Transfer Pricing for the International Practitioner

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Fall 2023 Transfer Pricing Forum Transfer Pricing Controversy

Multinational enterprises (MNEs) today face an increasing number of transfer pricing disputes, which may result in major legal and financial consequences for their various stakeholders. This issue of the Transfer Pricing Forum explores the topic of transfer pricing disputes to gain the unique perspectives of practitioners in each country.

1. In your jurisdiction, how do the tax authorities select taxpayers for audits for transfer pricing cases and what are their focus areas that could lead to transfer pricing audits? And what measures and technology do the tax authorities have available to capture the essential information?
2. Which approaches are followed by the tax authorities during transfer pricing audits and what are the key elements considered by courts when deciding on transfer pricing related disputes? Please describe a few recent cases or rulings as examples to help illustrate your explanation.
3. In relation to tax audits How can MNEs best prepare for potential disputes in light of the factors described in Questions 1 and 2, and what can they do to mitigate the risks of future disputes?

THE TRANSFER PRICING FORUM is designed to present a comparative study of typical transfer pricing issues by Country Panelists who are distinguished transfer pricing practitioners in major and emerging industrial countries. Their discussions focus on practical questions posed by guidance, case law and practice in their respective jurisdiction, with practical recommendations whenever appropriate.

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Argentina

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1. In your jurisdiction, how do the tax authorities select taxpayers for audits for transfer pricing cases and what are their focus areas that could lead to transfer pricing audits? And what measures and technology do the tax authorities have available to capture the essential information?

International exchange of tax information has been the triggering event for large transfer pricing disputes lately. For example, the Argentine Revenue Service ("ARS") has access to import and export prices of goods cleared through the Customs within the Mercosur area. Consequently, in the case of triangular transactions—quite common for exporters of primary products—which have experienced material pricing discrepancies between the values declared at the source market compared to the ones at destinations, a transfer pricing investigation is usually rapidly implemented. In such cases it is highly difficult to find agreement among the tax authorities involved concerning a sound pricing allocation along the supply chain. Despite the tax treaty framework dispute resolution mechanism, MNEs are expected to ground their affiliate's profit allocation policies on a jurisdiction-by-jurisdiction basis. Regionwide, this long-standing problem is expected to be eased after Brazil's decision to drop its former safe harbor transfer pricing framework to line up with the OECD Transfer Pricing Guidelines. It will certainly pave the way for consistent policies based on harmonic standards. While the Brazilian transitional rules allow taxpayers to migrate to OECD standards as of the current year, the lack of substantive rules is a practical deterrent. Business restructurings—including intangible asset reallocation—is another source of conflict, for it will certainly be less advantageous to implement such cross-border restructurings after the new framework is fully implemented.

International exchange of tax information within the Mercosur is conducted by the ARS online, in real time, so tax audit responses are quite immediate. While transfer pricing audits involve companies from almost every economic sector—services, goods, information technology, and financial transactions—the foods and primary products exporting industry is a common target in view of its revenue significance and the Mercosur tax information exchange. Additionally, such exporters are major contributors to the Central Bank dollar reserves, which is currently experiencing an unprecedented shrinkage. Consequently, the ARS focuses tax audits heavily on commodity exporters, who rely on related-party traders to overcome the domestic foreign-exchange restrictions applicable on their regular hedge transactions. The ARS burdens such exporters with the regular submission of detailed evidence aimed at establishing that the profits allocated to such intermediaries are commensurate to their assets, risks, and functions. However, profit split outcomes are not the ARS' preferred solution, for the local regulations imposed the burden to test the Argentine resident party. Once again, the likely outcome would be a price adjustment on the Argentine resident exporting company, which would be forced to generate a secondary adjustment in the trader's country.

In other cases, the ARS focuses its transfer pricing audits in selective industries, which may face common methodology challenges. For example, deciding whether Argentine based distributors of foreign MNEs should determine their transfer prices on a gross margin compared to an operating one is certainly quite common, for tax authorities are well versed in these kinds of controversies which are also revenue sensitive.

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In addition, tax authorities do select taxpayers for transfer pricing audits when they find inconsistencies in the transfer pricing report, unjustified changes in the methodology used in different fiscal years, regular losses after a startup period, market support payments, or the regular use of debit and credit notes to steer transfer prices ex-post.

2. Which approaches are followed by the tax authorities during transfer pricing audits and what are the key elements considered by courts when deciding on transfer pricing related disputes? Please describe a few recent cases or rulings as examples to help illustrate your explanation.

Robust documentation is essential to succeed in the Courts. For example, in the recently decided *Dart Sudamericana S.A.*[1] case ("*Dart*"), the Tax Court upheld the ARS assessment since the taxpayer argued that recurring losses were the result of an economic downturn cycle, which was not properly evidenced. In addition, while Argentine MNEs may be allowed to segregate extraordinary losses from their financial statements in special circumstances to ensure a better comparability with the market set, the Court ruled that the taxpayer had failed to substantiate it properly. In the Court's opinion, a grounded capacity adjustment requires evidencing the theoretical maximum production capacity, the regular production amount, and the actual production figure during the economic downturn, which should be properly compared with the set of comparables.

Conversely, grounded documentation supporting such loss-segregation adjustments was upheld in a recent car industry case involving *Scania Argentina S.A.*[2] ("*Scania*"), where the court fully sided with the taxpayer. The taxpayer properly elaborated its idle capacity adjustment in its transfer pricing study, which was subsequently defended in the Courts through economic, accounting, and engineering witness experts' analysis. Such experts consistently concluded that the extraordinary losses were the consequence of material fixed costs that could not be set off against the reduced sales volume resulting from an unprofitable business cycle. The negative business cycle, the evidence of governmental policies adversely affecting the car-manufacturing industry, and the regional economic downturn were properly verified.

The Tax Court also places a heavier burden of proof on the party that provides less substantiated transfer pricing reports. For example, in *Dart*, the Tax Court sustained that a taxpayer may not make unilateral loss-segregation adjustments unless it proves that the comparables did not experience similar extraordinary losses. The outcome is opposite to the one reached for the car industry, which has been historically more diligent at the time of substantiating idle capacity or similar loss-segregation adjustments.

3. How can MNEs best prepare for potential disputes in light of the factors described in Questions 1 and 2, and what can they do to mitigate the risks of future disputes?

Methodology changes over the years must be well supported. Operating transfer pricing is essential in countries like Argentina in which the Customs Code does not allow for true up, true down, or similar price adjustments. In fact, recent case law from the Tax Court Customs Chambers may even expose the taxpayer

[1] Federal Tax Court, Chamber "A", March 30, 2023.

[2] Federal Tax Court, Chamber "A", April 17, 2023.

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to Customs penalties in case of material inconsistencies between the transfer pricing policies and the Customs declaration. In fact, in the *Maltería Pampa S.A.*[3] case ("*Maltería Pampa*"), the Tax Court sustained the argument that if the taxpayer did recognize that an affiliated trader was unsubstantiated, the Customs could validly impose penalties for the profit that was allocated to such trader and deprived from the export proceeds subject to Customs declaration. For this reason, operating transfer pricing is very relevant for transfer pricing and Customs law to mitigate the need for material ex-post adjustments.

Concerning triangular transactions on commodity exporters, the Federal Supreme Court recently sided with the taxpayer in the long-standing case of *Vicentin*.[4] The Upper Tribunal sustained that Presidential Decree 916/04 was null and void from a constitutional viewpoint since it violated the legality principle. While this specific framework is no longer in force, the case is relevant not only for the material tax controversies yet waiting for such a leading case decision but also for the relevance that the Court ponders on the full affiliation along the supply chain at the time of grounding a transfer pricing adjustment on triangular transactions.

Finally, *Dart* illustrates various pitfalls usually encountered in transfer pricing controversies:

1. Changing the transfer pricing methodology without a grounded reason. The taxpayer had used the transactional net margin method in the transfer pricing report but included a comparable uncontrolled price analysis in the Court discussion, based on the fact that CUP data was not available beforehand. The Tax Court reacted by imposing a high burden of proof on the taxpayer to back up this CUP, which was finally dismissed.
2. Use of comparable companies with material losses, without evidencing how such losses did not compromise the arm's length pricing outcome. Two of the comparables experienced business restructuring expenses. The taxpayer's single argument that such expenses were accounted separately from the operating margin did not suffice.
3. Regular losses experienced by the taxpayer over the years were also pondered negatively and further resulted in a higher burden of proof on the taxpayer.

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[3] *Federal Tax Court, Chamber, Chamber "E", October 6, 2021.*

[4] Federal Supreme Court, 5.3.23, "Vicentín SAIC c/Estado Nacional – Poder Ejecutivo s/civil y comercial – Varios" https://www.cronista.com/negocios/la-corte-suprema-le-dio-la-razon-a-vicentin-en-un-juicio-con-el-gobierno-por-el-impuesto-a-las-ganancias/; https://www.diariojudicial.com/news-94956-un-corte-a-la-reglamentacion-tributaria-en-exceso; https://abogados.com.ar/precios-de-transferencia-la-sentencia-de-la-corte-sobre-la-extension-del-sexto-metodo/32755.

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Australia

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1. How does the ATO select taxpayers for audits for transfer pricing cases and what are their focus areas that could lead to transfer pricing audits? And what measures and technology do the tax authorities have available to capture the essential information?

The Australian Tax Office (ATO) principally gains its information from annually filed international dealings schedules (IDS), the Country-by-Country Reporting (CbCR) forms, and income tax returns (ITRs). In Australia, the preparation of TP documentation is recommended on a self-assessment basis but not mandatory. However, not having compliant contemporaneous TP documentation in place can result in high penalties and TP adjustments if challenged by the ATO.

MNEs with aggregated amounts of international related party dealings (IRPDs) greater than 2 million Australian dollars (AUD) are required to disclose the details of their IRPDs including the level of compliant transfer pricing documentation in the International Dealings Schedule (IDS) which is required to be completed and lodged with their annual income tax return (ITR).

The ATO has for many years compiled data from the CbC report, IDS and ITRs into its comprehensive databases, which are then screened using algorithms from which the ATO assesses risks of non-compliance, tax avoidance and profit shifting. The ATO uses the extracted data to plan and strategize for its risk review assessment programs and campaigns of Australian inbound and outbound MNEs. For example, the 2023 Company Tax Return form contains a number of questions designed to elicit information that will help the ATO target its compliance activities:

- Company reconciliation items – section 46FA deductions for flow-on dividends (Label C Q 7), offshore banking unit adjustments (Label P Q 7);
- Overseas transactions – interest expenses overseas (Label J Q 6), royalty expenses overseas (Label W Q 6);
- International related party dealings - was the aggregate amount of the transactions or dealings with international related parties (including the value of property transferred or the balance outstanding on any loans) greater than 2 million AUD? (Label X Q 26); and
- Overseas interests – did the taxpayer have overseas branch operations or a direct or indirect interest in a foreign trust, foreign company, controlled foreign entity or a transferor trust? (Label Z Q 28)

The ATO's activities through these programs involving audits, risk reviews and Practical Compliance Guidelines (PCGs) have over the years provided practitioners with profound insights into the ATO's expectations and thinking regarding TP documentation and what is perceived as low-risk TP frameworks. Further, this has solidified the ATO's approach to documentation away from a pure pricing/benchmarking

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exercise, demonstrating that the IRPDs are following the arm's length principle (ALP) towards an approach of providing supporting contemporaneous evidence of the behaviour and motivation of the IRPDs or global TP structure being in harmony with the ALP.

Since 2019, the ATO have also been developing an Artificial Intelligence system which utilizes a similar algorithm to those used on platforms such as Google and LinkedIn. The system known as 'ANGIE' (Automated Network & Grouping Identification Engine) facilitates the identification of suspicious activity within the complicated affairs of MNEs and large private groups.

The system produces a network of maps connecting corporate entities and their related transactions across time. This information enables the ATO to identify "patterns of interest" based on common linkages. ANGIE has been used by ATO staff to scrutinize the integrity of corporate structures and transactions.

2. Which approaches are followed by the ATO during transfer pricing audits and what are the key elements considered by courts when deciding on transfer pricing related disputes? Please describe a few recent cases or rulings as examples to help illustrate your explanation.

The enactment of fundamental changes to the transfer pricing provisions in *Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Act 2013* significantly expanded the ability of the Commissioner of Taxation to amend assessments on transfer pricing grounds.

In *Roche Products Limited v Federal Commissioner of Taxation* (2008) 70 ATR 703 and *Federal Commissioner of Taxation v SNF (Australia) Pty Ltd* (2011) 193 FCR 149, the Commissioner was unsuccessful in applying profit-based methods for the purpose of determining arm's length consideration for intra-group transactions. Both the Administrative Appeals Tribunal (**AAT**) and the Federal Court of Australia preferred transaction-based methods. In addition, the Federal Court of Australia in *SNF Australia* cast doubt on the ability of the Commissioner and taxpayers to rely upon the OECD's *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD Guidelines).

Subdivision 815-B replaced Division 13 of Part III of the 1936 Act and Subdivision 815-A from 1 July 2013. Unlike the provisions in Division 13 and Subdivision 815-A, Subdivision 815-B is self-executing. The other critical provision is s 815-115, which provides that if an entity gets a *transfer pricing benefit* from conditions that operate between the entity and another entity in connection with their commercial and financial relations, those conditions are replaced with the arm's length conditions. The conditions that operate include, but are not limited to, such things as price, gross margin, net profit, and the division of profits between the entities.

The regime shift is also apparent in the numerous Practical Compliance Guidelines (PCGs) the ATO have released since 2016. The PCGs are indeed helpful as they showcase ATO's thinking and expectations and outline the ATO's consideration of what is viewed as low risk (unlikely to require scrutiny) and high risk (likely to attract scrutiny). The higher the risk rating, the more likely the ATO will review the MNE's arrangement. Most of the PCGs also provide examples of arrangements ranked according to the ATO's risk assessments. These examples are very useful and provide almost recipe-like instructions for a successful entry into the Australian market with minimized risks of scrutiny by the ATO.

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Some of the most useful PCGs include:

- PCG 2017/1 – ATO compliance approach to TP issues related to centralized operating models involving procurement, marketing, sales, and distribution functions;
- PCG 2017/2 – Simplified transfer pricing record-keeping options;
- PCG 2017/4 – ATO compliance approach to taxation issues associated with cross-border related party financing arrangements and related transactions;
- PCG 2019/1 – Transfer pricing issues related to inbound distribution agreements;
- PCG 2020/7 – ATO compliance approach to the arm's length debt test;
- PCG 2021/5 – Imported hybrid mismatch rule – ATO's compliance approach (mismatches on account of arrangements between deductions and/or non-inclusions of payment between jurisdictions); and
- PCG 2023/D2: Intangible arrangements.

The ATO's Practical Compliance Guideline program also serves to highlight its areas of focus. The ATO is strategically focused on closing the net tax gap of 7% (being the overall tax gap - the difference between revenue actually collected and revenue expected to be collected) of $33.4 billion (AUD) as a proportion of the expected revenue collected of approximately $480 billion (AUD)), with a specific focus on MNEs and private groups. This initiative entails an expansion of the ATO's task force and the introduction of targeted compliance programs. For example, the release of PCG 2017/4 highlights that the ATO will be focussed on intra-financing arrangements of multinational companies. Similarly, PCG 2023/D2 serves notice that the ATO will be targeting arrangements involving intellectual property migration and embedded royalties.

While the legislature has provided the ATO with broad powers in relation to transfer pricing matters, by contrast, the Courts have been more circumspect. The Full Federal Court decision in *Commissioner of Taxation v Glencore Investment Pty Ltd* [2020] FCAFC 187 is evidence of the practical and sensible approach undertaken by the Courts. This judgment was significant because it provided further clarity to Australia's transfer pricing rules and, in particular, further elucidated key aspects of previous Full Federal Court decisions.

The *Glencore Case* provided novel insights into the application of Australia's transfer pricing rules to an integrated global business, particularly with respect to how the rules take into account the commercial and market risks impacting such a business. Specifically, the key lesson learned from this case is that related party transactions should be conducted in the following manner:

- The form of an arrangement should be consistent with its substance;
- All arrangements, agreements, and contracts between related parties should be thoroughly documented; and
- Contracts made between related parties should be commercially realistic and consistent with dealings undertaken by unrelated third parties.

The ATO, however, have been successful in a decision which confirms and follows the landmark *Chevron* decision - *Singapore Telecom Australia Investments Pty Ltd v Commissioner of Taxation* [2021] FCA 1597 (SingTel). This decision represents a further key development in the Australian transfer pricing landscape.

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In *SingTel*, the TP provisions operated to partially deny interest deductions on intra-group debt issued in 2002 in connection with the acquisition of Optus by the SingTel group. While the decision reflects an application of the principles emanating from *Chevron* rather than any significant development in the law, it does demonstrate that the Commissioner was once again successful in establishing that parental support should be hypothesised thereby significantly reducing the interest rate for Australian deductibility.

As with the *Glencore* FFCT decision, the *Singtel Case* was concerned with the application of Division 13 and Subdivision 815-A of the Income Tax Assessment Act. Accordingly, the question which many taxpayers with arrangements outside the ambit of those provisions will be asking is whether the implications may be quarantined to those matters heard under Division 13 or Subdivision 815-A and how the approach of the Courts in the *Chevron* and *SingTel* cases may apply to matters heard where Subdivision 815-B applies.

Notwithstanding amendments to the transfer pricing rules, the arm's length principle continues to underpin all of the provisions. Accordingly, it is arguable that the provisions have the same overriding objective even though the text of the legislation and therefore the statutory tests are markedly different. While there will be technical differences between the cases determined under the current and previous provisions, it is considered that both *Chevron* and *SingTel* nevertheless provide valuable guidance on economically relevant conditions and practical considerations in assessing transfer pricing risk associated with cross border financing arrangements under Subdivision 815-B of the ITAA 1997. Similar arguments could be made in respect of the precedential value of the FFC judgment in the *Glencore Case*.

With the ATO becoming increasingly concerned with cross border financing, the necessity of comprehensively documenting related party financing arrangements is paramount. PCG 2017/4 provides a guide to taxpayers to undertake a risk assessment against the Commissioner's compliance approach and outlines what evidence may be gathered in the event of a review.

3. How can MNEs best prepare for potential disputes in light of the factors described in Questions 1 and 2, and what can they do to mitigate the risks of future disputes?

As evidenced by the preceding discussion and the numerous PCGs, risk reviews and court cases, the ATO is clearly signalling that supporting contemporaneous evidence on the behavioural/motivational aspect is much stronger than retrospective benchmarking. The authors also find that there are other issues with applying the retrospective benchmarking approach to fulfill TP documentation compliance and obligations, such as:

- Australia is running out of comparable local independent benchmarks for MNEs;
- It is a backdated approach in a proactive forward-looking and moving business environment; and
- Revisiting and updating TP documentation on an annual basis will most likely be more costly over time and will not provide MNEs with optimal protection if challenged by the ATO.

The authors have for some time now been using the concept of compiling contemporaneous evidence of the commercial reasoning to the IRPDs when preparing TP documentation. The authors believe this approach also gets ahead of the current and upcoming challenges facing MNEs and will further ensure bulletproof TP positions in the future.

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This change in approach to TP documentation can be used on any scale for both inbound and outbound MNEs. The authors emphasize customizing the approach to the individual situation and circumstances and ensuring a balance between risk exposure and compliance burden and costs for the MNE.

The authors' approach includes the following benefits:

- Holistic and will change as businesses move and expand;
- Examines the entire value chain;
- Can be included in the business decision model;
- Can easily be converted into a global TP policy and intercompany agreements;
- Annual compliance burden becomes a trivial and immaterial exercise;
- Can assist in complying with PCGs' and new requirements from BEPS like Pillar One & Pillar Two; and
- Assist with APA application and risk review/audit defense through supporting evidence and a documentation trail.

Regardless of the size of the MNE, with TP risks exposure and new compliance challenges coming from the ATO and the OECD, the authors highly recommend a shift in mindset to a holistic forward-looking approach. Irrespective of new rules, guidelines, or whether consensus is met for Pillar One or Pillar Two or other ambitious OECD recommendations, a proactive approach to the TP position will make it much easier to tackle the new challenges. A TP position should be based on actual commercial decisions and business plans and therefore should be documenting that the behavioral and motivational aspects of the IRPDs are at arm's length and follow the relevant PCGs. This will make the TP position more likely to be assessed as low risk if challenged by the ATO.

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Austria

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1. In your jurisdiction, how do the tax authorities select taxpayers for audits for transfer pricing cases and what are their focus areas that could lead to transfer pricing audits? And what measures and technology do the tax authorities have available to capture the essential information?

In Austria, there are no specific transfer pricing tax audits. Instead, such audits generally cover all corporate income tax, VAT and withholding tax matters of corporate taxpayers. Taxpayers are selected based on different selection criteria, such as certain industries being in the focus of auditors or irregularities reported in the financial KPI information to be included in the tax return for specific fiscal years. In general, the selection of the companies to be audited is made by means of an automatically generated mathematical selection, time selection (selection of the longest past unaudited periods), or individual selection. The latter can be based on separate instructions or notifications but can also be occasion-related due to specific perceptions of the tax authorities, such as inconsistencies in tax returns or changes in legal relationships. In 2016, the predictive analytics competence center was established in Austria, with the aim of ensuring that potential tax risks and thus tax audits requirements are identified early. Lately, DAC 6 reportings have initiated tax audit proceedings, and the related software support has been introduced. Overall, transfer pricing has been receiving an ever-increasing focus in all tax audits.

2. Which approaches are followed by the tax authorities during transfer pricing audits and what are the key elements considered by courts when deciding on transfer pricing related disputes? Please describe a few recent cases or rulings as examples to help illustrate your explanation.

In the context of tax audits, the trend continues of taxpayers increasingly having to explain the commercial soundness of their interactions with related parties and to indicate any realistic options they may have with respect to such interactions.

In their daily practice, the authors have also observed an uptick in the requirement for solid documentation to prove that transactions were commercially meaningful and at arm's length. What is more, the Austrian tax authorities often not only ask for proper documentation of an entity's functions, and risks and assets (i.e., by way of a functional analysis in the local file) but also for details of its contribution to the group's value chain and evidence that the direct-benefit test is met. Even though it is not required by the Austrian Transfer Pricing Documentation Act ("VPDG"), the Austrian tax authorities are increasingly keen to see an entire value chain analysis as part of the transfer pricing documentation. Additionally, in the context of a tax audit, tax authorities have recently begun to test transfer pricing models against a simulated profit split. Care must therefore be taken as to what information is disclosed in the transfer pricing documentation so that local tax authorities are not "invited" to test existing transfer pricing models against a profit split simulation.

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Recent Austrian tax audits show an increased focus on license payments between associated companies. The Austrian tax administration regularly denies the deductibility of license fees based on the attribution rules of Chapter 6 of the OECD Transfer Pricing Guidelines 2017, taking a close look as to which company carries out the DEMPE functions. Further, the tax authorities also regularly object to the amount of the license payments, often labelling such license payments as hidden profit distribution on the basis that the intention "obviously" was to grant an advantage to the shareholder.

It needs to be emphasized that negotiating with the tax auditors to keep the number of complaints as low as possible and to avoid future legal proceedings has become rather scarce during the last two years. In fact, the Austrian tax authorities have become quite intimidated by the Austrian Central Public Prosecutor's Office for Combating Economic Crime and Corruption (WKStA), as some of their colleagues had to explain themselves in front of the WKStA for lenient determinations during tax audits. It seems that for all transactions that involve a lower tax counterpart, tax authorities prefer the courts to make the decision, even if the case is well grounded from a transfer pricing perspective. This way, they avoid any risk of a possible hearing.

3. How can MNEs best prepare for potential disputes in light of the factors described in Questions 1 and 2, and what can they do to mitigate the risks of future disputes?

The best defense is always to have a transfer pricing set-up which transparently reflects commercial reality. The transfer pricing documentation should be "an easy read" and should also ensure that the transfer prices make sense from the perspective of a "prudent business man" for the group entities concerned. Appropriate documentation and defense papers should be set up before or at the beginning of the transaction at the latest.

Austrian taxpayers do have the possibility to obtain a legally binding ruling on transfer pricing issues pursuant to Section 118 of the Austrian Federal Fiscal Code. Upon written request, the Austrian tax administration is required to issue an information notice on the assessment of a fact pattern that has not yet been realized at the time of the request. In such a ruling the following transfer pricing issues can be discussed:

1) choice of the most suitable transfer pricing method;
2) application of a specific transfer pricing method (e.g., determination of cost basis, categorization of services); and
3) acceptability of the use of benchmarking studies for the search of comparative values.

One of the main weaknesses of such a ruling application, pursuant to Section 118 of the Austrian Federal Fiscal Code, is that the tax authorities are only obliged to review the underlying facts to a limited extent (in line with recent jurisdiction). This may be a matter for a potential subsequent tax audit. Further, the Austrian tax authorities do not carry out an official examination of the comparability of the chosen final comparables but merely confirm the appropriateness of the chosen search strategy. Thus, there is no final legal certainty that the median as well as the interquartile range of the benchmarking will withstand scrutiny by the tax audit.

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At present, rulings on transfer pricing questions are quite time consuming, which is partly due to staff shortages at the respective department of the Austrian tax administration and partly due to a decision of the Austrian court of first instance, which ruled that tax authorities only have a limited obligation to analyze the plausibility of the fact pattern. Thus, it regularly takes up to a year for the ruling to be issued. APAs are also possible but may consume even more time.

Austria further participates in the International Compliance Assurance Program (ICAP), which has been implemented under § 118b of the Austrian Federal Fiscal Code.

Contributors

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Belgium

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1. In your jurisdiction, how do the tax authorities select taxpayers for audits for transfer pricing cases and what are their focus areas that could lead to transfer pricing audits? And what measures and technology do the tax authorities have available to capture the essential information?

Over the past few years, the transfer pricing audit environment has significantly evolved in Belgium, reshaping the way the tax authorities gather information and identify "red flags" from a transfer pricing perspective. Historically, the Belgian tax authorities ("BTA") were mostly focused on the general analysis of published statutory accounts and submitted corporate income tax returns from the taxpayers, but this has changed.

Since Belgium introduced[1] the requirement to submit transfer pricing compliance forms (corresponding to each layer of the OECD three-tier structure of the transfer pricing documentation), the BTA have been receiving high numbers of structured transfer pricing data from Belgian taxpayers since 2017. The accumulation of such data in e-format for more than five years has ushered in a new era of opportunities in the realm of transfer pricing audits in Belgium.

In addition to the Local File forms submitted, the BTA are also using other available sources of information in the context of transfer pricing audits, including the Master File form, Country-by-Country Reports, advanced pricing agreements/rulings exchanged between tax authorities, and DAC 6 reportable transactions.

Although the tax authorities[2] have applied datamining tools in the selection of the transfer pricing audits in the past, the substantial increase in relevant information available at the level of the tax authorities has transformed the transfer pricing datamining tool into a powerful audit selection tool. The structure of the information included in the Local File Form is especially useful in enabling the tax audit selection tools to easily identify taxpayers with a higher transfer pricing risk fact pattern.

The authors observe in practice that the following types of elements and changes in the Local File form are likely to be taken into account for transfer pricing audit selection purposes:

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[1] Articles 185, 321/1 – 321/7, and 445 (Section 3) of the Belgian Income Tax Code ("BITC"), as embedded through the Program Law of July 1, 2016, and the related Royal Decree of October 28, 2016.
[2] For a detailed analysis of the structure and activities of the General Administration of Taxation with respect to transfer pricing audits in Belgium, *see*:
https://kpmg.com/be/en/home/insights/2021/03/txl-an-overview-of-tax-audits-in-belgium.html

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- Changes in the ownership structure of the taxpayer;
- Participation of the taxpayer in the business restructuring(s) and/or transfer of intangible assets (a specific box has to be ticked in the Local File form when this is the case);
- Recurring operating losses of the taxpayer;
- Important volumes of intercompany transactions;
- Significant fluctuations in the volumes of intercompany transactions and mismatch with the actual related-party payables and receivables of the company;
- Significant transactions involving royalties and intangible assets;
- Significant balance amounts of intercompany financing transactions with a lack of the actual interest accrued thereof (including cash pool related information, which is to be separately indicated in the Local File form);
- Lack of transfer pricing policies/documentation/benchmarking studies;
- Abnormal trends or mismatches in the allocation of remaining profit or loss to the permanent establishments of the taxpayer.

Most often, it is a combination of several of the above elements that gives rise to the initiation of a transfer pricing audit in Belgium.

In addition, the BTA also monitor the submission of the Master File Forms and Country-by-County Reports ("CbCR")/CbCR Notifications. Concerning the CbCR, there have been several discussions between the BTA and MNEs over the past year, with the aim of understanding and adjusting the CbCR data of MNEs rather than auditing the MNEs.

As mentioned above, the BTA are also adequately equipped to capture essential information for transfer pricing audit purposes through other instruments – such as DAC6 reporting as well as the exchange and review of rulings with the tax authorities from other tax jurisdictions. To a more limited extent, there is also an exchange of information between various departments within the BTA (e.g., with the VAT, Personal Tax, Customs, Corporate tax) to detect anomalies, inconsistencies, or patterns that may indicate tax evasion or non-compliance.

In terms of specific measures and technology, the BTA are harnessing the power of datamining tools to flag irregularities in the intercompany transactions and to identify potential risk patterns from a Belgian transfer pricing perspective. Moving toward digital reporting and compliance systems not only reduces paperwork for the BTA but also enables accurate monitoring of reporting and compliance, as well as exchange of information with the tax authorities from other countries, enhancing transparency and collaboration to resolve disputes in the transfer pricing area.

With respect to artificial intelligence ("AI"), the authors are not aware of specific AI-powered transfer pricing tools being used by the BTA to review information before or during transfer pricing audits. The BTA do, however, stay abreast of publicly available sources of information (e.g., LinkedIn profiles, websites, quarterly MNE reporting and communications toward investors and other stakeholders, public news, etc.).

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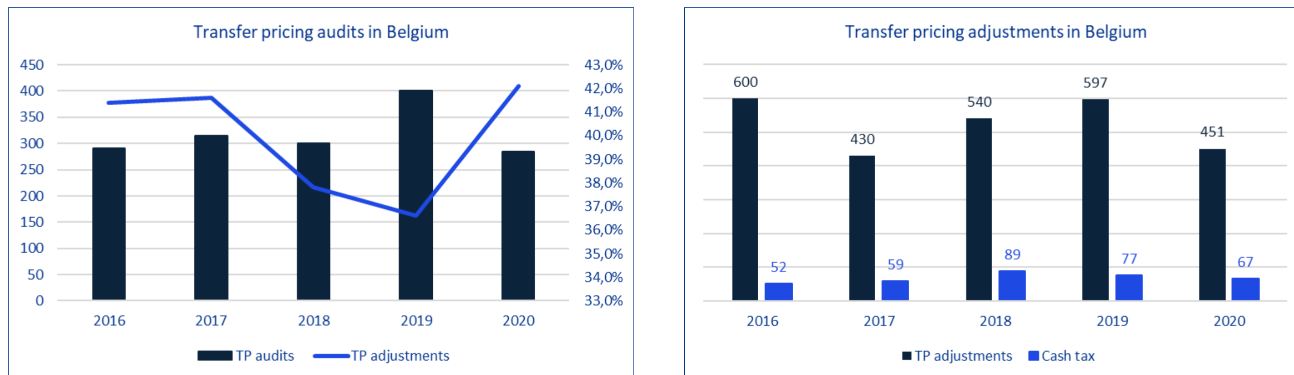
2. Which approaches are followed by the tax authorities during transfer pricing audits and what are the key elements considered by courts when deciding on transfer pricing related disputes? Please describe a few recent cases or rulings as examples to help illustrate your explanation.

Since 2020, the approaches followed by the Belgian tax authorities during transfer pricing audits have become increasingly aggressive, resulting in less settlements and exacerbating the controversy. The tables below include the latest published statistics in this respect:



Source: Statistics from the Belgian tax authorities (ref. Parliamentary question – Marco Van Hees – 10/02/2021)

The approaches to the audit can vary depending on the transfer pricing inspectors and their backgrounds. Some tax inspectors are no longer only testing the arm's length character of the transfer pricing arrangements but also attempting to identify the maximal adjustment possible while scrutinizing the intercompany transactions. The authors therefore expect more frequent use of judicial procedures and additional procedures meant to eliminate double taxation, including Mutual Agreement Procedures in the future.

A number of Belgian transfer pricing court cases are available to provide guidance.

In one specific court case, the inspectors tried to challenge the arm's length character of certain transactions while providing only limited evidence that such rectifications had been correctly applied (court case 2016/AR/455 (Ghent Court of Appeal, June 8, 2021)). The tax authorities' argument was not accepted, as it was based on Art. 26 of the Belgian Income Tax Code ("BITC"), which requires proof by the BTA of the existence and extent of abnormal and benevolent advantage.

In another court case, 2017/AR/1640 (Antwerp Court of Appeal, March 5, 2019), the BTA's argument was similarly not accepted due to the lack of a detailed functional analysis and appropriate evidence that the transfer pricing method applied by the taxpayer would not be appropriate (at arm's length). The court also pointed out that the transfer pricing inspectors had been trying to rely on other rulings (reflecting individual decisions based on functional analysis and transfer pricing studies) while not being able to prove the comparability of the functional and risk profiles due to the absence of any such analysis performed by the tax authorities for the case under audit.

Transfer pricing audits might also encompass varying dimensions depending on whether they are initiated/led by: 1) corporate tax inspectors that are not specialized in transfer pricing but have received only

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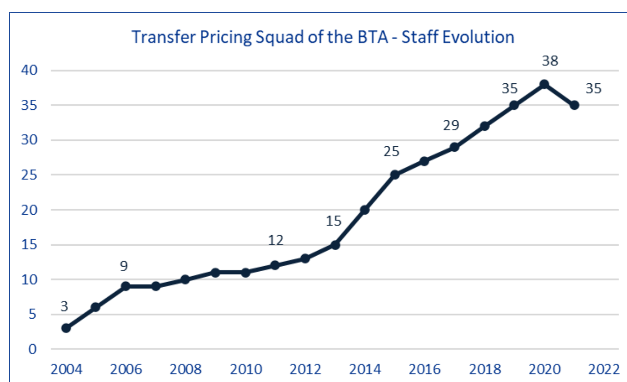
high level transfer pricing trainings, or 2) members of the specialized Transfer Pricing Squad of the BTA, which are dedicated to transfer pricing audits on a full-time basis. The graph below provides an overview of the evolution of the number of people in the Transfer Pricing Squad of the BTA:



Source: Statistics from the Belgian tax authorities

Generally, transfer pricing audits in Belgium cover the review of all intercompany transactions, including interactions with joint ventures. Significant mergers, acquisitions, and divestitures of Belgian taxpayers naturally draw the attention of the tax authorities. Business restructuring and intercompany financing remain hot topics of discussions in the course of the audits.

The standard statute of limitations has been increased from three years to six years as from the financial year 2022 for (among others) companies which have to file a Local File form. This will have a significant impact as well on the future of Belgium's transfer pricing audit environment.

3. How can MNEs best prepare for potential disputes in light of the factors described in Questions 1 and 2, and what can they do to mitigate the risks of future disputes?

In navigating the turbulent waters of transfer pricing controversy, MNEs should craft strategies as nuanced as a Belgian Trappist ale:

- **Conducting continuous scenario analysis and stress testing:** to remain attuned to changes in major transfer pricing positions within the MNE and to avoid taking too aggressive of an approach as a safeguard against potential challenges;
- **Employing technological advancements:** to master efficient, adaptable, and streamlined operational transfer pricing that limits year-end adjustments and aligns well the transfer pricing with the day-to-day implementation method;
- **Navigating internal policies and procedures:** to adopt a structured and pro-active exchange of information between the business and the tax (transfer pricing) department that avoids changes in functional profiles that the tax (transfer pricing) department is not aware of;
- **Ensuring regulatory compliance:** to maintain clear and comprehensive transfer pricing policies that are well documented in advance and consistently applied, to fulfill the Belgian reporting requirements and to have corroborating documentation (intercompany agreements, board meetings, group annual accounts, website information, etc.) that validate the pricing strategies and serve together as a strong shield against disputes;

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- **Developing contingency planning:** for high-risk transactions (e.g., business restructurings), it is recommended to request a unilateral ruling from the BTA, which still remains a good cost-benefit instrument;
- **Establishing transparent lines of communication and collaboration with the tax authorities:** for taxpayers doing business in Belgium, there is also an option to request bi-or multilateral advance pricing agreements ("APAs")[3] between Belgium and the tax jurisdiction(s) of the counterparty. Even though obtaining the APA is a lengthy process, it is paramount to reducing the risk of disputes in complex structures over the years. It is also possible to consider other alternative tax compliance instruments where Belgium is also a participant to—such as the Co-operative Tax Compliance Program ("CTCP"), International Compliance Assurance Program ("ICAP"), European Trust and Cooperation Approach ("ETACA") and others—that might provide faster legal certainty and better hedging of transfer pricing risks;
- **Pursuing sustainable approaches to dispute resolutions:** to use the mutual agreement procedure ("MAP") between Belgium and the country of the counterparty in case of double taxation that will enforce responsible and reasonable approaches to the transfer pricing adjustments by transfer pricing inspectors on both sides of the intercompany transactions.

Striking a balance between tax efficiency and compliance, between transparency and safeguarding sensitive financial data, requires MNEs to adopt a risk management framework as intricate as a Magritte painting—continuously challenging themselves to analyze the ongoing business processes in a new context and to adapt themselves to the ever-evolving transfer pricing landscape. In light of these processes, transfer pricing automation tools[4] can become the paintbrush that brings efficiency to the canvas of intercompany transactions. By leveraging technological advancements, staying abreast of regulatory changes and adhering to best practices of risk management mechanisms available within the Belgian legislative framework, MNEs can successfully mitigate the risks of future disputes in their voyage toward certainty and stability in transfer pricing.

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[3] For more details on the current APA landscape in Belgium, *see* https://kpmg.com/be/en/home/insights/2023/08/ctx-the-apa-landscape-in-belgium.html

[4] Such tools as Alteryx, Digital Gateway, TPAD, CbC Risk Assessment, and other solutions are available in the Belgian market. For some examples of the application of Transfer Pricing Technology Solutions for efficient data processing and management, *see* https://kpmg.com/be/en/home/services/tax/corporate-tax-and-legal/transfer-pricing.html

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Brazil

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1. In your jurisdiction, how do the tax authorities select taxpayers for audits for transfer pricing cases and what are their focus areas that could lead to transfer pricing audits? And what measures and technology do the tax authorities have available to capture the essential information?

In general, tax audits have a special focus on large taxpayers and consider the following indicators: (i) the amount of the tax liabilities; (ii) equity value; (iii) revenue amount; (iv) amount of tax credits to be refunded or offset; and (v) number of employees. Therefore, there is no focus on any specific area but instead on these factors.

In this sense, the federal tax authorities must indicate, for the differentiated or special monitoring, which legal entities have: (i) annual gross revenue greater than or equal to BRL 300 million (differentiated monitoring) or BRL 2 billion (special monitoring); (ii) presented tax returns reporting debts whose sum is greater than or equal to BRL 40 million (differentiated monitoring) or BRL 150 million (special monitoring); (iii) a wage bill whose sum is greater than or equal to BRL 100 million (differentiated monitoring) or BRL 150 million (special monitoring); or (iv) imports or exports greater than or equal to BRL 200 million (differentiated monitoring).

The Brazilian Federal Revenue Service may establish indicators, targets, selection criteria, jurisdiction, and specific forms of control and evaluation for work processes or activities related to these legal entities.

Regarding measures and technologies to capture essential information, the tax authorities have implemented electronic systems that automatically cross-check the tax returns submitted by the taxpayers and indicate inconsistencies, including by crossing information provided by other taxpayers that have participated in the same transactions. In addition, the federal, state, and municipal tax authorities may exchange information.

2. Which approaches are followed by the tax authorities during transfer pricing audits and what are the key elements considered by courts when deciding on transfer pricing related disputes? Please describe a few recent cases or rulings as examples to help illustrate your explanation.

During transfer pricing audits, Brazilian tax authorities usually review the criteria adopted by the taxpayers to calculate the parameter price adopted according to the application of transfer pricing rules. Until the end of 2022, Brazilian legislation provided for transfer pricing rules based on a pre-determined margin system that deviated from the pure arm's length approach adopted under the OECD Transfer Pricing Guidelines. In this scenario, most transfer pricing disputes relate to the interpretation and application of Brazilian rules.

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A discussion that illustrates this scenario was analyzed by the Brazilian Superior Court of Justice ("STJ") in October 2022, in the trial of the Special Appeal 511.736/SP. The taxpayer argued the illegality of applying the transfer pricing methodology using the Resale Price minus Profit method as established in Normative Instruction 243/2002.

In the appeal analyzed by the STJ, the taxpayer discussed the calculation criteria of the Resale Price minus Profit method established by a Normative Instruction enacted in 2002 by the Brazilian Federal Revenue Service. The Normative Instruction would have extrapolated the methodology provided for in the law which regulated the matter. In summary, the difference was related to the way of calculating the profit margin to be deducted from the net resale price, with an impact on the definition of the corporate income tax calculation basis. While the law established that this profit margin would be obtained from a percentage of 60% on the value of the net sales price of the product, the Normative Instruction defined that this margin should be calculated from the application of this percentage of 60% on "the participation of the good, service or imported right in the sale price of the good produced."

The taxpayer's appeal was granted since the STJ recognized that the methodology defined by the Normative Instruction exceeded the criteria provided by law.

We note that this discussion only applies to periods from 2002 to 2012, when the law was modified, however, it is illustrative of transfer pricing related disputes in Brazil. In fact, many taxpayers are still discussing this issue, as the decision from October 2022 was the first rendered by the STJ on the matter.

Finally, we emphasize that a new transfer pricing regulation was enacted in Brazil to introduce the standard established in the OECD Transfer Pricing Guidelines. Considering that this new methodology will be in force from 2024, we still do not know how it will be interpreted and the disputes that may occur.

3. How can MNEs best prepare for potential disputes in light of the factors described in Questions 1 and 2, and what can they do to mitigate the risks of future disputes?

To best prepare for or to mitigate risks of potential disputes, MNEs should comply with the methods established in the legislation and maintain all the studies, documents, and tax records that support the calculations adopted for the purposes of complying with the transfer pricing rules.

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China

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1. In your jurisdiction, how do the tax authorities select taxpayers for audits for transfer pricing cases and what are their focus areas that could lead to transfer pricing audits? And what measures and technology do the tax authorities have available to capture the essential information?

The Chinese tax authorities have traditionally adopted a risk-focused strategy to handle the transfer pricing of multinational corporations. This implies that they will likely allocate their resources to examine in detail the enterprises with heightened risk profiles. The 2017 publication of the State Taxation Administration's Announcement on Administration on the Promulgation of the Administrative Measures on Special Tax Investigation, Adjustment and Mutual Agreement Procedure ("Announcement 6") outlines various risk factors which tax authorities should prioritize when selecting targets for transfer pricing audits, including companies:

- with a large amount of related party transactions or with multiple types of related party transactions;
- with long-term losses, low profits or fluctuating profits;
- whose profits are lower than the industry level;
- whose level of profits are not commensurate with the functional profile, or whose distribution of profits are not commensurate with the allocation of costs;
- that enter into related party transactions with related parties located in low tax jurisdictions;
- that fail to declare related party transactions or prepare contemporaneous documentation as required;
- whose ratio of debt and equity investments from the related parties exceeds the stipulated standards;
- established in countries or regions controlled by China resident companies and/or Chinese individual residents, where the actual tax burden of those companies is less than 12.5%, do not allocate or reduce profits without reasonable business needs; and
- that engage in other tax planning or arrangements that do not have a reasonable business objective.

In practice, while the tax authorities generally adhere to the principles outlined in Announcement 6 when selecting an audit target, the authors' recent observations indicate a departure from the authoritative procedures previously used by the authorities towards a less formal approach. For instance, in the past, a multinational corporation may have been selected for a formal investigation on transfer pricing solely on the grounds of having a comparatively low profit margin when compared to industry peers, or experiencing losses as per the tax information system. Now, the tax authorities will use informal inquiries to build a case through risk analysis identified by the tax authorities' tracking system. This process allows companies to

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explain and address any risk factors and concerns raised by the tax authorities, or to carry out a self-assessment or adjustment to rectify the inappropriate transfer pricing position they have previously taken. This informal procedure usually resolves most disputes, and only in exceptional circumstances where the taxpayer and the tax authorities are unable to come to an agreement through these informal queries will the tax authorities commence formal transfer pricing audits. This is part of a continuous effort by the Chinese tax authorities to encourage taxpayers' businesses, in line with the goal of further opening up China's economy. While this soft approach may seem to be more effective in managing communication and maintaining relationships with the relevant tax authorities, there is the risk that any transfer pricing adjustments made through self-assessments could result in double taxation without any avenue to mutual agreement procedures.

The Chinese tax authorities have built various technology tools and have rolled out profit monitoring mechanisms that assist in the identification of high-risk taxpayers with intricate transfer pricing structures, particularly where the outbound non-trade payments are significant or the profit margins are thin. The risk monitoring mechanisms tap into various sources of data collected by the tax authority's system following China's adoption of the three-tier transfer pricing documentation framework with modifications to the BEPS Action 13 recommendations. These include the company's annual related party transaction reporting forms ("RPT forms"), comprising a total of 22 forms with comprehensive data on related party transactions and participating entities, and through other government sources.

In addition, as part of a trial initiative to digitize the company's related party transaction data disclosed in Transfer Pricing Local Files, certain taxpayers in Shanghai, Jiangsu, Beijing, and Guangdong received requests from their in-charge tax authorities to fill out several Local File summary forms ("summary forms"). The information requested in these forms go beyond the disclosure requirements of the China local file and entails gathering additional financial data on the upstream and downstream affiliates involved in the same value chain as the Chinese company. To date, the authors are not aware of cases in which the Chinese tax authorities select transfer pricing audit targets solely based on the data submitted in these summary forms.

2. Which approaches are followed by the tax authorities during transfer pricing audits and what are the key elements considered by courts when deciding on transfer pricing related disputes? Please describe a few recent cases or rulings as examples to help illustrate your explanation.

Announcement 6 provides for affected taxpayers to seek resolutions on transfer pricing disputes through litigation following an audit. However, in practice, no transfer pricing cases were brought to the courts in recent years. This is partly because China does not have a developed litigation system for tax and transfer pricing cases.

In carrying out transfer pricing audits, the Chinese tax authorities traditionally have a particular preference for testing the actual profitability retained by the Chinese entities in the multinational group by using the transactional net margin method for its simplicity and compatibility. This usually involves a detailed review by the tax authorities of the functions performed and risks assumed by the local entity, leading to the conclusion that an overseas principal controls the financial and operational decisions of the local entity and therefore the local entity should not bear any significant business risks. This would be particularly applicable to companies suffering sustained losses during the years under audit. The operating profits would be adjusted

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to the median derived from the benchmarking analysis, which would normally result in a significant tax payment.

As the Chinese tax authorities have become increasingly sophisticated, they have also reflected on the approach they have usually taken in previous transfer pricing cases. In recent transfer pricing discussions, tax authorities have increasingly focused on analysing the value drivers along the business's value chain. This includes analyzing the contributions of the local entity, as well as location-specific factors that contribute to the success of the business. This trend has emerged in transfer pricing disputes that call for the use of the profit split method, or at least the consideration of the profit split method, as part of the analytical framework of the audit process. This shift in approach permits tax authorities to scrutinize the transfer pricing agreements of multinational corporations even if they may have robust profit margins.

In a recent informal inquiry case with the Chinese tax authorities, a U.S.-based auto parts manufacturer established new production capacity for its technologically advanced products in China, and the new production segment generated a high profit margin. The production line was established to be close to its main customer, an electric car manufacturer. The Chinese taxpayer argued that the profits generated by the local plant should be largely attributed to the IP owned by its overseas headquarters. The taxpayer emphasized that the significant difference in profitability observed in the segmented financials of the new products compared to the traditional products suggested that the IP was the key value driver of the business success. As such, the headquarters should receive the majority of the profits through royalties. While the tax authorities acknowledged that the IP of the new products was innovative and valuable and that the head office was entitled to a share of the profits in the supply chain, they maintained that the local manufacturing and sales efforts and local factors, such as the Chinese market premium, proximity to customers, a well-established local supply chain, and government support/subsidies to the automotive industry, were equally important. As such, the authorities adopted the stance that all profits associated with the local elements must be kept within China. Following discussions with the local tax authorities, the taxpayer self-assessed and adopted a 5% royalty rate, significantly lower than the original rate, as a measure to mitigate transfer pricing risks in China.

3. How can MNEs best prepare for potential disputes in light of the factors described in Questions 1 and 2, and what can they do to mitigate the risks of future disputes?

One cannot overstate the importance of thorough transfer pricing documentation, as well as the impact of local specific factors. First and foremost, comprehensive transfer pricing analysis and documentation demonstrates to the tax authorities that the management of the company is willing to comply with the relevant rules and regulations, which could be used as the first line of defense if formally or informally inquired by the tax authorities. Secondly, the documentation provides evidence that the transfer pricing policy set by the management is based on technical grounds, even though the tax authorities may not share this position. In addition, management should consider involving a professional tax advisor to augment its internal resources and experience in navigating the intricate tax environment in China.

In the process of implementing the transfer pricing policy, the management should closely monitor the profitability of the various parties involved in the value chain on a regular basis and take corrective actions to bring the profitability back to the arm's length level if the actual performance of the parties deviates from the target profit margin. In monitoring the transfer pricing arrangements, operational transfer pricing ("OTP") would be a relevant tool for companies to deploy if they have a complex web of related party transactions that make it difficult to effectively monitor the transfer pricing arrangements.

Furthermore, having regular informal communications with the in-charge tax authorities on tax and transfer pricing issues can also help mitigate the risks of future disputes to some extent. However, any discussions held informally with the tax authorities are not considered binding in the event of a formal transfer pricing audit. Recent observations suggest that the in-charge authorities are becoming less willing to provide their opinions on matters related to transfer pricing during informal discussions with taxpayers to avert a backfire in a potential formal transfer pricing audit in the future.

The year-end transfer pricing adjustment remains a crucial mechanism for taxpayers to manage transfer pricing risks. In 2020, the State Administration of Foreign Exchange released a Q&A on the Foreign Exchange Administration Policy on Services, providing a legitimate avenue for taxpayers to perform year-end transfer pricing adjustments, but the application is mainly restricted to cases in which the profit margin falls below the target profit margin, requiring taxpayers to voluntarily adjust their profitability to the arm's length level. Despite the release of the Q&A, the success of a transfer pricing adjustment to uplift the profitability of a taxpayer would still depend on the facts and should be approached on a case-by-case basis.

Last but not least, taxpayers may seek to obtain an advanced pricing agreement ("APA") with the Chinese competent authorities. This option provides the highest degree of certainty when it comes to transfer pricing for those with a good record of compliance.

The APA may take the form of a unilateral, bilateral, or multilateral agreement (the multilateral agreement is not commonly seen in China). Ideally, a bilateral APA is more effective in resolving double taxation on both ends, and negotiations are made between competent authorities to reach agreements in a more cordial environment. Unilateral APAs, meanwhile, are negotiated between taxpayers and local tax authorities. Since local tax officials are more revenue driven, unilateral APAs can feel like an audit at times.

While APAs can take a long time to resolve and conclude, the authors have seen improvements in the speed in which APAs are concluded in China. The latest statistics from the State Taxation Administration ("STA") show that more APAs are being settled at a quicker pace, and there have been cases where competent authorities reached agreement after just one competent authority meeting. So, with a well-prepared APA analysis and package, the authorities would be able to conduct their negotiations more effectively and efficiently.

In the past few years, the Chinese tax authorities have been getting more creative in their drive to provide additional avenues of dispute resolution to taxpayers. In 2022, the local Shenzhen Customs and Shenzhen Tax Bureau released a regulation for a joint mechanism to monitor related party import prices. It is a form of customs/tax unilateral APA where the customs authorities issue advance rulings and the tax authorities agree to a unilateral APA on the covered transactions. This ensures certainty in the transfer price management of import transactions and avoids risks of customs and tax bureau investigations. The validity of the joint agreement would be for three years.

In another initiative, the STA issued a regulation on simplified unilateral APA procedures in July 2021. The simplified unilateral APA procedures shorten the process from the normal six stages to just three stages. The regulation clarifies a definitive time schedule for the tax authorities to analyze and respond to taxpayers. As such, simplified UAPAs can potentially be concluded within nine to twelve months from the date of acceptance by the tax authorities.

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Denmark

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1. In your jurisdiction, how do the tax authorities select taxpayers for audits for transfer pricing cases and what are their focus areas that could lead to transfer pricing audits? And what measures and technology do the tax authorities have available to capture the essential information?

The Danish Tax Agency ("Skattestyrelsen") has adopted a risk-based selection process and, accordingly, the selection of potential companies for audit purposes is generally based on an evaluation of their transfer pricing risks. So far, Skattestyrelsen has mainly focused on transfer pricing compliance within larger multinational enterprises. This approach will likely change going forward so that small enterprises will also be part of the systematic risk assessment and audit selection process. The focus areas for transfer pricing audits vary; however, there seems to be an emphasis on restructurings, intangibles, and intra-group financing.

With regard to capturing the essential information, from income year 2021 and onwards, the transfer pricing documentation (assuming that the taxpayer is subject to the documentation requirement) must be submitted to the Danish Tax Agency within 60 days of the statutory date for filing the tax return; hence, the documentation is available to the Agency for an arm’s length assessment automatically. The documentation requirement applies, generally, to all Danish entities and permanent establishments with cross-border transactions if certain thresholds are met at a group level.

Further, in a recently published report ("Selskabernes skattebetaling 2022"), the Danish Tax Agency points out that the exchange of information under the Directive on Administrative Co-Operations (DAC) will continue to have a strong focus going forward, since the Tax Agency uses international data to assess companies’ and groups’ risks, in relation to whether the rules on transfer pricing have been complied with. If the Tax Agency suspects that the rules have not been complied with, an audit process can be initiated. To illustrate: in the period 2019-2021, the Danish Tax Agency received almost 3,800 pieces of information as a result of DAC4 (the EU directive concerning the exchange of country-by-country reporting information).

Moreover, the Danish Tax Agency uses financial data when selecting taxpayers for transfer pricing audits.

Finally, the Tax Agency takes into consideration news from various media.

In the period 2010-2021, adjustments made by the Tax Agency have resulted in a total net increase of the companies' income base in Denmark in transfer pricing cases of more than DKK 120 billion (approximately EUR 16 billion).

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2. Which approaches are followed by the tax authorities during transfer pricing audits and what are the key elements considered by courts when deciding on transfer pricing related disputes? Please describe a few recent cases or rulings as examples to help illustrate your explanation.

If the Danish Tax Agency, based on an arm's length compliance analysis, intends to adjust the income of a taxpayer, it will notify the taxpayer in writing of their intention and, furthermore, present the facts of the case to the taxpayer concerned, allowing the taxpayer to comment on the Tax Agency's basis for decision-making (in Danish: a so-called *agterskrivelse*). Upon the taxpayer's submission and a dialogue with the Tax Agency, the Agency will issue its final decision or withdraw from making adjustments.

If the taxpayer wishes to challenge an adjustment, an appeal must be filed with the National Tax Tribunal (the highest administrative appeal body for tax-related matters). If the ruling from the National Tax Tribunal is not in favor of the taxpayer, the taxpayer may bring the case before the courts. The taxpayer further has the opportunity to take the case directly before the courts, hence skipping the National Tax Tribunal.

In many instances the Tax Agency disregards the taxpayers' transfer pricing documentation based on minor formalities, whereupon the Tax Agency adjusts the transfer prices based on an estimate (discretionary income adjustment) and accordingly attempts to shift the burden of proof for arm's length compliance to the taxpayer. Hence one key element considered by the courts is whether there is a *basis for a discretionary adjustment*.

In a case decided by the Supreme Court on January 31, 2019 (case 75/2018, published in SKM2019.136.HR), the Court ruled that the tax authorities can only disregard taxpayers' transfer pricing documentation insofar that the documentation is so flawed that it does not provide the tax authorities with an adequate basis for assessing whether the arm's length principle is met at the time of the assessment.

Another key element considered by the courts is the *evidence* presented by the parties.

The Danish Supreme Court ruled on June 25, 2020 (case BS-42036/2019-HJR, published in SKM2020.303.HR) in favor of the claimant company in a transfer pricing case regarding trademark royalties, setting aside the Danish Tax Agency's contention that the royalties were not deductible business expenses and were not on arm's length terms.

First, the Supreme Court held that the company's transfer pricing documentation for the relevant accounting periods was not so insufficient that it was comparable to a lack of documentation. The Supreme Court noted the fact that the Danish Tax Agency disagreed with, or raised legitimate doubt about, the company's comparability analysis did not per se make the documentation highly insufficient. Therefore, the company's income could not be assessed on a discretionary basis.

Second, the Court then investigated whether the royalty rate (2% of revenue) in the license agreement was at arm's length. The Court noted that the subsidiary had presented license agreements between the parent and unrelated benchmark companies showing that a royalty rate of 2% was being paid for the right to use the trademark with no access to knowhow or customer referrals. The Supreme Court went on to state:

> *We are not satisfied that a 2% royalty rate is not an arm's length payment or that the financial and commercial circumstances of the benchmark companies differ so much from*

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the Danish company's circumstances as to render them unsuitable for comparability analysis purposes. The Tax Agency has not stated what relevant differences exist between the Danish market and the markets in the countries covered by the license agreements. Thus, the Tax Agency has not demonstrated that any such differences matter to the rate of royalty an independent party would be willing to pay to [the parent] in those countries.

The fact that [the subsidiary] has been operating at a loss for a number of years cannot, in our opinion, change this, since this is not enough per se to prove, even on a balance of probabilities, that the company was kept going only or primarily in the interests of the group, i.e. in order to preserve a local operating company in Denmark.

Also, the Tax Agency has, in our view, not proved, even on a balance of probabilities – including through comparability analyses – that [the subsidiary's] marketing in Denmark of [the subsidiary] justifies a deduction from the royalty payment which reflects non-payment of remuneration or compensation for marketing of the global trademark.

Thus – and since none of the Tax Agency's other submissions can lead to any other finding – we believe that a royalty rate of 2% of the revenue would not have been inconceivable between independent parties ….

3. How can MNEs best prepare for potential disputes in light of the factors described in Questions 1 and 2, and what can they do to mitigate the risks of future disputes?

Clearly, the most important preparation MNEs can make to avoid or mitigate potential disputes is ensuring that the transfer pricing documentation is prepared contemporaneously and in compliance with the requirements in the law. This includes documenting the rationale for dispositions and their pricing, etc. to ensure there is evidence that will be crucial in a later dispute, as illustrated by the cases referred to above.

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France

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1. In your jurisdiction, how do the tax authorities select taxpayers for audits for transfer pricing cases and what are their focus areas that could lead to transfer pricing audits? And what measures and technology do the tax authorities have available to capture the essential information?

From a general perspective, the French Tax Authorities (FTA) will focus on the usual markers at the French company level that can signal a potential transfer pricing (TP) risk or inaccuracy, namely:

- recurring tax loss position, notably following an initial launching period;
- significant swings in profitability despite no external signs of a business model change;
- significant changes in the balance sheet and/or profits and loss (P&L); or
- intragroup asset sales or any form of official or undisclosed business restructuring (which may be evidenced by a drop in turnover and/or clients for instance).

Of course, transfer pricing audits can also be triggered by the need for the FTA to check:

- whether a previously agreed upon TP position during a former tax audit is still consistently applied;
- whether a transfer pricing position resulting from an advance pricing agreement (APA) or a mutual agreement procedure (MAP) has been appropriately complied with;
- whether a company has amended its TP policy if challenged successfully by a final determination from the tax courts following a tax litigation; or
- a specific TP position, if a possible issue or request has been raised by another tax authority during exchange of information procedures.

Finally, French subsidiaries of MNEs as well as French MNEs themselves are usually subject to general tax audits that will encompass transfer pricing matters on a routine basis, often once every two or three years, with the normal statute of limitations being three fiscal years (FYs) in France. During these routine audits, the FTA will of course expect an update on the following:

- the TP legal documentation (Master/Local Files, agreements, update of the perimeter depending on whether any company has entered or exited the TP perimeter…); and
- the TP economic documentation (notably by updating the FYs over which comparables have been reviewed and other economic studies have been performed).

Beyond these usual "triggers" for a TP audit, other circumstances can lead to an audit or discussions with the FTA.

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For instance, the authors have witnessed tax audits focusing on permanent establishment (PE) issues, notably a PE of foreign MNEs at the level of their French subsidiaries, ending in TP discussions. It is indeed rather frequent that if such a PE cannot be characterized by the FTA, the latter considers that the French subsidiary holds more functions or risks than initially considered by the MNE and requires a different or higher remuneration for its role vis-à-vis the MNE's related foreign companies. Similarly, but less frequently, anti-hybrid provisions or other thin capitalization provisions impacting financial interest deductibility can lead to discussions on the appropriate level of an interest rate from a TP perspective. There are of course other examples of non-TP discussions leading to TP debates: a VAT audit can be an opportunity to spot certain operations or flows, the French Digital Service Tax filling requirements can be an opportunity to identify similar elements as well as the DAC 6 Directive (2018/822) provisions implemented in France (under Article 1649 AD and 1649 AH of the French Tax Code, FTC).

Regarding measures and technology used for TP purposes, many tools are and will be made available to the FTA.

First of all, mandatory TP documentation applies to MNEs with annual turnover (*excluding VAT*) or gross balance sheet assets of €400 million or more (L13 AA French Tax Procedure Code (FTPC)). This obligation also extends to legal entities controlling or controlled by a company with annual turnover (*excluding VAT*) or gross balance sheet assets of €400 million or more. Finally, this obligation also applies to legal entities that are members of a tax consolidation group when this group includes at least one legal entity that meets one of the above conditions.

This €400 million threshold is reduced in the 2024 budget law to €150 million (the 2024 budget law was published on September 27, 2023, and is being discussed in the French Parliament). The former Minister of Public Accounts Gabriel Attal announced in May 2023 that the 2024 budget law would include a reform aimed at "making large companies more accountable," which would mean lowering the threshold for mandatory TP documentation. This declaration was confirmed recently in the beginning of June through a press kit, which stated that in order to make companies more responsible for their transfer pricing policy, a potential measure would be to "lower the threshold for transfer pricing documentation. The new threshold could be set at €150 million in sales." The 2024 budget law indeed integrates this new threshold.

This documentation must be made available to the tax authorities during the start of a tax audit (as soon as the auditor goes on the site for the first time). If the company does not produce the declaration (or produces an incomplete one) when the tax audit begins, the tax administration will give it a formal notice to produce or complete it within 30 days.

The company may request an extension of up to two months to produce the declarations. In that case, the tax administration must notify the company of its decision and the newly granted deadline.

If, in the end, the company fails to submit the documentation on time, it risks being fined a minimum of €10,000 (increased to €50,000 by the 2024 budget law) for each year covered by the tax audit, up to the highest of the following amounts:

- 0.5% of the value of the transactions concerned by the documents or additions not forwarded to the tax authorities; or

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- 5% of the rectification of income based on Article 57 of the FTC (the Article used to enforce the arm's length principle in French law).

On a digital level, when a company keeps its accounts in an electronic form, where computer processing is envisaged, tax officials (the Brigade de verifications des comptabilités informatisées (BVCI)) will inform the taxpayer in writing of the nature of the investigations required (under Article L47 A of the FTPC).

The following three options are left to the taxpayer:

a) The agents carry out the audit on the equipment used by the taxpayer (who must take all necessary measures to preserve the integrity of the data and the security of the hardware and software).

b) The taxpayer may ask to carry out all or part of the processing required for the audit.

c) The taxpayer may request that the audit not be carried out on the company's equipment. In this case, the taxpayer provides the auditor with copies of the documents, data, and processing required to carry out the audit.

A *Fichier des Ecritures Comptables* (FEC) must be provided to the tax administration before the audit starts and within a maximum of 15 days from receipt of the tax audit notice (under Article L 47 AA,1 of the FTPC).

The FEC is basically an accounting entries file in an electronic format. The copies of files given to the auditor must meet the standards set out by the FTPC (under Articles L47 A, 1 and L47 A, 2). This file allows the auditor to evaluate the data electronically.

Failure to submit the FEC, or submission of files that do not comply with the required standards, may result in a fine of €5 000 or, in the event of rectification and if the amount is higher, an increase of 10% in the taxes payable by the company (under Article 1729 D of the FTC).

The tax administration must destroy the files in their entirety before the tax is assessed or after the notice of non-rectification is sent.

Beyond these general TP measures, documentation, and audit tools, the FTA can rely on other required information including TP content.

First, Country-by-Country Reporting ("CbCR") provisions are applicable under French law. CbCR applies to groups with consolidated annual turnover (excluding VAT) of €750 million or more (under Article 223 quinquies C of the FTC), including companies with foreign branches or companies that own or control, directly or indirectly, entities established outside of France. "Groups" are defined as (under Article 46 quater-0 YE, II of annex III of the FTC) the whole of a legal entity, the subsidiaries included in the consolidated financial statements, and their branches.

The declaration must include financial data expressed in euros (for example: sales, tax paid, capital stock…), information on the group's main activity (e.g., R&D, manufacturing etc…), and a list of the group's entities and their activities.

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The declaration must be filed in electronic format within 12 months of the end of each financial year (failure to transmit the documents may result in a fine of up to €100,000 under Article 1729 F of the FTC). Obviously, at the MNE level, this disclosure can be key to identifying operations that lead to debatable profit shifting.

Also, certain French companies have to file an annual TP "short form" (Cerfa #2257). This short form must be filed by companies with annual turnover (excluding VAT) or gross balance sheet assets of €50 million or more (under Article 223 quinquies B of the FTC**)**. This obligation is extended to companies that are owned directly or indirectly by an entity or that owns directly or indirectly an entity that passes this €50 million threshold. This obligation also applies to companies that are members of a tax consolidation group when this group includes at least one legal entity that meets one of the above conditions.

The TP short form contains general information about the group (such as a description of the activity, a list of the main intangible assets, and a general presentation of the group's TP policy…) and some specific information about the company (summary statement of transactions with associated companies when the aggregate amount by type of transaction exceeds €100,000, presentation of the TP policy…).This short form can be a useful and an easily exploitable document to identify any year-over-year changes at the company level, for instance.

From a technological perspective, the FTA can use data mining tools to identify possible TP issues or discrepancies. This technology was first introduced in 2014 with the creation by the tax authorities of a specific unit dedicated to the use of AI tools. Since then, data mining has taken a dominant place in targeting tax audits. In 2022, half of the tax audits (52%) were started using data mining. Moreover, with the forthcoming reform of electronic invoicing (initially planned for July 2024 but postponed by the forthcoming 2024 budget law), the FTA will have greater access to data, and will be able to carry out consistency checks on transfer pricing.

In particular, the reform provides for data to be transmitted almost continuously to the tax authorities for outgoing flows (i.e., intra-Community deliveries and exports) and incoming flows (i.e., intra-Community acquisitions). The tax authorities will then have access to data (such as the FEC and management data) that will enable them to carry out more in-depth consistency checks on groups' transfer pricing policies using AI and data mining technology, in particular.

Former Minister of Public Accounts Gabriel Attal also stated that for tax audits, "priority will be given to auditing the largest groups, while strengthening tax support for businesses."

2. Which approaches are followed by the tax authorities during transfer pricing audits and what are the key elements considered by courts when deciding on transfer pricing related disputes? Please describe a few recent cases or rulings as examples to help illustrate your explanation.

TP audits can be performed by the local tax authorities based upon the corporate domicile of the concerned company.

At the central level, a specific division of tax audit is in charge of the largest taxpayers and international matters, including TP, and is called the *Direction des Verifications Nationales et Internationales* (DVNI). Responsible for auditing large/multinational companies (sales in excess of €152.4 million and services in excess of €76.2 million), the DVNI is made up of some 30 brigades specialized in the economic sector and 9

brigades specialized in computerized accounting systems, for a total of some 350 public finance inspectors in the field. The BVCI also assists the general brigades with audits.

Once the TP documentation has been provided at the start of the tax audit, and assuming the concerned tax audit is a contentious one, which is the most usual (jeopardy assessments require either fraud or undisclosed activities or severe accounting failures to be implemented), back and forth exchanges will take place between the taxpayer and the tax inspector. During exchanges of information and Q&A, both in physical meetings and by email or written correspondence, the tax inspector will ask questions or more directly challenge the documentation provided. If at the end of this adversarial process the tax inspector is not satisfied with the information or answers provided, he or she will inform the taxpayer and its advisers of the prospective tax reassessment and its basis during the final summary meeting (*réunion de synthèse*), before a written notice is given to the taxpayer, laying out the details of the position of the FTA. From there, the normal course of appeals, claims, and tax procedure, followed by tax litigation, can proceed.

Each TP case is different, but the main tendencies we can identify from recent tax audits in terms of approaches from the FTA are:

- There is a tendency to shift the burden of proof to the French taxpayer. Indeed, while comparable studies from the taxpayer and their advisers have often been criticized or challenged by the FTA, sometimes the concerned tax inspector does not have its own study allowing it to sustain its position or disclose contemporaneously its own set of comparables, which would allow the taxpayer to conduct a similar critical review.

  There are some situations where the requests for justification go beyond the territorial scope of a French tax audit. For instance, on certain centralized management fee flows or cost sharing arrangements, the FTA can require a full breakdown and justification of costs or allocations to non-French entities, which leads, in practice, to a critical review or audit of non-French entities and/or to use this information to challenge the deductibility of the share of services borne by the audited French company. This also means that a significant volume of foreign entity-related information will be requested. The authors have also seen requests to provide the Master File of foreign parent companies of French subsidiaries subject to a French tax audit, or at least excerpts from such a File, leading to confidentiality issues.
- The FTA tends to challenge the systematic use of the transactional net margin method (TNMM) and cost plus methods for complex transactions or even for distributor companies with a certain level of functions or risks. As seen in other countries, the approach from the FTA tends to use profit sharing methods as the preferred method or at least use it to test the profitability level achieved by a TNMM or cost plus method. This approach has been confirmed during a seminar with the Head of the central tax audit services, Mr Frédéric Iannucci, during summer 2022.
- The authors have seen a significant number of TP reassessments resulting in settlements between the FTA and the taxpayers, before any tax litigation has started.

Also, a new mechanism enabling officials from EU member states' tax administrations to take part in joint tax audits has been implemented in the FTPC (since January 1, 2023, under Article L45 of the FTPC). As such, they may, with the authorization of the competent authorities, assist or participate in administrative procedures taking place in France or in the territory of one or more other EU member states. The information obtained may be used against taxpayers in accordance with the control procedures applicable in France. This procedure is new; thus, there is still very limited practical experience from it.

In addition, the legislature has already planned to extend the powers of administrative officers (starting January 1, 2024) of other EU member states by granting them the power to:

- question taxpayers and examine documents; and
- collect evidence during tax audits.

Regarding the burden of proof, the French transfer pricing regulations state that the tax authorities bear it. However, it is in fact not so clear-cut in practice, as the authorities tend to shift the burden to the taxpayer.

An example of this is the case SA Tropicana, Administrative Court of Appeal of Douai (*"Cour administrative d'appel"*), 25 August 2022, N°20DA01106.[1]

In this case, the tax authorities considered that they were not required to prove the existence of a dependence because a company was located in a privileged tax country (Under Article 238 A of the FTC, a "privileged tax country" means a country where the company is not taxable, or is subject to taxes on profits or income that are 40% or more lower than the tax on profits or income for which they would have been liable under ordinary French law, had they been domiciled or established in France).

The Court of Appeal found that this demonstration was insufficient since a low rate of corporate income tax does not prove the existence of a privileged tax regime, which made it impossible for the tax authorities to rely on such a regime in order to be exempt from establishing the existence of links of dependence. However, the authorities, who had the burden of proof, did not establish any relationship of dependence between the two companies within the meaning of Article 57 of the FTC.

Many decisions issued by the French Supreme Administrative Court (*"Conseil d'Etat"*) show that the basis of the application of Article 57 of the FTC is the dependence between related parties involved in the transactions. The *Conseil d'Etat* ensures that the burden of proof lies with the tax authorities and has not hesitated to reject the tax authorities' position if their case was not adequately proven.

Examples of relevant decisions include:

On one hand, a recent decision from the Administrative Court of Appeal of Lyon, 25 May 2023, N°21LY03690[2] shows that the burden of proof falls on the FTA, which needs to wisely choose the comparables when trying to demonstrate indirect profit transfers based on Article 57 of the FTC.

In this case, the tax authorities had compared a French company's net margin rate, calculated after the deduction of financial expenses, with that of independent companies with no financial functions, using a sample of 14 independent companies.

However, even if the activity or turnover was similar, the products distributed by the applicant were solely intended for the industrial sector, whereas the sample of comparable companies selected by the tax

[1]https://juricaf.org/arret/FRANCE-COURADMINISTRATIVEDAPPELDEDOUAI-20220825-20DA01106
[2]https://www.legifrance.gouv.fr/ceta/id/CETATEXT000047624987?init=true&page=1&query=21LY03690&searchField=ALL&tab_selection=all

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authorities included companies that were selling to private individuals, and companies that distributed household equipment to professionals for resale to private individuals.

In this respect, the margin differences observed by the FTA were explained by the difference in situation between the French company and nine companies on the panel.

While the remaining five companies were, by the French company's own admission, relevant comparables, their operating margins appeared consistent with the margin levels it had achieved.

The Administrative Court of Appeal concluded that, in the absence of appropriate comparables, the FTA had not established the existence of an advantage by comparison and therefore could not invoke the presumption of Article 57 of the FTC.

On the other hand, two decisions from the Administrative Court of Appeal of Paris, 1st of March 2023, n°21PA06438[3] and n°21PA06439[4] seemed to cast doubt on the burden of proof.

In these two decisions (with identically worded rulings), the facts were as follows: a French company marketed goods abroad, either through subsidiaries or independent sales agents, depending on the territory.

The FTA considered the difference between the intermediation commission paid to subsidiaries (similar to what the company would get acting as a direct reseller) and that paid to independent agents (20% of selling price) to be unjustified, and therefore qualified it as a transfer of profits abroad.

In this case, the Administrative Court of Appeal of Paris seemed to largely limit the comparison of factors examined as evidenced by the following:

- the Court did not draw any conclusions from the fact that the markets compared were significantly different geographically and strategically; and
- with regard to the functions performed, a key point in determining remuneration, the Court noted the taxpayer's argument that its subsidiaries performed far more important functions than third-party agents, even when they acted as intermediaries, but nevertheless concluded that the documents it produced were not sufficiently conclusive.

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[3]https://www.legifrance.gouv.fr/ceta/id/CETATEXT000047259053?init=true&page=1&query=21PA06438+&searchField=ALL&tab_selection=all
[4]https://www.legifrance.gouv.fr/ceta/id/CETATEXT000047259054?init=true&page=1&query=21PA06439&searchField=ALL&tab_selection=all

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This decision raises questions about the burden of proof: if the French company seems, on reading the decision, not to have provided sufficient evidence to justify a functional difference, it can legitimately be asked what evidence is in the file on the basis of which the tax administration is able to provide proof that there is no functional difference and therefore the remuneration between the subsidiaries' activity as agents and that of the independent intermediaries should be identical.

As a side note, the 2024 budget law introduces a new mechanism to "make the documentation in which companies present their own transfer pricing policy enforceable against them. This measure will require them to justify any failure to apply their own policy, and to demonstrate compliance with transfer pricing rules." As a result, the TP documentation would therefore be enforceable against the company, and the burden of proof would be reversed in cases where a company would fail to apply its own transfer pricing policy.

The 2024 budget law also provides that the tax authorities now have the option of adjusting the value retained in the context of a transfer of a hard-to-value intangible (HTVI), on the basis of results subsequent to the financial year in which the transaction took place. To help the tax administration control this type of transfer, the limitation period is extended to the sixth year following the one in which the tax is due.

3. How can MNEs best prepare for potential disputes in light of the factors described in Questions 1 and 2, and what can they do to mitigate the risks of future disputes?

The first, obvious, preparation is to have TP documentation ready before any tax audit starts, in order to provide it upon first notice at the start of the audit, and to ensure it is as contemporaneous as possible.

Also, a law dated August 10, 2018, known as "ESSOC", has promoted trust in relationships between users, both individuals and companies, and the administration. In particular, this law introduced the right to error, a mechanism to encourage spontaneous regularization (before or during a tax audit). The right to error allows a correction without paying a penalty when the company has made an inaccuracy or omission in a tax return. It does not apply to recidivists or to errors made in bad faith.

Under the regularization procedure, which can encompass TP matters, the taxpayer will have to pay the additional tax resulting from the correction of the inaccuracy or omission, to which the interest on arrears representing the cost of time may be added, but no surcharges or fines.

In a similar vein, France has an advance pricing agreement (APA) mechanism. The French APA guarantees the company that the prices charged in its intra-group (industrial, commercial, or financial) relations do not constitute a transfer of profits within the meaning of Article 57 of the FTC.

Prior to carrying out transactions between affiliated companies, the APA procedure determines a set of appropriate criteria (notably the method to be used, the elements of comparison, and the main assumptions as to future trends), enabling the transfer price applicable to these transactions to be set for a given period (generally 5 years).

This APA constitutes a formal position taken by the tax authorities and is therefore enforceable against them (tax ruling under Article L80 B, 7° of the FTPC), securing the future TP position from a tax audit or litigation perspective.

According to EU statistics, 28 APAs were granted by the FTA (15 EU and 8 non-EU) out of the 44 requests (26 EU and 18 non-EU) made in 2021.

In addition, the Tax Compliance Service (*Service de mise en conformité fiscale* SMEC) is a creation of the ESSOC law and it allows companies to regularize their situation before a tax audit. The mechanism applies in particular to tax irregularities discovered, before or after takeovers, by the new owners and transferees of a company.

All operations liable to attract the 40% surcharge for deliberate failure to comply with tax legislation (under Article 1729 a, of the FTC) concern entities whose tax returns are filed with the department responsible for large companies (DGE). Companies will be required to pay the tax that was evaded but that did not fall under prescription, together with the corresponding penalties and fines.

The spontaneous nature of the company's approach is taken into account by adjusting the rates of the applicable surcharges and late payment interest by means of a settlement. The tax compliance service applies a penalty scale known in advance:

- 80% goes down to 30% (interest reduced by 40%);
- 40% goes down to 15% (interest reduced by 40%);
- 10% goes down to 0% (interest reduced by 50%).

A general tax ruling does exist in French law but was not designed to deal with transfer pricing issues. Therefore, only the APA mechanism (under Article L80 B, 7° of the FTC) can enable a taxpayer to secure its transfer pricing policy with the FTA.

Furthermore, for intra-group asset sales, the French APA does not secure the valuation adopted by the company, but only the method used to determine the fair remuneration. The FTA state in their official documentation that "the agreement concerns the method to be used and not the setting of transfer prices as such within the multinational group."

Finally, the mutual agreement procedure (MAP) is hardly an appropriate tool to secure future disputes because its very nature is to intervene, post-tax audit, to settle an already existing discussion and possible double taxation between States. The FTA is very reluctant to use the MAP as a tool for this purpose, even if in practice, the concerned taxpayer can maintain the same position for fiscal years beyond the ones covered by the MAP.

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Germany

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1. In your jurisdiction, how do the tax authorities select taxpayers for audits for transfer pricing cases and what are their focus areas that could lead to transfer pricing audits? And what measures and technology do the tax authorities have available to capture the essential information?

Overview

Even before the latest OECD initiative, nearly all international companies were continuously audited in Germany. Germany's auditing system is already more comprehensive compared to that of other countries, in terms of the frequency in which companies are audited and in the level of detail with which auditors investigate the issues.

Audits are principally conducted by the local tax offices (Finanzamt) and are often supported by specialists from the state and/or federal authorities. In particular, the Federal Central Tax Office (Bundeszentralamt für Steuern (BzSt)) participates in audits of large companies to ensure common standards and prevent indirect tax competition between states.

Audit Selection and Focus

In recent years, there has been a slight decline in the number of tax audits and the number of auditors in Germany. However, despite this decline, the overall volume of audits remains substantial and is anticipated to return to pre-pandemic levels in 2023. Notably, the primary focus of German audits continues to be on large multinational corporations.

The most recent publicly available statistics pertaining to audits in Germany are from 2021. The number of auditors decreased from 13,300 in 2019 to 12,900 in 2021. Additionally, the number of businesses examined decreased slightly from 181,300 in 2019 to 150,400 in 2021.[1] This 17% decrease in audits is primarily attributed to tax authorities' internal challenges stemming from the COVID-19 pandemic, such as initial difficulties in utilizing IT solutions. For example, at the onset of the pandemic, auditors frequently encountered issues with standard video conferencing systems and were sometimes hesitant to establish shared folders for collaborative work.

[1] Bundesministerium der Finanzen. "Ergebnisse der steuerlichen Betriebsprüfung der Länder 2021." Monatsbericht des BMF, October 2022.

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Despite these challenges, tax adjustments from these audits resulted in an additional EUR 13.1 billion in tax revenue, of which EUR 9.6 billion is attributed to the examination of large companies. Additionally, 17.1% of large companies were subject to examination. These figures not only highlight the extensive audit activities taking place in Germany but also underscore the heightened scrutiny directed towards large corporations.

Criteria for Audit Selection

In the case of large enterprises, the audit periods typically follow on from the preceding period, ensuring a continuous examination of all assessment years. Consequently, large companies are generally audited without significant gaps while smaller businesses are selected for examination based on various factors. As audits typically span multiple years, some large companies consistently have auditors on their premises. One company, in response to a question about the duration of auditors' presence, humorously remarked, "since World War I."

For large companies audited in 2021, the average audit period covered 3.3 assessment years, compared to 3.0 assessment years for medium-sized and small businesses and 2.9 assessment years for micro-businesses. Regarding smaller companies, it is stipulated that an audit period typically encompasses no more than three consecutive assessment periods.

The selection of businesses for examination is based on internal risk considerations. For mid-sized and smaller taxpayers, audit selection is generally influenced by factors such as adjustments made in previous audits, involvement in foreign transactions, and industry classification. In some instances, media reports or leaked data can trigger transfer pricing audits as well.

Technologies Used for Risk Identification

A more recent trend has been the use of (Country-by-Country-Reports (CbCR) data to identify taxpayers with potential transfer pricing risks that should be audited. This data usage trend has been particularly driven by the BZSt, although the main responsibility for audits lies at the state (Länder) level. This is partially done via technology, although the use of technology is typically still limited to spotting certain deviations, rather than more sophisticated AI. CbCR data metrics that may trigger an audit are:

- Sudden year-on-year changes in profits, especially for German entities and entities in perceived low-tax jurisdictions,
- Changes in functional profiles; and
- Large deviations from industry averages regarding profitability.

The use of CbCR data is only a risk assessment tool and does not itself result in transfer pricing adjustments.

Focus Areas That Could Lead to Transfer Pricing Audits: Intercompany Financing, Relocations, and Restructurings

German tax authorities put a large emphasis on examining the economic substance of transactions involving intellectual property (IP), particularly in the context of those involving a relocation of functions and recent legislative updates like the "Funktionsverlagerungsverordnung" and changes to the "Außensteuergesetz" (ASTG) governing function relocations highlight this emphasis.

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Another crucial audit issue pertains to the evaluation of licenses for intangible assets. Auditors often argue for local development, enhancement, maintenance, protection, and exploitation (DEMPE) contributions. They scrutinize these contributions and, at times, contest the legitimacy of license payments made in connection with intangibles.

The use of comparable uncontrolled price (CUP) benchmarking studies in transfer pricing assessments has also come under increased scrutiny. This heightened scrutiny is driven by multiple factors including the aforementioned consideration of local DEMPE contributions within Germany, and the critical aspect of "profit potential," as emphasized by the OECD, which is not consistently controlled for in CUP studies. Consequently, in ongoing audits, unsupported CUPs are increasingly rejected by tax authorities. Taxpayers are frequently required to present alternative methods for calculating arm's length license rates, with the profit split method emerging as a prevalent alternative.

More recently, auditors have focused on financing transactions, with various, sometimes conflicting, decisions rendered. In the current rising interest rate environment, the following issues are challenged and reviewed by auditors:

- Cash pool position, where it is reviewed whether cash pool participants, merely have a short-term borrowing or lending position, or if it should be re-classified as a loan.
- With rising interest rates in the market, actual interest rates are an important issue in audits. Auditors regularly reject third-party offers by banks for interest rates, and instead demand a benchmarking search for arm's length interest rates considering maturity, rating, implicit support, and other relevant factors.
- Increasingly, German authorities focus on the substance of financing transactions, particularly when relatively low-substance lenders are situated in low-tax jurisdictions. When such entities charge interest to a German company, German authorities will sometimes reject the use of the CUP method and seek to apply a pure cost-plus model based on the operating costs of the lender. When such lending companies are used by a German-headquartered company, tax authorities sometimes stipulate that the actual lending decisions are made in the treasury department rather than the local financing company; therefore, and that the interest income should be attributable to the (German) headquarters.

Audits can be initiated by a diverse array of information:

- **Proactive Audits:** In a recent notable instance, the submission of an Advance Pricing Agreement (APA) to the federal tax administration for future years triggered the scrutiny of tax authorities at the local level.
- **Restructuring and VAT:** Occasionally, a corporate restructuring involving alterations in product flows and financial transactions can lead to abrupt changes in value-added tax (VAT). Tax authorities are adept at promptly detecting such shifts and often initiate an extraordinary VAT examination. These investigations frequently extend to a comprehensive review of the restructuring itself.
- **Collaborative Auditing:** While customs duties fall under the purview of distinct federal auditors, it is worth noting that findings from customs duty audits are shared seamlessly across various tax auditing divisions. Consequently, a customs duty audit may serve as a catalyst for a subsequent tax audit, reinforcing the collaborative nature of the audit process.

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2. Which approaches are followed by the tax authorities during transfer pricing audits and what are the key elements considered by courts when deciding on transfer pricing related disputes? Please describe a few recent cases or rulings as examples to help illustrate your explanation.

Use of Compromises from Previous Audits

Having reached a compromise in previous audits is If compromises have been reached in previous audits, such compromises are not binding for auditors and taxpayers in future years, but generally there is an implicit understanding that such issues should be treated consistently, as least as long as the economic fundaments have not significantly changed (—although what exactly constitutes a significant change can be subject to debate).

This is problematic insofar as these compromises are often the result of excruciating negotiations that taxpayers only agree to in order to minimize their administrative burden in the current audit. Consequently, taxpayers are sometimes surprised when these results form the new basis for even more aggressive negotiations in the next audit.

Alleged Probability to Cancel Contracts

In several audits, the unique idea of an implicit probability to cancel contracts has manifested, often for routine functions but also for relocation of function cases involving IP licensing. While highly questionable, these approaches have resulted in significant transfer pricing adjustments by auditors and have been brought to fiscal courts by taxpayers.

Unfortunately, due to the absurdity of the approach, no court decisions have been made, as the judges have made it clear in formal discussions during the proceedings that the tax authorities would be unsuccessful. Consequently, no court decision has been made the authors' , and the approach is still being followed in several audits until such a court decision manifests.

As noted above, a strong emphasis is placed on issues surrounding the valuation of IP and financing topics. This is reflected in the following court decisions:

Judgment of 22 February 2023 (Case No. I R 27/20)

The case involved whether a loan given by a German limited liability company (GmbH) to its domestic shareholder, recorded in a current account, was appropriately interest-bearing. In this instance, the GmbH (the plaintiff) maintained a current account for its shareholder and managing director, A, who owned 60% of the company. The account showed a positive balance in favor of the GmbH. No interest was applied to this balance, during the disputed years of 2014 and 2015. The tax office assessed a deemed dividend distribution (verdeckte Gewinnausschüttung) according to § 8 para. 3 sentence 2 KStG, estimating an appropriate interest rate of 4.5% under § 162 AO, using the margin-sharing principle based on customary credit interest rates.

Decision: The Federal Fiscal Court (BFH) dismissed the plaintiff's appeal, agreeing with the lower court's finding that a deemed dividend distribution was indeed present and upheld the tax office's use of a 4.5% interest rate.

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The BFH, along with the tax office and the lower court, concluded that the GmbH's claim current account held against A from the current account constituted a loan; thus the lack of interest led to it being classified as a deemed dividend distribution.

The benchmark for a deemed dividend distribution is typically the arm's length price that unrelated third parties would have agreed upon in similar circumstances. In this case, the BFH affirmed that the margin-sharing principle was an appropriate empirical basis for determining reasonable interest rates, especially when there are no other indicators for estimation. The BFH saw no need for changes based on its previous decisions dated 18 May 2021.

Bandwidth Consideration: The BFH confirmed that in determining arm's length transfer prices, a single arm's length price is not always feasible, and often necessitates consideration of a range. However, when calculating a deemed dividend distribution, it is generally best to use the price most favorable to the taxpayer. The BFH emphasized that there is no compelling reason to solely focus on the debit interest that the lender could alternatively achieve in the lending situation and the interest that the borrower could alternatively accept in the borrowing situation', as this would lead to different arm's length prices for a single legal relationship.

Collateral (Arm's Length): The BFH attached special significance to the question of "arm's length collateral" when determining arm's length interest. In this case, the absence of collateral was seen as a supporting the argument for an applied interest rate of 4.5%, as a lack of collateral generally results in an increase in interest rates. Potential garnishable salary claims or offsetable severance claims from A were not regarded as adequate security.

This judgment offers insights into the methodologies applied to intercompany loan arrangements and could have implications for cross-border transfer pricing cases. The application of the margin-sharing principle may raise questions in the context of calculating deemed dividend distribution, particularly in cases with international elements and potential issues of double taxation. The clarification of "arm's on "arm's length collateral" could provide some guidance for future discussions in tax audits.

Judgment of the Lower Saxony Fiscal Court Dated March 16, 2023 (10 K 310/19)

The core of the matter issue involves a decision made by global parent company, Z Corporation. Z Corp. It decided to halt production at its subsidiary X located in Area A and primarily relocate production to Area B under the management of its group company Y Enterprises. During this transition, the production facilities were transferred to sister companies, while Y Enterprises bore the associated costs. This transaction caught the attention of the tax office, which perceived the transaction as a transfer of functions to Y Enterprises, resulting in an increase in income.

However, the Lower Saxony Fiscal Court (Finanzgericht "FG") took a different stance. According to the FG, there was no transfer of functions because no assets, benefits, or business opportunities moved between the entities. Furthermore, the FG saw no direct correlation between the transfer of benefits and the capacity to perform a function.

The FG also dismissed the idea of a deemed dividend distribution (verdeckte Gewinnausschüttung), as it did not find it justified in this particular case, underscoring that such a distribution requires a reduction in assets (or a non-increase in assets that would otherwise have occurred were it not for the restructuring).

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Additionally, the FG determined that there was no transfer of a business opportunity from X to Y. This was a pivotal point because a business opportunity must possess independent profit potential and be distinguishable from other economic assets. The FG concluded that X did not leave behind an independent business opportunity.

The FG deemed the transfer of functions regulations inapplicable. The FG found that although a function did exist, there was no actual transfer of assets, advantages, or business opportunities from X to Y. Moreover, there was no established causal link between the transfer of benefits and the capacity to perform a function. Intangible assets were not transferred, and both X and Y had access to the same technical developments.

In essence, the FG's ruling contradicts the tax office's interpretation of the situation. It underscores that specific criteria must be met for a transfer of functions to be recognized.

3. How can MNEs best prepare for potential disputes in light of the factors described in Questions 1 and 2, and what can they do to mitigate the risks of future disputes?

The best defense against the challenges posed during transfer pricing audits is, of course, to be appropriately prepared. This means a combination of:

- Understanding that a German company will likely come under a tax audit at some point, and that transfer pricing is a key element of auditing multinational companies.
- Proactively monitoring and managing factors that could increase the risk of audits while anticipating the likely topics that are typically subjected to an audit. For example, (e.g., closely monitoring the CbCR reports and developments in local profitability).
- Actively managing transfer pricing topics as they occur, especially for high-value transactions such as relocation of functions and IP transfers.
- Preparing comprehensive and detailed documentation, especially for items that are considered extraordinary. The documentation should contain a specific account of the most relevant transactions and not just be a run-of-the-mill iteration of facts and basic policies.
- For especially contentious transactions, we advise using a secondary method to substantiate the results of the primary methods. For example, when a local German entity could potentially be seen as conducting certain DEMPE functions, it is often prudent to present a profit split calculation along with the primary methods of TNMM to proactively manage the debate.
- Overall, the authors' advice is to prepare documentation that will hold up and be convincing in tax *courts*, not just during the *audit itself*. Even when taxpayers would prefer to settle an issue in the audit, taxpayer's bargaining position is considerably improved if they can escalate the process with a high likelihood of succeeding. Several recent cases—both the authors' and in the wider tax sphere—have demonstrated that tax courts are increasingly open to listening to taxpayers and are reigning in arbitrary approaches by tax authorities.
- In the audit itself, we the authors typically advise leading the discussion with tax authorities proactively by explaining any intricacies in a fair and transparent manner i.e., (e.g., in the initial meeting at the same time as when the transfer pricing documentation is handed in).

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Hong Kong

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1. In your jurisdiction, how do the tax authorities select taxpayers for audits for transfer pricing cases and what are their focus areas that could lead to transfer pricing audits? And what measures and technology do the tax authorities have available to capture the essential information?

Although the number of transfer pricing audits/examinations has not significantly increased thus far in 2023, the authors expect that this will change soon. The Hong Kong Inland Revenue Department ("HK IRD") continues to build up a more sophisticated working team focused on transfer pricing as well as a database repository of transfer pricing arrangements through its reviews of taxpayers' master files and local files. In terms of focus areas, the authors have observed that the HK IRD has been shifting from its traditional territorial tax regime areas of profits tax and on/offshore profit attribution (where transfer pricing is discussed more as an undertone) to a more transfer pricing focused audit/examination, raising queries on capital attribution tax adjustments, as well as performing transfer pricing documentation compliance reviews. The authors anticipate seeing more transfer pricing audits and/or litigation going forward, as the HK IRD collects more data and starts building up its experience in identifying non-arm's length transactions.

Certain indicators could trigger scrutiny of transfer pricing issues, for instance, transactions conducted with high-risk/low tax rate jurisdictions, fluctuation in the entity's profit level, occurrence of new related party transactions ("RPTs"), and relatively uncommon transaction types, such as those involving intangible assets, profit split pricing policy, etc.

In general, the HK IRD will first collect any essential information from taxpayers through the annual profits tax returns, followed by the issuance of transfer pricing query letters. To date, there seems to be no particular special measures or technology adopted to capture essential information for transfer pricing related audits by the HK IRD.

2. Which approaches are followed by the tax authorities during transfer pricing audits and what are the key elements considered by courts when deciding on transfer pricing related disputes? Please describe a few recent cases or rulings as examples to help illustrate your explanation.

In the past, queries into transfer pricing matters were usually triggered by other initial tax queries. However, since the enactment of the transfer pricing legislation in Hong Kong in 2018, there has been an increase in the number of tax queries focusing primarily on transfer pricing matters, such as related party services arrangements (e.g., on the benefits test, benchmarking comparables, appropriate mark-ups, etc.), interest-free loans (e.g., whether an interest rate should be imputed), management fee allocations, etc.

The authors understand that the HK IRD intends to first collate information from a general perspective before raising any specific transfer pricing challenges to taxpayers. For example, the HK IRD may initially start by

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understanding the place of business and operations of the counterparties and then moving on to collecting copies of the intercompany agreements and questioning specific details of the related party transactions, etc. Hence, it may take several rounds of exchange before the taxpayer can grasp the HK IRD's intentions. In addition, the HK IRD may arrange field audits/on-site investigations to validate and examine the case. Then, negotiation and in-depth discussion will be conducted with a view to reaching an agreement on the case.

As the HK IRD becomes more proficient in identifying non-arm's length related party transactions, the authors anticipate that transfer pricing will become one of the key tax audit targets of the HK IRD in the near future. Hong Kong entities are therefore advised to revisit their transfer pricing policies in anticipation of this potential uptick in queries.

3. How can MNEs best prepare for potential disputes in light of the factors described in Questions 1 and 2, and what can they do to mitigate the risks of future disputes?

In light of the above developments, Hong Kong entities should take an in-depth look into their transfer pricing arrangements in order to determine whether there is sufficient substance and documentation to support their arm's length nature. If not, gaps in the pricing policies should be reviewed and rectified as soon as possible.

For several years now, since the enactment of the transfer pricing legislation in Hong Kong in 2018, the HK IRD has gradually requested that more and more Hong Kong taxpayers supply information through the issuance of queries. Taxpayers are strongly advised to engage a tax advisor for assistance to help ensure the response to the HK IRD will not trigger potential transfer pricing risk. The authors have seen taxpayers who have tried to attend to queries themselves, and in many instances this has resulted in unfavorable tax positions due to misinterpretation of the HK IRD's concerns, over-disclosure of information, etc. Such cases have also dragged on for extended periods, impacting the taxpayer's business and creating significant administrative burdens as well.

As an alternative route, taxpayers may consider reaching an agreement with the HK IRD and/or the counterparty tax authority(ies) on existing transfer pricing policies by entering into an advance pricing arrangement ("APA"). An APA provides certainty on an appropriate transfer pricing methodology in relation to the related party transactions. APAs concluded bilaterally or multilaterally with double tax agreement ("DTA") territories provide an increased level of certainty in Hong Kong and those territories, lessen the likelihood of double taxation, and may proactively prevent transfer pricing disputes.

Under the Hong Kong transfer pricing regulations, a taxpayer is eligible to apply for a unilateral APA to provide certainty for related party transactions with jurisdictions in which Hong Kong does not have DTAs in place, or to apply for a bilateral or multilateral APA to provide certainty for related party transactions with jurisdictions in which Hong Kong does have DTAs in place.

If an APA can be concluded, the taxpayer can request a rollback of the agreed transfer pricing methodology. The rollback option helps to manage historical risk in that tax audits/transfer pricing queries from prior years may be resolved with less penalty pressure.

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India

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1. In your jurisdiction, how do the tax authorities select taxpayers for audits for transfer pricing cases and what are their focus areas that could lead to transfer pricing audits? What measures and technology do the tax authorities have available to capture the essential information?

In India, transfer pricing (TP) cases are generally selected for audit through either a computer assisted scrutiny system or a compulsory manual selection system. The TP risk parameters used by the Indian Revenue Board are not made public and remain internal matters of consideration.

Further, normal income tax cases selected for audit on the basis of non TP risk parameters, but involving international transactions undertaken by taxpayers with overseas related parties, are also scrutinized under TP audits in any of the circumstances, where :

(a) the Revenue Officer comes to know that the taxpayer has entered into international transactions with overseas related parties, but the taxpayer has either not filed the mandatory report of a Chartered Accountant with respect to the international transactions along with its tax return or certain international transactions have not been disclosed in the report;

(b) there has been a TP adjustment of Indian Rupees 100 million (i.e. approximately US $ 1.25 million) or more in the audit relating to any earlier fiscal year and such adjustment has been upheld by judicial authorities, or is currently pending an appeal;

(c) there has been a TP adjustment in the audit relating to any earlier fiscal year and such adjustment has been either fully or partially set aside or restored by the Tax Tribunal or High Court or the Supreme Court to the file of the Revenue Officer; or

(d) search and seizure or survey operations have been carried out in the case of a taxpayer under the provisions of the Indian Income-tax Act and findings regarding TP issues have been recorded by the investigation wing or the Revenue Officer during the course of operations.

Typically, Revenue Officers gather information on international transactions entered into by a taxpayer with overseas related parties from the accounts, websites and report of a Chartered Accountant, carrying all the necessary information relating to TP, the last of which is required to be obtained by a taxpayer and filed with its tax return. Revenue Officers generally do not deploy any special technology to decipher data with respect to international transactions entered into by a taxpayer with overseas related parties, except in matters involving search and seizure or survey operations, where the investigation wing of the Indian Revenue deploys technology to extract data from the accounting software of taxpayers.

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2. What approaches are followed by the tax authorities during transfer pricing audits and what are the key elements considered by courts when deciding on transfer pricing related disputes? Please describe a few recent cases or rulings as examples to help illustrate your explanation.

3. How can MNEs best prepare for potential disputes in light of the factors described in Questions 1 and 2, and what can they do to mitigate the risks of future disputes?

Response to Questions 2 and 3

While Indian Revenue Authorities try to maximize collection of taxes from TP audits by adopting slightly aggressive views, some taxpayers attempt to counter the stands of the Revenue, primarily through interpretations of tax legislation embodying the provisions of TP, rather than taking recourse to the fundamentals of TP on the bedrock of economic principles, including advanced statistical analyses.

As a result, the majority of the disputes in TP get adjudicated by Tax Tribunals and Courts with reference to legal arguments of taxpayers and the Indian Revenue, based on interpretation of statutes, rather than on: (a) the fundamentals of TP, which are available in the TP guidelines of the Organisation for Economic Co-operation and Development (OECD) and United Nations (UN) and (b) advanced statistical analyses. The manner of handling TP disputes by taxpayers and the Indian Revenue Board and the similar approach to adjudication by Tax Tribunals and Courts, often leave the major or fundamental issues in TP unaddressed or unresolved, fuel more protracted litigation, and fail to resolve the disputes through mutual cooperation.

For a seamless analysis of some of the major areas of disputes in TP and how taxpayers can mitigate risks of future disputes and resolve the existing disputes by adopting correct positions under TP, questions (2) and (3) are clubbed together for a detailed discussion to jointly address the matters and any overlap.

A. MARKETING INTANGIBLES – ADVERTISEMENT, MARKETING AND SALES PROMOTION EXPENSES

The single most important source of dispute and litigation in TP in India, and one that has prevailed for over a decade, has been around the issue of incurring advertisement, marketing and sales promotion (AMP) expenses by the Indian licensee of a foreign trademark. The modus operandi of the Indian Revenue Board in making TP adjustments has been that if the ratio of AMP expenses to turnover of the Indian licensee of a brand owned by its foreign related party, exceeds the average of those of comparable companies selected for the purposes of testing the profitability of the Indian licensee under the overall transactional net margin method (TNMM). For any excess, the taxpayer would be deemed to have rendered a service for promotion of the brand for the benefit of the licensor. A separate reimbursement for that service, in the amount of the excessive AMP expenses is therefore allegedly receivable by the Indian licensee, along with a mark-up, from the foreign licensor, thus resulting in a TP adjustment.

The Indian Revenue Board has applied the above rationale across the board for all types of licensees, irrespective of their cast or creed, which in the parlance of TP is referred to as characterisation, namely distributors and entrepreneurial licensed manufacturers. The Indian Revenue has alleged the presence of a rendition of services as an "international transaction, which is the sacred sceptre for triggering TP as generally understood by most constituents in India, in all casesin which the Indian licensee's ratio of AMP expenses to turnover exceeds the average of those of comparable companies. In such cases, the Revenue Board makes TP adjustments in the hands of the taxpayer licensees.

Taxpayers have been contesting such TP adjustments in appellate forums and have successfully defended their cases up to the level of High Courts of the country. The High Courts have decided the matters in favor of taxpayers, both in the context of distributors and licensed manufacturers. It is noteworthy that the High Courts have decided the cases in a manner that addresses the specific questions and arguments put forth by the taxpayers, in response to the modus operandi adopted by the Indian Revenue while inflicting TP adjustments in the cases of distributors and licensed manufacturers, as discussed above.

Brief synopses of the rulings of the High Courts are as follows :

- In the cases of distributors, the High Courts have held that since taxpayer distributors have argued that the rewards around their excessive AMP expenses are subsumed within the overall profit margins of distribution, the taxpayers cannot at the same time contend that AMP expenses are not "international transactions". However, having held as above, the High Courts added that while a taxpayer distributor, who may perform additional functions on account of AMP, as compared to comparable companies, would generally require additional remuneration for such functions, such additional rewards may be granted through pricing of products or distribution margins, and if so received, then the Indian Revenue cannot demand a separate remuneration through reimbursement of excess AMP expenses along with a mark up, as such action would clearly result in double addition or taxation.
- In the cases of entrepreneurial licensed manufacturers, the High Courts dismissed the attempt on the part of the Indian Revenue to impute a TP adjustment of the above nature, for the excess AMP spend of taxpayers, as a percentage of turnover, over the average of those of its comparable companies selected under an overall TNMM. The main reasoning of the High Courts, while concurring with the arguments of the taxpayers, was that the AMP spend on a stand-alone basis cannot be treated as an "international transaction" under the provisions of the Indian TP regulations, in the context of licensed manufacturers. Thus, the TP adjustment with respect to any part thereof, in the manner proposed by the Indian Revenue, namely reimbursement of the "so-called" excess amount of the AMP spend, by the foreign licensor of brand, was clearly not sustainable.

Appeals arising from rulings of the High Courts, filed both by taxpayers and the Indian Revenue, are currently pending adjudication before the Supreme Court. The main ground contested by both parties is whether or not AMP expenses constitute an "international transaction". The issue around AMP expenses, which is a sub-set of the overall concept of marketing intangibles, can be resolved only through the Supreme Court considering this issue, albeit in the backdrop of different facts and taxpayers. If the Supreme Court were to hold that the incurring of AMP expenses is an "international transaction", then would the Indian Revenue have unfettered rights to make TP adjustments through the mechanism of reimbursement of excess AMP expenses, in any and every case? Again, if the Supreme Court were to hold that incurring AMP expenses is not an "international transaction", would it mean that the Indian Revenue would never have the right to deal with the larger issue of marketing intangibles in the cases of licensee taxpayers? The common answer to both the questions appears to be in the negative.

The Supreme Court may only rule on the controversy before it - the manner of making TP adjustments by the Indian Revenue, namely reimbursement of excess AMP expenses of a licensee with a mark-up. The onus was, or still is, upon the Indian Revenue to seek guidance from the Supreme Court in the context of marketing intangibles, of which, AMP expenses is only a subset, instead of defending the arbitrary manner of making TP adjustments through the mode of reimbursement, as above. It is important to note that taxpayers,

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particularly entrepreneurial licensed manufacturers, have never been under any obligation to request the High Courts to lay down such principles as they were only defending the manner of adjustments made by the Indian Revenue. Such taxpayers were perfectly justified to plead for the knocking down of such adjustments made by the Indian Revenue on the ground that AMP spend, on a stand-alone basis, do not constitute an "international transaction" in the context of an entrepreneurial licensed manufacturer, so as to trigger a TP adjustment, instead of requesting the High Courts to provide overall guidance on the subject. One is, therefore, not sure as to how and to what extent the larger issue around marketing intangibles would be addressed by the Supreme Court and whether the Supreme Court would be laying down detailed guidance around the same in the context of different classes of taxpayers, in absence of specific questions being raised by the taxpayers and the Indian Revenue.

The published rulings of various judicial authorities show that the genesis of the disputes around the issue of AMP expenses have primarily resided in the taxpayers having not adopted proper methodologies and approaches in their TP documentation, particularly in selecting profoundly wrong comparable companies in the cases of distributors and exposing the financial results for comparability analysis under overall TNMM in the cases of entrepreneurial licensed manufacturers. The Revenue Officers, instead of asking the taxpayers to revise their TP studies or themselves embarking upon such path during the course of tax assessments, chose to build their cases upon the inherently erroneous base documents of taxpayers, which was akin to building castles on quicksand, only to be thwarted by the judicial authorities, albeit without addressing the overall concept around marketing intangibles, since the same never came up for consideration in the litigations. If the taxpayers had adopted the fundamentals of TP, then more than three-fourths of the disputes and litigations around the issue of marketing intangibles and AMP expenses, likely would not even have arisen in India.

There cannot be any doubt whatsoever that in the absence of any agreement or arrangement between the foreign licensor of a trademark and the Indian licensee under which the Indian licensee would be rendering services on behalf of the foreign licensor by promoting and marketing the foreign licensor's trademark, incurring AMP expenses alone cannot be said to trigger any stand-alone "international transaction" in the hands of the Indian licensee, thus dispensing with the requirement of reimbursing any portion by the foreign licensor along with any arm's length mark-up. Thus, it is hard to understand the continuing legal battle over what constitutes an "international transaction" in the context of AMP expenses when there has been no focus on functional, asset and risk (FAR) profiles. Having said that, the OECD's TP guidelines on marketing intangibles might have thrown some fuel on the fire, and provided support for the Indian Revenue's approach to a certain extent.

A brief discussion follows on possible approaches, which may be collaboratively adopted by both the Indian Revenue and taxpayers in order to amicably resolve pending and future cases relating to marketing intangibles, whether through the route of domestic litigation or alternative dispute mechanisms under bilateral international tax treaties, i.e. through Advance Pricing Agreements (APAs) and Mutual Agreement Procedures (MAPs).

Distributors

When and under what circumstances a licensee of trademarked products can be said to contribute towards unique and valuable marketing intangibles under a quantitative analysis of TP, are extremely intriguing questions. The OECD has attempted to provide some solution to the above issues, but some deficiencies

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remain. The discussions may be summarized in two major issues, as highlighted in the main paragraphs (1) and (2) below:

1. What actually triggers unique and valuable marketing intangibles under a quantitative analysis of TP by a selling entity, which is a licensee of a foreign trademark? Is it overall selling and general administrative (SG&A) expenses, or AMP expenses, which are a subset of overall SG&A expenses?
    a. The OECD has applied AMP expenses as a trigger for contribution of marketing intangibles without carrying out any deliberation or discussion.
    b. Statistical analyses conducted on selected empirical data have proven that neither SG&A expenses nor AMP expenses have any correlation whatsoever with distributors' net profit margins.
    c. These statistical analyses have also proven that SG&A expenses have far greater impact on distributors' gross profit margins than AMP expenses, thus suggesting that SG&A expenses should be the trigger for determining contribution towards marketing intangibles and not AMP expenses.
2. Once it is decided that a selling entity, having long-term license rights, has contributed to unique and valuable marketing intangibles, what method or principle of TP should be applied to that selling entity?
    a. This aspect is extremely critical and requires deliberation irrespective of whether or not SG&A expenses or AMP expenses may be finally said to constitute the trigger for marketing intangibles, being the larger issue, referred to in paragraph (1) above.
    b. The OECD has provided options to taxpayers and Revenue Officers to adopt any one of the following three solutions, namely:
        i. Excess AMP expenses of the distributor, as percentage of turnover, may be reimbursed by the overseas legal owner of trademark, with an arm's length mark-up;
        ii. Profits of the distributor may be adjusted with reference to profits of comparable companies having similar levels of AMP expenses, as a percentage of turnover; and
        iii. Apply the Residual Profit Split Method (RPSM).

Now, the first two options provided by the OECD are unworkable for the following reasons:

a) The first option, i.e. the one referred to in item (i) above, aims to forcefully convert the FAR profile of a full-fledged marketing distributor, enjoying long-term distribution rights and thus economic ownership of marketing intangibles, if any, to that of a service provider, as if it is purportedly incurring AMP expenses for, and at the behest of the overseas manufacturer, i.e. the legal owner of the trademark. This goes against the very concept of DEMPE (development, enhancement, maintenance, protection and exploitation) functions in the context of intangibles. Thus, the first option, which has always been the fallback support of the Indian Revenue, is simply unworkable in the case of a selling entity, enjoying long-term license rights around the trademark.

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b) Now, coming to the second option referred to in item (ii) above:

- It has been statistically proven that AMP expenses have no impact whatsoever on net profits of distributors, thus the question of selecting comparable companies with similar level of AMP expenses, as percentage of turnover, as the taxpayer distributor, for the purposes of applying their net profit margins as the arm's length return for the taxpayer distributor, does not apply.
- While AMP expenses have some impact on gross profit margins of comparable distributors, however, it has been statistically proven that SG&A expenses have far greater correlation and impact on gross profit margins than AMP expenses, which again opens up the issue and debate of AMP expenses versus SG&A expenses, being the larger issue referred to in paragraph no (1) above.
- Thus, if comparable distributors in the data set do carry ratios of SG&A expenses to turnover (the ideal) or AMP expenses to turnover, at levels higher than those of the taxpayer, then the gross margin of the taxpayer may be adjusted to the gross margin of such comparable distributors by applying sophisticated statistical tools, e.g. regression analysis.
- Such adjustment would fall under the normal nuances of resale price method (RPM) in TP, and not be the result of any fallout of the issue of marketing intangibles, since the taxpayer would not be said to have contributed to any unique or valuable marketing intangibles under quantitative analysis, since its selling and marketing expenses would have still been within the periphery of similar spends by comparable companies, albeit limited in number.
- Where such ratios of the taxpayer are higher than those of all comparable companies in the data set, such that the taxpayer may be said to contribute towards unique and valuable marketing intangibles, then no further upward adjustment to the gross margin of the taxpayer would be feasible under RPM, since statistical tools would fail in such case, as the aforesaid financial ratios of the taxpayer would fall outside the dataset.
- Further, in any event, if a taxpayer is said to have contributed towards unique and valuable intangibles, then the taxpayer cannot be subjected to a "one-sided" testing either under RPM, i.e., with reference to gross profit margin or TNMM, i.e. with reference to net profit margin, since it altogether goes out of the realm of comparability analysis under TP.
- Therefore, even the second option, referred to in item (ii), is not workable under the scenario hypothesized by the OECD, namely where the selling entity has long-term selling and distribution rights.

Thus, where a selling entity can be said to contribute unique and valuable marketing intangibles, irrespective of whether SG&A expenses or AMP expenses are applied as the trigger for such determination, the application of RPSM appears to be the only logical solution.

The OECD has not revisited its existing TP guidelines around marketing intangibles, despite requests to do so. With no possible sign of the OECD taking corrective steps with respect to these guidelines, it falls upon taxpayers and the Indian Revenue to reach logical conclusions in pending litigation and in future tax determinations. The Courts can only act on legal questions placed before them and unless the litigants require the Courts to adjudicate on matters of principles or fundamentals relating to TP, one cannot expect the Courts to go beyond the legal questions before them and adjudicate upon such principles or fundamentals on their own. It is therefore high time that both taxpayers and the Indian Revenue move away

from disputing the legal interpretation of the term, "international transaction" in the context of marketing intangibles and focus on solving issues around TP by resorting to economic principles and fundamentals.

Licensed Manufacturers

One would next deal with the issue of entrepreneurial licensed manufacturers, who generally take significant strategic decisions, both for manufacturing and distribution functions, while exploiting the intangibles, in the form of technology and brand, which are obtained on license from an overseas licensor. The question of marketing intangibles in the context of an entrepreneurial licensed manufacturer, with economic ownership of such intangibles and its selling functions, including AMP functions, centers around whether it has passed on to the foreign licensor the profits relatable to economic ownership of the marketing intangibles through transactions, which could be in the form of import of raw materials and components, as well as payment of royalties for technology and brand.

The answer lies in a robust stand-alone testing of two primary transactions - (a) import of raw materials and components, ideally under a cost plus method, by taking the foreign supplier as the "tested party", being normally the least complex of the two entities; and (b) payment of royalties for technology and brand, under the comparable uncontrolled price (CUP) method, duly corroborated by RPSM, in case reliable third party license agreements are not available in global databases for the relevant industry. One should not apply an overall TNMM on the results of the Indian entrepreneurial licensed manufacturer, since under the fundamentals of TP, an entrepreneurial licensed manufacturer should never be taken as the "tested party". Thus, the genesis of dispute and litigation around AMP expenses in the context of entrepreneurial licensed manufacturers in India is the adoption of erroneous TP methods by the taxpayers, which the Indian Revenue has used to its advantage.

One would need to initially provide routine returns for the manufacturing and distribution functions carried out by the Indian licensed manufacturer by selecting comparable companies engaged in routine manufacturing and distribution functions, which do not carry any significant intellectual property, whether trade or marketing intangibles. The residual profit/ loss may then be split between the Indian licensee and overseas licensor in proportion to contribution of unique and valuable intangibles, namely – (i) excess of SG&A expenses of the Indian licensee, as a percentage of turnover, over the average of those of comparable companies selected for computing routine returns, being the contribution of marketing intangibles by the licensee; and (ii) global spend by the licensor, as duly adjusted to the level of the turnover in India, on account of R&D and also possibly SG&A, in case the facts suggest that distribution strategies, including brand-building, of the licensor at the global level, have positive impact on sales in India, being the contribution of trade and, possible marketing intangibles, by the licensor.

If the above transactions are found to be at arm's length on the basis of this approach, it would lead to the automatic conclusion that the Indian entrepreneurial licensed manufacturer had not diverted any portion of the profits relating to the economic ownership of marketing intangible, in favor of the foreign licensor of the trademark. Accordingly no TP adjustment on account of marketing intangibles would arise in the hands of the taxpayer. On the other hand, if the royalty actually paid by the licensee taxpayer on behalf of the overseas licensor of IP, exceeds the arm's length rate of royalty, which may be determined under RPSM, then any excess would need to be disallowed as a TP adjustment, on account of marketing intangibles. Thus, the significance of marketing intangibles may arise in the context of overpayment of royalty in the case of entrepreneurial licensed manufacturers and not in making stand-alone TP adjustments with reference to AMP expenses of the licensee taxpayer.

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B. ATTRIBUTION OF PROFITS TO DEPENDENT AGENT PERMANENT ESTABLISHMENT

Under international tax treaties, if a dependent agent secures orders or concludes contracts on behalf of its foreign principal, particularly in a related party scenario, that agent creates a dependent agent permanent establishment (DAPE) of the foreign enterprise in the host or local jurisdiction. The regulations relating to triggering of DAPE have been significantly strengthened as an outcome of Action 7 of the OECD and G-20 BEPS initiative. The matter of independent agency is not addressed in this response, since the current discourse aims to deal with the issue of attribution of profits to a DAPE and not whether a DAPE exists in the first instance.

Over the last couple of decades, disputes around the issue of attribution of profits to PEs, particularly DAPEs have surged in India. On one hand, taxpayers, being foreign enterprises having taxable presence in India through DAPE, have sought resolution from appellate authorities and Courts on a generic or motherhood proposition, bereft of unique facts involved in individual cases: if the Indian subsidiary company (I Co), which acts as the dependent agent of a foreign enterprise (F Co), is remunerated at arm's length for its agency functions, then no additional profits can be attributed to the DAPE of F Co in India, which is triggered by I Co, under any circumstances whatsoever. On the other hand, Revenue Officers tend to use a formulary approach in attributing profits to a DAPE through the use of a rule of thumb. The issue is currently pending resolution before the Supreme Court because different High Courts have taken divergent views on a formulary approach.

There is another line of cases decided by High Courts in which taxpayers never submitted any sophisticated study for attribution of profits to a DAPE to the lower authorities, including Tax Tribunals, as the taxpayers argued that they did not have a DAPE in India. They did not prepare for and build up the second line of defense in the matter of attribution of profits to a DAPE, in the event such DAPE were ultimately held to exist.

In such scenario, the High Courts had no choice but to approve the formulary approach adopted by the lower authorities, based on an unprincipled rule-of-thumb application of a profit split method, since the High Courts are not fact finding authorities and accordingly can only decide cases based on facts presented to them. In most of those cases, the High Courts had also specifically observed the fact of such limitations faced by them, namely, the taxpayers having failed to proactively submit proper approaches for attribution of profits to a DAPE before the lower authorities.

Before discussing the opportunity for applying statistical analysis in the context of attribution of profits to a DAPE, one needs first to deal with the overall concept of attribution of profits to a DAPE. A fundamental presumption on the part of taxpayers, that if I Co is remunerated at arm's length for its agency functions performed on behalf of F Co, then no additional profits can ever be attributed to the DAPE of F Co, which is triggered through the presence of I Co. This is not correct since the issue of attribution of profits to a DAPE is not a matter of interpretation of statute, but one involving principles of TP, economics, and analysis of the texture of international tax treaties, all of which are entirely fact specific. Without examination of the facts involved in each case, it is not possible for any authority to address such a fundamental or generic presumption.

The Indian Revenue, on the other hand, tries to buttress its position with the argument that a formulary approach is the only way to attribute profits to PEs, instead of making reference to economic principles. One may not be wrong to presume that the Indian Revenue's preference for the adoption of a formulary approach in the attribution of profits to PEs is perhaps the result of the reliance on the fundamental or

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generic proposition by taxpayers. This, quite justifiably, raises an element of apathy within the Indian Revenue. Incidentally, the Indian Revenue, particularly the APA Authorities, have taken extremely positive views in the matter of attribution of profits to a DAPE, with reference to sophisticated and correct principles of TP.

Some considerations regarding the attribution of profits to a DAPE include:

1. There is a fundamental difference between the concepts of a DAPE and any other form of PE under tax treaties. In cases of fixed places of business PEs, branch PEs, service PEs, etc., the physical presence of a foreign enterprise in the host country triggers a PE. In the case of a DAPE, there is no physical presence of the foreign enterprise in the host country. Instead, the activities of a dependent agent, a separate legal entity altogether, create a PE of the foreign enterprise subject to the fulfilment of certain conditions.
2. Why is there a need to create a deemed PE of a foreign enterprise under the PE Article of tax treaties when it is represented by a dependent agent in the source or host country, as opposed to allocating proper profits to that deemed PE by taking recourse to the Business Profits Article of tax treaties? Why is that the TP provisions under the Associated Enterprise Articles of tax treaties by themselves cannot address the issue of allocation of arm's length profits in the host jurisdiction by subjecting the local entity, the dependent agent, to the same?
3. The functions of the Indian dependent agent entity, that trigger the existence of a DAPE under the PE of tax treaties are different from those that lead to attribution of profits to the DAPE under the Business Profits Article of tax treaties.
4. he dependent agent functions of securing orders or concluding contracts on behalf of a foreign enterprise trigger the existence of a DAPE of the foreign enterprise in the host jurisdiction under the PE provisions of treaties. However, such limited functions by themselves do not automatically result in attribution of profits to the DAPE of the foreign enterprise under the Business Profits provisions of tax treaties. The performance of significant peoples' functions (SPF) by the dependent agent for assumption of risks and economic ownership of assets, being debtors and inventory, on behalf of the foreign enterprise, which incidentally are different from the mere securing of orders or conclusion of contracts, trigger the attribution of profits to the DAPE of the foreign enterprise under the Business Profits Articles of tax treaties.
5. Analyzing the scenario in the context of India, in carrying out agency functions on behalf of the foreign enterprise (F Co), such as securing orders or concluding of contracts, the Indian subsidiary company (I Co) would have earned an arm's length remuneration from F Co in the form of an agency commission, which may be properly monitored through the application of the TP provisions in the Associated Enterprises Article of the relevant tax treaty.
6. It is elementary that DAPE is a proxy for distribution functions, which the entity in the host jurisdiction would have carried out in discharging mere functions of agency. To put it simply, a normal agent merely acts as a matchmaker in either securing orders or even concluding contracts on behalf of its principal. On the other hand, a distributor performs the functions of buying and selling products, and in such process, often carries out significant people functions with respect to debtors and inventory.
7. If I Co, in addition to securing of orders or concluding contracts on behalf of its overseas principal, i.e. F Co, carries out significant peoples' functions with respect to debtors and

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inventories, e.g. determining credit worthiness of customers and managing inventory, going beyond routine functions of logistic handling, then it assumes the risks with respect to debtors and inventory on behalf of F Co, and accordingly the rewards with respect to such risks and also economic ownership of assets associated with such risks, i.e. debtors and inventory, being generally commensurate to functions of distribution, would need to be attributed to the DAPE of F Co, by invoking the Business Profits Article of the relevant tax treaty, to the extent the agent, i.e. I Co, had not been already remunerated with the same.

8. Such additional rewards or profits would be attributed to the DAPE of F Co by deeming it to be a distributor of products, where the additional profits would represent the difference between the arm's length profits of a distributor, having commensurate FAR profile or intensity of selling functions and the commission received by I Co in its capacity as the agent.

9. The reason for invoking the Business Profits Article of tax treaties to attribute additional profits to the DAPE is that under the classical TP approach under the Associated Enterprises Article of tax treaties, the risks and rewards commensurate to distribution functions are generally not allocated to an agent in the absence of legal ownership of debtors and inventory. Thus the arm's length profits relating to significant people functions for assumption of risks and economic ownership of assets carried out by the agent would not have otherwise been subject to tax in the host jurisdiction, and thus one would have had to create an artificial or deemed entity of the foreign enterprise, in the form of the DAPE, as a distributor with commensurate FAR profile, having legal ownership of debtors and inventory and attribute such profits to that PE of the foreign enterprise.

10. Thus, under the classical approach of TP, the TP provisions of the treaty would have been insufficient for taxing such additional profits in India in the hands of I Co, and one would have needed to invoke the charging provisions of the PE and Business Profits Articles of the tax treaty, for first artificially creating a presence of F Co in India in the form of a DAPE, and then determining the income to be allocated to that DAPE.

11. It is not that any and every DAPE would automatically lead to attribution of incremental profits. If the dependent agent, in securing orders or concluding contracts on behalf of the foreign principal, in substance does not carry out significant people functions on behalf of the foreign principal for the assumption of risks relating to debtors and inventory, then no incremental profits relating to any such assumed or presumed distribution functions would be attributed to the DAPE.

12. An attempt is made to provide a solution through a hypothetical example, the facts of which are as follows:

    a. F Co directly sells products worth US$ 100 million to independent customers in India.

    b. All selling activities in India are undertaken by I Co, being the dependent agent of F Co. All functions around marketing, including strategies, product ordering, delivery, etc., are undertaken by I Co.

    c. I Co is remunerated on a full cost-plus mark-up (15%) model for its agency services. Total costs of I Co are US$ 10 million. Thus, the mark-up at the rate of 15% thereon is US$ 1.50 million.

    d. Debtor management functions, particularly determining credit worthiness of customers, are undertaken by I Co, though inventory and debtors are legally owned by F Co under all circumstances.

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e. F Co has suffered a loss of US$ 1 million on account of bad debts relating to sales made to customers in India.

f. Through an audit of the DAPE of F Co in India, it is noted that although I Co carries out strategic functions around advertisement and marketing, AMP costs worth US$ 3 million relating to India reside in the books of F Co at the level of the foreign country and not I Co.

13. It is therefore noted that I Co, in essence, has been carrying out all the functions of a distributor of products, albeit under the arrangement of agency. Since I Co performs all the significant people functions with respect to debtors and inventory, the risks and corresponding rewards relating to the economic ownership thereto, need to be allocated and taxed in the hands of the DAPE of F Co in India, to the extent the same had not already been reported in the books of I Co, as remuneration received from F Co for agency functions.

14. Before proceeding to resolve the issue of attribution of profits to the DAPE of F Co, it is imperative to draw up a memorandum profit and loss account of the DAPE, from the facts and figures laid out above:

Particulars	**US$ million**
Turnover	100.00
Less: Cost of Goods Sold (COGS) (balancing figure)	88.50
Gross Profit (GP), i.e. fees received by I Co [US$ 10 million + (15% of US$ 10 million)]	11.50
Less: SG&A expenses, being operating costs of I Co	10.00
Net Profits (NP) actually reported by DAPE in India	1.50

15. Now, the following financial ratios emerge from the memorandum profit and loss account of the DAPE of F Co in India :

- Intensity of functions (IOF) or SG&A expenses/ Turnover of the DAPE, as proxy distributor, is 10%.
- GP Margin and NP Margin of the DAPE are 11.50% and 1.50% respectively.
- Return on operating cost, i.e. NP/ SG&A expenses of the DAPE, is 15%, which represents the mark-up received by I Co from F Co.

16. There are two additional expenses and losses, which need to be assigned to the DAPE, beyond what are recorded in the accounts of I Co - AMP expenses relating to India amounting to US$ 3 million and bad debts written off relating to India amounting to US$ 1 million. Although these functions have been performed by I Co and accordingly the DAPE, they have been recorded in the books of account of F Co.

17. The revised IOF or SG&A expenses/ Turnover of the DAPE of F Co works out to 13% [(10.00 + 3.00)/ 100 x 100]. Assume that a robust economic benchmarking analysis under TP reveals that comparable distributors, having a commensurate FAR profile to the DAPE of F Co (namely IOF of 13%), earn a median arm's length gross margin of 17%, , and that the gross margin actually earned

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by the DAPE, namely 11.50%, falls outside the inter-quartile range of gross profit margins of comparable companies. The memorandum of arm's length profit and loss account of the DAPE of F Co would then be drawn up as follows :

Particulars	US$ million	US$ million
Turnover		100.00
Less: Cost of Goods Sold (balancing figure)		83.00
Arm's length Gross Profit Margin of the DAPE		17.00
Less: Expenses and losses –		
Operating costs of I Co	10.00	
AMP costs, relating to functions performed by I Co	3.00	
Loss on account of bad debt for sales relating to India	1.00	14.00
Arm's length Net Profit of the DAPE		3.00
Less: Profits actually reported by DAPE through I Co		1.50
Additional profits attributable to the DAPE of F Co		1.50

18. The return on operating cost, i.e. NP/ SG&A expenses, of the DAPE, based on arm's length profits, works out to 23.08% [3.00/ 13.00 x 100], which as such, is not exorbitant for a distributor.

19. Of course, if I Co had earned such additional reward of US$ 1.50 million as part of its remuneration for agency functions from F Co in the first instance, then the memorandum profit and loss account of the DAPE would have reflected a net profit margin of US$ 3.00 million, thus negating the need to attribute any further profits in the hands of the DAPE of F Co. It is submitted that in such event, the fundamentals of TP, as enshrined in the Business Profits and Associated Enterprises Articles of the tax treaty, would have been sufficient to extinguish any additional attribution of profits.

20. The OECD has said in the final discussion paper on attribution of profits to a PE, released under BEPS Action 7, that for the sake of convenience, such additional profits, which could have otherwise been taxed in the hands of the DAPE of the foreign enterprise in the host jurisdiction, may be taxed in the hands of the agent, namely the local subsidiary company, with a view to absolve the tax administration of the host jurisdiction from the unnecessary hassle of conducting two separate tax audits, one in the hands of the subsidiary company and the other in the hands of the DAPE of the foreign enterprise. In other words, the additional profit of US$ 1.50 million, as above, may be taxed in the hands of I Co, for the sake of convenience.

21. Incidentally, the unilateral APA team of India has been pleased to adopt such a pragmatic approach in some of the concluded unilateral APAs with Indian subsidiary companies of foreign multinational companies (MNCs), which act as agents of their foreign counterparts, By agreeing to allocate the arm's length profits commensurate to distribution functions to the Indian subsidiaries, an understanding has been entered into in the APAs that the foreign enterprises would be

insulated from any tax liability, in the event the respective Revenue Officers were to assert existence of DAPEs of such foreign enterprises at any future point.

Thus, it would be incorrect for taxpayers to make a generic proposition that if an Indian dependent agent is remunerated at arm's length for its agency functions performed on behalf of a foreign enterprise, then no additional profits could ever be attributed to the DAPE of the foreign enterprise. Since this issue is entirely fact specific, it requires an enquiry into the following fundamental aspects:

i. What do taxpayers mean by the term "arm's length reward received by the dependent agent"? Does the term cover only normal agency functions of securing of orders or concluding contracts or does it also take into account distribution functions, if any, performed by the dependent agent, albeit under the formal arrangement of agency?

ii. Has the dependent agent carried out functions commensurate to a distributor, namely significant people functions for assumption of risks with respect to debtors and inventory, if any, and accordingly economic ownership of the assets?

iii. In case the answer to question (ii) is in the negative, then the arm's length reward received by the dependent agent for carrying out basic agency functions of securing orders or concluding contracts would be sufficient arm's length reward for the DAPE of the foreign enterprise, and no further profits would need to be attributed to the DAPE.

iv. In case the answer to question (ii) is in the affirmative, then it is necessay to arrive at the arm's length reward for commensurate distribution functions, and if the same exceeds the reward already received by the agent, then that excess needs to be attributed as additional profits of the DAPE of the foreign enterprise. However, a convenient approach may be agreed upon with the Revenue Authorities to allocate the profits in the hands of the agent, merely to dispense with the administrative hassles of carrying out more than one tax audit.

It is imperative for taxpayers to draw up a memorandum profit and loss account of the DAPE on the lines discussed above, as it would help in defining the FAR profile and IOF of the proxy distributor, for the purposes of selecting comparable distributors with commensurate FAR profile. Of course, the Revenue Authorities would be within their rights to examine whether all the functions carried out by the dependent agent, and their corresponding costs are factored in the FAR profile and memorandum profit and loss account of the DAPE, which would assist in defining the IOF of the proxy distributor.

C. FINANCIAL GUARANTEES

Prior to the introduction of an amendment in the year 2012 with retroactive effect from 2001, to *interalia* expressly include financial guarantees as part of the definition of the term, "international transaction", taxpayers had won motherhood arguments before Tax Tribunals that in absence of financial guarantees being expressly covered within the definition of "international transaction", financial guarantees could never be subjected to TP. The adoption of the amendment provided clarity on the issue and stopped taxpayers from making motherhood arguments.

In reality, the legislative amendment was never required since the actual issue arising in the case of financial guarantees involving related parties for the purposes of TP, is whether or not the guarantor has rendered any service to the related party entity, who has borrowed money from a third-party lender, through the provision of an express guarantee to such third-party lender. The "provision or rendition of services" is a broad concept and has always been covered within the overall definition of "international transaction".

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However, prior to the amendment, the arguments of taxpayers and the rulings of the judiciary had unfortunately strayed towards justifying the point that financial guarantees were not covered by the TP regulations in India.

Recently, both the OECD and UN have released detailed guidelines on the application of TP to financial guarantees. Both the OECD and UN have explained in detail under what circumstances the provision of financial guarantee by the guarantor could be said to constitute either – (a) rendition of services to the borrower, generally being a subsidiary of the guarantor, so as to command receipt of arm's length guarantee fees; or (b) shareholder's functions, which would ideally benefit the guarantor instead of the borrower, thus not requiring any receipt of guarantee fees. The OECD and UN have also provided detailed guidelines for determining the quantum of arm's length guarantee fees, by analyzing the implicit and explicit natures of the guarantees and other factors including the credit rating of the borrower, comparability issues, etc.

Rulings were delivered by Indian Tax Tribunals, even before the release of the detailed guidelines on financial guarantees by the OECD and UN, but importantly after the insertion of the retrospective amendment around financial guarantees in 2012, in which the Tax Tribunals acknowledged the concepts of shareholder's functions, explicit and implicit natures of guarantees and other factors in the context of financial guarantees. In doing so, they made reference to various global literature available at the material time, including circulars and guidelines issued by revenue authorities of certain countries and thereafter ruled on whether, under the unique facts of a specific case, a particular financial guarantee actually constituted a shareholder's function (not requiring a receipt of fees) or the rendition of services (requiring receipt of arm's length fees).

It was extremely heartening to notice that the principles enunciated by such pragmatic rulings of Tax Tribunals ultimately found marked similarity with the guidelines on the relevant subject subsequently released by the OECD and UN. However, it was equally, if not more, disheartening to notice that in subsequent times, various taxpayers would rely upon such pragmatic rulings of Tax Tribunals, to argue, that the provision of financial guarantees always constituted shareholder's functions, thus not requiring receipt of arm's length guarantee fees. Incidentally, such arguments also managed to find favor with Tax Tribunals in some of the cases.

Thereafter, the Tax Tribunals in subsequent cases went on to hold that the pragmatic rulings delivered in the earlier cases, which were on lines similar to the subsequent OECD and UN guidelines on the relevant subject, were *per incuriam* or erroneous, since after the insertion of the retrospective amendment in 2012, the provision of every financial guarantee would compulsorily require arm's length guarantee fees. Furthermore, there would be no need to analyze the concepts of shareholder's function, explicit or implicit natures of guarantee, etc., for the purposes of determining as whether the provision of a financial guarantee actually resulted in the rendition of services by the guarantor.

Neither of the later Tax Tribunal rulings' lines of analysis of earlier rulings is correct. Concluding that the provision of financial guarantees would always constitute shareholder's functions, thus not requiring receipt of arm's length guarantee fees was the result of taxpayers misleading Tax Tribunals on the need to analyze facts in each case before deciding issues under TP. However, ruling after the insertion of retrospective amendment in 2012, that the provision of any financial guarantee would compulsorily require receipt of arm's length guarantee fees was the result of placing undue importance on legal interpretation of the word, "international transaction", while deciding an economics-based subject like TP.

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As noted, the retrospective amendment around financial guarantees was unnecessary and in fact meaningless. There was never a doubt that financial guarantees are quite common and well recognized in the commercial world, including TP regulations of any and every country. The issue arising in the case of financial guarantees involving related parties, for the purposes of TP, has always been whether or not, based upon the specific and unique facts of each case, the guarantor has provided any service to the related party entity, who has borrowed money from a third-party lender, through the provision of an express guarantee to such third-party lender. If the rendition of service can be justified, a need would arise to receive arm's length guarantee fees.

D. REMUNERATION POLICIES FOR PROCUREMENT SERVICES

Many foreign MNEs have set up subsidiaries in India for carrying out procurement support functions for their overseas group entities. The brief facts involved in most of the cases, as generally presented by the taxpayers, namely the Indian subsidiary companies, before the Indian Revenue and judicial authorities are as follows:

1. The Indian subsidiary company (Sub Co) provides routine procurement support services on behalf of the foreign enterprise (F Co), where F Co buys products directly from third party vendors in India.
2. F Co identifies third party vendors in India, negotiates terms and conditions with such vendors and enters into contracts with the vendors for manufacture and supply of products as per the specifications provided by F Co.
3. Sub Co is entrusted with the simple role of coordination with the third party vendors in India for ensuring that the vendors manufacture the products as per the specifications provided by F Co and export in them on timely basis.
4. For carrying out these routine functions relating to procurement, Sub Co is reimbursed by F Co for all its costs and is also awarded an arm's length mark-up on such costs.
5. The costs of materials are not recorded in the books of Sub Co as the products are purchased by F Co directly from the third-party vendors in India.

The Indian Revenue has challenged the above pricing policy of cost plus mark-up adopted by taxpayers in most of the cases and has argued that the taxpayers should be awarded an arm's length percentage on the value of goods procured by the overseas related parties from third party vendors in India and has made significant TP adjustments in the hands of the taxpayers. The Indian Revenue justifies its position on the ground that taxpayers actually carry out more intense functions relating to procurement than what is stated by such Indian taxpayers, such as identifying third party vendors and negotiating the terms of contracts with such vendors on behalf of their overseas related parties, the buyers of products. In some of the cases, the Indian Revenue has also alleged that the Indian taxpayers have developed and deploy supply chain intangibles while providing procurement services on behalf of their overseas enterprises.

The Indian Revenue generally selects the median of net profit margins of comparable distributors dealing with similar products as the taxpayers and applies the same to the value of goods procured by the overseas related parties from third party vendors in India, for arriving at the arm's length net profits of the taxpayers under TNMM.

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While some taxpayers have successfully defended their cases before Tax Tribunals and High Courts with reference to arguments based upon fundamentals of TP, backed by statistical analysis, other taxpayers have won their cases before High Courts more on the basis of legal arguments and interpretation of statutes. In such latter cases, the taxpayers, in addition to reiterating their averments of not carrying out any functions beyond routine procurement activities, as referred to in subparagraph (c) above, which justifies a reward of arm's length mark-up only on their operating costs, have also argued before High Courts that under TNMM, the Indian Revenue is not permitted to apply any mark-up or profit margin on the value of goods procured by their overseas related parties directly from third party vendors in India, since the same are not recorded in the books of account of the taxpayers in India. Such legal arguments have been accepted by the High Courts and the matter is currently pending adjudication before the Supreme Court of India.

Taxpayers would be advised to defend their cases with reference to fundamental principles of TP, backed by statistical analysis, instead of relying upon legal arguments involving interpretation of application of TNMM, since it is not uncommon for a procurement agent to be awarded a commission on the value of goods by the purchaser, if the FAR profile of a taxpayer carrying out procurement functions is akin to that of a procurement agent. How an arm's length rate of commission or net profits of such a taxpayer would be arrived at, namely whether by adopting CUP or RPM or TNMM, is a different matter altogether. The point to note is that if the facts of the case so demand, the taxpayer, carrying out procurement functions, may need to be awarded a revenue linked remuneration even though the value of goods are not reflected in the books of account of the taxpayer.

A detailed discussion is made below for the proper course of action, which may be adopted by the taxpayers, while defending their cases before the Indian Revenue and judicial authorities:

1. Generally, there are three conceivable types of entities, who carry out procurement functions - procurement support service providers, procurement agents, and procurement buy-sell companies. The general nature of the functions performed by each one of them and their respective usual remuneration policies are highlighted in the table below:

Serial No.	Type of procurement company (Sub Co)	General Nature of Functions	Usual remuneration policy
1	Procurement support service provider	• Sub Co provides coordination between F Co and third party suppliers. • Identification and selection of suppliers and negotiation of terms and conditions with suppliers are done by F Co. • Product specification is determined by F Co. • F Co buys products directly from suppliers.	Sub Co receives reimbursement of operating costs plus an arm's length mark-up.

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Serial No.	Type of procurement company (Sub Co)	General Nature of Functions	Usual remuneration policy
2	Procurement agent	• Sub Co identifies third party suppliers and negotiates terms and conditions with them. • Product specification is determined by F Co. • F Co buys products directly from suppliers.	Sub Co receives arm's length commission on value of goods procured by F Co.
3	Procurement buy-sell company	• Sub Co identifies third party suppliers and negotiates terms and conditions with them. • Product specification is determined by F Co, though Sub Co may also assist F Co in some cases. • Sub Co buys products from third party suppliers; and sells them to F Co.	Sub Co receives arm's length margin on value of goods procured.

2. Now, facts relating to the entities referred to in (1) and (2) in the above table may sometimes overlap. That is, it may not be always easy for a taxpayer, i.e. Sub Co, to conclusively demonstrate that it had not played any role in identification and selection of vendors and the negotiation of terms and conditions with them.
3. Thus, it may not be always possible to justify a cost-plus form of remuneration by solely relying upon the factual matrix of a procurement support service provider and it may be prudent for such a taxpayer to conceive of a second line of argument, through an interplay of the remuneration models of mark-up on operating costs and commission on the value of goods.
4. In other words, in justifying a cost plus form of remuneration based upon the factual matrix of a procurement support service provider, a taxpayer, i.e. Sub Co, may need to make an alternative argument, namely that even assuming (but not admitting) that the allegation of the Indian Revenue of the factual matrix being that of a procurement agent is true, how a revenue linked form of remuneration, which is typically associated with a procurement agent, would impact the determination of arm's length profits in its own case.
5. It is common on the part of Revenue Authorities across the world to suggest that an arm's length rate of commission on the value of goods may be arrived at through the application of the CUP the method, by identifying comparable third-party agency agreements in public databases. However, the application of the CUP method to determine the arm's length rate of commission on a standalone basis often poses difficulty, since in a CUP study involving rates of commission, the lack of knowledge regarding the differences in the levels of IOF between the taxpayer and comparable companies render the method highly unreliable.
6. Further, in a CUP analysis, the financials of the comparables are never available. Thus, it is not possible to understand the levels of return on operating expenses the comparable companies

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had earned by charging commission rates, which are otherwise available in public databases.

7. The matter may be viewed from another perspective. The commission rate of an agent is a proxy for the gross margin of a buy-sell company, subject to certain adjustments. Since buy-sell procurement entities are difficult to identify in public databases, one may consider selecting buy-sell distributors as comparables, though they reside on the diametrically opposite side of the supply chain as compared to buy-sell procurement companies.
8. It has been proven by statistical analysis carried out on selected empirical data that there exists an extremely high level of correlation between the IOF, i.e. the ratio of operating expenses to turnover; and gross margins in the case of distributors across industries. Further, it is possible to predict an arm's length gross profit margin from a data set of distributors, with reference to the level of IOF, i.e. the ratio of operating expenses to turnover of the tested party, through proper regression analysis, provided the level of IOF of the tested party otherwise falls within the range of such ratios of comparable distributors in the data set.
9. Since the current discussions are in the context of procurement services, the relevant ratios to be considered with reference to buy-sell distributors would need to be altered accordingly:
   - IOF ➔ ratio of operating expenses, i.e. SG&A expenses/ COGS;
   - Gross Profit Margin ➔ ratio of Gross Profit/ COGS
10. Let us assume that:
    a. F Co has procured goods worth US$ 1000 million from third party suppliers in India;
    b. Sub Co, which acts as a procurement support service provider of F Co, has incurred operating costs of US$ 10 million, for which it receives a mark-up of 15% from F Co, i.e. US$ 1.5 million, thus resulting in total fees of US$ 11.50 million; and
    c. The total fees of US$ 11.50 million received by Sub Co translates into a derived commission of 1.15% [11.50/ 1000.00 x 100] on the value of goods procured from third party suppliers.
11. Since it is not possible to identify comparable procurement buy-sell companies in public databases, the Indian Revenue selects buy-sell distributors from public databases in order to arrive at arm's length rewards linked with value of goods in the hands of taxpayers, who are involved in procurement functions, which is accepted globally.
12. As discussed earlier, the Indian Revenue generally selects the median of net profit margins of distributor companies dealing with similar products and applies the same to the value of goods procured by the overseas related parties from third party vendors in India to arrive at the arm's length net profits of the taxpayers under TNMM, which have generally hovered around 2% to 4% of turnover.
13. While it is not uncommon for a distributor of products to earn a net profit margin of 2% to 4% on turnover, it is important to understand that a revenue linked remuneration model cannot simply be imposed upon a taxpayer, without appreciating the impact on its operating cost, i.e. Berry Ratio, unless the taxpayer can be said to contribute to unique and valuable supply chain intangibles, in which case even a corroboration by a measure of return on operating costs would be a futile and an erroneous exercise.
14. Let us assume that the Indian Revenue carries out a benchmarking analysis with reference to distribution companies operating in the relevant industry sector as Sub Co, selected from public

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databases, which yields the following median of results from the financials available with respect to them:

Particulars	US$ million
Turnover	100.00
Less: Cost of Goods Sold	90.00
Gross Profit	10.00
Less: SG&A expenses	8.00
Net Profit	2.00

15. The following key ratios emerge from the analysis of the financials of the comparable distribution companies, which may have otherwise earned a median net profit margin of 2%:
    - The IOF with reference to COGS is 8.89% [8/ 90 x 100];
    - Gross Profit margin with reference to COGS is 11.11% [10/ 90 x 100]; and
    - The Berry Ratio (Gross Profit/Operating Expense) is 125% [10/ 8 x 100], denoting a derived profit of 25% [2/ 8 x 100] on operating costs.
16. For the sake of better understanding, Sub Co is hypothesized to be a buy-sell procurement company, which is a notch higher than a procurement agent, in which case, the memorandum profit and loss account of Sub Co may be drawn up as follows:

Particulars	US$ million
Turnover, i.e. price at which goods would be sold to F Co. (balancing figure)	1011.50
Less: COGS, i.e. value of goods procured from third party vendors	1000.00
Gross Profit, i.e. fees received by Sub Co from F Co [10.00 + (15% of 10.00)]	11.50
Less: Operating costs of Sub Co	10.00
Net Profit of Sub Co	1.50

17. Due to the significant disparity between the level of operating costs (US$ 10 million) and the value of goods procured (US$ 1 billion), despite the hypothesized buy-sell character of Sub Co reflecting more or less a healthy Berry Ratio of 115% [11.50/ 10 x 100], i.e. a mark-up of 15% on operating cost, the gross profit margin and net profit margin, both with references to COGS, of

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such hypothesized buy-sell character of Sub Co are low at 1.15% [11.50/ 1000.00 x 100] and 0.15% [1.50/ 1000.00 x 100] respectively. In the case of the hypothesized buy-sell character of Sub Co, the IOF, with reference to COGS, is 1% [10/ 1000 x 100], as compared to the ratio of 8.89% in the case of comparable companies.

18. Now, given the huge disparity between the operating costs of Sub Co and the value of goods priced at US$ 1 billion, applying an otherwise reasonable gross profit margin, with reference to COGS, of 11.11% to the value of goods dealt with by Sub Co, in the hypothesized form of either a – (a) commission agent, where commission of the agent is a proxy for gross profit margin of a buy-sell distributor; or (b) buy-sell procurement company, would result in attribution of net profit of US$ 101.10 million [(11.11% of 1000, i.e. 111.10) – 10] in the hands of Sub Co, namely a TP adjustment worth US$ 99.60 million [101.10 – 1.50].

19. Such net profit of US$ 101.10 million would yield a return of 1011% [101.10/ 10.00 x 100] on operating costs, being better described by the corresponding Berry Ratio of 1111% [111.10/ 10.00 x 100], which is simply unimaginable, when the distributors, which the Indian Revenue had itself chosen as comparables, had a modest Berry Ratio of 125%, i.e. a return on operating cost of 25%. Any such approach would result in the attribution of additional profits worth US$ 99.60 million in the hands of Sub Co.

20. Thus, in certain circumstances, particularly where there exists a huge disparity between the quantum of operating costs of the procurement agent and the value of goods procured directly by a foreign enterprise from third party suppliers, even an apparently small and innocent net profit margin of 2% on turnover relating to buy-sell distributors cannot be blindly attributed as profits of the agent. Any attempt for revenue linked attribution of profits would mandatorily need to be corroborated by the application of the Berry Ratio, more so when it may be impossible to obtain a representative set with reasonable number of comparable distributors from the public database, having such low level of IOF, with reference to COGS, as the taxpayer, which in the above example is 1%.

21. For instance, if the average return on operating costs in the case of comparable distributors chosen for the purposes of economic analysis by the Indian Revenue, namely, 25%, is attributed as profits to Sub Co, it would result in an additional 10% [i.e. 25% - 15%] net profit on operating cost, namely US$ 1 million (10% of US$ 10 million), which could be otherwise acceptable to the taxpayer, in place of the TP adjustment of US$ 99.60 million, as detailed in subparagraph (19). Taxpayers would need to understand that unlike matters relating to income tax, which are generally won or lost on the basis of legal arguments with reference to interpretation of statutes, in an economics-based subject like TP, success may be measured by the ability to resolve cases with Revenue Authorities through logical negotiations.

22. It has been proven by statistical analysis of empirical data across industries that there is a low level of negative correlation between IOF and the Berry Ratio. While the Berry Ratio increases with the decrease in the level of IOF, the low level of negative correlation makes it difficult to accurately predict an arm's length Berry Ratio corresponding to the IOF of the taxpayer by the application of regression analysis. In such case, it may be a good practice to identify the interquartile range of the results of the Berry Ratio for all the distributors within the data set and fix a floor and cap of such Berry Ratio with reference to the 25th and 75th percentile points respectively, to corroborate the arm's length rate of commission arrived at either by the CUP method or as a proxy of gross margin of distributors. Further, for the sake of being conservative, if the level of IOF, i.e. the ratio

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of operating expenses/ COGS, of the taxpayer, in this case being Sub Co, is abysmally low to the extent of 1%, as in the example above, then the floor and cap for the corroborative Berry Ratio may be set at the median, i.e. 50th; and 75th percentile points, respectively.

23. This would ensure that the procurement service provider within an MNE Group, even if remunerated with reference to a rate of commission on the value of goods purchased by the operating companies of the MNE Group, would neither be under nor over compensated having regard to its level of operating expenses. This is a critical aspect to be considered where the procurement service provider would be providing services only to companies within the MNE group.

24. In case a procurement buy-sell company is found, during the course of a detailed FAR or qualitative analysis, to possess and contribute unique and valuable supply chain intangibles in the form of specialized and in-depth knowledge of the goods to be procured for its overseas group entities (i.e., specifications, unique features, credibility and capabilities of third party suppliers in who may manufacture and supply such goods on a timely basis), then such procurement buy-sell company would ideally need to be rewarded though split of combined profits relating to procurement functions residing in the system of the MNE group. By virtue of possessing and deploying unique valuable supply chain intangibles, the procurement buy-sell company would be outside the realms of one-side testing under TP. This aspect has also been highlighted in the UN's TP guidelines on procurement functions.

Note from the Author:

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Ireland

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1. In your jurisdiction, how do the tax authorities select taxpayers for audits for transfer pricing cases and what are their focus areas that could lead to transfer pricing audits? And what measures and technology do the tax authorities have available to capture the essential information?

Irish legislation provides that the Revenue Commissioners (the "**Revenue**") are the competent authority with respect to the review and enforcement of transfer pricing compliance in Ireland. With effect from May 1, 2022, Revenue is engaging in transfer pricing compliance interventions under the new Code of Practice for Compliance Interventions (the "**Code**"), which places a greater emphasis on collaborative compliance. The new framework has three graduated compliance levels: Level 1, Level 2, and Level 3.

Revenue engages in both risk-reviews and transfer pricing audits under the new process. The Transfer Pricing Compliance Review Program ("**TCPR**") is categorized as a Level 1 intervention. The TCPR is a self-review process where the company is selected by Revenue, on a risk-assessment basis, to review its compliance during a specified period and then provides an assessment to Revenue.[1] During Level 1 intervention the taxpayer may still correct any errors identified and disclose them to Revenue without penalty. The TCPR has been a feature of Irish transfer pricing compliance for a number of years. In recent times, however, there has been a significant increase in the number of transfer pricing audits.

Transfer pricing audits are the remit of the Transfer Pricing Audit Branch within the Large Corporates Division. The audits follow the same principles as a corporation tax audit, and the burden to prove compliance sits with the taxpayer. An audit is a Level 2 intervention,[2] and the taxpayer is restricted with the avenues available to them to reduce the possibility of late interest and penalties.

Revenue is highly technologically enabled and has made significant investment in software with advanced data analytics capability. Taxpayers are selected for compliance intervention based on the presence of various risk indicators.[3] The presence of these risk indicators is detected by the Revenue Electronic Risk Analysis System ("**REAP**").

[1] Tax and Duty Manual Part 35A-01-01 Monitoring Compliance with Transfer Pricing rules.
[2] TDM Part 35A-01-01.
[3] Code of Practice for Revenue Compliance Interventions.

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REAP is designed to analyze vast amounts of data (including third party data), and attributes scores to taxpayers based on the level of risk posed to Revenue. Revenue also uses other methods for audit selection, such as the screening of tax returns and information gathered through industry reviews.

2. Which approaches are followed by the tax authorities during transfer pricing audits and what are the key elements considered by courts when deciding on transfer pricing related disputes? Please describe a few recent cases or rulings as examples to help illustrate your explanation.

Ireland's Tax Appeals Commission has not ruled on any transfer pricing related disputes to date. Revenue, in their most recent annual report, noted that 51 transfer pricing compliance interventions were initiated in the period from 2015 to the end of 2022.[4] Many of the assessments issued as a result of these interventions are currently being appealed to the Irish Tax Appeals Commission ("**TAC**"), with a number of these cases due to be heard in the later part of 2023. It is expected more insights will be available on the details of cases under consideration and the determinations of TAC over the next 12 to 18 months.

3. How can MNEs best prepare for potential disputes in light of the factors described in Questions 1 and 2, and what can they do to mitigate the risks of future disputes?

Revenue's focus on taxpayer-led compliance means that the value of adequate, accurate documentation should not be underestimated. Ireland introduced new transfer pricing documentation requirements for chargeable periods commencing on or after January 1, 2020.[5] Documentation must be prepared no later than the corporate tax return filing date and must be available within 30 days of a written request from Revenue.

Where documentation requirements are satisfied, certain protections from penalties are available where a transfer pricing adjustment is ultimately assessed. Where, as a result of an adjustment, additional tax is due the taxpayer will be protected from tax geared penalties where the documentation was prepared within the specified timeframe and demonstrates a reasonable effort to comply with the arm's length principle.

MNEs should ensure that regular functional updates are performed to ensure that the description of functions (in particular), together with assets and risks, have not changed. This may require regular internal functional interviews across the organization. It is important that this functional analysis reflects the full spectrum of the supply chain. This functional analysis is also good preparation for potential functional interviews as a part of any Revenue compliance intervention.

Large MNEs may also benefit from applying to Revenue's Co-operative Compliance Framework ("**CCF**"). CCF is a voluntary program that forms a mutually supportive relationship between Revenue and large corporates.[6] The CCF approach involves Revenue and the taxpayer agreeing on actions to ensure compliance. CCF does not offer protection to taxpayers from transfer pricing audit, and Revenue reserves

[4]Revenue Commissioners 2022 Annual Report.
[5]Section 835G TCA 1997.
[6]Tax and Duty Manual – Large Corporates Division: Co-operative Compliance Framework.

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the right to initiate a transfer pricing audit at any time inside and outside the formal CCF process. However, CCF provides an opportunity to build a relationship with Revenue based on trust, openness, and transparency. In the event of an audit, this open communication channel can be key to productive negotiations and timely resolution of the matter.

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Israel

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Multinational enterprises (MNEs) today face an increasing number of transfer pricing disputes, which may result in major legal and financial consequences for their various stakeholders. This issue of the Transfer Pricing Forum explores the topic of transfer pricing disputes to gain the unique perspectives of practitioners in each country. Please share your thoughts on this topic, with a focus on the following specific areas:

1. In your jurisdiction, how do the tax authorities select taxpayers for audits for transfer pricing cases and what are their focus areas that could lead to transfer pricing audits? And what measures and technology do the tax authorities have available to capture the essential information?

The current Transfer Pricing ("TP") legal framework in Israel is based primarily upon Section 85A ("Section 85A") of the Israeli Tax Ordinance (ITO). Section 85A, which was enacted in 2006, introduced the arm's length principle which was previously informally enforced through Section 86 of the ITO (the section which deals with artificial transactions).

There is a dedicated Transfer Pricing Department (the "TPD") within the Israel Tax Authority (ITA) which is responsible for performing audits and economic analyses to determine the arm's length price of a taxpayer's controlled transaction. The TPD audits Israeli subsidiaries of multinational enterprises (MNE), permanent establishments (PE), and local corporations with subsidiaries outside of Israel, and has full authority to review (and tax) previously approved assessments, and to reopen final assessments approved up to three (3) years before their inspection. The TPD also provides guidance and instructions to local tax assessment officers ("AO") to screen and initiate audits on a wider level. In the case of an audit by a local tax assessment officer, certain disagreements may be handed over to the TPD.

A taxpayer engaged in a cross-border controlled transaction is required to include in its annual tax return, Form 1385, describing the intercompany transaction. Form 1385 contains details about the nature of the transaction, including references to its price and other relevant terms and conditions. Consequently, the taxpayer is expected to maintain contemporaneous documentation, updated on an annual basis. By signing Form 1385, the taxpayer declares that the company is compliant with the arm's length principle and that it maintains up-to-date transfer pricing documentation (i.e., the transfer pricing study, inter-company agreement and where applicable, a transfer pricing policy). Therefore, it is advisable to have in place an annually updated transfer pricing study. In addition to preventing penalties and fines, maintaining a current transfer pricing study and other related transfer pricing documentation shifts the burden of proof to the tax AO, and offers the taxpayer a compelling position to refute any transfer pricing adjustments made by the tax AO.

Furthermore, Israel implemented BEPS Action 13 as of 2018. As a result, in addition to the regular local file (i.e., the transfer pricing study), Israeli taxpayers that are part of an MNE group also must submit data at the corporate level, namely, a Master File accompanied with related data of the MNE group. Moreover, an Israeli

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taxpayer that serves as the ultimate parent of an MNE group with consolidated turnover that exceeds 3.4 billion new Israeli shekels (sum may be subject to amendments) also must submit a Country-by-Country report (CbCR).

Beginning in fiscal year 2022, Israeli entities also must file Form 1485, disclosure of inter-company loans, and Form 1585, information on the UPE of the multinational enterprise group and the whereabouts of the CbCR filing within such MNE Group, if applicable. The revised Form 1385 requires the disclosure of whether the taxpayer has an available TP report supporting the disclosed intercompany transaction, at the time of filing of the tax return, to meet all local TP documentation requirements, on an annual basis.

This enables the ITA to create its own database of Israeli entities based on these forms (1385, 1485, and 1585). The ITA then allocates its resources among selected taxpayers based on the information in the forms, such as the volume of the transaction, the "tested party" profits if applicable, and automatically in cases where companies have not declared updated TP documentation (as required in the forms) or failed to submit the required forms.

Additional TP audit targets also may include focus on a specific industry (e.g., gaming, Bitcoin, or R&D centers which are compensated on a cost plus basis, etc.). Likewise, restructuring (mainly an economic transfer of IP) attracts many TP audits in Israel, as discussed below in the *Medingo Ltd.*, May 2022 case.

Currently, there are no specific penalties for transfer pricing, so the general penalties specified by Section 85A of the ITO apply. Penalties may be imposed on a taxpayer for failure to prepare and submit timely transfer pricing documentation. The current legislation allows for 30 days from request by the ITA to present the documentation. In any case, the lack of contemporaneous documentation at the time the tax returns were filed, is likely to shift the burden of proof to the taxpayer, as discussed above.

2. Which approaches are followed by the tax authorities during transfer pricing audits and what are the key elements considered by courts when deciding on transfer pricing related disputes? Please describe a few recent cases or rulings as examples to help illustrate your explanation.

The ITA issued Income Tax Circular No. 15/2018 related to Business Restructuring in Multinational Groups (the "ITA Circular" or the "Circular"). In this Circular, the ITA stated that a business restructuring may include a full transfer of the ownership rights of intangibles or provision of a right to use them for a certain period. To correctly characterize the transaction, the transferred rights, their extent, and their nature must be clearly identified. The analysis would begin with written agreements related to the restructuring, if available, in line with the OECD approach.

Insofar as a business restructuring is identified, emphasis should be placed on the tests listed below, which are based on the unique characteristics of a business restructuring. In particular, the following should be examined:

1. What is the economic life of the transferred asset? If rights were transferred for a limited period, but this period is the same as the asset's economic life, this sufficiently indicates a sale of all the transferor's rights in the asset and not simply the assignment of a right to use.

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2. Does the recipient of the right receive rights in future developments of the transferred asset? In principle, the fact that the recipient is granted the right to the asset's future development indicates that the transferred rights to use the asset for a period corresponds to the economic life of the asset and therefore indicates a sale of the asset's ownership rights.
3. Who manages and controls the functions related to the development and safekeeping of transferred intangibles?
4. Who bears the risk and costs associated with safekeeping and developing intangibles? Insofar as it is determined that the recipient of the right is the one that bears the risk and rewards associated with the development and safekeeping of the transferred intangible, the transaction is the sale of an asset's ownership rights.
5. Who makes the business decisions regarding the assuming of risks, development, and safekeeping of the intangibles.

In terms of the compensation to be paid, the arm’s length principle remains the core of the assessment. The application of this principle is in line with OECD Transfer Pricing Guidelines (TPG), Chapter 1, Paragraph 1.38, which provides:

> “Independent enterprises, when evaluating the terms of a potential transaction, will compare the transaction to the other options realistically available to them, and they will only enter into the transaction if they see no alternative that offers a clearly more attractive opportunity to meet their commercial objectives. In other words, independent enterprises would only enter into a transaction if it is not expected to make them worse off than their next best option.”

The application of the arm’s length principle to compensation, however, is generally subject to examination by the ITA.

The arm’s length price of the functions, assets, and risks (“FAR”) transferred, ceased, or eliminated following a business restructuring is determined by calculating the difference between the value of all the Israeli company’s FAR before and after the business restructuring.

If all or part of the ownership rights of intangibles were transferred, then the transaction is deemed a sale and will be classified as a capital transaction. Conversely, if only a temporary right to use the intangibles was provided, then the transaction will be classified as an ordinary income transaction.

The ITA’s position is that even if legal ownership was not transferred in the business restructuring, this fact has no effect on determining the market conditions of the transaction. In any case, the transferred FAR should be examined, whether there was a transfer of legal ownership or not. Insofar as rights or other assets or going concern are transferred during the restructuring, compensation is required for such transfers.

If the Israeli tax officer believes that the essence of the transaction differs from the manner by which it was presented, and that the transaction price differs and must be amended to adhere to transfer pricing rules on the basis of FAR, then the burden of proof is on the taxpayer to prove that it is not a different transaction.

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Medingo Ltd.: **A Post-Acquisition Business Restructuring Case**

In a May 2022 decision by the Tel-Aviv District Court related to a post-acquisition business restructuring involving *Medingo* Ltd. (Appellant), the court reviewed the ITA's decision to tax Appellant in connection with a deemed transfer of its FAR to a related party. The issue of FAR transfers has been a frequent contention point in Israeli income tax audits in the last decade, as the ITA routinely claims that local technology companies that are acquired by MNEs, transfer their FAR immediately following their acquisition. The ITA's position is arguably based on the OECD Transfer Pricing Guidelines with respect to business reorganizations and changes of business models. FAR transfers have been the focus of two separate court rulings issued by the Central Region.

Summary of the main ruling in *Medingo*:

Facts of the Case

Appellant is an Israeli company that developed a proprietary insulin pump (the "Product"). In April 2010 Roche Pharmaceuticals Group (Roche) acquired the entire share capital of Appellant for USD 160 million in cash, and an additional earn-out payment of up to USD 19 million. Roughly six months after the acquisition, Appellant entered into four intercompany agreements with retroactive effect with other companies in the Roche group, all of which were set to expire by the end of 2013, as follows:

1. **R&D services agreement**, pursuant to which Appellant provided R&D services in exchange for cost + 5% remuneration. All IP developed under the R&D services agreement was owned by Roche.
2. **Services agreement**, pursuant to which Appellant provided Roche with additional marketing, technical support, administration and consultation and support services with respect to certain patents, in exchange for a cost + 5% remuneration.
3. **Manufacturing agreement**, pursuant to which Appellant provided Roche with manufacturing and packaging services with respect to the Products, in exchange for a cost + 5% remuneration.
4. **License agreement**, pursuant to which Roche was allowed to manufacture, use, sell, exploit, continue development and sublicense to related parties the legacy IP that Appellant had developed until the acquisition took place, in exchange for 2% of the net revenue from sale of products in which Appellant's patents were used.

Furthermore, in January 2012, Appellant's employees were notified that the operations in Israel would be terminated no later than December 31, 2013. On November 1, 2013, Appellant entered into an agreement to sell its legacy IP to the Roche group for approximately NIS 166 million, roughly USD 45 million.

The ITA classified the foregoing transactions as a single scheme to transfer Appellant's FAR to Roche immediately following its acquisition in 2010, resulting in Appellant being subject to a capital gains tax on the sale of FAR. The ITA used the acquisition price of Appellant shares paid by Roche as a benchmark to determine the value of the FAR at NIS 481 million, approximately USD $160 million (with certain adjustments).

The court reviewed two separate questions in this matter. First, whether the intercompany agreements, disregarding the fact that they were entered into between related parties, should be viewed as a sale of Appellant's FAR. Second, whether the fact that the parties are related affected the characterization of the

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agreements such that the agreements should be viewed as a sale of Appellant's FAR. The court's discussion on each of these questions is summarized below.

Should the intercompany agreements, disregarding the fact that they were signed between related parties, be viewed as a sale of Appellant's FAR?

The court answered this question in the negative by analyzing the changes in Appellant's functions, assets, and risks, and whether such changes meant that FAR was indeed transferred.

Functions

The court determined that Appellant continued its activity post-acquisition, including with respect to its R&D, manufacturing, marketing, and management functions. The court rejected the ITA's claims that Appellant had transferred the management and decision-making related to these functions. The court noted in this respect that the main relevant function was conducting the actual R&D (and not its management), and that the R&D budget was decided in cooperation between both parties to the agreement. The court emphasized that the fact that the R&D products were owned by Roche, does not mean that the R&D function was no longer owned by Appellant. The court also relied on the fact that the number of Appellant's employees increased after its acquisition, as did its revenues (in fact, over the years Appellant went from a loss position to a profit position).

In criticizing the ITA, the court noted that it "does not distinguish between Roche as a shareholder, and Roche as an acquirer of [business] activity". In fact, the court confirmed that controlling shareholders may "set the [business] policy," with or without regard to intercompany agreements, without it leading to the conclusion that "from now on there are no significant functions performed by the appellant and the appellant is not in charge of managing its ongoing affairs."

Assets

The court concluded that the legacy IP remained in the possession of Appellant and was not transferred. The license agreement was for a limited period, upon expiration of which Roche acquired the legacy IP from Appellant to continue to use it. Roche was also not allowed to license the IP to unrelated parties. Importantly, the court rejected the ITA's claim that it was impossible to differentiate the "legacy IP" from the "new IP" developed under the R&D services agreement. Moreover, the court rebuffed the claim that the useful life of the IP was limited to the duration of the license agreement, as Roche in fact acquired the IP after the end of the license period.

Risks

The court accepted Appellant's arguments that it had not divested its business risks and recognized the risk of having only one client and the fact that the royalties and continued activity of Appellant depended on the business success of the Product (even if to a lesser extent than before). The risk related to the failure of the Product remained with Appellant and there was a risk, which materialized, that Appellant's activity would be terminated if the Product failed.

The court rejected the ITA's position that reducing risks is inherently indicative of a sale of business activity. The court noted that the main question is whether following the signing of the intercompany agreements, Appellant became indifferent to its business activities and results, or whether it continued to develop its

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business, even if under different conditions. Since Appellant clearly did not abandon its business activity, the risk analysis cannot lead to the conclusion that the business activity was sold, the court said.

The court criticized the ITA's position, which it described as "a-priori, every license and R&D agreement between companies in the same field is suspect as a disguised sale." The court stated that "an explicit legal provision or explicit terms" must be identified to justify the "fiction" of viewing the license as a sale without reviewing the circumstances of the case and the conduct of the parties. The court emphasized that the change in Appellant's activity following the signing of the intercompany agreements does not necessarily or automatically translate into Appellant selling its FAR to Roche.

Did the fact that the parties were related affect the characterization of the inter-company agreements such that the agreements should be viewed as a sale of Appellant's FAR?

The court referred to the OECD TPG that instruct tax authorities in characterizing transactions among related parties and the proper transfer pricing of the transaction. The court noted that under these OECD TPG, the characterization of the transaction would be different from the actual agreements between the parties only in rare cases where the "agreements are fundamentally unfounded or do not allow by any means to determine an arm's length price."

With respect to the characterization of the transaction, the court found that the licensing and R&D agreements are common among unrelated parties and therefore the ITA cannot argue that the characterization of the agreement was necessarily affected from the relationship between the parties. Accordingly, the court found that the ITA can, at most, challenge the pricing of these transactions. The ITA made no arguments with respect to the arm's length consideration that should have been paid in these intercompany transactions.

The court noted the business logic behind Appellant entering into these agreements and the fact that the Product had not been profitable up to the acquisition. The intercompany agreements provided Appellant with greater chances of survival and ensured its future. In this context, the court criticized the ITA for taxing Appellant in hindsight and noted that under the OECD TPG, a transaction will be re-characterized only if there is a "clearly more attractive opportunity" (emphasis in source). The ITA cannot reclassify a transaction simply because Appellant had other business opportunities.

The court went on to reject the ITA's argument that there was no business logic for Appellant to prefer the intercompany agreements over other business alternatives, considering the loans that Roche extended to Appellant. The court determined that Roche could not be expected to continue to extend loans forever and other business opportunities should be examined while considering both parties to the transaction.

Finally, the court rejected the ITA's position that Roche decided to transfer the FAR at the *Medingo* acquisition date. The court determined in this context that even if the FAR was transferred (which was not the case), then such transfer cannot be backdated to the date of the decision to transfer FAR, only to the date of the actual transfer.

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3. How can MNEs best prepare for potential disputes considering the factors described in Questions 1 and 2, and what can they do to mitigate the risks of future disputes?

As described in detail above, MNEs should keep their TP documentation up to date and prepare their cases in advance of an audit, especially considering the ITA's approach toward profit split methods and potential restructuring. MNE should build their "story" (facts and circumstances) and support it with comprehensive TP documentation. Additionally, MNEs should strive to be prepared for audit from day one by evaluating the business's FAR beforehand, and by anticipating potential questions from the ITA.

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Italy

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1. In your jurisdiction, how do the tax authorities select taxpayers for audits for transfer pricing cases and what are their focus areas that could lead to transfer pricing audits? And what measures and technology do the tax authorities have available to capture the essential information?

On 20 June 2022, the Italian Revenue Agency (IRA) issued Circular 21/E, providing guidelines regarding tax audit and assessment activities. The Revenue Agency reiterated that transfer pricing audits should always be characterized by a high degree of in-depth analysis of the circumstances of the case. The tax position of taxpayers must be analyzed with the help of the tools and applications in use, and the pre-auditing activity must be carried out based on the returns submitted for the last two tax periods. Regarding MNEs, the Circular suggests that the Italian Tax Authority's ("ITA") activities should be focused on countering tax planning cases that result in erosion of the tax base.

A judgment as to the taxpayer's higher or lower risk level will consider the risk indicators that emerge from analysis of the taxpayer's available information. The ITA focuses particular attention on information regarding the group to which the taxpayer belongs and may consult a dedicated database to conduct both a quick analysis as well as a selection of activity based on various criteria. In addition, the ITA operates based on internationally exchanged information reports (DAC 3 - BEPS Action 5), Country-by-Country Reports (DAC 4 - BEPS Action 13), and cross-border mechanisms (DAC 6).

In the authors' experience, the auditors show increasing interest in the following areas:

- Business restructuring: The ITA focuses more attention and resources on business restructurings (with specific regard to restructurings that involve intellectual property), inversions and conversions, intangible assets, and intercompany cost-sharing arrangements.
- *Management or service fees:* Intercompany services charges continue to be an area of high scrutiny by the ITA. In fact, the ITA continues to audit management fees with an emphasis on the calculation of arm's length service charges, especially the composition of the cost base, where a cost-based method is used. One of the most important discussion points in a tax audit concerning intragroup services is the question of whether the services were rendered for the benefit of the service recipient (benefits test). Generally, it is insufficient to provide only the costs of the service provider and a general description of the services rendered. Moreover, the ITA continues to focus on shareholder expenses, duplication, challenging inbound markups, forced outbound markups, and pass-through costs. Related to low value-adding services, Italian regulations allow taxpayers to provide specific documentation (description of services, agreements, methods, calculation) to obtain penalty protection.
- *Financial transactions:* After the release of the OECD's Transfer Pricing Guidelines on Financial Transactions, the ITA expanded their scrutiny of financial transactions, including intercompany loans,

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intra-group cash pooling, and the recharacterization of loans into equity. Another challenge is whether the provision of guarantees affects the risks assumed by the guaranteed company and how these transactions should be priced. A continuing trend in audits is the analysis of the real nature of cash pooling arrangements. In fact, the ITA sometimes argues that contributions to the cash pool were effectively long-term loans.

- *Intangible transactions:* The ITA analyzes cases of business restructurings that involve the transfer of intangible assets (e.g., trademarks, patents, customer lists) or intra-group royalty flows to assess at first the use of intangible assets and the competitive advantage derived from them. Then, the amount of the transaction is analyzed based on internal or external CUP based on availability. Therefore, the ITA places greater relevance on the development, enhancement, maintenance, protection, and exploitation (DEMPE) analysis in audits related to IP.

Regarding the technologies used, the IRA has published an explanatory document concerning the algorithms used for tax risk analysis models to identify taxpayers who present a high tax risk. Once the tax risk positions have been identified, they are transmitted to the units in charge of audits and assessments, which carry out further evaluations to identify the taxpayers with whom to begin an audit activity. Furthermore, the Tax Delegation Law (111/2023) allows the use of IT and artificial intelligence to obtain the information necessary to carry out focused audits against taxpayers with the highest tax risk.

2. Which approaches are followed by the tax authorities during transfer pricing audits and what are the key elements considered by courts when deciding on transfer pricing related disputes? Please describe a few recent cases or rulings as examples to help illustrate your explanation.

The ITA does not publish statistics or reports on their audits and therefore all information below is based on the authors' experience and on the review of published Italian jurisprudence.[1]

The ITA generally follows two different approaches during transfer pricing audits: The first is to analyze the transfer pricing documentation (if available), and the second is a more aggressive approach used especially in cases of business restructuring that entails downloading servers, emails, and available information in search of hidden transactions or other types of tax base erosion.

As for the former approach, most of the ITA's transfer pricing assessments are based on disregarding the comparables selected by the taxpayer. In that regard, the approach of the ITA is often to challenge the criteria used by the taxpayer in the benchmark analysis and/or to challenge the final set of comparables chosen by the taxpayer using a qualitative screening. The following trends are observed:

- Distribution activities: The ITA tends to apply the Transactional Net Margin Method (TNMM) using Return on Sales (ROS) as profit level indicator, disregarding the application of resale price methods. In some cases, for very profitable business profit split, the ITA applies this method by arguing against the

[1] It should be considered that most transfer pricing assessments are objects of administrative settlements or mutual agreement procedures and therefore are not reflected on court decisions.

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existence in Italy of valuable marketing intangibles.

- Sales support activities: Another area of interest is the remuneration of entities performing sales support functions, quite common for U.S. multinational groups. In such cases, the ITA tends to disregard the application of cost-based TNMM or a cost-plus method and to apply sales-related indicator (TNMM based on ROS).
- Asset management industry: During audits the ITA tends to disregard the use of external Comparable Uncontrolled Price (CUP) (in case of a lack of internal comparables) to determine rebates for distribution activities or to determine the fees for investment management services. One of the reasons is that the ITA does not have access to the database commonly used (e.g., Refinitiv Lipper). In most cases, the ITA challenges the application of profit splits even if such approach is often overcome in case of settlement.

Court decisions focus particularly on the following areas:

- *Burden of proof:* Several decisions have established that the tax authorities have the burden of proof to show that the intra-group transactions between independent parties under comparable market conditions, would have generated higher taxable income, although it is not necessary to prove evasive intent. Once the burden of proof is satisfied, the taxpayer bears the burden of proving that these transactions occurred at market values considered at arm's length, with regard to the same stage of commercialization, time, and place in which the goods and services were purchased or rendered, and with regard to the market environment in which the taxpayer was operating.
- *TP method:* The courts have repeatedly stated that the transfer pricing method adopted by the taxpayer can be disallowed only if the inapplicability of that method to the case under analysis is demonstrated in light of the principles expressed by the OECD Guidelines, assigning the OECD Guidelines a key role as an instrument of soft law (see Decision No. 276 of 26 January 2023 of the Second-Tier Court of Lombardia). Moreover, adequate reasons must be provided, as it is not sufficient to simply assert that there is a better method for valuing the transaction under analysis.
- *Benchmark analysis:* Regarding the application of the TNMM by the ITA, Decision No. 4097 of 26 October, 2022 of the Second-Tier Court of Lombardia stated the following regarding benchmark analysis:
  - The ITA should use the version of the database available in the reference year, and not the version updated on the date the analysis is carried out;
  - The three-year period to be considered should not also include the year under analysis because the relevant financial data may not be available;
  - To mitigate the volatility of the financial data, the marginality should be calculated using the weighted average and not the simple average.
- *Comparability analysis:* The tested party should not be compared with entities operating in a different sector (independently of the company's activity code), since a comparability analysis must include only those companies that are comparable to the tested party regarding products/services, functions performed, type of customers, risks assumed, and asset used.
- *Cash pooling:* Regarding an ITA reclassification of a zero-balance cash pooling agreement, Decision No. 1753 of 18 May 2023 of the Second-Tier Court of Lombardia stated that a contingent situation (a consolidated positive balance) may not prevail against the contractual cause and structure established

by the counterparts. Therefore, a cash pooling agreement could not be converted into a long-term loan without further analysis.

3. How can MNEs best prepare for potential disputes in light of the factors described in Questions 1 and 2, and what can they do to mitigate the risks of future disputes?

The Italian legal framework set forth that, after receiving a tax assessment notice, the taxpayer may apply for a settlement to obtain a reduction of the higher assessment and a corresponding reduction of the applicable penalty. In the event no settlement is either requested for or achieved, the taxpayer has the right to file an appeal before the court of first instance. The taxpayer may also decide to pursue a bilateral remedy through both the Mutual Agreement Procedure (MAP) established pursuant to a Double Tax Treaty and MAPs established pursuant to the Arbitration Convention (AC), depending on the case. Access to the arbitration phase cannot be requested if criminal penalties are imposed. This limitation seems to operate for all offenses provided for by Legislative Decree 10 March 2000, No. 74 (such as incorrect tax return, failure to file a tax return, use of false documentation, and issue of false invoices). This is different from the position taken by the Revenue Agency where a MAP is requested under the AC or a double tax treaty. In this case, a MAP is not permitted where fraudulent and/or fictitious behavior arose. Decree No. 49/2020 implemented in Italy includes provisions set out by the Dispute Resolution Directive (Council Directive 2017/1852, also "DRD") which established improvements for solving cross-border tax disputes more efficiently. Before the DRD, the MAP procedure was denied when there had been a pre-litigation settlement; the implementation of the Directive allows taxpayers to request a MAP even where there has been one.

The first way to mitigate risk is to prepare transfer pricing documentation, although in Italy it is not mandatory, but only optional for penalty protection. By making transfer pricing documentation consistent with the relevant regulations, taxpayers may avoid the application of penalties that could range from 90% to 180% of the higher tax. In addition to the economic benefit, the preparation of transfer pricing documentation allows the taxpayer to have an accurate description of the transactions, the functional, risks and assets analysis, and transfer pricing methods used, to avoid ITA's aggressive approaches. An additional point to consider regarding the preparation of transfer pricing documentation is that in the absence of penalty protection, in the case of a MAP, penalties are not refundable to the taxpayer, making the instrument less attractive.

Based on the authors' experience, the best way to achieve a successful controversy outcome is through the settlement procedure, which allows a relevant reduction of administrative penalties. In fact, other options present several weaknesses. The litigation option presents great uncertainty. Specifically, lower tier tax cases in Italy are heard by specific Tax Courts (Commissioni tributarie) whose judges are not professional judges. Official statistics released by the Ministry of Finance in June 2023 show that the taxpayer's success rate in tax litigation in 2022 is 27.6% with reference to the first tier, and 29.3% with reference to the second tier.; In addition, in 2022 the Supreme Court upheld only 32% of the appeals proposed by the taxpayers. Where penalties are not applied for the presence of transfer pricing documentation, competent authority procedures could be an effective way to resolve the dispute, particularly in the EU where AC and the new dispute resolution directive is available.

The Italian Advance Pricing Agreement (APA) program is the most reliable way to avoid transfer pricing disputes. In fact, an increasing number of taxpayers are taking advantage of the APA procedure provided by the Italian domestic law. The agreement, which sets out the criteria and methods for calculating the arm's length value relevant to one or more transactions, remains in force for five years starting from the tax period

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in which it is signed and is binding both for the taxpayer and for the ITA. However, it provides that: (i) in case of unilateral APAs, the taxpayer may amend with no penalty its tax returns for tax periods running between the filing of the application and the signature of the APA agreement in order to conform its taxable income to the terms of the agreement reached; (ii) in case of bilateral/multilateral APAs (APAs signed subsequently to a mutual agreement concluded with a foreign tax authority), there is a roll-back of the APA principles.

During this period, the Revenue Agency can only verify if the terms of the taxpayer has complied with the agreement and ascertains whether any changes have occurred to the de facto or de jure conditions on which the agreement is grounded.

Under Article 1, para. 1101, let. c), of the Budget law for 2021, on or after January 1, 2021, a user fee is required to request a bilateral or multilateral APA. There is a sliding scale of user fees for each bilateral or multilateral APA request, as follows:

- 10,000 euros if the total turnover of the group to which the applicant belongs is less than 100 million euros;
- 30,000 euros if the total turnover of the group to which the applicant belongs is between 100 million euros and 750 million euros; and
- 50,000 euros if the total turnover of the group to which the applicant belongs is greater than 750 million euros.

As indicated above, APAs are the best option to achieve greater certainty. In the current BEPS climate, greater tax certainty may become even more relevant than before. An APA may be a viable tool for taxpayers who wish to acquire greater tax certainty in connection with their transfer pricing transactions.

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Japan

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1. In your jurisdiction, how do the tax authorities select taxpayers for audits for transfer pricing cases and what are their focus areas that could lead to transfer pricing audits? And what measures and technology do the tax authorities have available to capture the essential information?

With social restrictions related to COVID-19 lifted, and with tax examiners shifting from remote to in-office work, tax audits appear to have gradually resumed a regular cadence. In fact, the number of tax audits have noticeably increased since 2022. During the pandemic period spanning 2020 to 2022, there were only a few media reports in Japan related to transfer pricing tax adjustments and transfer pricing tax lawsuits. As a result, this response is based solely upon these few reports and other information gathered during that time and may not provide a complete picture of recent transfer pricing disputes.

In June 2021, the National Tax Agency (the "NTA" or "tax authorities") released guidance titled "Review of efforts to enhance tax corporate governance." This guidance explains that the NTA has adopted the Risk-Based Approach ("RBA") in the selection of companies subject to tax audits.

The RBA, which applies both to domestic and international corporate tax matters, targets large companies under the jurisdiction of the NTA's Large Enterprise Examination Division and allocates investigative work more intensively to corporations with high tax risks. The RBA determines tax risk based on analyses of various factors, such as corporate tax governance, business performance, tax return/accounting details, and improvement upon issues raised in previous tax audits. After assessing the tax risk, the RBA selects the appropriate target companies and allocates workload accordingly. However, while the emphasis appears to be on applying the RBA to large company audits, the concept of RBA could similarly be applied to small and medium-sized corporations.

Despite the RBA policy for determining the tax risk, the amount of information available to the tax authorities prior to an audit is limited. Therefore, tax authorities use Schedule 17(4) of the corporate tax return as a tool for selecting target companies for intensive tax audit. Schedule 17(4) is an appended table used exclusively for transfer pricing taxation, and Japanese corporations with foreign related party transactions must submit it as an attachment to their corporate tax return. For the tax authorities, it is a convenient disclosure document that provides an overview of the business (business type, number of employees, etc.), sales and profits, and related party transaction amounts for each type of transaction of foreign affiliates. There are many details included on Schedule 17(4), but the tax authorities are likely to focus on the following information:

A) **Foreign affiliated companies with large sales and high profit margins**: The higher the profit margin of a foreign affiliate, the easier it is for the tax authorities to conclude that income from the Japanese corporation is being transferred to the foreign affiliate. However, even if the profit margin of these foreign affiliates is high at first glance, it also must be significantly higher than the profit margin of comparable companies in the same region for the tax authorities to point out or

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take corrective measures against Japanese corporations. Therefore, the NTA uses commercial databases such as Bureau van Dijk's ORBIS as a tool to search for the profit margin of comparable companies. If a transfer pricing local file is not prepared before the tax audit, there is an increased risk that the NTA will assess a tax adjustment using the comparable search data. This is because it may be extremely difficult to prepare and submit the requisite local file to the tax examiner within the 45- to 60-day legal deadline.

B) **Foreign manufacturing subsidiaries that pay zero or very little intangible asset usage fees to the Japanese parent company**: If a foreign manufacturing subsidiary does not purchase knock-down parts from and does not sell the finished products to its Japanese parent company, i.e., no tangible assets buy-sell transactions with the parent company, it is likely that this subsidiary locally procures parts necessary for production and sells the products in the local market. In that case, the consideration for the production know-how provided by the parent company must be collected separately as royalties. However, if the amount of royalties from the subsidiary is zero or too low, the NTA might determine that there is a high possibility that intangible asset-related income has been transferred outside of Japan, and an intensive tax audit may be conducted.

C) **When a large amount of royalties, service fees, borrowing interest, etc. are paid from a Japanese corporation to its foreign affiliate company**: In particular, if the subject foreign affiliate company is located in a low tax jurisdiction, such as Singapore, Hong Kong, or Ireland, the subject MNE group may be regarded as evading tax by reducing income of the Japanese company, and the Japanese company is highly likely to be subject to intensive tax audit.

Based on the recommendations of the OECD's Base Erosion and Profit Shifting (BEPS) Action 13, the NTA has implemented a three-tier transfer pricing documentation system, including the Country-by-Country Report (CbCR), which must be submitted by MNEs with total revenue of 100 billion JPY or more. The CbCR (as well as Schedule 17(4)) is an important document for the tax authorities' desk research because the CbCR shows the profit and loss profile of a corporate group by country. The tax authorities can efficiently understand the comprehensive transfer pricing situation through close inspection of the CbCR, especially for large MNEs with many foreign affiliates.

To summarize, the future direction of tax audits based on the RBA is likely to focus on more intensive tax audits for corporations that have higher tax risks. Of course, not all companies that may be subject to tax audits in the future will be deemed to be at high tax risk. However, it is certain that the RBA has narrowed down the scope of tax audits more than before, so it is expected that each tax audit will be conducted in more detail and over a longer period.

2. Which approaches are followed by the tax authorities during transfer pricing audits and what are the key elements considered by courts when deciding on transfer pricing related disputes? Please describe a few recent cases or rulings as examples to help illustrate your explanation.

(1) Approach by the tax authorities in transfer pricing tax audits

In addition to the RBA explained above, beginning in July 2020, the NTA eliminated the division specializing in transfer pricing in the regional taxation bureaus. Since then, transfer pricing tax audits have been conducted in conjunction with general corporate tax audits. This is in line with the objective of conducting in-depth investigations without distinguishing between issues related to transfer pricing taxation and other

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issues (including issues related to domestic transactions). In the past, transfer pricing tax audits were not conducted in general corporate tax audits except in small taxpayer cases. However, currently transfer pricing issues are usually investigated in general corporate tax audits.

In recent cases, the author has observed that by conducting domestic corporate tax audits and transfer pricing audits at the same time, the NTA can compare foreign related party transactions with domestic transactions and point out the difference. For example, when knockdown parts manufactured in Japan are exported to and assembled by foreign subsidiaries, in many cases a similar domestic transaction such as selling the knockdown parts to its Japanese assembly subsidiary is simultaneously conducted. In such cases, the tax authorities have investigated both domestic and foreign transactions and pointed out that the export prices of the knockdown parts to foreign subsidiaries were lower than the selling prices to the domestic assembly subsidiary. However, since economic circumstances such as the market size and the nature of transactions are different between Japan and foreign countries, such comparisons (even if the same parts are sold) are somewhat unreasonable compared to formal transfer pricing methods such as the Comparable Uncontrolled Price ("CUP") method. If the tax authorities make such claims, taxpayers could make logical counter arguments to the points raised. Nevertheless, as the NTA may continue to conduct such investigations and use domestic transactions as a comparable for foreign related party transactions, taxpayers need to be careful going forward.

In addition, although the following points are not particularly different from the pre-COVID-19 trends, the Japanese tax authorities would be highly concerned if a Japanese corporation's segment operating result related to foreign related party transactions were at a loss. In particular, when a Japanese corporation is a subsidiary of a foreign MNE, in general the Japanese subsidiary has limited functions and risks and does not own non-routine intangible assets. In such cases, the tax authorities argue that the subsidiary should not take profit risks, meaning, the profit margin must always maintain a surplus within the scope of the Transactional Net Margin Method (TNMM) analysis. If the Japanese subsidiary's loss is due to related party transaction prices, the probability of a transfer pricing adjustment is extremely high. Thus, price corrections must be made as soon as possible. On the other hand, if the cause of the loss is due to factors unrelated to related party transaction prices, such as a sharp drop in market demand or problems with a specific third-party business partner, taxpayers must reasonably explain in the transfer pricing local file that the related party transaction prices are not the cause of the losses and comply with arm's length standards.

Furthermore, if a Japanese parent company's segment operating result related to a foreign related party transaction is at a loss while the foreign subsidiary shows a profit, the investigation will generally become stricter. Theoretically, when the foreign subsidiary has only limited functions and risks and does not own non-routine intangible assets, the foreign subsidiary must maintain consistent arm's length profitability based on the TNMM. By contrast, the Japanese parent company, which has greater functions, risks, and non-routine intangible assets, is supposed to earn excess profit but sometimes bears the risk of incurring losses. Nevertheless, the Japanese tax authorities tend to apply the method equivalent to the contribution profit split method or the residual profit split method and insist that the consolidated profit (or loss) should be divided proportionally between the parent and subsidiary. However, the application of the contribution profit split method, which does not use third-party data, should be limited to cases where it is difficult to apply the TNMM. Moreover, the residual profit split method should be applied only if the foreign subsidiary owns non-routine intangible assets and is eligible for a certain share of excess profit. Therefore, these profit split methods or an equivalent should be applied carefully and, if the tax authorities propose the use of such profit split methods, taxpayers should consider making a counterargument.

(2) Transfer pricing court case

There are few transfer pricing lawsuits in Japan for the following reasons:

- Critics of Japan's judicial system have said, and some data indicates, that the judicial system (especially tax litigation) is skewed toward the government and signals a lack of fairness. In fact, some statistics show that the probability that a company would win a tax lawsuit against the tax authorities is less than 10% each year. This is in stark contrast to data from other countries such as the United States or India.
- If a tax adjustment is made, an under-reporting penalty of 10% to 15% will be imposed on the amount of additional tax collected. Combined with the low probability of prevailing in tax litigation, many corporate taxpayers choose to compromise with the tax authorities and voluntarily correct transfer pricing in amended tax returns.

Additionally, since the COVID-19 pandemic, the progress of tax audits and litigation has been slow. During the pandemic, there was only one transfer pricing court decision reported by Japanese media, as observed by the author. And, while it is impossible to adequately analyze Japan's transfer pricing decisions based on one case, it is worth discussing a summary of the case below.

The original tax issue in this case was the NTA's claim that the royalties paid by a Polish subsidiary to its Japanese parent for the use of intangible assets was underestimated in relation to the high profit margin of the Polish subsidiary, a manufacturer of exhaust gas purification filters for diesel engines.[1] The tax authorities imposed an additional tax of 6.2 billion JPY (approximately 43 million USD) on the parent company. The parent company disputed the assessment but received only a meager 400 million JPY reduction of the additional tax at the National Tax Tribunal. Thus, the parent company appealed to the Tokyo District Court. In November 2020, the Tokyo District Court accepted most of the parent company's claims and ordered the tax authorities to eliminate 5.8 billion JPY (more than 90%) of the total additional tax. The Japanese government (i.e., the tax authorities) appealed to the Tokyo High Court, but the High Court in March 2022, upheld the judgment of the District Court and dismissed the government's appeal. The High Court's judgment became final, as the government did not appeal to the Supreme Court. In the sense that the company won the tax lawsuit, this is a rare case considering the low probability of a company winning a tax lawsuit against the tax authorities, as mentioned above.

Generally, during transfer pricing tax audits, the tax authorities often emphasize the research and development ("R&D") expenses invested by the Japanese parent company to create intangible assets. Therefore, all or at least most of the excess (residual) profit, if any, belongs to the parent company. Similarly, in the above court case the tax authorities used the residual profit split method and claimed that all excess profits were derived from non-routine intangible assets owned by the Japanese parent company, and that the Japanese parent should have received more consideration from the Polish subsidiary. The taxpayer argued that the Polish subsidiary made a large capital investment appropriately and successfully responded to the increased demand for the purification filters in Europe due to the tightening of exhaust gas regulations. Hence, the amount of the capital investment also should be considered as a factor for allocating

[1] *NGK Insulators v. the NTA.*

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the excess profit.

Both the District Court and the High Court agreed with most of the taxpayer's arguments. The judgments state that in this case it is inappropriate to determine the allocation of excess profit based solely upon non-routine intangible assets. In other words, under the residual profit split method, it is impossible to determine the allocation of excess profit only by the ratio of R&D expenses. Instead, actual contribution to excess profit also should be incorporated as an allocation factor. The judgments are groundbreaking in a sense that both courts agreed on the necessity to look beyond the preconceived notion that non-routine intangibles created by R&D expenses are only eligible for the allocation of excess profit.

3. How can MNEs best prepare for potential disputes in light of the factors described in Questions 1 and 2, and what can they do to mitigate the risks of future disputes?

As previously mentioned in Questions 1 and 2, due to the recent changes related to the RBA and the integrated (transfer pricing and all other general corporate) tax audits set by the NTA, future transfer pricing audits are expected to be more focused and more in depth, potentially increasing the tax exposure per case. Corporate taxpayers should be mindful of this propensity and consider taking the following steps (1) and (2) regarding transfer pricing tax risks:

(1) Risk assessment with preparation of documents and pricing policies

First, corporations should (if they have not done so) assess their own transfer pricing risks for related party transaction prices and pricing policies. A risk assessment is a type of due diligence that evaluates whether both substance (e.g., their actual operating results and existence of transfer pricing policies) and form (e.g., internal documents such as contract, agreement, or pricing memorandum) comply with the arm's length principle. There are still many companies that do not prepare written contracts for related party transactions, which would pose a disadvantage if a tax audit were conducted. Because it is common for third parties to draw up a contract when conducting transactions, the absence of a contract itself is considered a deviation from the arm's length principle. In addition, the absence of a written contract indicates that there is a high possibility that transaction terms could be arbitrarily determined between related parties and that income could be transferred overseas. Unless a corporation can prove that the industry practice does not require a contract even between third parties, it is strongly recommended that at least a basic contract that incorporates clear pricing policies be prepared for the related party transactions.

(2) Transfer pricing local files

Second, but equally as important, is that corporations should prepare high quality transfer pricing local files. The quality of the local files greatly affects the content of the transfer pricing economic analysis, unlike the more standardized CbCR and master file. Local files containing low quality analyses are not useful for tax audit defense. Rather, in some instances it may increase the risk of tax adjustments and penalties. High quality local files are undoubtedly the best armament in transfer pricing audit defense.

If the value of transactions with a foreign related entity is below the legal threshold of 5 billion JPY per year (less than 300 million JPY per year for intangible assets transactions), preparation of the local files for the related party transactions with that entity is not required by law. Therefore, there are still many Japanese corporations that do not prepare the local files. However, in the event of a tax audit, even companies whose transaction amounts are below the legal threshold must eventually submit documents equivalent to the local

files within 60 days upon request from tax examiners. If the local files are not prepared before the tax audit, there is a higher risk that failing to submit the local files by the due date would result in larger tax adjustments due to the tax authorities' biased search results based on their own comparables. As previously mentioned, the overall risk of transfer pricing taxation for Japanese corporations is steadily increasing. Therefore, even small- and medium-sized corporations not generally subject to the legal threshold should consider preparing high quality local files as a best practice for tax audit defense.

(3) Bilateral Advance Pricing Arrangement

The most ideal way to reduce future tax audit risk is through a bilateral advance pricing arrangement (APA). This is because related party transactions that are covered under a bilateral APA are exempt from transfer pricing tax audits during the APA period. Many Japanese companies have entered into bilateral APAs, primarily for U.S.-Japan transactions.

However, the cases in which an APA is an optimal risk tool are extremely limited, especially recently. First, signing an APA now requires a considerable amount of processing time, normally three to four years even with the U.S. Since it takes such a long time, there is a risk that the economic environment assumed at the time of the initial application might change, and the original APA conditions would no longer apply when signed. Second, an APA requires significant costs (millions of US dollars) payable to external experts. Only large companies with very high tax risks can justify paying such costs.

To date, APAs have been oversold even to companies without large risks. Accordingly, the number of APAs, including renewals, is increasing annually, and is becoming an administrative burden for the NTA. Furthermore, APA negotiations with China and other developing countries are more difficult than with developed countries such as the U.S. An NTA official at a domestic seminar this year encouraged taxpayers to prepare high quality local files and to be more cautious before applying for APAs, although he clarified that his statement was his unofficial opinion.

Considering all of the above, it is recommended that risk assessments and the preparation of documents, such as contracts, along with the preparation of high-quality local files, are the best measures against the risk of future transfer pricing tax disputes.

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The Netherlands

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1. In your jurisdiction, how do the tax authorities select taxpayers for audits for transfer pricing cases and what are their focus areas that could lead to transfer pricing audits? And what measures and technology do the tax authorities have available to capture the essential information?

Selection of taxpayers for transfer pricing audit: Individualized approach for large enterprises and signal-based approach for medium and small enterprises

The Dutch Tax Authorities (DTA) are known for their openness regarding taxpayers, approachability and cooperativeness, as well as for their high-quality technical knowledge and reliability. The DTA have been evolving and making significant investments in structural changes of their team by: 1) attracting more transfer pricing (TP) resources into the Transfer Pricing Coordination Group that serves as an internal knowledge center for the tax authorities in the TP field; 2) hiring experienced professionals with different backgrounds (e.g., corporate and advisory backgrounds); 3) combining the experiences (e.g., through the movement of the MAP team under the DTA structure); 4) employing new technologies for performing internal checks and reviews; and 5) developing industry specializations. All this contributes to the increased capacity of the DTA for performing its rigorous system of risk analysis for the purpose of tax audits and heightened scrutiny. Therefore, for several years already, the frequency of the TP examinations has been increasing, resulting in more controversy around TP topics. It is also noticeable that the quality of the technical argumentation prepared by the DTA during audits and court proceedings has been substantially improving.

The DTA have actively sought out innovative methods and approaches to strengthen their regulatory efforts. In general, the tax authorities do not target specific industries or companies as such, but rather apply a risk-based approach for profiling companies as part of their supervision activities, allowing them to focus on specific topics in order to raise inquiries or start a tax audit.

The DTA follow an individualized approach when supervising large businesses (including Top-100 profit and Top-30 public organizations), whereby the supervision is tailored to the specifics of a particular (multinational) organization. According to the individualized approach, the supervisory activities are based on the knowledge, experience, and assumptions of the DTA about how their mission and strategy can be most effectively and efficiently applied for the specific organization, taking into account the (international) context in which the organization operates. The intensity of the individual organization treatment depends on various factors (e.g., the complexity and size of the organization, the overall compliance of the organization, the current tax issues, risks that have emerged in previous supervisory activities, business conversations, and previous tax audits). As part of this individualized approach, the DTA dedicate a primary permanent point of contact to an organization, the so-called client coordinator, who works closely with the permanent or temporary client management team. An individual customer profile, which includes insights into the organization, tax position, and the level of compliance, is formed for each large enterprise and is further analyzed in order to develop the strategic supervision plans and supervision strategies (in case of Top-100 profit enterprises – the individual supervision strategy), and to plan particular compliance activities.

The client coordinator determines the supervision strategy for a specific organization and carries out the supervision activities together with the assistant client coordinator and specialists in the fields of tax, audit, accounting, tax management, and tax collection. This process is supported through various factors that the DTA utilize, including information about the tax risks pertaining to organization and their estimated probability and potential impact, identified via the DTA's own systems, as well as collected through customer contacts, the media, foreign tax authorities and other sources. Thus, based on the individual customer profile, a decision can be made on the exact supervision activities, including a TP audit.

For small and the majority of medium-sized enterprises, the DTA apply a signal-based approach, whereby the DTA are more reactive and perform supervision based on when certain signals trigger compliance or investigation activities. Signals can emerge from the regular contacts with the organization, review of the customer profile update based on the available information, as well as other sources available to the DTA. Thematic signals can also come from the specialist teams, including the Transfer Pricing Coordination Group. In consultation with specialists and considering the nature of the incoming signals and the existing customer profile, the client coordinator can determine the relevant supervision strategy going forward. There are no permanent client management teams for small- and medium-sized enterprises. Instead, teams are assembled on an ad hoc basis according to the required compliance activities and the availability of specialists.

At this moment, it is not known whether the DTA will launch any new audit programs and/or new pre-or post-filing dispute resolution mechanisms.

Main focus areas that could lead to transfer pricing audits: No significant change from prior years, but certain developments following the publication of the 2022 Dutch TP Decree

The DTA's ongoing focus is on identification of tax fraud and prevention of tax avoidance and tax evasion. In the field of TP, they are particularly interested in examining the commercial rationality and the economic (functional/people) substance of the intercompany arrangements rather than merely the pricing set-up. In many cases, the DTA scrutinize the alignment between risk assumption and people functions, the accuracy of the delineations of intercompany arrangements, and the control over the DEMPE functions. As a natural result of the risk analysis, the DTA have also focused on transactions with entities in countries with low effective tax rates and specific deductions or losses. These focus areas are also clearly traced in the known TP cases brought to court.

Amongst the common categories of intercompany arrangements that have been on the radar of the DTA, one can outline the following:

- The performance of head-office operations, including intragroup services and other activities performed by the head office, and the economic substance of the transactions, in terms of alignment of functions and risks are often investigated and evaluated by the DTA.
- Intangible transactions (licensing/ franchising/ royalty payments) are often evaluated and increasingly scrutinized by the DTA. These arrangements are looked at both from the perspective of the business rationale behind the transactions as well as from the perspective of their remuneration. With respect to the latter, the DTA remain skeptical about the substantiation of the arrangements through the use of the external comparable uncontrolled price (CUP) method and often request corrobative substantiation, e.g., with a profit split based approach.

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- Business reorganizations and cross-border transfers of something of value (functions, risks, assets), are on the DTA's radar screen, too. The DTA follow a two-sided approach with much emphasis placed on the importance of the commercial rationale behind a transaction. In the case of an asset transfer, attention is also paid to the ability of the acquiring company to enhance the value of the asset (investigated through an assessment of the underlying functionality requirements and risk management contributions). It is worth noting that for the substantiation of the arrangements, the DTA expect a comprehensive analysis following Chapter IX of the OECD TP Guidelines.[1]

  Additionally, valuations used in the TP analyses have also been under scrutiny by the DTA. Under the Dutch approach, it is expected that the buyer perspective reflects a higher price as compared to the seller perspective, and that the two-sided approach would typically reflect a value that falls within the range established by the buyer vs. seller perspective.

- Financial transactions, including loans, cash pooling arrangements, and intercompany guarantees, are increasingly scrutinized by the DTA. In particular, specific areas investigated are highly leveraged structures/debt arrangements, whether there is sufficient control over risks and/or necessary financial capacity of the routine financial service entities, the commercial rationale behind guarantee arrangements, the approach to determining credit ratings of related parties and the pricing applied, the deductibility of credit losses by the taxpayers acting as lenders or guarantors, and significant foreign exchange losses of a Dutch taxpayer without sufficient risk control functions with respect to the FX exposure (or if it is hedged at the group level).
- Centralized purchasing arrangements are being investigated mostly from the perspective of accurate allocation of the achieved additional benefits and synergies (e.g., purchasing discounts) to the part of the group that enable the purchasing entity to realize the benefits.

The published 2022 Dutch TP Decree[2] provides further guidance on these topics (as well as many others), capturing recent changes of the OECD TP Guidelines. With respect to TP audits, the 2022 Dutch TP Decree sheds more light on the formal position of the DTA, which is binding for them but not the taxpayers, on the interpretation of the arm's length principle.

It is not expected that the tax authorities will shift their audit focus onto new or different issues in the coming years.

Measures and technology used to capture the essential information

When performing its supervisory duty, the DTA ensure that tax returns comply with the applicable laws and regulations. In that respect, the availability of good information becomes essential. The breadth and scope of information and documentation required by tax authorities is rapidly expanding. Lately, the DTA have been actively involving IT specialists as part of their risk analysis activities for processing large dumps of information in order to facilitate sampling and other specialized reviews based on the taxpayers' data.

[1] OECD (2022), OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2022, OECD Publishing, Paris, https://doi.org/10.1787/0e655865-en.
[2] Dutch TP Decree dated June 14, 2022 no. 2022-0000139020.

In order to obtain essential information for further analysis, several measures can be utilized by the DTA whereby data is derived from various sources. For example:

- As part of standard procedure, the DTA review the tax returns filed by a taxpayer in a regular compliance cycle. The DTA can also derive necessary details contained within the tax returns pertaining to other taxpayers as well. Further, the DTA can retrieve data from the annual financial statements of a taxpayer made public through their submission to the Dutch Chamber of Commerce's trade register as well as notarial deeds submitted to the trade register.
- Another way to derive data about a taxpayer and/or intercompany arrangements of a taxpayer is by sending information inquiries. Inquiries are often sent informally and labelled as "voluntary." However, they might contain numerous detailed questions that require significant time and resources to complete. In most cases, there is no legal compulsion to respond to these inquiries. However, it is not advisable to ignore these inquiries, as this could lead to the use of formal information-gathering powers and weaken relations with the DTA. The number of informal inquiries for detailed information has been accelerating in recent years.
- Another means to obtain information about a taxpayer and/or intercompany arrangements is through the request of the taxpayer's TP documentation, including master file and local file(s). Recent instances have shown that the tax authorities have extended requests for such documentation, both in the context of assessing tax returns and as part of general inquiries. In addition, random checks can be done by the DTA to assess the level of readiness of the TP documentation amongst the taxpayers. The DTA also derive information from the risk assessment of the Country-by-Country reports, either filed in the Netherlands or received through the respective exchange mechanism from the authorities of other jurisdictions.
- One more way for the DTA to capture the essential information for audit purposes is through the reporting done under the Dutch Mandatory Disclosure Rules. This is particularly relevant for several TP areas, including the application of unilateral safe harbor (hallmark E1), arrangements including hard-to-value intangibles (hallmark E2) or arrangements including intragroup cross-border transfer of functions, risks, and/or assets (hallmark E3).
- In addition, the DTA also widely leverage publicly accessible information, including data obtained from external databases, official reporting under the GRI 207: Tax, marketing publications, and various Internet sources.

Information requests from the DTA should not be viewed as a clear sign of a future transfer pricing audit, although the possibility cannot be excluded

The DTA have a well-developed and sophisticated electronic tax compliance and audit system. That being said, in the Netherlands, information inquiries and TP audits typically occur after the tax return filing, although this is not mandatory. As specified above, the DTA can request information from taxpayers about their intercompany arrangements outside the perimeter of a formal TP audit. In fact, the DTA are allowed to request an extensive list of information and explanations that could be relevant to clarifying and validating facts influencing the levy of taxes. The aim of these information requests is usually to get to know the taxpayer better, but they might be used in risk identification and thus a selection of the case for potential further TP audit.

The DTA are aiming to follow an enhanced cooperation approach, through which they pursue a higher level of transparency of their relations with taxpayers. Enhanced cooperation implies active and transparent

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collaboration of taxpayers with tax inspectors and necessitates taxpayers establishing a tax control framework, which among other things, includes documentation and determination of transfer prices. In response to taxpayer collaboration, the DTA have committed to resolving material issues, including TP, more promptly.

2. Which approaches are followed by the tax authorities during transfer pricing audits and what are the key elements considered by courts when deciding on transfer pricing related disputes? Please describe a few recent cases or rulings as examples to help illustrate your explanation.

General principles of good governance are followed in transfer pricing audits

When performing TP audits, the DTA follow the regulations established by the general principles of good governance that include the principles of legal certainty, protection of legitimate expectations, equality, due care, prohibition of arbitrariness, duty to give reasons, prohibition of abuse of power, and proportionality. The code of conduct and the guidelines for tax inspectors are included in 'The Audit Manual' (Handboek Controle)[3] published by the DTA.

Furthermore, the supervision performed by the DTA is based on the principles and models of the audit approach[4] ('Controleaanpak Belastingdienst') and application of the "acceptable tax return" standard. This standard implies that during the audit process the DTA would rely as much as possible on the work already carried out by the entity in question and external experts involved. The standard is in turn based on the "layer model",[5] which explains how the work done by others can be utilized for the purpose of the audit. With regard to the control activities of the DTA, the tax inspector shall not perform control activities that have already been adequately performed by the taxpayer itself or their accountant and/or tax advisor. The starting point of this model is that an organization is responsible for the good management, tax control framework, and accountability of its company and therefore benefits from the good quality of information resulting from its business processes. The model also makes it possible for external control (e.g., through third-party investigation) to add certainty or increase the quality of the information available. In addition, the DTA apply the "transaction model," which provides insight on the transactional data that is usually processed within the organization and in which ways they are processed, as well as what data can be used in audits. The transaction model implies that, in cases of proper internal control measures, every item in the tax declaration can be checked (indirectly) on the basis of the primary records and source documents linked to the items. In addition, the DTA also follow the "workflow model," which explains how to conduct a practical translation of the transaction and layer models into the sequence of particular audit activities to reach the most efficient and effective execution of the audit.

Transfer pricing audit – what to expect

If a formal TP audit is initiated, the DTA are obligated to provide a taxpayer with an explanation regarding the purpose of the audit and its scope, including the entity(ies) concerned, the TP issue under review, as well as the years concerned. It is advisable to clearly outline and agree (with further written formalization) on the

[3] Handboek Controle - 1 oktober 2022 (belastingdienst.nl).
[4] Controleaanpak Belastingdienst.
[5] Figure 1, page 11, Supervision of Large Business in The Netherlands: guide - March 2023 (belastingdienst.nl)

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scope of the TP audit in the initial discussion with the tax authorities in order to avoid an increase by the tax authorities of the scope of the audit at a later stage of the process.

The DTA start their analysis from the perspective of the method and approach adopted by the taxpayer at the time of the transaction. In other words, the DTA follow a "system based" approach, whereby the review is based on the information provided by the taxpayer and relies on the internal control framework of the taxpayer. The "data driven" approach is followed when the DTA believe that the "system based" approach is not reliable enough and a conclusion is made that the method applied by the taxpayer does not lead to an arm's length outcome for the transaction in question. In that case, the tax authorities' position would be supported by the data obtained through their own reviews, tests, and additional investigation.

It is important to stress that in the Netherlands the burden of proof lies with the tax authorities and not with taxpayers, if contemporaneous TP documentation is available that supports the applicable TP policy and its compliance with the arm's length principle.

At the audit's conclusion, the DTA issue an audit report outlining the DTA's view of the tax implications of the audit, which is shared with the taxpayer and explains the maximum exposure to additional taxes and penalties in light of the audit results. It is advisable to discuss the draft outcome of the audit since all proposed profit adjustments are still negotiable until the final report is prepared. After the issuance of the final report, the taxpayer can either accept the audit's findings or file objections to the assessments.

Bringing a transfer pricing dispute to court is not a preferred solution but should be assessed as part of the taxpayer's strategy for a tax audit

It is very common in the Netherlands to settle TP disputes with the DTA through settlement negotiations and compromise. The resolutions can occur in personal discussions with the tax inspector either at the pre-audit stage, before the opened audit is completed, or even during the objection and appeal phases. Although the process for reaching a dispute settlement with the DTA is not strictly defined, its outcome must be formalized through a "determination agreement" or "settlement agreement." Alternatively, the taxpayer and tax inspector can decide to enter into a mediation process or, in case of a double taxation issue, into a mutual agreement procedure (MAP). In addition, Dutch taxpayers also have the option to obtain settlement for future years by filing for an advance pricing agreement (APA). The 2022 Annual report on Rulings with international character[6] issued by the DTA clearly indicates the developing practice of requesting and obtaining advance certainty. Considering the above, TP disputes are rarely brought before courts, which explains the relevant scarcity of Dutch case law on transfer pricing specific matters. Another reason for this is that the outcome of legal proceedings is highly uncertain and taxpayers typically seek to avoid even the remote risk of substantial corrections being imposed. Nevertheless, when determining the taxpayer's strategy for a TP audit, it can be advantageous to consider an approach that includes the possibility of taking the dispute to court, even if the taxpayer ultimately does not intend to pursue that course of action.

[6] Rulings met een internationaal karakter Jaarverslag 2022 (overheid.nl).

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Key elements considered by courts when deciding on transfer pricing related disputes

Although Dutch case law is relatively limited compared to other jurisdictions, the currently known court cases allow us to trace certain similarities in the elements that are considered by courts when deciding on TP-related disputes. These are:

- Accurate delineation of intercompany transactions and consistency of the presented information originating from different sources;
- Burden of proof and its allocation; and
- Concept of control over risks.

For example, some of the above-named elements were argued in the following court cases:

- ECLI:NL:PHR:2023:226, February 2023 – One of the points of this case was regarding the arm's length nature of the transfer pricing applied for the sales of fertilizers from a producer to an affiliated sales organization. The case confirms that the burden of proof can be shifted to the taxpayer in case of an inconsistency of the information provided (including a wrong conclusion on the functional and risks analysis in the TP documentation, deviations from the information provided in the master file on the activities and profile of the entity, and the lack of a proper comparability analysis) and the misalignment of the contractual relations with the actual conduct of the parties, i.e., "legal reality" does not correspond to the "economic reality."
- ECLI:NL:RBNHO:2022:8936 and ECLI:NL:RBNHO:2022:8937, October 2022 – These cases covered several points, including the disallowance of certain fees related to financial transactions (mostly factoring and guarantees fees), profit split application, and intercompany loan pricing. One of the observations related to these cases is the importance of the availability of fully compliant TP documentation along with the relevant accompanying documents to support the TP policy, such as invoices, internal emails, and other documents that can be used (e.g., for the benefit test purposes). Another important note from the case was that the availability of the contractual agreements and their consistency with other documents and actual business conduct can "make or break" the case.
- ECLI:NL:GHSHE:2020:968, March 2020 - This case was regarding the arm's length nature of the payment for the transfer of activities from a taxpayer to a centralized global organizational structure and the remuneration applied for the remaining activities of the taxpayer. The challenge of the case was built around the actual execution of the decision-making functions and control over risks by the taxpayer after the restructuring, implying that it should have received more than a routine remuneration. Besides this issue, this case also provides insights on the division of the burden of proof and a concept of a "double burden of proof," wherein the tax inspector needs to first demonstrate that an intercompany transaction was based on non-business motives before arguing that the transaction did not meet the arm's length standard.

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3. How can MNEs best prepare for potential disputes in light of the factors described in Questions 1 and 2, and what can they do to mitigate the risks of future disputes?

Compliance, transparency, pro-activity and willingness to cooperate are key in order for taxpayers to prepare for potential disputes

Historically, TP has been one of the biggest concerns among tax and finance executives. According to the most recent 2023 EY Tax Risk and Controversy survey,[7] 63% of respondents flagged TP as the leading tax technical area of risk. Furthermore, the leading source of tax risk is considered to relate to a greater focus on enforcement by revenue authorities, including an increasing number of tax audits. In combination, these observations show significant importance of proper preparation for potential TP disputes, whereby a strong and effective tax governance framework should become essential for MNEs.

This growing focus on tax governance is a trend observed worldwide, including in the Netherlands. One of the reasons for this is that the DTA are employing the presence or absence of good governance principles in taxation as a means to classify taxpayers into various risk categories, based on which the audits and subsequent potential disputes can be initiated. Another reason is the increasing realization within tax functions of MNEs that an effective tax governance framework presents numerous opportunities to assist organizations in creating enduring significant value for various stakeholders. At the same time, in practice, there is often a disconnect between thought and action when it comes to the group's tax risk and controversy management strategy. Among the key factors for this are:

- Lack of visibility of active disputes – in many cases, MNEs do not have insight into all active audits and disputes. This allows for misalignment and inconsistency, and provides challenges for knowledge and experience sharing among jurisdictions. This disconnect also poses the challenge of adapting to emerging geopolitical, economic, and tax policy changes, all of which are introducing unprecedented complexities in tax risk management. Particularly for TP, inconsistent data, inaccurate processes, insufficient insight, and inadequate controls can cripple an MNE's tax strategy.
- Lack of access of the tax function to business decision-making – currently, tax functions are rarely, if ever, engaged by executive leadership when it comes to substantial changes in existing business operations, such as changes in business models, introduction of new products, or provision of new services. This lack of involvement heightens the potential for unforeseen tax exposure arising from these activities.
- Restricted tax risk assessment activities – only in half of the cases will MNEs carry out global risk assessments covering TP and other tax risks across all geographies.

To adeptly navigate through this new era of risk and controversy, as well as to prepare for potential disputes and mitigate the risks of future disputes effectively and efficiently, businesses operating in the Netherlands should take the following steps in building a strategic approach to tax risks and controversy management:

- Build strong and effective tax governance;

[7] Why tax governance is key in an era of more tax risk and controversy | EY - Global

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- Strive for accurate and accessible data and insights;
- Ensure strong relationships with the Dutch tax authorities;
- Embed tax management in the overall business control framework;
- Create greater visibility and insight; and
- Put tax certainty at the heart of any tax controversy strategy, especially with the beneficial tools in hand that the Dutch investment climate provides.

Many MNEs have already started proactively making changes to their tax controversy governance framework to adapt to the constantly evolving environment. For those who are at the beginning of the process, the following actions can be considered for execution:

- Be more proactive in identifying and managing TP risks before they turn into an audit/dispute and build a trustworthy and transparent relationship with the tax authorities. Both the existence and the outcome of a tax dispute can dramatically reduce tax certainty. Proactive behavior can help an MNE understand the DTA's concerns and objectives before a tax audit commences, allowing the MNE and DTA to prioritize their timely resolution. It will also help ensure that any settlement reached considers the potential impact for multiple years and multiple jurisdictions in an international context. Finally, proactive behavior with the DTA will ensure that each audit or dispute is entered with as much knowledge of the standard Dutch audit process and cultural approaches as possible.
- As specified above, cooperate with the DTA through providing factual and financial information under all reasonable requests for information.
- Further enhance tax governance strategy by defining policies, roles, controls, and accountability in clear, easily understood ways that better enable the effective management of tax risk and controversy within a global framework. A tax function that is better connected to the business through a robust tax governance framework and that makes use of the latest data capabilities will be in a position to contribute more long-term value to the organization's overall objectives. This way, risks can turn into opportunities.
- Centralize key collaborative processes, including the oversight and coordination of the most significant tax audits, disputes, and litigation across the global organization. Maintain a register or database of active TP audits and/or disputes as well as TP policies and manuals regarding TP. Improve or transform tax and financial data management approaches to enable precise and timely responses to ongoing reporting obligations while providing valuable insights into global tax disputes, MAPs, and tax litigation, both potential and ongoing.
- Make sure that all decisions and deliverables are ''audit ready,'' e.g., by having documentation of key decisions made with respect to the business, operational, and/or TP models, and documentation of risk assessments in internal and external memorandums.
- Ensure full compliance with the TP documentation requirements and improve related internal processes if needed. It is advisable to ensure that the right documentation is available, along with all underlying documents, and can be provided to the tax authorities for inspection.
- Streamline operational TP to drive consistency, reduce complexity, deliver strategic insights, enable sharper governance, and foster better decision making. Among other things, operational

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TP improves data availability, segmentation, and quality for TP purposes, subsequently leading to more accurate delineation of transactions, actual vs. target analysis, and TP adjustments. It is also an important tool for an alignment of the TP policy and its implementation with strategic business goals. As noted before, given the DTA's approach of placing taxpayers in certain risk categories based on the quality of their governance, robust operational TP is a key area for ensuring that the taxpayer reduces their perceived risk profile.

- Increase the level of adoption of dedicated technology for gathering and assessing TP risks, managing tax controls, and tracking ongoing disputes.
- Try to solve issues in the pre-audit/pre-dispute stage through pre-emptive discussions that would otherwise be conducted after the fact with the DTA. Secure tax certainty (ideally, in advance) at every opportunity, seeking out ways to manage tax risks while also taking advantage of the many proactive dispute prevention and resolution programs offered by the DTA, such as bilateral, multilateral, and unilateral APAs; advance tax ruling (ATRs); MAPs; and the horizontal monitoring program.

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1. In your jurisdiction, how do the tax authorities select taxpayers for audits for transfer pricing cases and what are their focus areas that could lead to transfer pricing audits? And what measures and technology do the tax authorities have available to capture the essential information?

The Federal Inland Revenue Service (FIRS) in its *Frequently Asked Questions on Transfer Pricing,*[1] listed as *Question Number 24*, the following *Q & A*: "Will there be TP audits?" "Yes. The FIRS may carry out TP examinations in order to verify that prices adopted by a company with respect to controlled transactions comply with the arm's length principle." According to the FIRS, a "Tax Audit is an examination of underlying records to determine whether a taxpayer has correctly reported its tax liabilities. Tax audits are more detailed and extensive than other types of examinations such as desk examination, compliance monitoring/reviews."[2]

Essentially, the FIRS may pick taxpayers for audits due to the volume or size and/or terms of controlled transactions *vis-a-vis* turnover and potential impact of such transactions on the taxable profits of the relevant taxpayers, especially if the vendor or service provider is a nonresident. Since the FIRS cannot conduct TP audits on all eligible taxpayers, there are materiality thresholds; in reality, MNEs are more likely to be subject to TP audits than their wholly Nigerian owned/resident group peers. Part of the rationale is that MNEs are required to file Country-by-Country Reports, unlike peers with only Nigerian resident affiliates.[3]

The TP Documentation submitted by the taxpayers (such as TP Policy, TP Declaration, TP Annual Returns, and TP Disclosure) will disclose information that the FIRS may deem worthy of further investigation by way of TP audit. "Unique" controlled transactions may also attract attention for more detailed scrutiny, and an audit may afford the taxpayer the opportunity to further explain such transactions to the FIRS.

The focus of a TP audit is to explore whether there is opportunity to adjust subject transactions (TP Adjustment) to result in higher taxable profits than reported, if the arm's length principle is applied to them. Generally, the "FIRS selects taxpayer for tax audit using multifaceted approach including risk profiling, intelligent information, request for refund, etc."[4]

The FIRS has an online portal for TP filing, and has since 2021 ceased to accept manual filings, although a

[1] https://firs.gov.ng/wp-content/uploads/2022/03/TP-FAQ-2021.pdf (accessed September 5, 2023).
[2] *See* FIRS, 'Tax Audit Process': https://www.firs.gov.ng/tax-audit-process/ (accessed September 5, 2023).
[3] *See* FIRS, Country by Country Reporting page: https://www.firs.gov.ng/country-by-country-reporting/ (accessed September 5, 2023).
[4] *See* FIRS, 'Tax Audit Process': https://www.firs.gov.ng/tax-audit-process/ (accessed September 5, 2023).

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related publication on the FIRS website suggests otherwise.[5]

2. Which approaches are followed by the tax authorities during transfer pricing audits and what are the key elements considered by courts when deciding on transfer pricing related disputes? Please describe a few recent cases or rulings as examples to help illustrate your explanation.

The first leg of the above question can be considered answered with these *Q&A Numbers 25–27* from the FIRS' *Frequently Asked Questions on Transfer Pricing*:

> *25. How far back will TP audits go?: TP audits shall apply to accounting years commencing from 2nd August 2012. To this end, relevant taxable persons must maintain TP documentation from this date onward and for a minimum period of 6 (six) years for each successive accounting period. In the event of wilful default or fraud, there may be no limit to how far back the tax authority can go in order to deal with such criminal tendencies.*
>
> *26. Is TP audit replacing regular tax audit?: No. Regular tax audit will continue to hold in order for the Service to satisfy itself that taxable income sources have been fully and properly disclosed and that deductions allowed are wholly, reasonable, exclusively and necessarily incurred for the purposes of earning the income.*
>
> *27. Is TP audit not a duplication of the regular tax audit? No, TP audit is not a duplication of regular tax audit. While regular tax audit is to verify whether or not a taxable person complied with statutory provisions with respect to proper disclosure of income and business expenses, TP audit is concerned with the pricing of transactions occurring between connected taxable persons. In other words, regular tax audit is checking to ensure full compliance with legal provisions on income and expenses, whereas TP audit is checking to ensure full compliance with arm's length prices for all transactions occurring with persons connected with the taxable person.*

Nigeria considers a more robust TP regulatory enforcement approach as one of the ways to stem the flow of "illicit cash" out of the country and to improve Nigeria's current unimpressive tax to GDP ratio. This has underpinned many of the FIRS' TP related initiatives and actions, including the documentation on the TP page of the FIRS website.[6]

If the courts find the position of the FIRS on potential TP related adjustments more in line with the regulatory prescriptions, then they are likely to find in the FIRS' favor, as was the outcome in Nigeria's first ever TP case, *Prime Plastichem Nigeria Limited v. FIRS*.[7] Essentially, the courts will be interested in seeing that connected

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[5] *See* https://www.firs.gov.ng/wp-content/uploads/2021/06/Guidelines-for-Filing-TP-Returns-1.pdf (accessed September 5, 2023).
[6] *See* FIRS TP page: https://www.firs.gov.ng/transfer-pricing/ (accessed September 5, 2023).
[7] (2020) 51 TLRN 1. *See* discussion of the *Plastichem* case at pp. 5-6 of the Nigerian Chapter contribution (by Afolabi Elebiju, *et al.*) to *Bloomberg Tax's Winter 2020/Spring 2021: Transfer Pricing Forum*, available at: https://lelawlegal.com/add111pdfs/Nigeria.pdf (accessed October 8, 2023).

transactions do not translate into tax revenue leakages to the detriment of the *public fisc* through any profit shifting arrangements, when compared with arm's length transactions with unrelated parties.

There have not been many reported transfer pricing cases in Nigeria. However, recently a momentous TP decision was rendered in August 2023 in favor of the taxpayer by the Lagos Zone of the Tax Appeal Tribunal (TAT) in *Check Point Software Technologies B.V. Nigeria Limited v. FIRS*.[8] The facts of the case were as follows.

The Appellant had been served with two Notices of Administrative Penalties respectively for late filing of its 2019 and 2020 Country-by-Country Notifications under the CBC Regulations 2018 (CBC Regs). The Appellant duly objected to them on the basis that they were *ultra vires* null and void since the CBC Regs imposed a penalty that exceeded statutory penalties in the enabling legislation,[9] which the CBC Regs sought to enforce. Following the FIRS' refusal to discharge the Notices (after considering the objections), the Appellant appealed to the TAT.

At the TAT, the Appellant also argued successfully that although the CBC Regs were issued by the FIRS following ratification of the OECD Country-by-Country Multilateral Competent Authority Agreement (CBC MCAA) by the Federal Executive Council (FEC), the same was null as a treaty obligation because it had not been domesticated by the National Assembly as required by Section 12 of the Constitution of the Federal Republic of Nigeria (as amended).[10] Finally, because Section 61 of the FIRSEA contemplated delegated legislative authority to the Board of the FIRS, such powers could only be validly exercised by the Board.[11] Therefore the FIRS' purported issuance of *the CBC Regs* in 2018, when it had no Board in place, was fatal: *delegatus non potest delegare*. Furthermore, Section 61 of the FIRSEA did not delegate power to impose the penalties being challenged on the FIRS. This is more so that late filing is a contravention unrelated to tax liability, hence the applicable penalty is as enshrined in the FIRSEA.[12] As a result, the TAT upheld the Appeal and found against the FIRS.

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[8] *Appeal No. TAT/LZ/CIT/121/2022 of 17th August 2023.* A soft copy of the judgment is also available at TAT's website: https://tat.gov.ng/judgement/details.php?id=237 (accessed October 8, 2023).
[9] FIRS (Establishment) Act, Cap. F36 Laws of the Federation of Nigeria (LFN) 2004 (FIRSEA).
[10] The CBC Regs mimic the CBC MCAA, which itself was signed by Nigeria on January 27, 2016, and ratified by FEC on August 3, 2016.
[11] Section 61 of the FIRSEA provides, *"The Board may, with the approval of the Minister, make rules and regulations as in its opinion are necessary or expedient for giving full effect to the provisions of this Act and for the due administration of its provisions and may in particular, make regulations prescribing the - (a) forms for returns and other information required under this Act or any other enactment or law; and (b) procedure for obtaining any information required under this Act or any other enactment or law."* (Emphasis added).
[12] Regulation 11 CBC Regs imposed a ₦10 million administrative penalty for the late filing of a CBC Report and ₦1 million for every subsequent month for such late filing. According to Regulation 9, the due date "is not later than 12 months after the Reporting Accounting Year of the MNE Group."

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3. How can MNEs best prepare for potential disputes in light of the factors described in Questions 1 and 2, and what can they do to mitigate the risks of future disputes?

The most important preparation is to ensure that requisite, credible (easy to follow and consistent) documentation is in place (both contemporaneous and historic, the latter because of back year audits), that explains the MNE's position, and which are consistent with the prescribed regulatory requirements. Rigorous internal reviews cum examinations of such documentation with a view to correcting gaps ahead of disputes and/or to ensure that documentation to be filed are in the best possible shape, are also prescient. Sometimes, a "mock audit" can identify issues and lead to action items that optimize the MNE's TP compliance status.

Generally, the above illustrative quality assurance process speaks to the robustness of the tax governance system of the relevant MNE. On time (prompt) TP filings, and responses to queries/ requests for clarifications, or additional documentation are also important. Typically, the quality of the MNE's feedback could obviate a potential dispute or reduce the potential amounts that could be in issue in potential disputes. Pre-dispute engagement must be well managed so the MNE does not unwittingly fall victim to untoward happenstances—for example, failure to object to an assessment within 30 days as required by law could make such assessment "final and conclusive" against the MNE taxpayer, thereby potentially precluding any challenge of such assessment on the merits.

Another critical point is to monitor regulatory developments and constantly stay abreast of regulatory changes, in particular changes disseminated through FIRS Circulars and Guidelines, so the MNE can timeously craft its responsive strategy. Sometimes, the FIRS website may not keep pace with changes that have been introduced (by way of immediate uploads and/or removal of dated information).[13]

Expectedly, the MNE's Finance function will have professional relationships with FIRS officials, and the MNE's tax consultants and advisers also represent another (indirect) point of contact and engagement with the FIRS. Since MNEs are usually able to afford the services of the leading firms and hence presumably enjoy quality advisory services, they provide good leverage for MNEs to better prepare for disputes, nip disputes in the bud, or enhance prospects of successful dispute outcomes for the MNE.

On a final note, it is apposite to mention that Nigeria's future TP regulatory landscape may also be affected by the outcome of the changes that would be midwifed by the recently established Presidential Policy on Fiscal Policy and Tax Reforms at the end of its one-year assignment.[14]

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[13] *See* the example of FIRS Guidelines on filing of TP Returns in footnote 2 above but which no longer represent the correct position, as manual filings is no longer allowed.

[14] *See* for example James Agberebi, "Tinubu Inaugurates Presidential Committee on Fiscal Policy, Tax Reforms", *The Guardian* (August 8, 2023): https://guardian.ng/news/tinubu-inaugurates-presidential-committee-on-fiscal-policy-tax-reforms/ (accessed October 8, 2023): ***The Committee will be responsible for various aspects of tax law reforms, fiscal policy design and coordination, harmonization of taxes, and revenue administration. …the President recognised how important a sound fiscal policy environment and an effective taxation system are for the functioning of the government and the economy. …The Committee will not only advise the government on necessary reforms but will also drive the***

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implementation of such recommendations in support of the comprehensive fiscal policy and tax reform agenda of the current administration.

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Portugal

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1. In your jurisdiction, how do the tax authorities select taxpayers for audits for transfer pricing cases and what are their focus areas that could lead to transfer pricing audits? And what measures and technology do the tax authorities have available to capture the essential information?

The Portuguese Tax Authorities ("PTA") publish a document presenting the strategic pillars for the activities to be carried out for a three year-period. The latest document publication focuses on the 2020–2022 period. This report typically addresses the main topics/areas that the PTA are willing to focus on during tax audit procedures in that period. In the last few years, profit shifting has been consistently highlighted as a priority for tax authorities, namely identifying tax transparency and cooperation with other tax authorities as the main paths to purse their agenda.

Within the PTA, there is a specialized transfer pricing team integrated into the Large Taxpayers Unit that is in charge of taxpayers that, due to their size, sector of activity, and other factors, are classified as large taxpayers. These taxpayers are in a state of continuous monitoring by the unit, and the transfer pricing team tends to focus their tax audits on these large taxpayers.

At a practical level, and according to the authors' experience, the most common transfer pricing audits in the Portuguese jurisdiction tend to be conducted on taxpayers with continued tax losses or with significant oscillations in their revenues/profitability margins. The authors' experience also shows that other main triggers for transfer pricing audits include:

(i) business restructurings, especially those with impacts in the company's functional profile or cross-border business transfers, and

(ii) financial transactions.

During the preliminary phase of a tax audit, the main sources of information that the PTA relies on are, generally,

(i) the Annual Tax and Accounting Return (*Informação Empresarial Simplificada*, "IES"), with a main focus on the transfer pricing form disposed in Table 03 of Appendix H,

(ii) the corporate income tax return, and

(iii) the Country-by-Country Report.

Throughout the tax audit procedure, tax inspectors usually request more detailed and specific information from the taxpayer regarding the subject/topic under audit to gain a deeper understand of the taxpayer´s business activities and its position in the group´s value chain. Detailed accounting information and intercompany agreements also tend to be requested during this deeper analysis.

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Lastly, regarding technology tools employed by the tax authorities, although the PTA is currently developing new tools that will rely on specific technologies for transfer pricing analysis, there are no tools being used at this stage. As established in the Portuguese Transfer Pricing Regime, we would like to mention that the taxpayer must provide, whenever requested by the PTA, access to the databases used to support the studies of the comparable elements presented in the taxpayer’s transfer pricing documentation.In certain situations the PTA also requests the taxpayer to provide further analysis on specific topica as they seek to validate what is presented in the transfer pricing documentation.

2. Which approaches are followed by the tax authorities during transfer pricing audits and what are the key elements considered by courts when deciding on transfer pricing related disputes? Please describe a few recent cases or rulings as examples to help illustrate your explanation.

During transfer pricing audits the PTA must prove the binding legal assumptions legitimizing their actions, and the taxpayer is responsible for proving the facts that support the claims and rights they invoke. The information provided by taxpayers during tax audits usually raises controversy that, in certain cases, local tax authorities tend to consider as insufficient or unable to demonstrate alignment with the arm´s length principle.

The main subjects of disagreement on transfer pricing that give rise to litigation between the PTA and taxpayers have been, among others:

- Level of comparability between controlled and uncontrolled transactions;
- Choice of transfer pricing methods;
- Verification of the legal conditions for the application of the transfer pricing regime; and
- Burden of proof.

A key element considered by courts is whether it has been proven by the taxpayer that the controlled transaction under analysis complies with the arm's length principle. Much of the analysis also concerns whether there has been an economic analysis of a particular controlled transaction, as well as whether the PTA has demonstrated the reason for reversing the burden of proof. Court decisions often focus on the reasons alleged by the PTA in demonstrating the reasonableness of the selected transfer pricing method when compared to the taxpayer's choice and the technical merits of the results obtained through the selection of a different transfer pricing method that consequently developed a new economic analysis.

Example 1

On a practical level, there have been several cases of “Principal vs. Limited risk entity” relationships where the PTA did not agree with the analyses performed by the taxpayers in support of the arm’s length principle. The topic of discussion is usually the profitability earned by those limited risk entities vs the principal´s profitability.

An example of case law related to this subject is the case 109/2015-T from the Tax Arbitral Court. This dispute focused on the contractual terms of a distribution agreement between a taxpayer subsidiary and a non-resident related entity (distributor). In compliance with this agreement, the subsidiary issued a credit

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note to the distributor for support and maintenance costs related to the commercial structure of the non-resident entity. They additionally asserted that:

i. The pricing of products sold by the subsidiary to the distributor are determined to grant the latter a 2% operational margin on sales;

ii. In the event of discrepancies between estimated and actual costs, as well as costs arising from unexpected market conditions, adjustments in prices or compensatory payments were to be made to ensure the distributor maintained the said margin.

The PTA alleged that the taxpayer did not provide all the necessary elements to assess the conformity with the arm's length principle of the transfer pricing policy adopted in the transaction under analysis. Consequently, the PTA disagreed with the transfer pricing policy adopted by the taxpayer. However, the PTA did not demonstrate to what extent the related-party transactions deviated from the conditions imposed by the Comparable Uncontrolled Price (CUP) method.

In contrast to the PTA perspective, the taxpayer argued that the Tax Authorities had infringed on the transfer pricing regime due to the lack of substantiation for the adjustments proposed. According to the taxpayer's understanding, it was the PTA's responsibility to establish relevant comparability factors and select the most appropriate transfer pricing methodology for the respective comparison. Therefore, only after identifying the terms of comparable transactions conducted by independent entities can the PTA demonstrate whether, and to what extent, a related-party transaction deviated from the conditions imposed by the arm's length conditions and, if necessary, proceed with the respective tax correction.

The Court deemed the assessment raised by the taxpayer regarding the PTA actions to be valid, concluding that the application of the transfer pricing regime could not be carried out in the manner adopted by the Tax Authorities in this case. The Court also clarified that, in cases where the Tax Authorities deem it necessary to make corrections based on transfer pricing rules, the methods legally provided must be applied to quantify the respective effects. This is the only way the PTA can substantiate their actions.

Example 2

Concerning controlled financial transactions, the approach often adopted by the PTA in transfer pricing adjustments consists in disregarding the economic analysis performed by the taxpayer, arguing that there are either internal comparable transactions that should rely on or, in case of the selection of external uncontrolled comparable transactions, arguing that the screening criteria applied are not aligned with the characteristics of the controlled transaction and therefore should be disregarded.

The recent case 1339/13.BELRA from *Tribunal Central e Administrativo do Sul* (publicly available since June 2022) relates to financial transactions between holding companies and subsidiaries, specifically concerning the application of transfer pricing methods to evaluate the remuneration applied in an intragroup loan. The PTA argued that the taxpayer had not properly prepared the transfer pricing documentation that functioned as evidence of the adequacy of the terms and conditions outlined in the loan agreement.

In this case, the Court ruled that the PTA should clearly demonstrate that uncontrolled comparable transactions are remunerated. However, the PTA failed to identify which uncontrolled transactions were used as comparables and which criteria for comparability were applied. Consequently, the Court determined that

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the transfer pricing requirements had not been met and that the correction made by the PTA was considered illegal.

Example 3

The PTA has been frequently challenging any restructuring that involves a Portuguese company, looking for identifying the arm's length payments/compensations that should be attributable to/supported in Portugal.Under business restructurings, the topic of economic vs. legal IP ownership is often discussed. The PTA tends to be more aggressive when there are royalties paid to related parties in foreign countries and when, through a DEMPE analysis, the PTA concludes that the economic ownership is owned by Portuguese company.

In this regard, the Court decision 559/2015-T from *Centro de Arbitragem Administrativa* ("CAAD") concerns a transaction involving the sale of rights associated with a product brand between a Portuguese taxpayer and a related entity which resulted in a capital loss in Portugal.

The brand rights had been previously acquired by the Portuguese taxpayer from another related entity. On that occasion, the taxpayer also established an agreement for the supply of finished products carrying the designated brand with an independent entity. The terms of this agreement were still in force when the taxpayer sold the brand rights.

The PTA deemed that the parties involved in the transaction should be considered related parties under Portuguese transfer pricing rules, and therefore, any transaction carried out between them should follow transfer pricing rules. After applying the CUP method and using the price from the acquisition of the brand rights (that was also a controlled transaction) as a comparable, the Tax Authorities concluded that the price applied in the sale did not match the CUP method analysis performed.

The Court had to decide whether this transaction should be considered a controlled transaction and whether the PTA correctly applied the CUP method, namely if the transaction used as a comparable was adequate.

In this instance, the Court decided that there was a contradiction regarding the principles on which the transfer pricing regime is based. This pertains particularly to the transaction that was selected as a comparable and consequently was used to compute the proposed transfer pricing adjustment. In fact, the uncontrolled transaction that was deemed as comparable by the Portuguese Tax Authorities could not be used as a referential, as it was not a transaction conducted between independent entities but rather a transaction carried out between associate enterprises based on Portuguese transfer pricing rules.

Considering the above, the Arbitral Court decided that the transfer pricing adjustment performed by the PTA lacked legal basis, as its amount was determined by the comparison of the price of two controlled transactions.

3. How can MNEs best prepare for potential disputes in light of the factors described in Questions 1 and 2, and what can they do to mitigate the risks of future disputes?

As previously discussed, the Portuguese Transfer Pricing regime generally follows the OECD Transfer Pricing Guidelines. Portuguese transfer pricing rules also include the possibility of negotiating advance pricing

agreements (APAs), either unilateral, bilateral, or multilateral, with the PTA. In the authors' experience, APAs will always be an effective procedure to mitigate potential disputes.

The main advantages of an APA include the following:

- Prior approval from the PTA of transfer pricing methodology;
- Avoiding tax audits for the transactions covered by the APA (reduction of related costs and efforts) and elimination of potential transfer pricing adjustments;
- Elimination of late payment interest and penalties for potential transfer pricing adjustments; and
- Avoidance of double taxation.

There might be certain situations where the taxpayer would be willing to have some certainty about the tax framework applicable to a specific situation but not specifically a transfer pricing methodology/pricing. For those cases, there is a specific instrument foreseen in the Portuguese internal rules, commonly called a binding request for information, that is addressed to the PTA. This binding request for information can also be used as a mechanism to avoid further disputes, as the Portuguese Tax Authorities will be bound to apply a certain tax treatment, provided there are no changes to the facts and circumstances described by the taxpayer in the binding request.

Additionally, to be better prepared for potential disputes, it is important that MNEs prepare documentation from a controversy readiness perspective, specifically when non-regular controlled transactions occur, such as a business restructuring or when intragroup remuneration is reviewed. This sort of documentation aims to go beyond the compliance tasks typically adopted in transfer pricing compliance, and the target of this approach concerns the anticipation of defense arguments and evidence to be used in potential future audits and/or disputes.

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Spain

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1. In your jurisdiction, how do the tax authorities select taxpayers for audits for transfer pricing cases and what are their focus areas that could lead to transfer pricing audits? And what measures and technology do the tax authorities have available to capture the essential information?

The Spanish tax authorities (STA) approve on a yearly basis an Annual Tax and Customs Control Plan, which establishes the guidelines on tax risks that tax audits will focus on. For instance, this year the STA highlighted the following topics for tax audit purposes:[1] (i) business restructurings; (ii) valuation of intercompany asset transfers, particularly intangible assets; (iii) transactions resulting in significant tax deduction, such as royalty payments or intercompany services; (iv) financing transactions; and (v) recurrent loss-making entities.

Specifically, based on our experience the STA are paying special attention to the following transfer pricing topics:

- *Branding:* The contribution of the brand should be valued even if the entity is not commercializing branded products – the brand as a service may be valued by customers and should therefore be remunerated.
- *Management fees:* The benefit test should be properly applied to recipient entities, including support for costs actually incurred by the service providers and commercial advantages received to support the compensation agreed.
- *Intercompany financing:* Interest may be disallowed if transfer pricing documentation supports pricing only. The STA understand that third parties will also undertake a debt assessment, including debt quantum and borrowing capacity.
- *Cash pooling transactions:* One single interest rate (the one applied by MNEs to either debit or credit balances) may be applied to all Group balances unless the taxpayer performs a thorough analysis of cash pool leader's functions and risks, and how savings are split among cash pool participants.
- *Development activities for renewable energy parks:* Traditionally remunerated on a cost-plus basis, sales to third parties result in significantly higher value at arm's length. Intercompany development services by Group developers are assessed on this basis.

The STA relies on a significantly developed IT system that inputs data from several sources (including public data, companies and people's forms and returns, etc.) for preliminary risk assessments and the identification of taxpayers for potential tax audit. The STA use this internal software to select taxpayers for audits in the

[1] Resolution of 6 February 2023, of the Directorate-General of the State Tax Administration Agency, approving the general guidelines of the 2023 Annual Tax and Customs Control Plan.

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framework of a "360-transfer pricing strategy", which makes use of the information available to assess intercompany transactions. This strategy is informed by an automated transfer pricing risk analysis system designed by the Central Delegation of Large Taxpayers, in collaboration with the National Office of International Taxation (ONFI). This system, which is regularly updated with new sources, is intended to identify patterns of high-risk tax behavior by combining all available domestic and international information on the taxpayer.

2. Which approaches are followed by the tax authorities during transfer pricing audits and what are the key elements considered by courts when deciding on transfer pricing related disputes? Please describe a few recent cases or rulings as examples to help illustrate your explanation.

Generally, the STA follow the OECD Guidelines and related principles, along with the instructions established on the Annual Tax and Customs Control Plan.

Based on the author's experience, recent cases show the following remarkable approaches by the STA/courts:

- *Benchmarking:* The STA show a clear preference for segmented financial information for benchmarking purposes and may challenge comparability otherwise. Furthermore, local or regional comparables are preferred. While pan-European benchmarking analyses may be accepted, the STA may challenge the approach if there are no local comparables in the final set.
- Intercompany services: A usual focus of the STA's attention, MNEs usually struggle to retain the level of documentary evidence requested in tax audits and deemed necessary in consideration of high charges from service providers. Proof is required in relation to activities performed by service providers, costs incurred (and whether these are internal or originated by third parties), and benefits received by local companies.
- *Assessment approach:* The STA published a note[2] explaining that transactional results found to be out of the interquartile range will be generally assessed in consideration of the benchmarking median value (as opposed to the reference of the closest interquartile value). In this regard, case law to date[3] has only challenged this criterion when there is lack of motivation by the STA regarding the persistence comparability defects preventing to rely on interquartile values instead.
- *Cash pool: The* STA have developed a so-called "symmetry principle" to challenge the different rates applied by cash pooling structures for debit and credit balances. Specifically, whenever the cash pool leader is understood to perform low value-added services only, such as administrative activities, which are not considered to be comparable with the functions performed by third-party banks.[4] Depending on the taxpayer's position, the pricing applied by MNEs to either credit or debit balances will be

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[2] February 24, 2021. Note regarding several issues on arm's length ranges for transfer pricing.
[3] SAN 1072/2019, of March 6; SAN 416/2021, of February 4; SAN 5336/2022, of November 19.
[4] TEAC 00/6537/2017-5536/2018, of October 8, 2019; TEAC 3631-00, of October 24, 2022; TEAC 00/04377/2018, of March 23, 2022; SAN 113/2020, of March 23, 2023.

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applied to each and every balance (both credit and debit balances), assuming there is no commercial reason for the cash pool leader to remain in between and that the financing transactions should have taken place directly between lending entities and ultimate borrowing entities.

- *Service brand:* The STA have also worked with the ONFI to develop and apply a "service brand" royalty approach. The STA have recently challenged and assessed[5] the existence of a license for the use of the brand within a MNE group engaged in the insurance sector. The parent entity was the legal owner of the brand and proved to be of value in order to reach out to clients and secure market share. The parent entity was also responsible for setting the brand management policy in addition to general guidelines, risk policies, operational strategies, etc., that ultimately underpinned the global business strategy and resulted in a certain reputational level for the brand and the group as a whole in the market. While the use of an intangible asset owned by another entity would generally require a licensing agreement, Group companies were deemed to benefit from the global brand and the relevant related activities by the parent entity who was therefore considered to be entitled to an arm's length remuneration. The authors note that the STA also referred to certain circumstances where a royalty fee may not be applied (start-up phase or operating losses for up to three years).

3. How can MNEs best prepare for potential disputes in light of the factors described in Questions 1 and 2, and what can they do to mitigate the risks of future disputes?

Based on the authors' experience in recent audits and courts cases, the authors recommend MNEs to consider the following recommendations to prepare for potential disputes and to mitigate the risks of future disputes:

- *Intercompany financing – SHLs:* The authors recommend reviewing transfer pricing support documentation to ensure debt capacity assessment is in place in addition to loans pricing analyses, transaction documentation such as credit risk assessment, and intercompany agreements with covenants third parties would typically seek to include (e.g., provision of information, debt ratios, warranties, etc.).
- *Intercompany financing – cash pool:* The authors recommend reviewing transfer pricing support documentation to ensure that any cash pooling transactions are in accordance with the latest OECD Guidelines, including credit risk assessment, cash pool leader functions, and estimation of savings and how these are allocated among cash pool participants.
- *Intercompany services:* The authors encourage companies to contemporaneously gather and maintain documentary evidence regarding the reality of the service provision, the actual costs incurred by service providers, and the specific benefits obtained by service recipients (e.g., well written agreements in force, invoices, proof of payment, meetings agendas, deliverables, traveling tickets, emails, etc.).
- *Development activities:* The authors recommend companies to review transfer pricing policies applicable to development activities by Group developers and whether these are still aligned with the arm's length principle. For transaction purposes, tax treatment will be different if selling the assets

[5] TEAC 00/03631/2020, of October 24, 2020.

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developed or the shares of the owning entity/SPV, and the arm's length value of development activities will have a significant impact.

- *Restructuring transactions:* The authors encourage companies to prepare a contemporaneous defense file to support any changes to the operating model, the specific date for the changes to be implemented and how these took place, any other options realistically available (ORAs) considered, how changes regarding functions and risks were actioned, etc.

Finally, the authors are seeing a significant number of proceedings with the STA to mitigate disputes, including unilateral Advance Pricing Agreements (APAs), bilateral and multilateral APAs, and also MAP procedures to help the resolution of disputes and address any double taxation arising from tax audits. The STA and the ONFI are remarkably open to discussions with taxpayers, including both prior discussions (APAs) and MAP requests.

Additional resources have also been allocated to the multilateral risk assessment program carried out within the framework of the International Compliance Assurance Programme (ICAP) and the European equivalent European Trust and Cooperation Approach (ETACA), as well as the Code of Good Tax Practices submitted by the companies that have chosen to apply for it.

Finally, the STA also promotes joint audits and uses the numerous agreements of exchange of information with other administrations to gather and compare information on taxpayers.

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Switzerland

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1. In your jurisdiction, how do the tax authorities select taxpayers for audits for transfer pricing cases and what are their focus areas that could lead to transfer pricing audits? And what measures and technology do the tax authorities have available to capture the essential information?

While there are no formalized and publicly available guidelines indicating that any particular types of transactions, business/transfer pricing models, or risk factors that would lead to a higher likelihood of a transfer pricing audit in Switzerland, based on the authors' experience, the following can be observed to correlate with a higher likelihood of audit:

- Transfer of intangible property;
- Permanent loss-making positions of entities with material intercompany transaction volumes;
- Business restructurings;
- Visible drops in profitability or fluctuations of profitability in the case of entities expected to operate under a transfer pricing model that would normally involve relatively stable/target profitability margins;
- Groups/entities operating within industry areas known to undergo material changes or impacted by specific macroeconomic developments (e.g., commodity trading companies) – although this is not be considered as a fixed "covers-all" rule.

2. Which approaches are followed by the tax authorities during transfer pricing audits and what are the key elements considered by courts when deciding on transfer pricing related disputes? Please describe a few recent cases or rulings as examples to help illustrate your explanation.

The approaches followed by the tax authorities in Switzerland during transfer pricing audits vary depending on the case and the level of tax authority involved, i.e., whether the tax/transfer pricing audit is performed by the Cantonal Tax Authority (responsible primarily for direct taxes) or the Swiss Federal Tax Authority (responsible primarily for indirect taxes, withholding taxes, stamp duties, and other taxes). The audits may involve a more formalistic approach (e.g., information request lists covering all core transfer pricing analysis documents, such as benchmarks, Local/Master Files, financial statements, or valuation reports) as well as more limited, step-by-step queries, where the tax authority will first ask more general/qualitative questions. In the case of a transfer pricing dispute reaching litigation, it is expected that in the course of court proceedings a more formalistic approach will be followed. In certain cases, both the taxpayer and the tax authorities may resort to obtaining outside subject matter expert opinions in the form of memorandums or statements prepared specifically for the purposes of the case.

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Rather than spending resources and time on a unilateral transfer pricing topic, which typically leads to double taxation and withholding tax topics, taxpayers are well advised to consider filing a mutual agreement procedure to resolve transfer pricing disputes.

3. How can MNEs best prepare for potential disputes in light of the factors described in Questions 1 and 2, and what can they do to mitigate the risks of future disputes?

The approaches to transfer pricing dispute mitigation and resolution applied by MNEs with presence in Switzerland may involve the following approaches, depending on the complexity of the subject and the materiality of the transactions:

- "Document & Defend" approach, relying on upfront preparation of transfer pricing analysis (qualitative and quantitative) supporting the specific financial years or particular transactions/business restructurings. It is advised to prepare such a defense documentation package contemporaneously in order to avoid common issues with collection of data and availability of personnel with the right knowledge, multiple years afterwards in case of a transfer pricing audit and a possible dispute.
- Suspend the local tax audit procedures and file a mutual agreement procedure to resolve the transfer pricing dispute, avoid double taxation, and any withholding tax topics for secondary adjustments.
- Application for tax ruling to the Cantonal and/or Federal Tax Authorities – this is a popular approach among Swiss-based MNEs due to the time and cost efficiency of the tax ruling procedures and the mitigation of potential direct tax, indirect and (often importantly) withholding tax risks. The ruling application needs to be made in advance of the subject matter (e.g., transaction or new business model) being implemented, and needs to be supported with sound transfer pricing analysis documenting the arm's length nature of the proposed model or transfer pricing policy approach. Depending on the subject, such unilateral tax rulings are subject to automatic information exchange and a note in the TP documentation.
- An Advance Pricing Agreement (APA) concluded between the Swiss Competent Authority (which is a separate public body from the tax authority) and the Competent Authority(ies) of other countries. A bilateral or multilateral APA is considered to provide a high degree of comfort and transfer pricing risk protection, not only on the Swiss side but also in the other jurisdiction(s) that is or are party to it. The involvement of the counterparty Competent Authority(ies) and the time and cost effort involved in obtaining an APA is generally materially higher than for the unilateral approach involving Swiss tax ruling(s).

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Turkey

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EY Turkey

1. In your jurisdiction, how do the tax authorities select taxpayers for audits for transfer pricing cases and what are their focus areas that could lead to transfer pricing audits? And what measures and technology do the tax authorities have available to capture the essential information?

The Turkish Tax Authority utilizes a database to determine which companies will be selected for a tax audit. The tax audit plan (i.e., the companies that will be audited and the duration of the audits) are specified with an annual plan. In a general sense this database categorizes the companies as per tax loss risk by utilizing various indicators.

When it comes to focus areas, the Turkish Tax Authority identifies the industries and sectors where tax audits will be carried out annually. In recent years, the pharmaceutical, automotive, and FMCG industries have been subjected to transfer pricing audits.

In a general sense, Turkish branches and subsidiaries of multinationals are subjected to more transfer pricing related audits when compared to Turkish headquartered companies. Additionally, companies paying relatively high amounts of group service charges and royalties can also be subject to transfer pricing audits.

2. Which approaches are followed by the tax authorities during transfer pricing audits and what are the key elements considered by courts when deciding on transfer pricing related disputes? Please describe a few recent cases or rulings as examples to help illustrate your explanation.

Pan-European benchmarking studies have not been explicitly accepted or rejected by the Turkish Revenue Authority, and the transfer pricing legislation is silent on this issue. However, considering that there are no publicly available databases containing information on Turkish companies, Pan European databases are more or less the only source for benchmarking purposes. The Tax Authority is also aware of this, and for documentation purposes they generally do not challenge the results obtained via these databases.

However, in the case of a tax audit, The Tax Authority may tend to disregard the documentation (and thus the benchmarks found by the taxpayer), and they may use some secret comparables. In other words, they do not disclose the comparable set during tax audits.

During transfer pricing related disputes, the courts analyze the claims of the tax inspectors and may find the benchmark sets organized by the tax inspectors unreliable and inconsistent.

Having said this, tax amnesty programs launched by the government frequently also provide taxpayers with closure regarding the ongoing court cases. Therefore, most of the time, the court cases are settled with the tax amnesties and thus the position of the tax courts and/or higher-level courts is not known to the taxpayers.

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3. How can MNEs best prepare for potential disputes in light of the factors described in Questions 1 and 2, and what can they do to mitigate the risks of future disputes?

The first item would be transfer pricing documentation. Turkish TP documentation includes the local file, master file, and CbCR.

- Local File ("LF"): Corporations should prepare or provide the information and documents showing that the transactions were performed in line with the arm's length principle, and this information and these documents related to the documentation should be ready to be submitted to the Tax Authority or those authorized to perform the tax inspection, in case they are requested. Taxpayers are required to prepare an annual transfer pricing report. It needs to be prepared in Turkish, in line with the template provided in Communique No. 1. Taxpayers who fully and timely meet their transfer pricing requirements will receive a 50% tax penalty protection.
- Master File ("MF"): The Master File must be prepared by the corporate taxpayers affiliated with a Multinational Enterprise (MNE) group (a group of two or more entities resident in different countries) with an asset size in the balance sheet and a net sales amount in the income statement attached to the corporate tax return for the previous accounting period both TRY 500 million and above. The concerning report should be prepared by the end of the accounting period following the relevant fiscal period and, after this period ends, if requested it should be submitted to the Revenue Administration or those authorized to conduct tax inspections.
- /Country-by-Country Report (CbCR): The Turkish resident ultimate parent entity (UPE) or the surrogate entity of a multinational enterprise (MNE) group with consolidated group revenue of €750 million or above should prepare a Country-by-Country (CbC) Report by the end of the 12th month after the reporting accounting period and submit it to the Turkish Revenue Administration (TRA) electronically.

There are no TP-specific penalties stated; however, failure to submit or a late submission of any kind of transfer pricing documentation may trigger a tax audit. Also, incorrect disclosures may lead to a tax loss penalty charged to the taxpayer. For taxpayers who fulfill the above requirements, a 50% penalty relief will be applied to any penalty that may arise at the end of a transfer pricing audit.

Additionally, Advance Pricing Agreements (APAs) can be a reliable alternative for mitigating transfer pricing related audit risks. Corporate taxpayers can apply to the Turkish Revenue Administration concerning the transfer pricing methodologies relating to their cross-border related party transactions.

The agreed-upon methodologies would be binding for the parties through the period determined; however, it cannot exceed five years (with a possible extension of an additional year).

The transfer pricing methods determined as such cannot be subject to criticism by tax auditors. In Turkey, unilateral, bilateral, or multilateral APAs are possible.

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1. In your jurisdiction, how do the tax authorities select taxpayers for audits for transfer pricing cases and what are their focus areas that could lead to transfer pricing audits? And what measures and technology do the tax authorities have available to capture the essential information?

When assessing a taxpayer for audit selection, HM Revenue and Customs' ('HMRC') main sources of information include transfer pricing reports, legal agreements, and other business records. From April 1, 2023, these can be requested by HMRC without the need for an official audit to be opened. HMRC also uses data profiling and intelligence gathered from multiple sources (business websites, commercial databases, press reports, trade magazines and articles, internet searches, and overseas financial statements) to supplement its assessment, identifying taxpayers with specific features who might be appropriate to audit. For instance, HMRC works closely with other tax administrations to exchange information under the terms of tax treaties, including its partners in the expanding Joint International Taskforce on Shared Intelligence and Collaboration ('JITSIC') network.

When selecting a taxpayer for audit, HMRC will consider the scope for significant transfer pricing risks and the tax position of related businesses before any transactions are examined in detail. The size of tax at risk will also feature in their assessment since audit case teams need to consider where best to target their resources.

HMRC has published their key focus areas in their International Tax Manual and are due to release a Guidelines for Compliance ('GfC') product focused on transfer pricing this year. The GfCs are a series of products being released by HMRC with the intention of providing taxpayers with practical information about tax risks. They are viewed as an extra tool to help taxpayers manage their taxes and guide the behavior of those that wish to operate in a low tax-risk environment. The focus areas considered by HMRC are:

- UK taxpayers' profits or losses appearing inconsistent either with its business activities or with worldwide group results over a cycle of, say, five years
- UK taxpayer providing intangibles but receiving no or low royalties and does not seem to be generating an entrepreneurial reward for its R&D. For instance, if UK R&D functions are described as managing, controlling, and performing the development of valuable intangibles in the UK for the purpose of R&D expenditure credit or patent box claims but then described as low value for TP purposes and being rewarded by reference to a modest return on costs
- Borrowing appears disproportionately high in relation to shareholders' funds, bearing in mind the type of business involved
- Interest appears high in relation to the business's ability to service the debt from its operating profits before tax and interest payable. What constitutes "high" is a complex issue, but the key

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question is whether the debt burden appears sustainable, alongside the company's other requirements and obligations

- Transactions do not appear to make commercial sense (e.g., insertion, for no apparent commercial purpose, of a new UK group holding company with substantial debt), particularly in comparison to the previous position
- Transactions with related parties in low tax territories
- Payments by UK entities to overseas procurement or sourcing entities or "hubs" in low tax countries with limited functionality relative to the UK procurement function, or which relate to incidental benefits derived solely due to it being part of a larger MNE group (for example, group synergies or economies of scale)
- Sales and marketing entities in the UK performing key account management functions
- Acquisition of a UK group by a private equity firm, which will rely on heavy debt funding
- Notes in UK accounts, or other forms of information such as press or internet articles, which mention restructuring, acquisition/merger activity, transfer of UK activities to related parties and/or changes to the way in which the company is rewarded
- Disappearance of/significant decline in stock

HMRC also highlights further areas as risk indicators, such as an over reliance on transfer pricing policies predicated on contractual assumption of risk and legal ownership of assets, giving insufficient weight to the location of the control functions and/or the contributions to those control functions in relation to the risk and/or the important functions in relation to the assets. In particular, HMRC focuses on legal contracts between a UK entity and an overseas entity (or entities) which allocate key risks to the overseas entity which are then purported to support a limited or reduced reward for the UK, notwithstanding that functions related to the control of those key risks are performed by the UK. HMRC states where it has observed instances where the contractual allocation of key risks may not be consistent with the control of such key risks:

- commissionaire structures
- limited risk distributors
- toll or contract manufacturing arrangements
- contract research and development arrangements.

In the UK HMRC uses a broad range of material and technology to assess taxpayers' potential for audit, but at the same time provides clear indications of what constitutes a higher tax-risk environment.

2. Which approaches are followed by the tax authorities during transfer pricing audits and what are the key elements considered by courts when deciding on transfer pricing related disputes? Please describe a few recent cases or rulings as examples to help illustrate your explanation.

Transfer pricing inquiries are subject to a mandatory governance process. The three stages of transfer pricing governance are:

1. Making sure the selection of a case is appropriate;

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2. ensuring there is effective progress in a case; and
3. reaching the appropriate conclusion in a case.

When the second phase of a transfer pricing audit has been completed, a written review of the case by the case team has to be sent to the appropriate review body. The intention is for every case to proceed to resolution within the overall 18/36 month time limit. The review body will then determine whether to close the case without adjustment, settle by negotiation, or proceed to litigation. Where the decision is to negotiate, the review body will authorize the case team to settle according to clearly defined parameters. If settlement proves elusive, the case must be referred back to the appropriate review body with further recommendations.

Transfer pricing litigation in the UK is rare, but a recent case was *HMRC v. BlackRock Holdco 5 LLC*. This was also the first Upper Tribunal case on how to apply the just and reasonable apportionment provision in the loan relationship unallowable purpose rule. The key transfer pricing element considered by the court was whether the transaction was something that third parties would have agreed to. Interestingly it was the lack of defense that the transaction was commercial which meant that the tax avoidance alleged by HMRC was upheld. This serves to emphasize the importance of robust, clear, and detailed transfer pricing documentation.

3. How can MNEs best prepare for potential disputes in light of the factors described in Questions 1 and 2, and what can they do to mitigate the risks of future disputes?

In light of the factors above, taxpayers can best prepare for potential disputes by ensuring that not only their transfer pricing compliance documentation is robust and complete but also that they can demonstrate that they have clear, consistent, and commercially accurate policies and processes to support the documentation. Evidence is key; for example, is there any internal correspondence to support statements made in the documentation? Can this be archived separately in preparation of a potential audit?

Process is often overlooked, both in preparing for and mitigating the risks of future disputes. A process which outlines the planning and thought put into designing the transfer pricing policies, combined with an implementation manual that has been agreed with internal finance teams, can help tremendously. It is also advisable to ensure that there is an annual review of the policies against the commercial reality of the business. If this is not undertaken and documented by the business, then the taxpayer needs to ensure that there is evidence that the business has validated the review.

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Transfer Pricing Forum
Editorial Board and Country Panelists

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Mayra Lucas Mas has been an advisor at the Centre for Tax Policy and Administration, Tax Treaty, Transfer Pricing and Financial Transactions Division of the OECD since June 2008. She is responsible for chairing bilateral and multilateral transfer pricing events at OECD for the development of the OECD Transfer Pricing Guidelines, for the update of OECD Transfer Pricing Country Developments and for OECD accession review in the field of Transfer Pricing. She also provides technical assistance to non-OECD economies. In the past she has worked as a senior consultant for the transfer pricing group of a leading accounting firm and in the Taxation and Customs Union unit of the European Commission.

Mayra is a graduate of New York University School of Law (LLM), the University of Barcelona (Ph.D in Tax Law and Law Degree.) She has been a lecturer in tax law at the University of Barcelona, and a Research Fellow at the European Tax College at K.U. Leuven.

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Rahul K. Mitra is a Chartered Accountant and the former Transfer Pricing Leader of PwC and KPMG in India with over 28 years of experience in handling taxation matters. He specializes in transfer pricing, supply chain management projects, international taxation, BEPS, profit attribution to permanent establishments, and other topics. Rahul was formerly associated as an Advisor with M/s Nangia Andersen LLP, a member firm in India of the Andersen Global (erstwhile Arthur Andersen) network. He was a tax partner with PwC and KPMG in India for an aggregate period of 20 years, including having served both organizations as the leader of their national transfer pricing practices.

Rahul has been nominated by Financier Expert Worldwide as among the leading global corporate tax experts in its directory for 2021. He was invited by the OECD to speak in the 2012 Paris roundtable conference on developing countries' perspective on APAs. Rahul was invited by the Tax Tribunal and the Indian Revenue Board on several occasions to impart training on the topic of transfer pricing to Members of the Tax Tribunal and Senior Officials of the Indian Revenue. He received the "International Tax Contributing Author of the Year" award in the subject of transfer pricing in 2019 from Bloomberg Tax. Rahul is a member of the global editorial board of the Bloomberg Tax Transfer Pricing Forum. He has been consistently rated as a leading transfer pricing professional and tax litigator in India by Euromoney and International Tax Review since 2010. Rahul was the country

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Rahul independently handles litigation for top companies at the level of Tax Tribunals and has won several landmark rulings before Tax Tribunals in the field of transfer pricing, creating precedents in India, in matters relating to the Berry Ratio, Marketing Intangibles; Corporate Guarantee; Profit Split Method; Supply Chain nuances; and others. He has handled several APAs and MAPs in India, involving clients from across industries, covering issues like industrial franchise fees under non-integrated principal structures; distribution models with related marketing intangible nuances; financial transactions (loans and guarantees); profit split model for royalties; among others.

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Benedicte is the Managing Director of Transfer Pricing at Andersen Australia.
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Benedicte is passionate about putting clients first; always aspiring to deliver optimal client value by building simple yet sophisticated solutions, minimizing risk and ensuring technically complex information is understandable.
With over 16 years of experience working with global firms such as EY, Duff & Phelps & KPMG, she has amassed a wealth of expertise and developed Transfer Pricing strategies and solutions for several globally recognized brands.
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Benedicte has significant experience with:

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- Transfer Pricing compliance, planning & policy
- Complex global TP compliance/ controversy
- Intellectual property planning
- Conducting royalty analysis using DEMPE
- Supporting the Australian transfer pricing position for financing arrangements to the Australian Taxation Office (ATO).

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Dirk van Stappen is a partner with KPMG and leads KPMG's transfer pricing practice in Belgium. He joined KPMG in 1988 and has over 28 years of experience in advising multinational companies on corporate tax (both domestic and international) and transfer pricing issues. He leads KPMG's transfer pricing practice in Belgium.
Furthermore, Dirk is a former member of the EU Joint Transfer Pricing Forum (2002-2015).
Since 1996, Dirk has been a visiting professor at the University of Antwerp (Faculty Applied Economics, UA) teaching Tax to Master students.
He has been named in *International Tax Review*'s "World Tax –The comprehensive guide to the world's leading tax firms," *Euromoney*'s (Legal Media Group) "Guide to the World's Leading Transfer Pricing Advisers," and *Euromoney*'s "Guide to the World's Leading Tax Advisers."
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Benedicte is the Managing Director of Transfer Pricing at Andersen Australia.
She co-leads Andersen's Asia Pacific Transfer region and is a member of the global Andersen Transfer Pricing leadership team.
Benedicte is passionate about putting clients first; always aspiring to deliver optimal client value by building simple yet sophisticated solutions, minimizing risk and ensuring technically complex information is understandable.
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- Supporting the Australian transfer pricing position for financing arrangements to the Australian Taxation Office (ATO).

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- FBT
- Cross border transactions as they apply to SME businesses
- Tax issues impacting expats
- Tax policy and administration

AUSTRIA

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Alexandra Dolezel is a tax director at BDO Austria GmbH in Vienna, Austria. She has over 22 years of experience and specializes in international taxation and transfer pricing. Her expertise includes the conceptual design of international tax structures and business models, defense in tax audits, litigation and mutual agreement procedures, as well as the optimization of value chains from a transfer pricing point of view. In addition, she is a lecturer on European Union tax law and comparative tax law at FH Campus Wien, the largest university in Austria. Prior to joining BDO, Alexandra was a tax director at PricewaterhouseCoopers, where she specialized in transfer pricing, international tax structuring and value chain transformation, and mergers and acquisitions. Prior to that, she was Head of Corporate Taxes for Borealis AG, where she had overall responsibility for group corporate tax, including matters affecting tax risk management, transfer pricing, and international structures. Alexandra received her education at the Vienna University of Economics and Business Administration, and she is also a member of the Austrian Chamber of Accountants.

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CHINA

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GERMANY

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Partner, NERA Economic Consulting, Frankfurt
Philip de Homont is an expert in NERA's global Transfer Pricing practice, where he provides transfer pricing advice to international corporations and law firms. He specializes in the transfer pricing of intellectual property in tax audits and litigation cases, as well as in the digital economy. His recent projects have focused on DEMPE analysis and relocations of functions (*Funktionsverlagerung*), and he has extensive experience in the defense of licensing and valuation arrangements for intangibles. Philip is a frequent speaker at international tax conferences and regularly publishes articles on transfer pricing developments and on defense and planning cases. He authored two chapters on valuation for leading German textbooks on Transfer Pricing and Intellectual Property. He has repeatedly been listed as a "Rising Star" in transfer pricing by *Euromoney*'s Expert Guides.

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Tom Braukmann is a Director at NERA Economic Consulting in Germany.

HONG KONG

Irene Lee
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Irene Lee has practiced tax for 11 years, the last 7 specializing in transfer pricing matters involving the financial services sector. She joined KPMG in Hong Kong in 2013 and advises banking, asset management, and insurance clients on transfer pricing policies, documentation, and risk management in the Asia region. She earned a Bachelor of Business Administration (B.B.A.) degree from the Chinese University of Hong Kong and has studied at the University of North Carolina (Chapel Hill).

Jeffrey Wong
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Jeffrey Wong is a senior manager of Global Transfer Pricing Services at KPMG in Hong Kong. He is an experienced financial services transfer pricing advisor and works with clients from the banking, insurance, and asset management sectors. Jeffrey joined KPMG in Hong Kong in 2014 and has been based in Hong Kong for over seven years. He also worked as a transfer pricing specialist in New York for over two years. He holds a Bachelor of Science in Finance and International Business (Magna Cum Laude) from the NYU Stern School of Business.

Jodi Yiu
Manager, KPMG Global Transfer Pricing Services, Hong Kong
Jodi is a manager in the Global Transfer Pricing Services group of KPMG in Hong Kong with over 8 years of corporate tax and transfer pricing experience. Prior to joining KPMG in 2020, she worked in the corporate tax team of another Big 4 firm and also worked in a leading Hong Kong-based multinational textile and apparel group. She has served multinational companies in a broad spectrum of industries, including airlines, manufacturing, consumer products, property development, and industrial products, as well as financial services. Her work focuses on transfer pricing compliance and planning, risk assessment and optimization, and audit resolution. She earned a Bachelor of Science in Accounting and Finance from the Kelley School of Business, Indiana University.

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INDIA

Rahul K. Mitra
Chartered Accountant and Advisor, India

Rahul K. Mitra is a Chartered Accountant and the former Transfer Pricing Leader of PwC and KPMG in India with over 28 years of experience in handling taxation matters. He specializes in transfer pricing, supply chain management projects, international taxation, BEPS, profit attribution to permanent establishments, and other topics. Rahul was formerly associated as an Advisor with M/s Nangia Andersen LLP, a member firm in India of the Andersen Global (erstwhile Arthur Andersen) network. He was a tax partner with PwC and KPMG in India for an aggregate period of 20 years, including having served both organizations as the leader of their national transfer pricing practices.

Rahul has been nominated by Financier Expert Worldwide as among the leading global corporate tax experts in its directory for 2021. He was invited by the OECD to speak in the 2012 Paris roundtable conference on developing countries' perspective on APAs. Rahul was invited by the Tax Tribunal and the Indian Revenue Board on several occasions to impart training on the topic of transfer pricing to Members of the Tax Tribunal and Senior Officials of the Indian Revenue. He received the "International Tax Contributing Author of the Year" award in the subject of transfer pricing in 2019 from Bloomberg Tax. Rahul is a member of the global editorial board of the Bloomberg Tax Transfer Pricing Forum. He has been consistently rated as a leading transfer pricing professional and tax litigator in India by Euromoney and International Tax Review since 2010. Rahul was the country reporter on the topic "Non-Discrimination in international tax matters" for the IFA Congress held in Brussels in 2008.

Rahul independently handles litigation for top companies at the level of Tax Tribunals and has won several landmark rulings before Tax Tribunals in the field of transfer pricing, creating precedents in India, in matters relating to the Berry Ratio, Marketing Intangibles; Corporate Guarantee; Profit Split Method; Supply Chain nuances; and others. He has handled several APAs and MAPs in India, involving clients from across industries, covering issues like industrial franchise fees under non-integrated principal structures; distribution models with related marketing intangible nuances; financial transactions (loans and guarantees); profit split model for royalties; among others.

IRELAND

Catherine O'Meara
Partner, Matheson, Dublin

Catherine is a partner in the corporate tax department at Matheson and is chairperson of the Irish branch of the International Fiscal Association.

Catherine has a particular interest in transfer pricing, competent authority matters and business restructurings and also has extensive experience in mergers and acquisitions and corporate re-organizations. Catherine also advises on State aid in the context of taxation matters. Catherine's clients include many of the leading multinational corporations established in Ireland, primarily in the pharmaceutical, healthcare, ICT, and consumer brand sector.

Catherine has published articles in leading tax journals, is co-author on the Ireland section of the Bloomberg Tax Transfer Pricing Forum and is co-author of the Ireland chapter of the International Fiscal Association Cahiers on Cross Border Business Restructuring.

Anna Crowley
Associate, Matheson, Dublin

Anna Crowley is an associate in the corporate tax department at Matheson. Anna regularly advises Irish and multinational clients on corporate and international tax and transfer pricing. Anna also advises clients in relation to tax-effective structures for inbound and outbound investment and has advised on numerous cross border reorganizations. Anna assists leading multinational corporations with tax authority

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audits, tax risk management and multi-jurisdictional tax controversies.
Anna is a member of the Irish branch of the Young International Fiscal Association and regularly speaks on international tax and transfer pricing matters.

ISRAEL

Yariv Ben-Dov
Partner, YBD Transfer Pricing and Valuations Services – A Member of TPA Global, Israel
Yariv Ben-Dov is a Partner at YBD Transfer Pricing and Valuations Services – A Member of TPA Global. Prior to that, he was Head of Transfer Pricing at Lion Orlitzky & Co. – Moore Stephens Israel and Head of Transfer Pricing and Valuations Department at Herzog, Fox & Neeman. He is an expert in drafting and defending transfer pricing studies and intercompany agreements, with over 15 years of experience. Yariv counsels both multinational conglomerates and small start-ups on their transfer pricing matters, including multinationals which have no activity in Israel. Before working at HFN, Yariv was a co-founder of Bar-Zvi & Ben-Dov, a boutique law firm specializing in transfer pricing and high-tech and, before that, Yariv served as the Head of the Transfer Pricing Unit at Teva Pharmaceuticals. Yariv has published articles on the subject of transfer pricing and has been asked to keynote as an expert in transfer pricing at several conventions in Israel, Europe, and the U.S. Yariv is a member of Transfer Pricing Associates, the world's largest network of independent transfer pricing experts; the Israeli Bar Tax Committee; and the Board of the Israeli-LATAM Chamber of Commerce. Yariv is also a Board member of the Arthur Rubinstein Music Society and the head of the Society's NYC branch. Yariv provides counsel (pro bono) to the Israeli Navy Association. Yariv speaks Hebrew, English, French, and Italian and has often advised global clients in their local language.

ITALY

Marco Valdonio
Partner, Maisto e Associati, Milan
Marco Valdonio is a partner in the Transfer Pricing team of Maisto e Associati. Marco has been with Maisto e Associati since 2000 after working for another tax law firm. He headed the London office from 2002 to 2004 and has been a partner in the firm since 2011. He has received numerous awards as an adviser and has frequently been ranked as a leading tax professional. Marco's areas of expertise include transfer pricing, tax controversies and settlements, mergers and acquisitions, financial instruments, and international taxation.

Aurelio Massimiano
Partner, Maisto e Associati, Milan
Aurelio Massimiano is a partner in the Transfer Pricing team of Maisto e Associati. Aurelio has been with Maisto e Associati since 2005, after having worked for the International Tax Office of the Italian Revenue Agency and, prior to that, for a Big 4 accounting firm. He is the permanent assistant to Professor Guglielmo Maisto at the EU Joint Transfer Pricing Forum. Aurelio holds an LL.M. from the University of Leiden in the Netherlands in International Taxation. He has received numerous awards as a transfer pricing adviser, and his areas of expertise are international taxation and transfer pricing.

Mirko Severi
Senior Associate, Maisto e Associati, Milan
Mirko Severi is a senior associate in the Transfer Pricing team of Maisto e Associati. Mirko has been with Maisto e Associati since 2011. He has obtained a Master in Tax Law and has completed the Executive Program in Transfer Pricing (EPTP) at the Université de Lausanne (Switzerland). His areas of expertise include international taxation and transfer pricing.

JAPAN

Takuma Mimura
Managing Director, Cosmos International Management Co., Ltd, Nagoya

Takuma Mimura is the managing director of Cosmos International Management, a transfer pricing boutique consulting firm in Japan. He has more than 14 years of transfer pricing experience, including 6 years at Deloitte Touche Tohmatsu (both Tokyo and New York) and international banking experience prior to transfer pricing. He has worked extensively on transfer pricing issues worldwide and is especially experienced in Japan, U.S., and China TP matters. He has also worked with a broad range of clients in manufacturing, financial services, and telecommunications and has assisted many taxpayers in negotiations with the Japanese tax authorities on transfer pricing audit examinations. Takuma has authored articles for professional journals, including BNA's *Transfer Pricing Report* and *Monthly International Taxation of Japan* and is a frequent speaker on transfer pricing topics.

THE NETHERLANDS

Krzysztof Łukosz
Associate Partner, Ernst & Young Belastingadviseurs LLP, Amsterdam, Netherlands

Krzysztof Lukosz, an associate partner based in Amsterdam, is a key member of the Global EY Treasury and Finance TP network. He has been specializing in transfer pricing services since 2007, with the main area of his expertise revolving around financial transactions and treasury operations. He has consulted on multiple projects for large multinationals, including, among others, advance pricing agreements with tax authorities, TP controversy and dispute resolution, designing intragroup financing structures and TP frameworks for treasury centers, TP planning, M&As, benchmarking, and documentation. Krzysztof has spoken at various internal and external seminars and conferences. He is also a contributor to international journals in the field of transfer pricing.
Krzysztof holds a master's degree in Mathematics from the VU University Amsterdam and a master's degree in Financial Mathematics from the Jagiellonian University in Cracow. Krzysztof has spoken at various seminars and conferences, including Ernst & Young's Annual Transfer Pricing Symposiums in Amsterdam and Moody's Analytics RiskCalc User Group Meeting in Frankfurt.

Bo Wingerter
Partner, Ernst & Young Belastingadviseurs LLP, Amsterdam, Netherlands

Bo Wingerter is a member of EY's Transfer Pricing and Operating Model Effectiveness (OME) group in Amsterdam, Netherlands. He recently spent a couple of years working for EY in the International Tax Services group in Chicago, United States, before returning to the Dutch practice in early 2017. He has over 12 years of experience in international tax, transfer pricing, and OME planning projects, covering a wide range of industries, including different sectors within industrial products, steel, agriculture, chemicals, pharmaceuticals, life sciences, oil and gas, consumer products, logistics, and media.

Iana Iiudina
Manager, Transfer Pricing & Operating Model Effectiveness Group, Ernst & Young Netherlands

Iana Iiudina is a Manager in the Transfer Pricing & Operating Model Effectiveness Group of EY Netherlands, based in Rotterdam. Iana has 10 years of experience; she joined EY Netherlands in 2019 after she had worked for six years in the EY Russia team.

Iana has broad experience in participating and managing transfer pricing projects for large multinationals, including, among others, projects related to transfer pricing planning and transfer pricing methodology development, value chain transformation, negotiating advance pricing agreements with tax authorities, transfer pricing controversy, benchmarking, and documentation. Iana has a diverse and cross-functional skill set, combining in-depth transfer pricing expertise with fundamental economic insights.

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Iana graduated with honors from the Russian Foreign Trade Academy of the Ministry of Economic Development of the Russian Federation with specialization in International Economics.

Christel Rasidin
Senior Consultant, Transfer Pricing & Operating Model Effectiveness Group, Ernst & Young Netherlands
Christel Rasidin is a Senior Consultant in the Transfer Pricing & Operating Model Effectiveness Group of EY Netherlands, based in Rotterdam. Christel has almost four years of experience in the transfer pricing field. She has been involved in many projects for Dutch and multinational companies related to TP compliance, TP planning, and TP controversy. Christel has also worked on projects involving the application of the Dutch innovation box regime.

Furthermore, Christel has supported engagement teams with addressing requests from tax authorities in the course of pre-audit procedures, as well as with preparing supporting documentation.

Christel has worked with clients in different industries, mainly specializing in Technology, Media & Telecommunication, Specialty Chemicals, and Consumer Product & Retail.

Christel has her Bachelor's degree in Dutch Law and Tax Law and Master's degree in Tax Law from the Erasmus University Rotterdam (the Netherlands).

NIGERIA

Afolabi Elebiju
Founding Principal, LeLaw Barristers & Solicitors, Nigeria
Afolabi Elebiju, the Founding Principal of LeLaw Barristers & Solicitors (www.lelawlegal.com), obtained his two LLMs from: Harvard Law School (International Finance); and University of Lagos (Corporate & Commercial Law). He has almost three decades' career with Nigerian and multinational professional services firms, working on big ticket, cross-border and market defining transactions for Nigerian blue chips and HNIs, leading multinationals, the public sector, not-for-profits, and international development agencies.

He was one time Senior Manager in the tax regulatory practice of the leading Big Four firm in Nigeria and was once seconded to their Glasgow, Scotland offices. His penultimate role prior to LeLaw included establishing and leading one of the most respected law firm tax practices in Nigeria. Subsequently, Afolabi was General Counsel of Nigeria's pioneer private equity (PE) firm focusing on the Gulf of Guinea.

His LeLaw legal tax and regulatory work includes business advisory, transactions structuring, regulatory support, investment disputes strategy advisory, and tax dispute resolution services to clients across all sectors, leveraging his multidisciplinary background.

A serial author, presenter/trainer, and speaker, Afolabi has been contributing to Nigerian legal regulatory discourse since 1995. Specifically, his recent TP-related publications include: the Nigerian Chapter contribution to *Bloomberg's Winter 2020/Spring 2021: Transfer Pricing Forum*, (co-author); "Relationships and Scrutinisations: The Companies and Allied Matters Act 2020 and Transfer Pricing in Nigeria", (April 2021). "TP Regulations: Compliance, Stay Awake Issues & Litigation'" (April 2013); "Transfer Pricing in Nigeria: the New Reality" ((training presentation), November 2012); and "Why Our Anti-Avoidance Tax Provisions Need Review" (February 2012).

PORTUGAL

Patrícia Matos
Lead Partner, Deloitte Tax – Economistas Especialistas Em Fiscalidade, SP, S.A., Lisbon
Patrícia Matos is the Lead Partner in Deloitte's Lisbon office in the Transfer Pricing Department.

Patrícia has a business degree and is a chartered accountant. She started her professional career at Arthur Andersen in 1997 (presently Deloitte &

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Touche, as the result of an effective association of both firms since April 2002) and was promoted to Associate Partner in 2008.

Patrícia has extensive experience in tax planning, due diligence, and tax compliance for Portuguese and multinational companies. She advises clients in several aspects of transfer pricing, ranging from tax audits to comprehensive transfer pricing planning, structuring of intercompany transactions, and defensive documentation.

Her experience spans a wide range of industries, including communications, technology, media, financial services, automotive, consumer goods, tourism, and pharmaceuticals.

Patrícia has been a speaker at several seminars and conferences on tax, economic, and transfer pricing issues.

Raquel Almeida
Manager, Deloitte Tax – Economistas Especialistas Em Fiscalidade, SP, S.A., Lisbon
Raquel Pereira de Almeida is a manager on the Deloitte Portugal Transfer Pricing Team and joined the team as a junior 10 years ago.

She has been involved in designing intercompany business models, and she supports clients with tax audits, administrative litigation procedures, and mutual agreement procedures, as well as the optimization of value chains from a transfer pricing perspective.

Raquel´s client portfolio includes multinational companies with presence in Portugal and Angola across a variety of industries, but in the past she has focused on clients in the Energy & Utilities sector.

Raquel obtained her law degree from Universidade Nova de Lisboa, with a specialization in economic law.

Raquel Balhote
Manager, Deloitte Tax – Economistas Especialistas Em Fiscalidade, SP, S.A., Lisbon
Raquel Balhote is a transfer pricing manager at Deloitte in Portugal. After finishing her master's degree in Economic and Monetary Financials, Raquel Balhote started her professional career in 2014 on the Deloitte Portugal Transfer Pricing Team, Lisbon Office.

With more than 9 years of experience in transfer pricing, Raquel Balhote has been focusing on supporting Portuguese and international entities in several transfer pricing projects, namely in coordinating transfer pricing documentation projects, reviewing policy procedures, and designing/reformulating pricing policies associated with intra-group flows.

Also, Raquel Balhote assists multinational clients operating in a wide range of industries, typically operating in the pulp and paper manufacturing, transportation, beverages, and software and technology industries.

SPAIN

Marcos Perez Rodriguez
Partner, Ernst & Young Abogados, Spain
Marcos has a degree in Law and Business Administration, Universidad Carlos III (Madrid) and an Executive Master at Corporate Finance, Centro de Estudios Europeos of Garrigues. Marcos joined EY in 2011, where he is a partner of the International Transaction Tax Services team. Marcos is specialized in assisting clients in tax and transfer pricing designing, including complex supply chain solutions, business aligned conversions and controversy procedures. Over the past years, Marcos' work has included numerous international planning and documentation work under the framework of OECD Transfer Pricing Guidelines and EU Joint Transfer Pricing Forum regarding IP structuring, funding management, tax audits, tax court assistance and APAs procedures, and tax due diligence services.

Gabriel Suarez
Senior Manager, Ernst & Young Abogados, Spain
Gabriel has a master's equivalent degree in Business Administration and in Law at CUNEF (Madrid) and a master's degree in Business Taxation at ICADE Business School. Gabriel joined EY in 2010, and he is a senior manager on the International Tax and Transaction Services team. His professional activity focuses on continued tax advice to multinational companies, including valuation analyses of intangible assets, financial assets and business entities, forecasting scenarios and modeling of efficiencies and impacts for risks assessment, and optimization solutions.

Begoña Rodríguez González
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Begoña has a degree in Law and Business Administration from IE University and double master's degrees in Law and Tax Law from IE University. Begoña joined EY in 2021, where she is a junior on the International Transaction Tax Services team. She has specialized in company consulting services regarding market and industry analysis, as well as valuation of financial transactions, and tangible and intangible assets.

SWITZERLAND

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Jacob Parma is a director on the Transfer Pricing and Value Chain Transformation team at PwC Switzerland. Jacob works with globally present clients on all aspects of transfer pricing planning, compliance, and dispute resolution. He currently assists a wide range of groups in preparing for and adjusting to the incoming wave of regulatory changes surrounding the digitalization of the economy and other hot topic tax policy developments.

TURKEY

Akif Tunc
Partner, Ernst & Young, Istanbul, Turkey
Akif Tunç has been working for EY since 2004, and he is currently a partner at EY Istanbul Office tax department. He is specialized in transfer pricing planning and documentation, international taxation and cross border tax advisory. He has a background in tax and he has spent one year at EY New York Office – International tax desks.

He is a Sworn-in Fiscal Advisor in Turkey, and he also has CMA and CIA certifications.

UNITED KINGDOM

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Partner and Head of Transfer Pricing, Grant Thorton UK
Kirsty M. Rockall is Partner and Head of Transfer Pricing at Grant Thornton UK, where she leads Grant Thornton's transfer pricing practice in the UK. She has spent over 23 years working in transfer pricing both in the UK and internationally. Kirsty joined Grant Thornton from KPMG, where she was a transfer pricing partner.
She has designed, documented, and implemented economic transfer pricing policies and reports for a range of clients, from start-ups through to FTSE 100 groups, routinely working on projects that involve implementing transfer pricing strategies that take into consideration the number of stakeholders affected (tax authorities, investors, Board, etc). As such, Kirsty understands how to develop practical solutions that mitigate risk of transfer pricing adjustments/ challenges. She has also negotiated a number of APAs and ATCAs and is a member of HMRC's Transfer Pricing Forum. Kirsty is also an Economist Member of the Upper Tribunal Tax and Chancery Chamber in the UK.

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