Transfer pricing disputes: recent trends and cases - Taxes Committee newsletter article, August 2018

Marcel R Jung
FRORIEP, Zurich
mjung@froriep.ch

Report on session at the IBA/ABA 18th Annual Tax Planning Strategies - US and Europe Conference in Amsterdam

Friday 13 April 2018

Co-Chairs
Francesco Capitta *Macchi di Cellere Gangemi, Rome*
Jill Weise *Duff & Phelps, Boston*

Speakers
Aseem Chawla *Phoenix Legal, New Delhi*
Cyril Maucour *Bignon Lebray, Paris*
Arne Riis *Accura, Copenhagen*
Clemens Schindler *Schindler Attorneys, Vienna*
Jan van den Tooren *Hamelink & van den Tooren, The Hague*
E. Miller Williams *EY, Washington, DC*

Introduction

The panel addressed the latest trends and cases in transfer pricing (TP) disputes in the United States and Europe. The session Co-Chair, Jill Weise, started off by introducing the agenda of the panel, including current trends and TP audits, TP documentation, MAPs and EU Arbitration Convention, APAs, TP litigation, and case studies.

TP audits

Co-Chair Francesco Capitta outlined the process for TP audits and their specific issues, including special rules, the need for a specialised TP team, the differences compared to general tax audits and a review of the facts. He asked the panellists to briefly address these issues and to give a summary of the most important current trends and legislative updates in each jurisdiction.

Arne Riis of Accura addressed the process for TP audits and explained that in Denmark, TP audits are either a continuation of general tax audits or specific TP audits. Specialised TP teams with sophisticated knowledge may undertake thorough audits which include an in-depth review of the facts. He pointed out that in the case of intellectual property (IP) or restructuring, the revenue typically challenges the documentation. A proper documentation is, therefore, important.

India has a long history and sophisticated knowledge of TP. Aseem Chawla started with a brief look at the evolution of TP in India. In 2009, a dispute resolution panel was introduced and in 2001 a framework for TP. In 2012, the scope of extended-to-specific domestic transactions and an advance pricing agreement (APA) programme was introduced. The APA programme has received an enthusiastic response from taxpayers. It endeavours to provide certainty to taxpayers in TP by specifying the methods of pric-

ing and the prices of international transactions in advice. Safe harbour rules were introduced in 2013 and subsequently revised in 2017. The concept of secondary adjustment was formally introduced in 2017, to remove the imbalances between realised and reported profit as a result of transfer pricing adjustments. Country-by-country reporting (CbCR) and interest deduction limitations were also introduced in 2017. Chawla noted that it is advisable to prevent challenges in the fields of intangibles, financial arrangements, management services and share transactions due to the aggressive approach of the revenue. Finally, Chawla stressed that returns generated should be correctly shared with the companies that actually perform value-adding functions or bear the actual risks in the development of those intangibles. He then concluded that TP cannot merely remain a principle-driven tax compliance activity, but a mechanism that has a persuasive impact upon the business in its entirety, from strategy to actual operations.

E. Miller Williams started with the organisational chart of the Large Business and International (LB&I) Division Directory of the Internal Revenue Service (IRS) of the US and showed in an impressive way the sophisticated knowledge of the revenue. The TP audit roadmap from February 2014 provides best practices and reference materials for employees of the LB&I with respect to the administration of TP audits. The rules of engagement from August 2014 provide general guidelines for Transfer Pricing Practice (TPP) and International Business Compliance (IBC) examiners.

TP documentation

Session Co-Chair Weise raised specific questions of TP documentation, including: is TP documentation mandatory? What is the relationship between sufficient documentation and burden of proof? What are the penalties in cases where documentation is insufficient? He asked the panellists to briefly address these issues from the perspective of each jurisdiction.

Riis pointed out that the obligation of TP documentation and CbCR obligation depends on thresholds (turnover, profit, employees). Insufficient TP documentation may result in assessments by tax authorities and substantial fines. Cyril Maucour continued and explained that France also applies different thresholds to the CbCR obligation, the master and local file obligation and the annual documentation obligation. He further pointed out that the tax authorities have to prove the transfer of profit while the documentation is only an appreciation element and tax authorities may levy substantial fines in case of insufficient TP documentation. Chawla began with a general overview and outlined the entity-related, the price-related and the transactional-related TP documentation approaches. He further explained the process of TP documentation that starts with the functional analysis and continues with the economic analysis and the additional analysis, and results in the finalisation of the documentation. Chawla stated that India introduced the CbCR and the master file obligation in 2016.

Mutual Agreement Procedures (MAP) and the EU Arbitration Convention

Jan van den Tooren outlined the Mutual Agreement Procedure (MAP). MAP is an administrative procedure through which a taxpayer can report situations in which it is taxed contrary to the provisions of an applicable tax treaty. He pointed out that the contracting states have no obligation to achieve a result. In 2008, a binding arbitration provision was introduced in the Organisation for Economic Co-operation and Development (OECD) Model. Member states are, however, not obliged to incorporate this provision based on reasons of sovereignty. Van den Tooren illustrated the increasing significance of MAP. The OECD MAP statistics show an increase in MAP cases from 2,352 in 2006 to 6,176 in 2015. The average time taken to close MAP cases is about 30 months in TP cases and 17 months in other cases. Agreements that fully eliminate double taxation are achieved in about 60 per cent of the MAP cases, with no agreements being reached in about one per cent. Belgium, France, Germany, India and the US have the most MAP cases. Williams outlined US statistics, which show that the foreign-initiated adjustment requests are three-to-four times higher than the US-initiated adjustment requests.

Van den Tooren moved to the base erosion and profit-shifting (BEPS) project and noted that the BEPS measures will lead to a significant increase in cases of double taxation. BEPS countries have committed themselves to the MAP minimum standard. 20 countries have committed themselves to introducing a

mandatory binding arbitration provision in their bilateral tax treaties. This group of countries represents 90 per cent of the MAP cases that were shown in the OECD MAP statistics. BEPS countries may use the Multilateral Instrument (MLI) of the BEPS project to implement the MAP minimum standard and the mandatory binding arbitration procedure. Van den Tooren explained the MAP minimum standard in Article 16 of the MLI and the mandatory binding arbitration procedure in Article 19 of the MLI. Then he outlined the recent developments of the EU Arbitration Convention concluded by the EU Member States in 1990. The EU Arbitration Convention was only applicable to TP disputes. EU Member States were able to obstruct or to stall arbitration procedures. On 10 October 2017, the EU Commission adopted Directive 2017/1852 that extended the application to tax disputes which are not related to TP, with the exception of source taxation disputes. Further, measures were introduced to prevent EU Member States from obstructing or stalling arbitration procedures. EU Member States are committed to mandatory binding arbitration.

Advanced pricing agreements (APAs)

Clemens Schindler started by explaining the advanced tax ruling practice in Austria. There are three possibilities of tax rulings: (1) binding advance tax rulings; (2) non-binding good faith tax rulings; and (3) the non-binding Express Answer Service (EAS). Areas of binding advance tax rulings are reorganisations, group taxation and transfer pricing. The administrative fee ranges between €1,500-20,000. The taxpayer may apply for such tax rulings before the fact of the situation are determined. The taxpayer is required to describe the factual situation, the relevant legal questions and a detailed reasoning of its position. The tax authorities must reply within six months. The taxpayer has the right to appeal. In relation to applications for binding advance tax rulings, the Ministry of Finance issued information regarding indications for harmful tax-planning structures. It is worth noting that tax benefits arising from mismatches between different tax systems are not automatically regarded as abusive.

Williams started by explaining what an APA is from the US perspective. An APA is a binding written contract between the taxpayer and the IRS regarding facts, Transfer Pricing Method (TPM) and the arm's length range of results. Bilateral and multilateral APAs are binding written agreements between the taxpayer, the IRS and foreign tax authorities. APAs are typically three-to-five years renewable and can be applied to previous years. The APA Revenue Procedure (Rev. Proc. 2015-41) is applicable to all submissions after 29 December 2015. It contains detailed instructions for submitting a request. The Advance Pricing and Mutual Agreement (APMA) Revenue Procedure (Rev. Proc. 2015-40) is applicable to all submissions after 30 October 2015. It involves country-by-country negotiations by the Competent Authorities (CA) to eliminate double taxation. The advantages are the high success rate while the disadvantages are a slow process and the exclusion of the taxpayer from the negotiations.

Transfer pricing litigation

Session Co-Chair Weise raised the question of tax settlement or TP litigation. What are the pros and cons? What are the recent trends in this area? What is the preferred method? Further, Weise raised the question of the approach of the tax courts to TP cases. How do the tax courts address technical TP issues?

Riis began by pointing out that tax settlement is often faster and more flexible than TP litigation. He observed that Denmark has an Alternative Dispute Resolution (ADR) system that was inspired by the UK model and was introduced in 2016. Maucour continued with the French perspective and explained that settlement has become more difficult as tax authorities have hardened their practices. He further pointed out that tax authorities applied systematically a bad faith penalty. The courts apply mostly the OECD recommendations and discussions often centre on the burden of proof and the method applied. Chawla illustrated with a chart the recourse to appeal up to the Indian High Court and discussed the prevalent controversies in TP litigation. He went on to discuss recent Indian TP judgments.

Case studies

Finally, the panel discussed some case studies. The first case study concerned a commissionaire arrangement with a principal in Switzerland and a commissionaire in France. The commissionaire performs sales activities in its own name. The panel noted that Article 12 of the MLI includes an amended permanent establishment (PE) definition according to which the French commissionaire would constitute a PE of the Swiss principal in France.

The second case study addressed a Limited Risk Distributor (LRD) with a principal in Switzerland and an LRD in France. The LRD performs sales activities in its own name and for its own account and takes title to the goods. The LRD is stripped of most functions and risks (ie, inventory risks and bad-debt risks). The only difference to the commissionaire arrangement is having risks in relation to legal title products. Although economically comparable to the commissionaire arrangements, the French LDR does not constitute a PE of the Swiss principal in France (BEPS Action No 7). The panel concluded that the LDR should be addressed in TP rules. TP requires careful review of activities actually performed.

The third case study concerned a Trading Structure with a Brazilian parent and an Austrian trading subsidiary. Because Brazilian TP rules do not follow OECD TP standards, a cost-plus regime often applies. OECD TP rules adopted by Austria often deviate from Brazilian TP standards (eg, by applying the transactional net margin method (TNMM)). The panel concluded that the difference between the profit margins should be deemed an informal capital contribution from the Brazilian parent into the Austrian trading subsidiary, increasing the capital reserve account. Future distributions in the form of capital repayments to the Brazilian parent should not trigger Austrian Withholding Tax (WHT). Additional dividend distributions will have a reduced WHT rate due to the double tax treaty between Austria and Brazil.

The fourth case study concerned interest paid to linked companies. Maucour discussed some recent French court rulings and concluded that the French tax authorities request a high level of proof (effective and contemporary loan offer) and that there remains considerable uncertainty in this area.

https://www.ibanet.org/Article/NewDetail.aspx?ArticleUid=885FEAA1-AE97-4BE2-BAE7-3DDE0DC62A1D