the OECD’s base erosion and profit shifting (BEPS) project have brought to international tax and transfer pricing.

While taxpayers are awaiting the final guidance, it is clear they must begin to prepare their transfer pricing affairs for a significant change in regulation.

A number of countries have already begun to implement anti-avoidance measures. Annie Han, head of transfer pricing at LEGO China, has written about China’s general anti-avoidance rule and how that will impact her company’s transfer pricing preparations and how this fits in to the global BEPS issue.

DLA Piper has also submitted an article about the importance of supply chain planning in the post-BEPS era, with recommendations for what taxpayers can do now.

PwC Chile has also provided insights on what the Chilean government is doing to make way for BEPS.

In addition to the articles in this supplement focusing on BEPS we are also providing an update of the US TP litigation scene, written by partners at Fenwick & West, detailing Microsoft, Amazon, Medtronic and Zimmer Holdings, with information about IRS training and the audit roadmap.

We hope this digital issue proves useful to you in these uncertain times and encourage you to forward it onto your colleagues and peers in the transfer pricing field.
Why China is strengthening its anti-avoidance rules and how companies are preparing

Annie Han, head of China tax at LEGO, discusses how China is reacting to BEPS and how taxpayers are interpreting this within their own companies.

Against the backdrop of the OECD’s base erosion and profit shifting (BEPS) Action Plan, China’s State Administration of Taxation (SAT) has been active in developing international tax rules and has been taking advantage of global efforts to review transfer pricing norms and regulations. In this environment, the SAT has also been strengthening the anti-avoidance administration by issuing domestic regulations.

In April 2014 China submitted a letter, to the subcommittee of the UN Transfer Pricing Manual for Developing Countries, on service charges and management fees. This was followed by the issuance of Notice 146 in July to implement a comprehensive tax examination on significant outbound service fees and royalty fee payments to overseas related parties. Then, in September, Notice 54 was issued, for monitoring and managing special tax
adjustments. In December 2014 – and the most eye-catching – a notice on measures for administration of general anti-tax avoidance (trial implementation) was issued.

SAT has also been developing its skills in anti-avoidance investigation, since the issuance of Circular No 2 – the Implementation Measures for Special Tax Adjustment (Trial Implementation) – in 2009.

The Measures for Administration of GAAR (Trial Implementation) now operate in conjunction with Circular No 2 to provide a more comprehensive and transparent legal framework for administration of GAAR. The GAAR measure also provides instructive procedure for the anti-avoidance investigation aiming to provide more clarity on how the Chinese tax authorities conduct the anti-avoidance investigation.

Stipulated in the Measures for Administration of GAAR, the taxpayer has 60 days to submit documents to the tax authority after receipt of the tax examination notice (with a potential extension of 30 days for special cases) to demonstrate the commercial purpose and the business substance of the transactions. The burden of proof lies with the taxpayer. The tax authority is required to conduct a GAAR investigation within nine months after the case is approved by SAT. Compared with the current practices where cases can typically last for one to two years, the nine-month timeline is welcome.

GAAR is seen as a last-resort measure to avoid aggressive anti-avoidance tax arrangements and so it is not anticipated to be largely used in practice. Where specific rules such as transfer pricing, cost sharing, CFC, and thin capitalisation can be applied, the specific rules should be applied first. From the legislation itself, the stipulation that the case selection and the issuance of the adjustment notice need the approval from SAT also indicates SAT’s cautious attitude to apply GAAR. However, the responsibility of case selection lies with the local tax authorities.

**Non-deductibility**

On March 18, 2015, the SAT released an Announcement on expenses paid to overseas affiliated parties, which related to Corporate Income Tax (Notice No 16 [2015]) and attracted a great deal of attention from Chinese taxpayers. China is increasingly strengthening its administration on overseas payments to related parties and, similar to the administration of GAAR, this focus emphasises the need for economic substance.

In Notice No 16 [2015], it is stated that overseas payments cannot be deducted in calculating corporate income tax for four types of related party arrangements:

- Expenses paid to an overseas affiliated party that fails to perform functions and bears risks and has no substantial business activities;
• Service fees paid to an overseas affiliated party that does not provide economic benefits;
• Royalties paid to an overseas affiliated party with legal ownership of the intangible asset but does not contribute to value creation;
• Royalties paid to an overseas affiliated party that is established for the purpose of financing for going public and/or for the incidental benefits generated from the activities of financing for going public.

As provided in China’s Corporate Income Tax Law, any expense paid by an enterprise to its overseas affiliated party must comply with the arm’s-length principle; otherwise, the taxation authority may make adjustments.

According to Notice 16, if a taxpayer fails to prove the economic substance of its overseas payment to an affiliated party, the payment will be deemed as not compliant with the arm’s-length principle, and in the extreme, the transaction will be denied.

The standard for economic substance, expected in Notice 16, is quite high. Take service fees as an example, theoretically economic benefits should be expected for receiving services. However, there could be circumstances when some projects prove to be less effective or even fail on implementation because of unexpected changes to a business or incorrect predictions on future trends. Under third party circumstances, the payment to a service provider would not be denied. However if the payment is made to overseas related parties, such service fees may carry a risk of non-deductibility. This may be contrary to the Income Tax Law where article 8 stipulates that costs, expenses, taxes, losses and other reasonable expenditure incurred in relation to income received by an enterprise, may be deducted when computing the taxable amount of income.

In practice, economic benefits could be very difficult to measure or demonstrate in a lot of cases. If the local tax authority has a high documentation requirement, or even asks for a quantification of economic benefit, it can be anticipated that the settlement of overseas payments to an affiliated party could be more difficult because China is a foreign exchange controlled country. From a taxpayer’s perspective, multinationals needs to put more effort into documenting intra-group services, to demonstrate the economic benefit.

Global best practice
Subsidiaries of multinationals, operating in China, commonly adopt global best practices. In some cases, for an entity with simple functions, this can add more approval procedures, complicating the process. It is likely the tax authority will deny the use of global best practice if the benefit goes against them. Therefore, multinational companies should carefully consider whether to charge certain costs/service fees to China to avoid double taxation caused by non-deductibility in China.
Notice 16 also states that, when an enterprise pays royalties to its overseas affiliated party for using an intangible asset, the degree of the contribution made by each party needs to be taken into consideration to determine the economic return derived from the intangible asset. The concept is generally in-line with the OECD’s perspective on returns from exploiting intangibles, included in the OECD’s draft on intangible assets.

In practice, the Chinese tax authorities emphasise the contributions of local taxpayers by claiming they are physically performing part of the development, enhancement, maintenance and protection (DEMP) of intangibles. Recently a lot of Chinese entities performing contract R&D activities, especially in software industries, have been placed under anti-avoidance investigation. The Chinese tax authorities are striving for additional profit allocated to China in this respect.

Taxpayers should be very cautious in arranging contract R&D activities in China. Where a Chinese entity performs the functions of DEMP activities, it is not acceptable that the activity is claimed as contract R&D and remunerated with a low return based on a cost-plus method.

Multinationals should carefully examine the functions and risks in the R&D activities performed in China including: the personnel of the R&D team; the scope of the projects; how the technical specifications are communicated; and whether certain decisions are made by the Chinese team, etcetera. Multinationals should also take care to characterise a local R&D activity as a contract one.

With the issuance of Notice 16, more tax controversy should be expected related to overseas intercompany payments. In 2015 the Implementation Measures for Special Tax Adjustments (Trial Implementation) is expected to be revised. It is anticipated that the new Circular No 2 will introduce concepts from the latest BEPS developments and will also incorporate the principles set out in the series of regulations issued since 2014.
Supply chain planning in the post-BEPS era

Michael Patton and Oscar Burakoff of DLA Piper describe the issues taxpayers can expect with supply chain planning after the OECD has released its final BEPS guidance.

As governments around the world have established austerity measures to compensate for decreases in tax receipts, a new catch-phrase has emerged: double non-taxation.

Double non-taxation is the phrase used by governments to denote untaxed or lightly tax profits that result from effective, legal tax planning techniques. These techniques include application of well-established transfer pricing strategies, such as structuring certain functions, risks, and assets (including intangible assets) within a multinational enterprise (MNE) in tax-favoured locations.

Transfer pricing issues have become a significant political issue, as the G-20 nations focus on ways to combat double non-taxation.

For instance, double non-taxation has increasingly been the subject of political agitation by non-governmental organisations (NGO), resulting in
reputational risk for MNEs that are the target of NGO actions, such as the “Lux Leaks”. In addition, the US and other countries are demanding greater “transparency” in taxpayer disclosures.

Double non-taxation is the principal focus of a fast-moving project at the OECD, referred to as Base Erosion and Profit Shifting (BEPS).

At the heart of the BEPS project are efforts to align profits from controlled transactions with “commercial reality” and economic substance: concepts that appear sound, but that are ultimately only sound in the eye of the beholder.

The BEPS project has resulted in a crescendo of draft papers recommending changes to existing international norms, model tax treaty provisions, or domestic tax rules. Transfer pricing issues that are at the heart of the BEPS project include revisions to the rules regarding risk shifting within an MNE group, limitations on intercompany payments for interest, insurance or royalties, and revisions to the treatment of intangibles.

The OECD BEPS project encompasses efforts to revise the rules for defining and valuing intangibles and for redefining the concept of a permanent establishment (PE), especially with regard to companies engaged in digital commerce.

The year 2015 is shaping up to be a watershed year for bringing the multi-year BEPS efforts closer to fruition. In February, the finance ministers of the G-20 reiterated their commitment to implementing key BEPS action items during 2015. In the offing are the following BEPS-related actions that will affect transfer-pricing based international tax planning:

• Finalising the template for country-by-country reporting (CbCR) and establishment of procedures for automatic exchange of CbCR templates among tax treaty or tax information exchange agreement partners. The first automatic exchanges are planned to take place in 2017 based on reporting by multinational companies for tax year 2016.

• CbCR will enable countries to pinpoint double non-taxed or lightly taxed income reported in jurisdictions with few employees or low local brick and mortar investment.

• Finalising the revised rules for evaluating returns to contractual assumption of risks related to developing intangible property, as well as rules for re-characterising transactions that are based solely upon contractual assumptions of risks.

• Finalising a multi-lateral instrument (treaty protocol) that will potentially amend hundreds of existing OECD-based treaties. Amended treaty provisions would impose limitation of benefits provisions, place restrictions on the deductibility of interest in one jurisdiction that does not result in an income inclusion in the payee jurisdiction, and adopt changes to long-standing PE rules.
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Mike Patton focuses his practice on international transfer pricing. Mike has assisted many multinational corporations in a variety of industries in resolving IRS or foreign tax authority transfer pricing and other tax disputes, as well as in planning major cross-border transactions.

Mike was instrumental in obtaining the world’s first Advance Pricing Agreement (APA) and he has assisted clients in negotiating more than 100 APAs. He has also been active in resolving disputes for clients in Examination, Appeals and Competent Authority procedures.

Professional experience
Mike was an attorney in the IRS Chief Counsel’s Office for 15 years. He had national responsibility at IRS for technical issues, regulations and litigation of cases relating to transfer pricing. Mike was editor of and a major contributor to the Treasury/IRS Transfer Pricing White Paper. The White Paper laid the theoretical groundwork for the profit-based transfer pricing methods adopted by the US and the OECD, established principles for implementing R&D cost sharing arrangements, set forth guidelines for applying US “commensurate with income” adjustments and made recommendations for transfer pricing documentation and penalty provisions that have been adopted in over 40 countries. He was the lead US Treasury negotiator in many negotiations with foreign governments and US possessions for tax information exchange agreements.

Credentials
Education
University of Maryland J.D. Order of the Coif, with honors
Georgetown University Law Center LL.M., Taxation
University of Maryland B.A.

Admissions
California
New York
One general theme of the changes being considered is that taxable (or non-taxable) profits should follow economic substance.

In the case of risks, emphasis will be placed upon the actual management of the functions that give rise to the reward that is inherent in the risk being assumed.

OECD BEPS proposals emphasise that a rigorous functional analysis should be undertaken to justify returns to a controlled transaction and that the returns being allocated should reflect commercial reality. In an environment that abounds with “nattering nabobs of negativism,” is tax planning possible to justify profits in tax-favored jurisdictions?

Post BEPS tax planning and tax efficient supply chains

After BEPS actions are incorporated into OECD documents and local legislation, tax planning opportunities will still exist, but realising the benefits of tax planning will require a greater emphasis on economic substance supporting the profit generated around the world.

One often-overlooked area of opportunity is tax efficient supply chain planning. For many companies, particularly in the consumer products industry, an efficient supply chain is a critical value driver.

The efficient management of a company’s supply chain allows it to bring to market innovative products of the right quality, at the right price, and at the right time. Failure to efficiently manage a supply chain can have drastic implications.

In the apparel and footwear industries, for instance, the inability to meet a production schedule can lead to a brand missing a fashion season. It has been well documented that inefficient management of a supply chain can even lead to the collapse of a brand.

Conversely, an efficient supply chain enables the brand owner: to market products in a timely manner; to increase the number of product launches and offerings; to enhance the value of a brand through consistently high quality; to reduce costs; to better manage inventory levels; and to foster innovation.

Efficient supply chains allow a company to react to consumers in a more agile way. In fact, fast-fashion brands, such as H&M and Forever 21, have supply chains that enable them to bring trends to store shelves with unprecedented speed and efficiency, thereby driving less agile companies into bankruptcy or leading to sales declines for competitors.

Efficient supply chain management, as a key value driver, is not limited to fashion or similar consumer goods companies. For example, while technology companies are justly proud of having leading edge, technology-driven products, their technological innovations need to be incorporated into products that are produced efficiently, at the right time, and at the right price.

The world’s best leading-edge technology does not generate profits for the intangible property (IP) owner until that
Oscar Burakoff is a Principal Economist and focuses his practice on transfer pricing and valuation.

Experience
Specifically, Oscar has experience in:
- Analysing numerous transactions, including tangible property transfers, intangible property transfers, cost sharing, intercompany loans and various services transactions such as contract manufacturing, contract research and development and management services
- Valuing pre-existing intangibles to determine buy-in payments or Platform Contribution Transactions for companies implementing cost sharing arrangements that involve the development of technology and/or marketing intangibles
- Managing and preparing studies documenting the arm’s length nature of intercompany prices in various industry sectors to satisfy US, OECD, and local-country documentation requirements in countries including the United States, Argentina, Australia, Austria, Belgium, Canada, China, the Czech Republic, France, Germany, Hong Kong, Hungary, Italy, Japan, Korea, Mexico, the Netherlands, Poland, Russia, Spain, Switzerland, Taiwan, and the United Kingdom
- Valuing trademarks for tax/transfer pricing purposes in various industry sectors
- Analysing and implementing supply chain optimisation strategies and restructurings
- Performing business optimisation strategies, including recommending royalty rates related to design and marketing intangibles
- Advising in the restructuring of transfer pricing systems after a merger or acquisition
- Negotiating Advance Pricing Agreements
- Performing business entity valuations for tax purposes

Credentials
Education

Oscar Burakoff is not a lawyer.
technology is incorporated into a product that is made, delivered, and sold to the consumer. In short, turning leading-edge IP into globally realised profits requires a well-managed supply chain.

**Tax planning**

In the past, many consumer products companies have engaged in tax planning involving their supply chains. Typical, tax planning involved an intermediary entity located in a tax-efficient jurisdiction earning profit associated with supply chain transactions. In many cases, these entities lack sufficient economic substance to withstand scrutiny from a BEPS-type inquiry. With the implementation of BEPS-type provisions, these structures are no longer viable.

Opportunities exist, however, for companies to structure or restructure their supply chains in a tax-efficient manner.

The fact remains that for most companies, a well-managed supply chain is a significant value driver. Particularly in the consumer products industry, companies have generally employed companies (buying agents) located close to the factory base producing the company’s products. Historically, these agents were predominantly located in Hong Kong, close to production sites in China. However, as Chinese labour rates rise, and companies increasingly look to other countries for sourcing, opportunities exist to restructure the supply chain to centralise management of the production functions and enable efficient expansion of the supply base.

Because production involves company employees performing labour-intensive activities, supply chain management, through buying agents, contains the economic substance necessary to support tax planning in a post-BEPS era.

Buying agents generally earn a commission as compensation for the services that they provide. The industry practice is that buying agent commissions are expressed as a percentage of the free-on-board (FOB) price of goods sourced through the buying agent.

A buying agent’s commission rate depends on a number of factors, including the variety of goods that the agent handles, the complexity of the manufacturing process, the functions provided by the agent, and the size of the territory that the agent covers.

Based on extensive industry experience, there is a direct relationship between the number, type, and intensity of functions performed by buying agents and the commission rates they earn, with agents that perform more specialised, high value-added functions earning higher commission rates.

According to US Customs, there are standard activities that buying agents characteristically engage in when acting as an intermediary between manufacturers and principals.

These activities include (but are not limited to):
- Compiling market information;
G L O B A L  O V E R V I E W

• Gathering samples;
• Translating;
• Informing the seller of the desires of the buyer;
• Locating suppliers;
• Placing orders based on the buyer’s instructions;
• Procuring the merchandise;
• Assisting in factory negotiation;
• Inspecting and packing merchandise; and
• Arranging for shipment and payment.

As compensation for providing these standard buying agent activities, agents generally earn average arm’s-length buying agent commission rates in the range of 5% to 10%.

In some cases, there is either a separate commission paid or a higher total commission rate charged for additional services performed by a buying agent that are beyond the scope of services typically provided by a buying agent.

High value-added services justifying higher or additional commissions include the following:
• Product design and pre-production engineering services;
• Artwork;
• Additional quality control procedures; and
• Certain product testing.

Because of income sourcing rules that exist in many jurisdictions, high value-added services can be performed in a tax efficient manner using arm’s-length transactions to support the fees charged.

These types of transactions are not the type for which the BEPS proposals are designed. Rather, these types of transactions reflect the economic substance-based tax planning that should be acceptable in a post-BEPS environment.

What companies can do now
The authors recommend that companies review certain aspects of their supply chain, including the following:

1) Where products sourced and what are the plans for expansion of the supply base?
2) Are products sourced through company-owned facilities or unrelated manufacturers?
3) Which company employees are involved in performing supply chain activities close to the manufacturing source base, and where are these employees located?
4) Which headquarters employees are involved in performing supply chain activities?
5) Are internal or external buying agents utilised to assist with the sourcing of products?

This information can help determine whether opportunities exist to structure or restructure the supply chain in a tax-efficient manner.
GETTING IT RIGHT.

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Recognized among the world’s leading international tax and transfer pricing advisers globally (World Tax and World Transfer Pricing, 2015)

Transfer Pricing Firm of the Year – USA (Finance Monthly Global Awards, 2013)

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BEPS: Tax avoidance and evasion regulations in Chile

María Carolina Camargo and Lorenzo Gálmez of PwC Chile explain how BEPS provisions are changing the avoidance and evasion regulations in Chile.

The latest Chilean tax reform was published on September 29 2014 with the introduction of the Law No. 20,780.

Among the most relevant changes introduced by the reform; an immediate and gradual increase of the corporate income tax and the enhancement of the local tax administration (Servicio de Impuestos Internos (SII)) auditing powers have generally been highlighted.

Together with the above, the tax reform, in line with the international guidelines, has introduced anti-evasion and anti-avoidance rules to ensure that taxable transactions cannot be avoided by the use of legal loopholes, sham dealings, or by artificially diminished taxable bases or delayed tax payment.

Meanwhile, the OECD has been publishing an action plan to deal with base erosion and profit shifting BEPS.
The objective of BEPS is to redesign the framework of international tax procedures and tap into the possibilities of tax planning that the globalised economy offers.

The actions established in the plan can be grouped into three categories: (1) general (2) related to tax transparency and related to international tax treaties in fiscal matters and (3) related to permanent establishment and transfer pricing.

The Chilean reform has set out key aspects of BEPS in the Chilean tax regulation such as controlled foreign company rules (CFC); stricter thin capitalisation rules; and a sort of substance over form principle. The entry into force rules of such tax package provides for different dates for many of its parts and pieces, but in general the anti-avoidance rules will be fully in force as from October 1 2015.

With a modified Chilean tax code and the greater SII powers to prevent tax evasion and facilitate voluntary compliance by taxpayers, transfer pricing methods, rules, compliance and overall awareness has become both a basic and crucial tool to control tax avoidance.

We may expect that under a tax/transfer pricing audit scenario, the SII will consider both the new local rules and the general BEPS action plans, and as such, multinationals should be prepared for it. Some examples below:

**Action Plan No 13: “Implementation of transfer pricing documentation and country by country report”**

BEPS Action Plan No 13 provides that tax administrations may request the local transfer pricing file and the master file with information about the global group, and would set out mechanisms for sharing the country by country report among them.

Although under Chilean local rules it is not mandatory to prepare and file a full transfer pricing report, local law requires taxpayers to yearly declare such transactions under a sworn affidavit stating which transfer pricing method has been applied on each one of them.

With the new local substance-over-form rules available and BEPS action plans being published, we may expect that the local SII will generally request to review, not only a local transfer pricing study, but also a country by country report where available. As such, and although not mandatory, having proper transfer pricing documentation is highly advisable because it will be the first and foremost tool to defend a taxpayer position under a transfer pricing audit.

**Action Plan No 4: “Limit base erosion via interest, deductions and other financial payments”**

New strict thin capitalisation rules in Chile, and new limitations for the recognition of taxable expenses related to cross border intercompany transactions, are again in line with BEPS.
Taxpayers may foresee an increment on tax audit in this regard, where the local authority will request proof over the necessity of any such expense, the reality of the transaction, the reasonableness of its conditions and pricing, and the fact that local taxes have been duly paid when applicable.

This modification seeks that the taxpayers pay taxes for the intercompany transactions where applicable and in consequence take only adequate tax deductions.

**Action Plan No 3: “controlled foreign company”**

In Action Plan 3 of BEPS, one of the sources of concern is the possibility of creating offshore entities and routing income through them to avoid or defer taxation.

The Chilean tax reform is also concerned about this and has incorporated CFC regulations for local taxpayers in Chile who must register passive income (dividends, interest, royalties, etcetera) generated by overseas entities that they control directly or indirectly and will be taxed on an accrued basis over such income. Taxpayers will therefore be required to report their passive income on a yearly basis.

**Action Plan No 10: “The transfer pricing aspects of cross-border commodity transactions”**

One of the most important action plan set-ups by the OECD, that can impact the Chilean jurisdiction, is Action Plan No 10. This plan deals with the tax administration concern about

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She has been working in transfer pricing for more than nine years, focusing on compliance, strategic planning, consulting in transfer pricing disputes and competent authorities procedures.

María Carolina has rendered services to a wide range of industries over the years that include: energy, pharmaceuticals, consumer goods, IT and telecommunications, among others.
the difficulty to obtain information to verify the price of commodities (including price date conventions and comparability adjustments).

Action Plan No 10 wants to ensure that pricing reflects value creation in relation with commodity transactions. The draft Action Plan No 10 proposes to add Chapter II into the OECD transfer pricing guidelines, whereby the comparable uncontrolled price method is included as an appropriate TP method for commodities, together with the adoption of a deemed pricing date for commodity transactions.

Although according to Action Plan No 10 draft, quoted prices and premium prices for commodities can be obtained from the transparent markets trading in commodities (for example London Metal Exchange, Chicago Board of Trade, Tokyo Grain Exchange) or from price reporting agencies (for example Platts, Argus or Bloomberg), for markets such as the
copper industry, it will be still difficult to ensure the accuracy of this information in relation to premiums, ever since this premium price will depend on specific market circumstances and the information found on specialised publications may or may not include related party transactions.

Even though this particular subject is not directly treated under local legislation – Chile, being a mining country – Action Plan No 10 will be of most relevance because it will somehow provide the SII with new guidelines for more effective audits over commodity transactions.

In our experience, the Chilean Tax Authority is keen to receive, negotiate, and work together with the taxpayers and the international tax authorities in the promotion of relevant tools such as advanced pricing agreement (APA), transfer pricing corresponding adjustments, mutual agreement procedures (MAP) initiated under the framework of a double tax convention, and other dealings that, although new to the local scenario, sometimes appear as the best or only way to avoid double taxation and/or to actually gain certainty over a rightful tax position on cross-border intercompany transactions.

Having proper transfer pricing documentation available and suitable legal implementation is essential when approaching the local SII on any of these matters.
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PwC Chile has been distinguished in 2014 as “Transfer Pricing Firm of the Year” in the prestigious International Tax Review Magazine.

100 years in Chile
David Forst and Larissa Neumann of Fenwick & West provide an overview of the recent developments in US transfer pricing litigation in the US. The IRS has been aggressively litigating transfer pricing cases and is likely to continue to aggressively pursue transfer pricing issues, especially cost sharing buy-in payments.

Former IRS chief economist, Bill Morgan, said the IRS is trying to take more, and better, cost sharing cases to court. According to Morgan, the IRS views transfer pricing litigation as preferable to a lengthy and difficult effort to revise the cost sharing regulations.

**Microsoft**

Microsoft is an example of a recent cost sharing buy-in payment transfer pricing dispute and the company could be facing a multi-billion-dollar adjustment.
The Microsoft transfer pricing adjustment made headlines when Microsoft sued to enforce a Freedom of Information Act (FOIA) request against the IRS for its use of an outside law firm, Quinn Emanuel Urquhart & Sullivan.

Quinn Emanuel will receive a fee of $2.2 million from the IRS. The use of an outside law firm demonstrates the IRS’s willingness to more vigorously litigate transfer pricing, even in the face of a number of significant past losses.

Since the IRS is spending such a large amount of money on the Quinn Emanuel fees, the stakes for the IRS are high. Spending more than two million dollars in outside fees is a significant cost for the IRS, especially if it loses. In addition, calling in an outside law firm demonstrates that the IRS is not confident in the ability of its own attorneys.

The IRS’s engagement of Quinn Emanuel has been met with skepticism and Microsoft may claim that the engagement is inappropriate. Quinn Emanuel will work collaboratively with the IRS, reviewing key documents (including reports, position papers, IDR responses, etcetera, prepared by, or on behalf of, the taxpayer or the IRS).

New, temporary, regulations, which allow private contractors to participate in the summons process, were issued a month after the contract with Quinn Emanuel was signed. However, the new temporary regulations apply retroactively “to summons interviews conducted on or after June 18 2014,” and would therefore cover the Microsoft summons.

The IRS and Quinn Emanuel will have more time to audit Microsoft, since the IRS initiated court proceedings to enforce a designated summons, which automatically suspends the statute of limitations.

The limitations period will remain open as long as Microsoft has not fully complied with any district court order resulting from the designated summons enforcement proceedings.

The IRS also filed a summons enforcement action in a Seattle federal district court seeking additional information about Microsoft’s examination.

The IRS requested:
- value proposition analyses;
- annual revenue and expense budgets and targets;
- return on R&D spending information;
- marketing investment and sales spending;
- brand and image tracking;
- strategic plans and market research;
- performance evaluations and milestone goals for Microsoft executives and sales personnel;
- and a breakdown of all Microsoft employees worldwide for each of the fiscal years from 2001 through 2006.

Microsoft objected to the demand for certain documents, including performance evaluations, strategic plans, and related external and internal communications. Microsoft characterised those demands as impermissibly overbroad and overly...
Microsoft also asserts that the production would be approximately 4,025 annual performance evaluations. Microsoft instead committed to produce the annual performance evaluations for senior vice presidents or higher in each business group.

The IRS also filed 12 additional petitions enforcing related summonses. Eight of the related summonses demand testimony from current and former Microsoft executives, including former CEO, Steven Ballmer. Two are summonses issued to EY and KPMG.

Microsoft claims that it has been responsive throughout the audit, producing approximately 1.2 million pages of documents and making over 50 employees available for interviews, in response to 220 information document requests from the IRS.

The IRS appears to be developing an argument to adjust the buy-in price Microsoft used for transferring intangibles to two offshore affiliates under two different cost-sharing arrangements (CSA).

The CSA in APAC, effective April 3 2004, was entered into with an affiliated Bermuda corporation, Microsoft Asia Island Ltd. (MAIL). Under that CSA, Microsoft transferred to MAIL various rights to both technology and non-technology intangibles used in its APAC retail business. Microsoft took the position that it owned only a fraction of the non-technology intangibles used in its APAC retail business. The CSA for Americas, effective July 1 2005, transferred to the offshore affiliate only technology intangibles, such as software code. The Americas CSA was entered into with a Puerto Rican entity, Microsoft Operations Puerto Rico LLC (MOPR).

The IRS summons seek details on how Microsoft internally valued the intangibles it transferred to the offshore affiliates. The government is looking for information on Microsoft’s valuation techniques and procedures.

Amazon

Amazon.com, Inc. v. Commissioner, T.C. Dkt. 31197-12, involves a cost sharing agreement with income adjustments of over $2 billion for the two years in issue.

Amazon involves the same “perpetual useful life” issue that was litigated in Veritas v. Commissioner, 133 T.C. 297 (2009). The IRS lost in Veritas. It is difficult for the IRS to argue for a perpetual life for technology intangibles. Technology is constantly evolving and is usually seen as becoming obsolete quickly. The Amazon trial took place in November of 2014 and was closed to the public.

The IRS valued the preexisting technology and marketing intangibles buy-in at more than 20 times the amount paid by Amazon’s Luxembourg subsidiary to Amazon. A study performed for the IRS by Horst Frisch found that the intangibles contributed had a value of $3.6 billion using a discounted cash flow with an 18% discount rate and a perpetual life.
The judge stated that he rejected an assumption of a 5% increase in the intangible development costs (IDCs) a year. He said that a higher projected IDC, perhaps as high as projected revenues, is the right number. The larger the IDC that is required the smaller the initial buy-in value should be, which is good for Amazon.

The judge also said that ongoing investments would be needed to keep the “technology up to snuff.” These statements by the judge would seem to undermine the IRS’s perpetual life argument and diminish the IRS’s chance of success in this case.

**Zimmer Holdings**

In *Zimmer Holdings, Inc. v. Commissioner*, T.C. No. 19073-14, the IRS presented three different alternative positions in its Notice of Deficiency.

First, section 482 applies and Zimmer’s income should be increased by just over $100 million for each of two years.

Second, in the alternative if the first argument is not successful, the IRS asserts that Zimmer’s income should be increased by amounts over $100 million (more than under the section 482 adjustments) based on transfers of intangible property to its Dutch subsidiary under section 367(d).

In the third and final alternative if the first two arguments are not successful, the IRS asserts that Zimmer’s taxable income should be increased by nearly $1 billion under section 367(a) based on the value of a licensing agreement, workforce-in-place and goodwill, allegedly transferred to a Dutch subsidiary.

**Medtronic**

*Medtronic v. Commissioner*, T.C. Dkt. 6944-11, involves sections 482 and 367(d). The company is challenging income adjustments for tax years 2005 and 2006.

The IRS is asserting a $1.35 billion transfer pricing adjustment related to the value of the intangibles and the resulting royalties owed by Medtronic’s Puerto Rican entity to Medtronic.

In the alternative, the IRS claims that if the royalty payments are found to be at arm’s-length, then there was a transfer of intangible property under section 367(d). Medtronic maintains that no such transfer occurred because the intangibles always remained with the US parent.

Also at issue is a $793 million dividends-received deduction under section 965. The parties have agreed to hold that issue until the primary transfer pricing issue is resolved.

Medtronic had an expert witness testify that because Medtronic makes medical devices, quality is a matter of life and death, therefore, the manufacturing process it critical and justifies the higher return that the Puerto Rican entity receives.
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David Forst is the practice group leader of the tax group of Fenwick & West. He is included in Euromoney’s Guide to the World’s Leading Tax Advisers. He is also included in Law and Business Research’s International Who’s Who of Corporate Tax Lawyers (for the last six years). David was named one of the top tax advisers in the western US by International Tax Review, is listed in Chambers USA America’s Leading Lawyers for Business (2011-2014), and has been named a Northern California Super Lawyer in Tax by San Francisco Magazine.

David’s practice focuses on international corporate and partnership taxation. He is a lecturer at Stanford Law School on international taxation. He is an editor of and regular contributor to the Journal of Taxation, where his publications have included articles on international joint ventures, international tax aspects of M&A, the dual consolidated loss regulations, and foreign currency issues. He is a regular contributor to the Journal of Passthrough Entities, where he writes a column on international issues. David is a frequent chair and speaker at tax conferences, including the NYU Tax Institute, the Tax Executives Institute, and the International Fiscal Association.

David graduated with an AB, cum laude, Phi Beta Kappa, from Princeton University’s Woodrow Wilson School of Public and International Affairs, and received his JD, with distinction, from Stanford Law School.

IRS training slides
The IRS made public a number of international training slides developed by LB&I’s international practice networks.

The “Section 482 Fundamentals” slide states that the IRS examiner should consider the “functions performed, assets employed, and risks assumed”. They refer to the recent transfer pricing roadmap. The slides state that the arm’s-length range can be determined “either on a full range or an interquartile range”, depending on the application of certain criteria. The slides also recommend interviews of key personnel.
Transfer pricing audit roadmap

In 2014 the IRS issued the transfer pricing audit roadmap, which is intended to be a guide to international examiners in developing a transfer pricing case.

According to the roadmap, the key in transfer pricing cases is to put together a compelling story of what drives the taxpayer’s financial success, based on a thorough analysis of functions, assets, and risks, and an accurate understanding of the relevant financial information. The roadmap states that fact-development is the “bread and butter” of exam teams – it is what they are trained for and good at. An effective story explains the taxpayer’s value chain, competitive position in its industry, and financial results, in a clear and compelling fashion.

The roadmap emphasises that even a strong position may not be sustained on review if it is not presented clearly and persuasively. A notice of proposed adjustment (NOPA) should have logical structure, and should weave the facts and applicable legal and economic principles together in a storyline that resonates with the reader. All the relevant facts – good and bad – should be addressed. The conclusion should come across as “inevitable”.

This sort of presentation lends credibility to the proposed adjustment, and increases the odds of early resolution or sustention on review.

The roadmap lists a number of items that Exam should review in developing a transfer pricing case, including:

1) Form 5471 – Information Return of US Person with Respect to Certain Foreign Corporations;
2) Form 5472 – Information Return of a 25% Foreign-Owned US Corporation or a Foreign Corporation Engaged in a US Trade or Business;
3) Form 8833 – Treaty-Based Return Position Disclosure;
4) Form 8858 – Information Return of US Persons with Respect to Foreign Disregarded Entities;
5) Form 8865 – Return of US Persons with Respect to Certain Foreign Partnerships;
6) Form 926 – Return by a U.S. Transferor of Property to a Foreign Corporation;
7) Uncertain Tax Positions (UTP) Disclosures; and
8) Schedule M-3 analysis

In addition, the roadmap states that, because transfer pricing studies are generally based on book financial information, it is helpful to become familiar with qualitative and quantitative information found in publicly available documents, such as SEC Form 10-Ks.

Other detailed information particularly useful for a transfer pricing review includes:

- research and development activity and location;
- descriptions of patents,
- trademarks and other IP;
- geographic and organisational structure;
- segmented operational and profitability level; and
Larissa Neumann focuses her practice on US tax planning, tax controversy, and tax litigation for corporations, with an emphasis on international transactions. She has broad experience advising US companies and foreign-based clients on the taxation of cross-border operations, acquisitions, dispositions, restructurings and transfer pricing issues. She has successfully represented clients in federal tax controversies at all levels and has substantial experience managing complex tax controversies. She represents clients from a diverse set of industries and geographic areas. Her clients range in size from high technology start-ups to large Fortune 500 companies.


Larissa received her J.D. from the University of California, Berkeley, School of Law in 2005. She received her M.A. in public health from Yale University in 2002 and her B.S. in molecular cell biology from University of California, Berkeley, in 2000.

Larissa frequently speaks on US corporate and international tax issues at conferences for professional tax groups, including Tax Executives Institute, International Fiscal Association, Pacific Rim Tax Institute, Bloomberg BNA, and the American Bar Association. She is a member of the ABA Section of Taxation and the International Fiscal Association.

Larissa has published several articles, including recently:

- Character and Source of Income from Internet Business Activities, The Contemporary Tax Journal (July 2011)

Fenwick & West has one of the World’s Top Tax Planning and Tax Transactional Practices, according to International Tax Review (2014), and is first tier in tax, according to World Tax 2014. International Tax Review gave Fenwick & West its San Francisco Tax Firm of the Year Award a total of five times and its US Tax Litigation Firm of the Year Award a total of three times.
• section 6662 documentation.
  Exam is instructed to hold a transfer pricing orientation
  with the taxpayer to include discussions of:
• the taxpayer’s background and the history of intercompany
  transactions;
• all intercompany transactions in the year(s) under exam;
• the taxpayer’s rationale for entering into the transactions;
• the taxpayer’s value chain(s) associated with the intangible,
  services and/or tangible goods;
• whether the intercompany transaction is associated with
  the transfer of an income stream, or contribution to the
  value, of any intangible; the functions performed, assets
  employed, and risks assumed by each controlled party of
  the respective intercompany transaction;
• how the preparer of the transfer pricing study gained
  knowledge of each controlled party’s functions performed,
  assets employed and risks assumed; and
• request supporting documents (interview notes, minutes).
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- Honored with multiple M&A tax awards, including Americas M&A Tax Firm of the Year
- Five of our partners are recognized in ITR’s Tax Controversy Leaders