



Insights: Transfer Pricing

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October 2021

Third Quarter 2021 – Transfer pricing round up

In this edition of CRA's *Transfer Pricing Insights* we provide a round up of transfer pricing news for the third quarter of 2021 from the US, Germany, China, Hong Kong, and the OECD.

US

IRS update

The Office of the Chief Counsel of the IRS issued a memo titled “Section 482 Adjustments for Cost Sharing Agreements with Reverse Claw-Back.” The memo details the IRS view on the treatment of stock-based compensation (SBC) costs in cost-sharing arrangements that include a reverse claw-back provision where the taxpayer did not share SBC costs. In cost-sharing agreements, a claw-back provision allows a taxpayer to remove SBC from the cost pool if certain conditions occur. A reverse claw-back allows taxpayers who excluded SBC in their cost-sharing arrangements to include them if a trigger event occurs – in this case the final decision related to *Altera Corp v. Commissioner* matter – and as a result, taxpayers can make a true-up payment that quantifies the total SBC costs that should have been shared in past tax years.

The Office of the Chief Counsel identifies the issues to consider (see <https://www.irs.gov/pub/irao/am-2021-004.pdf> at p. 2) and concludes that:

“(1) Under Treas. Reg. § 1.482-7(i)(2), the IRS may make allocations to adjust the results of a CST (Cost Sharing Transaction) so that the results are consistent with an arm’s length result, including any allocations to make each controlled participant’s IDC (Intangible Development Cost) share equal to that participant’s RAB (Reasonably Anticipated Benefits) share....

(2) If the IRS adjusts the results of a CST for a taxable year to account for SBC costs, that adjustment should be treated as reducing the amount of any reverse claw-back true-up obligation by a corresponding amount, thereby avoiding an overpayment of the SBC costs.

(3) If allocations to adjust the results of a CST in the year the IDCs were incurred are not possible for certain years, the IRS may make other adjustments, if necessary, to reflect the contract or to ensure that the Non-SBC CS Agreement produces results that are consistent with an arm’s length result within the meaning of Treas. Reg. § 1.482-1(b)(1)...”¹

¹ <https://www.irs.gov/pub/irao/am-2021-004.pdf> at pp. 2-3.

State update

The State Intercompany Transactions Advisory Committee published an information exchange agreement in July which outlines the method by which states who want to pursue transfer pricing matters can share the same taxpayer information. As details are ironed out, there is concern about how confidential taxpayer information will be maintained.²

Germany

Germany's "Act to Modernise the Relief from Withholding Tax and the Certification of Capital Gains Tax," issued in June 2021, revised the provisions related to transfer pricing by

- Replacing the hierarchy of preferred transfer pricing methods (comparable uncontrolled price (CUP) method, resale method, and cost-plus method) to applying the "most suitable method."
- Ensuring that the functions and risks of an intercompany transaction are properly determined and are the basis of determining the arm's length price.
- Outlining new transfer pricing provisions related to the transfer or licensing of intangible assets. Intangible assets are defined similarly to OECD guidance and the owner of the intangible asset is required to compensate related entities that develop, enhance, maintain, protect, and exploit the intangible asset (i.e., the DEMPE concept)

Following on from this, the German Federal Ministry of Finance published its transfer pricing guidance in July 2021. These guidelines:

- Now refer to the OECD's transfer pricing guidelines, the "EU's Joint Transfer Pricing Forum publications," and the "UN Practical Manual on Transfer Pricing For Developing Countries."
- Specify the Ministry's stance on the arm's length pricing that mirrors the OECD transfer pricing guidelines.
- Have expanded the definition of related parties to include networks who may not be directly legally tied together but are considered related parties because they have a common commercial interest.
- Explain that the arm's length principle should not only determine if the intercompany pricing is reasonable, but also assess whether other terms and conditions of the intercompany transaction are appropriate.
- Provide specific guidance on service and financial transactions and intangible assets.

China

The Chinese State Administration of Taxation issued simplified procedures for advance pricing agreements (APA) on July 26, 2021 which include guidance on reducing transfer pricing risk and achieving tax certainty. The "Announcement of State Administration of Taxation on matters concerning the application of simple procedures for unilateral advance pricing arrangements" details that:

- The simplified procedures can only be used for unilateral APAs (and not bilateral or multilateral APAs)

² See <https://www.mtc.gov/getattachment/The-Commission/Committees/ALAS/ALAS-information-exchange-draft-7-7-16.pdf.aspx>

- The simplified rules apply to companies that, in the prior three tax years of the APA application, have transactions greater than RMB 40 million
- A taxpayer can apply for the simplified APA procedures if one of the three criteria listed below is met:
 - Three months prior to applying for the use of the simplified procedures, a taxpayer has provided contemporaneous information to the tax authority for the last three tax years.
 - An APA has already been in place for the last 10 tax years and the taxpayer has complied with the terms of the APA.
 - If a taxpayer has been involved in a tax investigation that led to a tax adjustment, the case is now closed.
- APA applications under the simplified processes will not be accepted under certain conditions, including but not limited to:
 - A transfer pricing adjustment is required by the tax authority, but that case has not closed.
 - The taxpayer has not completed a business transaction form or has completed it incorrectly or has not submitted contemporaneous data required under tax regulations.

When applying for the simplified APA process, taxpayers can:

- Apply for the APA to cover three to five tax years and a taxpayer can request for the APA to apply retroactively.
- Elect to choose whether to use the simplified APA process or the general APA procedures that already exist.
- Benefit from the fewer steps required under the unilateral APA simplified process which only has three steps (as opposed to the general APA process that includes six steps).
- Benefit from completing the entire process of negotiating and signing an APA within a year.

Hong Kong

On July 29, 2021, the Hong Kong Inland Revenue Department (IRD) issued its guidance on certain transfer pricing issues impacted by COVID-19. The IRD's guidance largely mirrors the OECD's "Guidance on the Transfer Pricing Implications of the COVID-19 Pandemic" dated December 2020 and reaffirms the arm's length principle to determine the transfer pricing of intercompany transactions.

The IRD states that it may be reasonable to (i) use a separate testing period for the duration of the pandemic, (ii) include loss-making comparables in benchmarking analysis, and (iii) include limited risk entities that have incurred losses if it can be determined that these losses would have occurred in an arm's length transaction.

Regarding APAs, the IRD is also aligned with the OECD's guidance that existing APAs should be upheld unless the critical assumptions that underline the APA have changed and would lead to a revision or cancelation of the existing APA. The IRD must be notified within a month if a taxpayer believes that circumstances exist that breach the existing APA.

OECD

Pillar One and Pillar Two update

At the beginning of Q3 2021, the OECD issued its “Statement on a Two-Pillar Solution to Address the Tax Challenges Arising From the Digitalisation of the Economy” which outlined the components of Pillar One and Pillar Two that have been agreed to by OECD members and the G20. According to the OECD, details of the implementation plan will be finalized by October 2021. See <https://www.oecd.org/tax/beps/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-july-2021.pdf>

Transfer pricing guidance update

In August 2021, the OECD published its country profiles on 20 countries which provide a very useful summary of domestic legislation related to transfer pricing, “including the arm's length principle, transfer pricing methods, comparability analysis, intangible property, intra-group services, cost contribution agreements, transfer pricing documentation, administrative approaches to avoiding and resolving disputes, safe harbours and other implementation measures. The information contained in these profiles is intended to clearly reflect the current state of countries' legislation and to indicate to what extent their rules follow the OECD Transfer Pricing Guidelines.” See <https://www.oecd.org/tax/transfer-pricing/transfer-pricing-country-profiles.htm>

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