



# Transfer Pricing Developments in 2012 and what to expect in 2013



Expert Transfer Pricing Services From Root to Branch

# Agenda

Promising developments of APA efficiency, challenges to the treatment of intangibles, and public skepticism of profit shifting will influence 2013.

## IRS Reorganization

IRS transfer pricing administration in the middle of various IRS restructuring. What will this mean?

## Canada stepping up to the APA Plate

From new leadership brings new opportunities and directions. Early success from the Canadian APA leadership.

## Global Pressures

Intangibles, Location Savings, and Profit Shifting.

## Significant Litigation

From the first Canadian Supreme Court Ruling. US Court cases of Note.

## Audit Trends

Transactions of Note from Canada and US perspective.

# IRS Restructuring

## Results from the IRS Restructuring include:

- 2010, Large and Midsize Business Division (“LMSB”) became Large Business and International Division (“LB&I”).
- International Practice Networks (“IPN”)
  - Inbound Transaction, Outbound Transactions
- Transfer Pricing Operations (“TPO”) is a practice now included in LB&I. TPO is headed by TP Director Sam Maruca (First TP Director, 2011)
- National Field program divided in 3 regions with 20 to 40 TP Professionals in each region.
- First Quarter 2012 - New Advance Pricing and Mutual Agreement Program (“APMA”)

# North American Advance Pricing Agreement Revival

## Public Comments and Experience indicate improvements in Advance Pricing Agreement Program:

- IRS Director of APMA , Richard McAlonan, disclosed recently the IRS completed 140 APAs in 2012
- CRA Director International and Large Business Directorate's Competent Authority Services Division, Sue Murray, has also indicated drastic improvements of Canada's competed APAs.
- Increased headcount – 55 staff for Canada that includes 35 economists. US APMA group has 120 staff that includes 60 new staff hires that consisted predominately of experienced transfer pricing professionals.
- In 2010-2011, the Canadian APA program applicants were directed to submit more detailed information upfront. This ensures applicants are committed, aware of transparency expectations, and weed out earlier those not suited for the APA program.
- US now rank APA cases according to difficulty for efficient staffing. Teams are assigned to geography – specifically now Canada, Japan and Rest of World.



# Global Pressures – Profit Shifting

## Recent headlines:

- Google avoided almost \$2b in taxes in 2011 by moving \$10billion to Bermuda unit
- SABMiller avoided \$30m a year in taxes in Africa and India
- American companies are thought \$1.6t in offshore accounts
- All but two of the firms in FTSE 100 have at least one off-shore subsidiary

## Recent developments:

- October 2012 US Congress hearings on “Offshore Profit Shifting and the US Tax Code”
- January 2013 UK’s Parliament Public Accounts Committee hearings
- February 2013 OECD’s Base Erosion and Profit Shifting Report

# Global Pressures – Profit Shifting

February 12, 2013 BEPS Report:

- Concrete recommendations to be provided to G-20 countries in June
- OECD is preparing an “action plan” regarding specific measures and a timetable for taking the implementation steps
- Six pressure Points Identified in the Report:
  - Transfer Pricing: The shifting of risks and intangibles
  - Application of treaty concepts from delivery of digital goods
  - Mismatches in entity and instrument characterization
  - Tax treatment of intragroup financial transactions
  - Effectiveness of anti-avoidance measures
  - Availability of harmful preferential regimes

# Global Pressures – Profit Shifting

## Current Tax Havens:

- 50-60 Tax Havens
- Over 2 million paper companies
- Cayman Islands-population 57,000 is the largest hedge fund domicile
- Bermuda population 65,000 is largest reinsurance domicile

# Global Pressures – Profit Shifting

If the arm's length standard is not working:

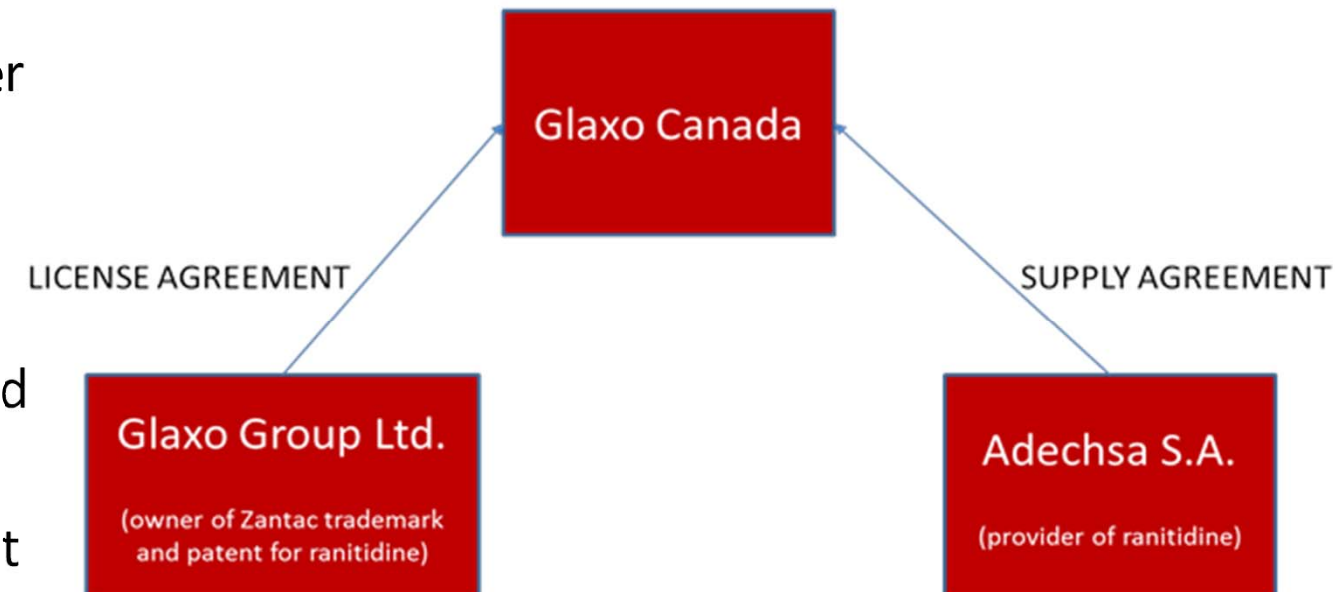
- Authorities may consider unitary tax or national regulatory rules similar to Brazil
- Increased disclosure of foreign country financials
- Taxation of foreign companies under domestic rules
- Require statutory auditors to confirm legitimacy of cross-border related party transactions similar to Mexico



# GlaxoSmithKline Canada Litigation

## Brief Summary

- Ranitidine – active pharmaceutical ingredient in blockbuster drug Zantac.
- Price paid by Ranitidine was between \$1,512 and \$1,651 per kilogram.
- Apotex and Novopharm, two generic Canadian companies, also purchased Ranitidine for \$194 and \$304 per kilogram.
- Glaxo Canada also paid 6% royalty on net sales of Zantac and other drugs.
- Glaxo Canada granted Zantac trademark and sold under that trademark.
- Apotex and Novopharm restricted and could not use Zantac tradename.



# GlaxoSmithKline Canada Dispute History:

- 1996 reassessment for 1990 to 1993 fiscal years for \$51 million.
  - CRA basis on a “transaction-by-transaction” approach.
  - Glaxo Canada argued that the price it paid was consistent with price paid by arm’s length marketing/distribution companies in Europe, elsewhere, who were subject to same licensing/marketing agreements
  - CRA argued that European distributors were subject to different patent rules, and had fixed/guaranteed selling prices from government bodies

# GlaxoSmithKline Canada Dispute History:

- 2008, The Tax Court of Canada finds for the CRA. Adds minor \$25 per kilogram increment due to processing differences.
  - Tax Court of Canada (TCC) found that the expression “reasonable in the circumstances” in s.69(2), limited the issue to the determination of the “fair market price” for Can-Sing transaction alone, based on its interpretation of *Singleton & Shell Canada*
  - TCC concurred with CRA position that the generic price was the “fair market price”, therefore was a comparable uncontrolled price (CUP)
  - TCC disregarded the licensing agreement for several reasons:
    - *Singleton/Shell* taken to mean that each transaction with each different entity should stand or fall on own merits on arm’s length standard
    - Neither the CRA nor GSK Canada disputed the royalty (withholding plus UK corp. tax worse than paying Canadian corp. tax ...)
    - Branded goods got a premium, but value of brand evidently limited given the extensive, intensive & expensive marketing efforts of GSK Canada

# GlaxoSmithKline Canada Dispute History:

- 2010 Federal Court of Appeal finds for Glaxo Canada and reverses TCC decision on the basis:
  - “reasonable in the circumstances” test requires all factors to be taken into consideration;
  - Zantac brand commanded premium over generics;
  - License Agreement granted GSK Canada access to a portfolio of products and services
- Therefore License Agreement must be included evaluation of transfer price; return case to TCC for proper evaluation

# GlaxoSmithKline Canada Dispute History:

- 2012 Supreme Court of Canada ‘weakly’ finds for Glaxo Canada and upheld FCA:
  - “Reasonable in *the entirety of the circumstances*” test is most appropriate
  - Gave short shift to TCC factual determinations re value of licensing agreement to GSK Canada
  - Followed FCA logic that the price needs to be determined based on the entirety of the transaction between GSK Canada and GSK group, not two transactions (GSK Canada & GSK UK, and between GSK Canada and “GSK Singapore”)
- SCC instructed the TCC in redetermination that:
  - 1) Licensing agreement is relevant; transaction is between GSK Canada and group overall
  - 2) Price, licensing agreement, value of IP and position of GSK Canada on royalty withholding (part XIII of the Act) should logically be consistent;
  - 3) Although parties did not address issue of royalty rate, withholding tax on royalties for IP and services paid to GSK Sing, value of IP and services, they may address that issue at retrial;
  - 4) Price should address fact that market places value on brand; generic mfg. co’s bought branded product from GSK Group;
  - 5) Reiterates that “transfer pricing is not an exact science” and that facts should be determined by trial judge; deference is due to TCC decision once all fact/issues properly considered = SCC does not want FCA to overturn TCC again

# GlaxoSmithKline Canada Dispute History:

- Upshot of decision:
  - Not that big of a win for GSK; issue of consistency between transfer pricing and withholding tax...
  - Opens up transfer pricing to all kinds of moves re “who owns what really does not matter, it is a group transaction”; really?
  - Not that relevant to the newer transfer pricing provision, no comments on newer OECD rules
  - SCC support for closer parsing of comparables
  - “As long as a transfer price is within what the court determines is a reasonable range, the requirements of the section should be satisfied. If it is not, the court might select a point within a range it considers reasonable in the circumstances based on an average, median, mode, or other appropriate statistical measure, having regard to the evidence that the court found to be relevant” (at para 61)
  - CRA has long held that ranges, medians and modes are not proper, SCC apparently says otherwise ...



# US Litigation

- Intersport Fashions West (Intersport) – U.S. Court of Federal Claims held that section 482 regulations prohibit a taxpayer from making any changes to the computation of transfer prices on an amended return if those changes would reduce the taxpayer's income.
  - Multiple avenues pursued and exhausted.
- Amazon.com Inc. (Parallels to Veritas) – IRS arguing buy-in payment for cost sharing arrangement was undervalued.
  - Veritas a significant defeat for the IRS that they did not appeal.
  - Addressing “perpetual useful life”.
  - Factual determinations key.

# Audit Trends

## Trends observed in 2012

- Audit focus and trends.
  - Intercompany Services – IRS increased emphasis, CRA remains high
  - Intangibles focus continues,
  - Intercompany lending transactions – increase emphasis by the IRS
- US Customs Policy five factors on post-importation adjustments.

# Audit Trends

## Trends observed in 2012: Royalty Payments for Intangibles

- **Key Concerns of Tax Authorities Related to Royalty Structures:**
  - › Economic substance of the transaction
  - › The facts and circumstances justify the methodology and remuneration
    - Is a royalty the appropriate way to recoup the value
    - Is the remuneration appropriate taking into account the specific facts of the transaction
  - › Bundling of transactions
    - Should the transaction be valued as a whole or the sum of its parts
    - Withholding tax and erosion of the tax base

# Audit Trends

## Trends observed in 2012

- Business Restructuring (and subsequent IP migration)
  - Global tax authorities are increasingly focusing on the restructuring of operations by multinational enterprises.
    - › Closer scrutiny of strategies that involve a “flight of functions”
      - Tax authorities are seeking to impute related-party compensation when a MNE unbundles functions/activities and moves them to another member of the corporate group particularly if a transfer of intangibles occurs. Examples include:
        - Conversion of full-fledged manufacturers into contract manufacturers
        - Conversion of full-fledged distributors into limited-risk distributors or commissionaire
        - Centralizing the procurement function for the entire group of companies
        - Creating intangible holding companies
  - Still uncertainty around whether related-party compensation is warranted for simply the flight of functions
    - Compensation not necessarily needed for the transfer/reduction of profit potential
    - Is workforce considered a compensable intangible

# Audit Trends

## Trends observed in 2012 Financial Transactions

- **CRA is prioritizing these transactions, but it is still a critical area of tax planning that is often overlooked, can assist with...**
  - › Deduction of interest against income otherwise taxed at a higher rate within the group;
  - › Utilization or preservation of foreign tax credits
  - › Minimization of foreign withholding tax on cross-border payments of dividends or interest;
  - › Matching foreign currency and interest rate risk management gains and losses with the corresponding items of gain or loss on the hedged exposure; and
  - › Utilizing tax treaties to minimize double taxation.

# Audit Trends

## Post-Importation Adjustments

- A written "Intercompany Transfer Pricing Determination Policy" is in place prior to importation and the policy is prepared consistent with IRS Code Section 482;
- The U.S. taxpayer uses its transfer pricing policy in filing its income tax return, and any adjustments resulting from the transfer pricing policy are reported or used by the taxpayer in filing its income tax return;
- The company's transfer pricing policy specifies how the transfer price and any adjustments are determined with respect to all products covered by the transfer pricing policy for which the value is to be adjusted;
- The company maintains and provides accounting details from its books and/or financial statements to support the claimed adjustments in the United States; and
- No other conditions exist that may affect the acceptance of the transfer price by CBP.



# Jonathan Garbutt



[jonathan.garbutt@taxchambers.ca](mailto:jonathan.garbutt@taxchambers.ca)

Tel: 416.847.7300

144 Front Street West

Suite 400

Toronto, Ontario

M5J 2L7

Jonathan N. Garbutt is a lawyer practicing Canadian income taxation and trusts and estates law. Jonathan is admitted to practice law in Ontario and in New York State.

Jonathan graduated from the University of Toronto Faculty of Law. Jonathan also holds a Bachelor of Arts from Université Laval (Quebec City), and a Masters Degree in International Political Economy from the Graduate School of International Political Economy at Tsukuba University in Japan.

Jonathan practices Canadian income tax law, including matters of general tax planning; global corporate tax minimization, tax advice for M&A, international private investment and tax controversy & litigation. Jonathan also has experience with international transfer pricing matters. Jonathan also practices Canadian trusts and estates law.



# Merv Edwards



Merv has over 20 years of experience providing transfer pricing documentation, planning, and defense services for multinational companies across a multitude of industries. His experience crosses a wide range of industries including technology, industrial goods, intellectual property, pharmaceutical, medical products, consumer goods, transportation, natural resources, oil and gas, heavy manufacturing, retail, telecommunications and financial. Merv manages a wide range of transfer pricing engagements including: Compliance, Planning and Implementation, Litigation Support, Expert Witness, Audit Defense, Competent Authority, and Advance Pricing Arrangements. Merv was a founding member of the Canada Revenue Agency's team that specialized in transfer pricing issues. Merv was also a founding member of KPMG Canada's specialty transfer pricing team where he assisted in developing a National Practice. He is a frequent speaker at conferences and seminars on transfer pricing issues and has published related articles. Merv has degrees in Commerce and Economics from the University of Toronto and is a Chartered Accountant.

**Direct: 416.850.1731**  
**Mobile: 416.737.6776**  
**Fax: 866.382.7445**

**merv.edwards@emgtp.com**  
**67 Mowat Avenue, Suite #135**  
**Toronto, ON M6K 3E3**

**EMG**  
Transfer Pricing Experts



# Dean Morris



As an economist with over 16 years of transfer pricing experience, Dean has developed and implemented a wide variety of economic analysis in the support for arm's length determinations. Dean has led transfer pricing projects across a variety of industries involving compliance, planning, and controversy engagements, and has been engaged in multiple projects specific to financial institutions and the pharmaceutical industry. Dean's education includes an undergraduate degree in honors economics from the University of Waterloo and a masters of business administration degree from McMaster University. Dean developed the international finance course for Mohawk College's post graduate international business program and taught the course for the first two years. In addition, Dean has spoken at numerous conferences and has written numerous articles on transfer pricing.

**Direct: 416.850.1751**  
**Mobile: 416.994.5286**  
**Fax: 866.382.7445**

**[dean.morris@emgtp.com](mailto:dean.morris@emgtp.com)**  
**67 Mowat Avenue, Suite #135**  
**Toronto, ON M6K 3E3**

**EMG**  
Transfer Pricing Experts