Transfer Pricing Controversy
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Others are not

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Transfer Pricing Controversy

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Dear readers,

The OECD’s base erosion and profit shifting (BEPS) project aims to make global tax distribution fairer but, while countries struggle to implement new policies and regimes, increased controversy may be inevitable and transfer pricing may be at the centre of global tax controversy for years to come.

The BEPS guidance calls for increased compliance burdens, particularly through transfer pricing documentation, where a master file, local file and country-by-country report are now expected by individual tax authorities. In addition, some governments have gone further than the OECD recommendations and implemented their own tailored BEPS measures.

This may lead to an environment of increased complexity for tax and transfer pricing executives at multinational companies.

Although controversy has become a fact of life for large multinationals, with this more difficult environment, managing risk has become more important than ever.

This selection of articles highlights certain changes in the dispute environment and some of the controversy risks companies face. We provide insight into how to approach these risks and what new systems multinationals should put in place to reduce the chance of unnecessary controversy.

We focus on intellectual property (IP) and how, as a result of the new OECD BEPS measures, it is an increasingly important part of a multinational’s transfer pricing consideration and is attracting more attention from tax authorities. Many aspects of IP, including issues involving definition and valuation are discussed.

Asia-Pacific is a particularly difficult region for multinationals to navigate. We have focused on China, India and Japan, in particular, to examine how they are developing in terms of transfer pricing controversy and we look at how these major countries will impact a multinational’s controversy defence strategy.

As an increasingly important area of their overall risk management programme, we have looked at the part advance pricing agreements (APA) play in controversy risk management. Multinational companies should consider the use of APAs as an important part of their controversy strategy.

We also look at how tax authorities’ attitudes and approaches are changing towards controversy, to allow taxpayers to look ahead and adapt accordingly.

As multinational companies are likely to face an increasingly complex global transfer pricing landscape, it has never been more important to have a comprehensive global strategy to manage controversy risk in the coming years.

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Strategic considerations for tax controversy risk management and double taxation avoidance

Darrin Litsky, Sanjay Kumar, and Eric Lesprit look at strategies for combatting controversy risks and double taxation and question whether mutual agreement processes are a taxpayer’s only option.

In response to a November 2012 G20 leaders’ meeting requesting action on tax base erosion, the OECD issued its February 2013 report, “Addressing Base Erosion and Profit Shifting.”

In September 2013, the OECD and G20 countries adopted a concrete 15-point “Action Plan” to address base erosion and profit shifting (BEPS) as set forth in the OECD report, “Action Plan on Base Erosion and Profit Shifting.” The Action Plan sought to establish international coherence of corporate income taxation, reinforce substance requirements in the existing international standards, improve both transparency and tax certainty, and implement swiftly the measures in the Action Plan. After the issuance of interim reports, in October 2015 the OECD issued final BEPS reports on the 15 points in the Action Plan.

As with any tax reform, significant uncertainty is bound to exist when new tax rules are implemented. In particular, while the OECD BEPS project seeks to align transfer pricing outcomes with value creation, reasonable people may differ on what activities create value and the relative value of such activities. Further, country-by-country (CbC) reporting introduces reporting requirements that may lend themselves to different interpretations of the arm’s-length standard. Whilst we expect that the objective of transparency may be achieved in the post-BEPS world, the objective of greater tax certainty may prove more elusive.

Although there may be less tax certainty, mutual agreement procedures (MAP) pursuant to tax treaties will continue to be an important mechanism providing a relatively high level of certainty that double taxation of income will be avoided. As discussed in further detail below, as a result of increased transfer pricing enforcement, the OECD reports that among OECD countries for 2014 there were 2,266 new MAP cases (a 119% increase from 2006) and 5,423 MAP cases at the end of 2014 (a 131% increase from 2006). See www.oecd.org/ctp/dispute/map-statistics-2014.htm (accessed February 23, 2016).

For OECD countries where data was provided, the average completion time was approximately 24 months for cases resolved during 2014. These publicly available statistics may be understated, because each country does not seem to evaluate its backlog and the completion time using exactly the same methodology, even if it is based on OECD guidance. Whilst Action 14, “Making Dispute Resolution Mechanisms More Effective,” is intended to make improvements in the MAP process, implementation of the BEPS Action Plan may place additional stress on a system that is already overtaxed.

Such a substantial tax reform, referred to as a “change in paradigm” by OECD Director for the Centre for Tax Policy and Administration Pascal
Saint-Amans, is a departure from prior law, practice, and attitudes toward tax enforcement. Some countries are already introducing the CbC reporting requirement and implementation of other OECD recommendations to ensure that their countries’ substantive and procedural rules are consistent with the newly developed OECD standards.

This may lead to an increase in the number of tax audits in some countries, more rigorous tax audits, and greater inclination to assert penalties. Of course, litigation will be available to contest this new approach to transfer pricing by tax administrations. However, MAP remains the only way to avoid the double taxation that may arise from this increased tax audit activity. Even the OECD has recognised that this is the only way to avoid the coming increasing pressure in the area of transfer pricing.

The BEPS action plan introduces two dedicated actions to try to balance the strengthening of other transfer pricing rules by the other actions. The first one, Action 14, identifies approaches to make MAP more effective. Countries participating in the BEPS project identified procedural improvements, including improving access to MAP, speed of resolution, and ensuring the real elimination of double taxation.

The second one, Action 15, is an innovative way to implement, as quickly and as effectively as possible, the new rules coming from the BEPS recommendations, including those connected to MAPs. The goal is to adapt bilateral treaties with a single multilateral document, signed by all participating countries. This will help avoid a multitude of bilateral discussions between treaty partners and work on several tax conventions. It will also afford participating countries reassurance that each treaty partner will apply the same rules with others in the same time frame.

Pre-BEPS state

To fully consider the impact of the OECD’s Action Plan on future controversies, it is important to understand the current pre-BEPS state.

OECD statistics on MAP proceedings

The OECD’s public MAP statistics allow examination of the history of tax administrations’ work in international tax areas, and specifically in transfer pricing. While these OECD figures do not indicate the proportion of MAP cases that involve transfer pricing adjustments, the prevailing view is that transfer pricing adjustments represent about 75% of the overall cases taken to MAP. For example, in the US, from 2010 through 2014, approximately 70% of new cases and inventory at year-end were transfer pricing adjustment cases.

The number of MAP cases, both new cases and cases pending at year end, has almost doubled in only seven years. In 2006, OECD countries reported 2,352 cases waiting for a MAP solution at the end of 2006, and by the end of 2014 (last public information provided by the OECD) there were 5,423 cases. (See www.oecd.org/ctp/dispute/map-statistics-2014.htm (accessed February 23, 2016)). Similarly, in 2006, OECD countries counted 1,036 new MAP requests filed during 2006; there were 2,266 during 2014. The increase in cases has been continuous even following the economic downturn, although it is possible that taxpayers facing economic downturn issues had the double headache of not being able to satisfy tax authorities’ expectations of their profitability or lack thereof.

The increase in pending OECD country MAP cases at year end is easily explained: New cases are being initiated at a rate faster than existing cases are being completed by competent authorities. From 2012 through 2014, the highest number of OECD MAP cases resolved was 1,443 (in 2012) and the typical number of cases resolved was approximately 1,400 cases annually. In comparison, the average the number of new cases for the same period was 1,951.

The OECD statistics do not show a significant rise in the average cycle of time for completion of MAP cases. It was 23.79 months in the 2014 reporting period, compared to 22.10 months in the 2006 reporting period (27.30 as a maximum in 2010 and a minimum of 18.93 in 2007). Of course, these figures are averages and some cases take a much longer time than average to resolve. Cases that take longer to resolve may be attributed to some countries taking unprincipled technical positions, differences in procedural views, or the large amount of tax involved.

A careful look at OECD MAP statistics of some countries – Belgium, France, Germany, Italy, Japan, the Netherlands, Spain, UK, and US – shows that the percentage of cases closed or withdrawn without elimination of the double taxation (that is, cases resolved with some level of double tax) was very low over the last seven years. This is a good sign, as OECD countries clearly try their best efforts to avoid situations where taxpayers bear the double taxation coming from tax adjustments. However, figures provided by some countries indicate that they do not hesitate to close or withdraw files without total elimination of the double taxation. This can be seen as a trend for some countries, as figures are slightly increasing over the years, and so this clearly represents a threat in a post-BEPS context (see below).

US statistics on MAP proceedings

With one of the larger inventories of MAP cases among OECD countries, the US publishes an annual comprehensive report of its MAP activities. The report contains statistics on cases handled by both the Internal Revenue Service (IRS) Advance Pricing and Mutual Agreement (APMA) programme and the Treaty Assistance and Interpretation Team (TAIT), and includes information on requests received, cases resolved, and pending cases. (See www.irs.gov/pub/irs-utl/2014%20USCA%20Statistics%20Report.pdf (accessed November 9, 2015).)

APMA handles transfer pricing cases, while TAIT handles other types of issues arising under the relevant tax treaty. The
key trend the IRS CA statistics reveal is an almost 50% increase in the number of transfer pricing cases the IRS received in 2014 (286 cases received in 2014, compared to 192 received in 2013). (See “IRS Releases MAP Statistics for 2014 Showing Jump in Filings and Inventory,” Bloomberg/BNA Transfer Pricing Report, April 16, 2015.) Historically, the IRS achieved a high degree of success—success being defined as the avoidance of double taxation—in its transfer pricing cases that went through MAP, and 2014 was no different. In 2014, the number of closed cases that resulted in full relief of double tax was 94% (or 88%, measured by the dollar amount of the total adjustments at issue). APMA and TAIt resolved 185 cases in 2014; however, they received a combined total of 354 competent authority requests, which is consistent with the global trend of new cases coming in faster than pending cases can be resolved. If the number of competent authority cases the IRS receives continues to rise in the future, the IRS and other tax authorities will need to increase staffing levels significantly to keep pace with demand.

Reflective of increased examination efforts by the IRS, the percentage of transfer pricing cases received by the IRS relating to US-initiated adjustments increased in 2014 (30% in 2014 compared with 18% in 2013). The processing time for transfer pricing double tax cases was 21.4 months, slightly below the OECD average reported for 2014. Remarkably, US-initiated transfer pricing double tax cases decreased from 23.8 months in 2013 to 15.0 months in 2014, which likely reflects efforts by the IRS to quickly withdraw adjustments in poorly developed cases and cases that have a low probability of success on the merits.

Interestingly, during 2014, the processing time of US-initiated non-transfer pricing cases was only about 14.3 months in 2014, while foreign-initiated non-transfer pricing cases processing time was substantially greater at 30.2 months. The increased processing time in foreign-initiated cases appears to be substantially related to withholding tax cases in which competent authority negotiations continue to proceed slowly as a result of differences in treaty interpretation between the US and some treaty partners.

The IRS continues to emphasise the need for US taxpayers to pursue effective and practical mediations, including recourse to competent authority, before claiming a foreign tax credit. (See U.S. Treas. Reg. §1.901-2(c)(5); see also, Procter & Gamble Co. v. U.S., (S.D. Ohio, Case No. 1:08-cv-00608, defendant’s motion for summary judgment granted 7/6/10).)

Other countries’ statistics on MAP proceedings
In France, another country with a significant MAP inventory, the number of new MAP requests has regularly increased since 2006, as the number was 93% higher in 2014 than in 2006. (See www.oecd.org/ctp/dispute/map-statistics-2014.htm (accessed February 23, 2016).) The number of cases at the end of the reporting period has also increased significantly, rising from 254 cases at the end of 2006 to 549 cases at the end of 2014.

However, the French figures require explanation. In 2013, France reorganised the tax authority to deal with APAs and MAPs. This reorganisation led to the merger of the previous APA team, imbedded in the Tax Audit Department of the French Tax Administration Headquarters, and the MAP team, part of the Tax Policy Department. The new team was actually created from scratch, meaning that it has been settled in new premises, new people have been hired and more effectiveness has been the main driver of the work. Because the new team effectively commenced its operation only at the end of 2013, the restructuring initially led to an increased backlog of MAP cases, but 2014 figures show France completing cases faster than new cases are coming in. For 2014, France experienced a decrease of 69 MAP cases at year end, while new MAP cases decreased by 15. Similar to the US, France’s MAP programme is successful in avoiding double tax and very few cases are closed without complete relief (generally a few cases each year from 2006).

In Canada, the Competent Authority Services Division (CASD) of the Canada Revenue Agency (CRA) has responsibility for the MAP programme. While CRA sets an overall target of 24 months to resolve a case in MAP, it also makes it clear that many factors are beyond the CRA’s control. These factors include the cooperation and timely receipt of information from the taxpayer, the complexity of the issue, the time the other competent authority requires to review and respond to a position paper, and the willingness of both competent authorities to adopt reasonable negotiating positions. These factors directly impact the timely processing of not just Canadian MAP cases, but all MAP cases. A large percentage of Canadian MAP cases are with the US and predominantly Canadian-initiated transfer pricing adjustments. Not coincidentally, the Canadian goal of resolving a case within 24 months coincides with the mandatory arbitration provision in the Canada-US tax treaty.

Breakdowns in the relationships between competent authorities have been reported sometimes, despite the existence of a tax treaty between the two countries, with good political relationship and business engagements. The overall impact of such breakdown is delay in resolution of existing MAP cases, and piling up of new MAP cases (for example, over half of the pending US transfer pricing MAP cases are with India). Such stalemates cannot be resolved through any legal instrument; putting them back on track can often prove arduous. In such impasse situations, oral exchanges of opinions through a joint commission or a joint working group can bring operation of the mutual agreement procedure on track. The joint commission mechanism or joint working group can help the competent authorities of the two tax jurisdictions arrive at a common framework. Though the OECD commentary on
Article 25 does not suggest going through diplomatic channels to resolve the stalemate, in the most difficult situations it can nonetheless be advisable.

**Post-BEPS state**

**Tax disputes expected to increase**

As mentioned earlier, the BEPS works, the final recommendations, and the OECD public communication when releasing the final reports have created a very specific climate. The OECD rules have been strengthened, and new obligations are now weighing on taxpayers. On their side, tax administrations and tax auditors of some countries may consider that they have a new opportunity to be more rigorous and use more easily the news tools designed by the OECD.

Developing countries will probably increase their efforts on transfer pricing audits, following what can be seen as a signal coming from the OECD BEPS works. This will further increase the burden on MNEs and the results may be large adjustments.

With both developed and developing countries focused on transfer pricing, this means that a quantum leap can be anticipated on international tax adjustments increasing the possibility of double taxation and corresponding penalties.

**Expansion of treaty networks**

The global increase in transfer pricing enforcement will require countries to expand their treaty networks lest their taxpayers get caught in the net of double tax. Despite the need for countries to increase their treaty networks, sometimes treaty ratifications became caught up in politics. For example, the US Senate has not ratified a tax treaty in over five years and currently has pending tax treaties and protocols with Chile, Hungary, Japan, Luxembourg, Poland, Spain, and Switzerland. In a statement to the US Senate Committee on Foreign Relations on October 29, 2015, Robert Stack, the US Treasury Deputy Assistant Secretary (International Tax Affairs) discussed the delay in the ratification of these pending treaties as follows:

- It denies US businesses important protections against double taxation. It denies our law enforcement community the tools they need to fight tax evasion. It jeopardizes US leadership on issues of transparency. It causes other countries to question our reliability as a treaty partner and makes it harder to gain cooperation in other matters important to the US.

- Stack stated that the Obama administration is committed to eliminating barriers to cross-border trade and investment, providing greater certainty to taxpayers regarding their potential liability for tax in foreign jurisdictions, greater ability to avoid double taxation, and toward eliminating discriminatory taxation in foreign jurisdictions. Tax treaties are the most effective means for achieving these objectives.

- In a post-BEPS world with increased transparency and enforcement, there is a greater need for countries to broaden their treaty networks. In the absence of broad treaty networks, trade barriers are likely to impact economic growth and subject multinational enterprises to double taxation.

**Implications for taxpayers**

**Impact on foreign direct investment**

Foreign direct investment (FDI) depends largely on unalterable factors such as natural endowment of physical resources,
efficiency of political institutions, market size, and productivity of the local labour force. But there are other factors that support FDI inflow. These factors, in the context of tax, are ease of profit repatriation, corporate tax rate, and existence of double taxation avoidance treaties.

The importance of tax treaties, in fact, has been increasing against the background of a rise in international investment activity. A tax treaty is an important legal instrument to coordinate cross-border taxation, eliminate double taxation, and resolve disputes between different tax jurisdictions. Accordingly, it is important to a country’s FDI that the country’s MAP process operate effectively and efficiently and achieve the intended objective of eliminating double taxation. Thus, a tax treaty and effectively functioning MAP process mitigate uncertainty for the foreign investor as to how the overseas profits will be taxed as earned and repatriated, and this can often positively influence FDI inflow.

Increase resources to defend against transfer pricing adjustments
Transfer pricing has always been a matter of interest for tax auditors. However, as detailed earlier, it is becoming even more a matter of concern in the post-BEPS context, as the recommendations are strengthening the transfer pricing rules, transfer pricing enforcement, and even providing an audit trail to investigate an MNE’s intragroup transactions.

Multinational groups have to consider a proactive strategy to anticipate unavoidable detailed transfer pricing scrutiny. Such strategies will include increased time and resources in the preparation of robust transfer pricing documentation to prevent tax adjustments. Preventing an adjustment from arising in the first place is preferred to defending against an asserted adjustment.

Multinational groups should also allocate more resources to defend transfer pricing adjustments at an early stage in the audit process. In most cases, the quality of elements provided at an early stage of an audit is decisive on the audit results. Providing strong support for the group’s position at this early stage increases the group’s chances of a positive outcome.

Knowing that a transfer pricing adjustment is the starting point of a long process, which will only end with the MAP settlement in most cases, none of the steps in that process should be neglected. Groups will benefit from dedicating appropriate resources to the follow-up of the audit, which may include settlement negotiations, litigation, MAP, and/or an APA.

Increased risk of double taxation including imposition of penalties and interest
Increased numbers of transfer pricing adjustments and uncertainty regarding application of the new transfer pricing rules are expected to increase the risk of double taxation and corresponding penalties and interest.

As long as tax administrations continue to be slow processing MAP requests, partly because of insufficient resources, but also because the procedure is not efficient (the BEPS Action 14 report includes recommendations in this area), taxpayers may fear double taxation.

As explained above, the post-BEPS context increases risks for multination groups to bear heavy penalties. This is of course a financial issue, but it is also a matter of concern as some countries do not accept to open a MAP when some penalties have been applied by tax auditors. One could consider that this is a “double penalty,” as taxpayers bear the penalty itself but are also deprived of their right to access the MAP.

Higher levels of financial statement tax reserves related to transfer pricing
The BEPS initiative has resulted in changes to substantive transfer pricing rules, increased complexity, and increased transparency. Taxpayers’ current transfer pricing arrangements must be reconsidered in light of these new rules. Taxpayers and the advisers assisting those taxpayers to redesign their transfer pricing policies as a result of BEPS will have no experience with how tax authorities will seek to apply the new transfer pricing rules. Additionally, CbC reporting may trigger audits for pre-CbC years as tax authorities may seek to apply these new standards retroactively to open tax years. As a result, taxpayers should expect increased uncertainty for past, current, and future tax years.

In October 2015, the International Accounting Standard Board (IASB) issued Draft IFRIC Interpretation DI/2015/1 Uncertainty over Income Tax Treatments, which addresses uncertain tax positions under International Financial Reporting Standards (IFRS). Existing IFRS standards for accounting for income tax, International Accounting Standard (IAS) 12, does not address uncertainty over income tax treatments. IFRIC Interpretation DI/2015/1, paragraph7. Under the draft IFRS standard, taxpayers are required to assume that tax authorities have full knowledge of all relevant information. With regards to recognition, if an entity concludes that it is probable that the taxation authority will accept an uncertain tax treatment, the accounting for income tax will be consistent with the tax treatment used or planned to be used in its income tax filings. Alternatively, if an entity concludes that it is not probable that the taxation authority will accept an uncertain tax treatment, then the accounting for income tax will be reflected in the financial statements based on one of two available methods.

The first option is “the most likely amount”, which is the single most likely amount in a range of possible outcomes. The draft guidance indicates that the most likely amount may provide the better prediction if the possible outcomes are binary (either one result or another result). The second option is the expected value – the sum of the probability-weighted amounts in a range of possible amounts. The
expected value may provide the better prediction if the possible outcomes are widely dispersed. An entity is expected to use the method that, in its judgment, is a better prediction of the resolution of the uncertainty. With limited exceptions, most transfer pricing issues are not binomial and reflect a range of potential arm’s-length outcomes; therefore, assuming the draft standard is finalised in its current form, we would expect taxpayers to measure their transfer pricing exposures on an expected value basis.

Interestingly, the draft IFRS standard contemplates uncertain tax positions for transfer pricing and provides a specific transfer pricing example in determine the expected value of a transfer pricing outcome. Under the example, six potential outcomes under which additional taxable would be assessed by a particular jurisdiction are assigned corresponding probabilities and an expected value for additional taxable income is determined. The example’s assumptions indicate that the “relevant tax rules indicate that this particular tax jurisdiction’s decision would not affect decisions to be made by taxation authorities in other tax jurisdictions, in respect of these tax treatments”. It may be surmised that under this example competent authority relief was either not available or practicable. If competent authority relief was available, we would expect that a similar calculation would be determined for assessing the expected reduction of taxable income achieved through a corresponding adjustment from the counterparty jurisdiction.

In quarterly and annual financial statements filed with the US Securities and Exchange Commission, multinational companies frequently attribute changes in their reserves for income taxes due to uncertainty over transfer pricing. (See, e.g., Bloomberg BNA Transfer Pricing Report, Securities and Exchange Commission Financial Statements Filed During October 2015, Detailing Transfer Pricing Issues.) In a post-BEPS world where transfer pricing uncertainty has attracted attention from accounting standards setters, both increased frequency of these disclosures and increased magnitude of such uncertain tax liabilities may be expected.

**Reactive strategies for taxpayers**

**Unilateral strategies outside of MAP**

Taxpayers often face transfer pricing issues for which there is no applicable tax treaty MAP. In other cases, when there is an applicable tax treaty with a MAP article, taxpayers will assess the validity of the transfer pricing adjustment and whether it expects that a challenge of such adjustment under available administrative processes is likely to be successful.

**Settlement with tax authority**

Even if experience shows that a settlement with a tax administration does not ease a MAP resolution, as it is not a way to convince the treaty partner that the remaining tax adjustment is correct, it may be a good solution to stop the dispute with the tax administration that initiated the assessments, when an appropriate outcome results from this national negotiation.

Settling with a tax authority should be viewed cautiously. Some countries exclude a taxpayer from the MAP, once a settlement is signed, considering that such a settlement is a recognition of the appropriate level to be taxed. Under these circumstances, the country that made the adjustment may not be willing to negotiate any reduction of the adjustment agreed to with taxpayer, and a taxpayer may be subject to double taxation as the other country involved may preclude access to MAP, not provide any correlative adjustment, or allow only for a correlative adjustment that provides for less than full double tax relief.

When the administrative appeals process is not independent from the audit and examination functions of the tax administration, the BEPS Action 14 report recommends that audit settlements not preclude access to MAP. See BEPS Action 14 Report, paragraph30-31.

**Administrative/appeals processes**

Each transfer pricing audit case is unique. But administrative remedies should not be ignored, even if the final outcome may not guaranty the elimination of double taxation. Depending on the details of the case, taxpayers may consider challenging transfer pricing adjustments, whether in an internal administrative appeal process or in a court proceeding. For example, pertinent case law may exist that indicates the tax administration may not have a strong position.

Internal administrative appeals may represent a simple way to significantly decrease the initial tax adjustments, if not to avoid it. Introducing the case in front of a judge may also lead to the
cancelation of the assessment, if robust elements have been prepared ahead of the tax audit or gathered during the procedure.

It can also be a remedy to tax collection, as a MAP request may not stop collection in some countries while the case is being negotiated by the treaty countries. This would then lead to initiate a litigation process and a MAP request in parallel.

In some cases, which will be highly dependent on the jurisdiction involved and the specific factual circumstances, it may be more efficient to seek to resolve the issue through available administrative processes as opposed to going to through the MAP process. In such instances, taxpayer should have full knowledge as to whether it has waived any rights to subsequently request MAP.

Implications of unilateral strategies on foreign tax credits

In the US, a multinational enterprise facing a foreign transfer pricing adjustment must exhaust effective and administrative remedies, including pursuing available MAP processes, lest it lose foreign tax credits associated with such adjustment. (U.S. Treas. Reg. §1.901-2(c)(5).) Other countries, where foreign tax credits are an issue, may have similar rules. Under recently published US MAP procedures, the IRS invites taxpayers to informally discuss its considerations as to whether or not to request MAP. (Rev. Proc. 2015-40, §2.03.)

Mutual agreement procedure

Once an adjustment is asserted, MAP is usually the best avenue to avoid double taxation. Under some treaties, due to the existence of mandatory arbitration provisions, it will greatly increase the likelihood that double taxation will be eliminated. (See, for example, the European Union Arbitration Convention, applicable to transfer pricing adjustments between EU member states, and US treaties with Canada, Belgium, France, Germany, and the UK.)

Even if it is sometimes seen as burdensome, long and expensive, this is an adequate procedure to make tax administrations realise the possible inconsistency of its position (a double check will be performed before entering in negotiation with the treaty partner) and a way to continue negotiations with a new partner within the tax administration and (not with the tax audit service anymore—even it can still be involved in the procedure in some countries).

This remedy can be improved by the tax administrations, as the BEPS Action 14 report on this area has suggested several recommendations connected to clarification of treaties, utilisation of resources, publishing of guidance on utilizing MAP, and quality of work among competent authorities.

Combining MAP with an APA

In some cases, MAP can be seen as an investment. To increase the outcome of that investment, MNEs may have interest to enter in the APA process at the same time. This may not be possible in each country (some of them do not accept an APA request when a MAP is pending). However, when possible, this would provide a solution for the past, but also for the future, granting a complete security on the covered transactions.

Experience shows that entering simultaneously into a MAP and an APA may also provide for more flexible negotiating room between competent authorities. For example, for a taxpayer with historical losses during the tax years under MAP, the transfer pricing method in an APA may be an opportunity to reverse its fortune or by the situation may be viewed more favourably if a longer time horizon of combining the APA and MAP years is considered. On their side, MNEs may have more security, as the final solution will include past years, future years, and intervening years. However, some countries do not accept to bridge the two procedures into a single negotiation, or do not agree to cover past years that have not been audited.

Proactive strategies for taxpayers

Robust documentation

Some countries mandate that taxpayers prepare transfer pricing documentation, while others that do not require
documentation will provide penalty relief if documentation is prepared. In some countries, documentation is required only if the transactions exceed a certain threshold. Some countries that allow for relief from penalties if documentation is prepared require contemporaneous preparation of the documentation. For example, in the US, documentation for a tax year is considered contemporaneous if prepared before filing of a timely filed tax return for such year. (IRC §6662(e)(3)(B)(ii)(II); U.S. Treas. Reg. §1.6662-6(d)(2)(iii)(A)). These requirements reflect the anxiety of tax administrations over the protection of their tax bases and the common perception among tax administrations that MNEs reduce local income taxes through transfer pricing manipulation. A proactive approach to analysing and documenting intercompany transactions has been vital to managing transfer pricing audit risk for multinational companies. Maintenance of documentation is important for two other reasons. First, it enables a taxpayer to explain its facts and transfer pricing policies to tax authorities and the success of determination of the arm’s-length price depends on its acceptance by the tax authorities. Most importantly, the documentation allows the taxpayer to frame, in a favourable fashion, the facts and issues for the tax authority. Second, it makes business sense to have the process of determination of price in intragroup transactions well documented.

Documentation may be necessary for a taxpayer to meet the burden of proof. In cases when the burden of proof is on taxpayers, it is necessary for taxpayers to maintain proper documentation to justify determination of the arm’s-length price. While compiling the documentation, it should bear in mind that the core objective is to determine the arm’s-length price for the international transactions in question. The OECD recommends that the extensiveness of the documentation process be determined by prudent business management principles. The greater the complexity and rarity of the international transaction, the more comprehensive the documentation should be. Even when the burden of proof lies with the tax authority, the tax authority might still reasonably oblige the taxpayer to produce the documentation about its transfer pricing, because without adequate documentation the tax administration would not be able to examine the case properly.

APAs in key countries
When MNEs anticipate reactions from tax auditors, a simple and safe way to deal with the problems is to request an APA. This procedure is appropriate to work with tax administrations on problems related to transfer pricing methods, or if transactions involving large amounts are involved, to avoid misinterpretation, or to avoid penalties.

Not all transactions may be covered by an APA. But the most significant (in financial or technical terms) can be selected and submitted to some tax administrations. The countries can be chosen depending on the efficiency of their APA programmes, or their ability to accept the method suggested.

Some multinationals will seek APAs in all countries where they have significant transfer pricing risk. Other multinationals may selectively choose several key jurisdictions to obtain bilateral (or multilateral) APAs. In this selective approach, the APAs obtained will serve as an anchor for the multinationals’ transfer pricing policies in jurisdictions where they do not have APAs. If a multinational enterprise’s transfer pricing policies are challenged in a jurisdiction where it does not have an APA, one or more bilateral APAs obtained in other jurisdictions may provide persuasive support for the transfer pricing policies applied in such non-APA jurisdictions.

Mandatory arbitration
Although there is no consensus among all OECD and G20 countries on mandatory arbitration, the BEPS Action 14 report on MAP identified the countries that have declared a commitment for mandatory binding MAP arbitration in their bilateral tax treaties to ensure treaty-related disputes will be resolved within a specified time frame. Those countries are: Australia, Austria, Belgium, Canada, France, Germany, Ireland, Italy, Japan, Luxembourg, the Netherlands, New Zealand, Norway, Poland, Slovenia, Spain, Sweden, Switzerland, the UK and the US. These countries are involved in more than 90% of outstanding MAP cases at the end of 2013, as reported to the OECD.

Mandatory arbitration is important to resolving MAP cases on a timely and principled basis and, most importantly, ensures that the issues will be resolved without double taxation of income. Unfortunately, it is not uncommon to observe some treaty partners embark on a strategy of delay and dubious positions when there is no provision for mandatory arbitration. Accordingly, wider implementation of mandatory arbitration is a welcome development. The objective of mandatory arbitration is not to actually have large numbers of cases go to arbitration; rather, the objective is for competent authorities to adopt reasonable negotiating positions and resolve cases in a timely manner.

Some jurisdictions that have adopted mandatory arbitration require substantially more information up front than previously required to ensure they have all the information they might need due to the time limit involved. Also, some jurisdictions do not start the clock (the “commencement date” of the MAP request) until they deem the MAP request complete.

Overall, multinational companies should welcome mandatory arbitration as it provides greater certainty that double taxation will be avoided, but also is expected to provide more speedy resolution of MAP requests. Mandatory arbitration is one provision cited in the BEPS Action 15 report as being as being ripe for inclusion in a multilateral instrument to modify existing bilateral treaties.
Dispute prevention

In a post-BEPS world, dispute prevention will be the preferred road for multinationals. However, BEPS initiatives are likely to increase the number of transfer pricing disputes, and taxpayers will use the MAP process to resolve many of these disputes. As a result, it is important that MAP processes function efficiently and effectively on a global basis. Implementation of the recommendations in the BEPS Action 14 report is expected to facilitate MAP processes and pave a smoother road for taxpayers’ future MAP trips.
Global APA programmes: Get ready to apply BEPS guidance prospectively

Kerwin Chung, Shiraj Keshvani, and Eddie Morris explain how BEPS guidance will impact APA programmes globally.

For many global multinational enterprises (MNEs), advance pricing agreements (APAs) have been a key element of their transfer pricing compliance strategies. APA programmes were first introduced in the late 1980s as a procedure to allow MNEs to achieve certainty with tax authorities on a unilateral, bilateral, or multilateral basis, with the goal of prospectively resolving potential transfer pricing disputes in an efficient, principled, and cooperative manner. Overall, global APA programmes have been successful in achieving these goals, and that success has led to the introduction of APA programmes in more than 40 countries, with several national APA programmes reporting hundreds of APA submissions in their case inventories.

APA negotiations are based on the arm’s-length principle as described in the respective countries’ transfer pricing laws, the associated enterprises articles or mutual agreement procedure (MAP) article of relevant tax treaties, and the OECD transfer pricing guidelines. The last two of those authorities are undergoing their most significant update in the last 20 years by means of the October 2015 release of the OECD’s final reports to address base erosion and profit shifting (BEPS). Several of those reports will update the OECD transfer pricing guidelines and introduce significant changes to substantive transfer pricing rules, information disclosure requirements, and dispute resolution procedures.

The interpretation of the changes to these authorities, whether simply in terms of the point-in-time of application or in terms of substantive issues, such as differences in the determination of value creation, is expected to lead to increased numbers of transfer pricing disputes. This is something the OECD itself has recognised – part of the BEPS work has to been to encourage dispute resolution through MAPs but also dispute prevention through APAs.

**Advance pricing agreements**

An APA is a multiyear agreement between an MNE and one or more tax authorities regarding:

- Number of years covered by the APA;
- Covered intercompany transactions;
- Transfer pricing methods for testing the covered intercompany transactions;
- A range of arm’s length results;
- Rules for making transfer pricing adjustments pursuant to the APA;
- Critical assumptions that allow either the MNE or the tax authority to revise or cancel the APA; and
• Reporting requirements to document compliance with the APA.

If an MNE complies with the terms of its APA, it will be protected against transfer pricing adjustments and potential tax penalties by the tax authorities that are parties to the APA. Statistically, it takes from one to four years for tax authorities to negotiate an APA. Generally, time to resolution varies with the nature of the covered intercompany transactions, the complexity of the proposed transfer pricing method, and the personnel resources of the tax authorities involved.

APA programmes have generally achieved the goal of prospectively resolving potential transfer pricing disputes in an efficient, principled, and cooperative manner (compared to the alternative of undergoing a transfer pricing examination and pursuing local administrative appeals or judicial remedies).

Bilateral or multilateral APAs ensure that double taxation will not arise. Undergoing a transfer pricing audit, local administrative appeals, or judicial remedies that still leave an adjustment on the table will often result in double taxation, and the need to go through an MAP to obtain redress and repayment of tax “at the other end of the transaction”. An APA removes the need to be subject to all of this, and provides the benefits of forward-looking certainty.

The US APA programme, which has made the most statistical data available publicly, has negotiated more than 1,400 APAs since the 1990s. MNEs are frequently repeat customers to APA programmes. Approximately 44% of the US APA case-inventory consists of APA renewals of existing agreements and, based on experience, many MNEs have negotiated three or more consecutive APAs with the IRS.

Ready for BEPS

BEPS Actions 8, 9, and 10: Aligning transfer pricing outcomes with value creation

Many of the issues identified in the BEPS Actions 8-10 report are likely to lead to more transfer pricing disputes. One such issue is the reduced suitability of one-sided transfer pricing methods such as the transactional net margin method (TNMM). This has been the subject of global APA negotiations for the last several years, resulting in tax authorities requesting more information and doing more analysis than might otherwise be necessary for the application of one-sided TNMM analysis. Such information requests often include BEPS-related issues such as:

• Reviewing system profitability;
• Transparency with respect to transfer pricing policies for other group members;
• Holistic view of value creation and mapping of all intercompany transactions;
• Existence or nonexistence of location-specific advantages;

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Kerwin’s practice has involved complex transfer pricing issues, including bilateral APAs, rollbacks, and competent authority representations with respect to inbound and outbound intercompany license transactions for clients in several industries.


Kerwin has been included in the Euromoney/Legal Media Group’s Guide to the World’s Leading Transfer Pricing Advisers since 2002. He is an active member of the ABA Tax Section Transfer Pricing Committee, having moderated a panel on transfer pricing down economy issues in 2009 and presented on a panel discussing the IRS APA program in 2011.

He holds a JD (cum laude) from Harvard Law School and a BBA in accounting and real estate from University of Hawaii. He is admitted to practice at the bar in New York and District of Columbia.
Shiraj Keshvani is a partner in the Ottawa office of Deloitte Canada’s global transfer pricing and tax controversy practice.

Before joining Deloitte, Shiraj was the chief economist for Canada Revenue Agency’s (CRA) Competent Authority Services Division and the national APA coordinator. He has a deep understanding of CRA’s policies and procedures and the CRA perspective and focus on many contentious issues.

With 15 years of service with the CRA, primarily in the area of international taxation and transfer pricing, Shiraj first served with the assistant deputy minister of the Verification, Enforcement, and Compliance Research Branch. In 1999, Shiraj joined the International Tax Division as a Transfer Pricing Economist, where he provided support to the field in the course of transfer pricing audits. He was subsequently appointed to the position of senior transfer pricing economist, and in May 2007 began serving, on an interim basis, as APA coordinator and chief economist, before being permanently appointed to that position.

As APA coordinator and chief economist, Shiraj took a leadership role in setting priorities, establishing policies, and issuing guidance for Canada’s APA programme. He was also a member of the Transfer Pricing Review Committee, which considers taxpayers’ compliance with Canadian legislation. On the global front, Shiraj was involved in developing Canada’s position on international initiatives such as the OECD’s work on the taxation of multinational enterprises and, having spent the greater portion of his career with Competent Authority, gained significant experience reconciling Canadian views on transfer pricing with those of other countries to resolve double tax issues. He was actively involved in negotiating the mode of application for the arbitration provisions under the 5th protocol to the Canada-US Treaty.

Since joining Deloitte, Shiraj has assisted clients to manage and resolve difficult tax controversy issues. He has conducted a number of transfer pricing projects, in a variety of industries, involving audit defence, competent authority assistance, APAs, and planning and documentation studies. These have addressed a wide range of transfer pricing issues including business restructurings and the treatment of intangibles. Shiraj remains active on the policy front and is a member of the BIAC Tax Committee and the International Chamber of Commerce Commission on Taxation.

Shiraj holds a BA (Hons) and MA degrees in economics.

Edward Morris is a partner in the London office of Deloitte UK. He served as a delegated competent authority for mutual agreement procedures and advance pricing agreements in the International Section of HMRC, was seconded to the European Commission to work on APAs and the Arbitration Convention, and joined Deloitte in December 2008. Edward is a well-known figure to the competent authorities of many of the world’s finance ministries.

Edward’s 12-year career at HMRC involved working on dispute resolution on MAPs, as well as dispute avoidance work on APAs with fiscal authorities around the world. Edward was also involved in a broad range of international tax issues and problems, but specialised in transfer pricing, permanent establishment, and treaty matters. Edward also represented the UK and the EU Commission at OECD, and was heavily involved in the OECD work on international dispute resolution (helping to draft the new arbitration clause in the Model Treaty) and business restructuring.

Building on his experience with APAs while in government (including the largest multilateral APA entered into by the UK), Edward has led several APAs for Deloitte clients, including two pan-European multilateral procedures.

While at HMRC, Edward enjoyed a two-and-a-half year secondment to Brussels, where he advised the EU Commission on APAs and transfer pricing matters. Edward was responsible for steering the EU APA Guidelines through the EU Council.

Edward’s eminence in the wider international tax field was recognized by the OECD when he was asked to speak at the 50th anniversary celebration of the OECD model tax convention and by IFA at the 2011 Annual Congress, when he participated in the opening panel on business restructuring issues.

Edward has a BA in Medieval and Renaissance history from Warwick University. He is happy to advise on the rise and fall of the Italian city states in the Quattrocento should the opportunity arise.
• Comparison of intercompany agreements with conduct of the parties;
• Inquiries about the relative value of the OECD DEMPE (development, enhancement, maintenance, protection, exploitation) functions; and
• Inquiries about managerial ability and financial capacity to control and bear risk.

Notwithstanding this, one-sided transfer pricing methods continue to be frequently applied by APA programmes. The US APA programme applied the TNMM for 78% of covered intercompany transactions in 2014, according to the IRS’s 2014 annual APA report. Similarly, Canada’s APA programme reported in the 2014-15 APA annual report that TNMM was used in 62% of cases in process as of June 2015. The Japanese APA programme reported in its 2014 annual report that TNMM was used in 63% of its cases in 2014. It’s impossible to predict whether these rates will continue into the future, but for now the TNMM seems to be an important feature of APAs.

BEPS Action 13: Transfer pricing documentation disclosure of APAs

BEPS Action 13 calls for a three-tier approach to transfer pricing documentation (master file, local file, and country-by-country report) that will provide tax administrations with useful information to assess transfer pricing risks.

Under the BEPS guidance, taxpayers must provide, as part of their master file submission, a list and brief description of the MNE group’s existing unilateral APAs, and other tax rulings relating to the allocation of income among countries.

Similarly, the guidance requires disclosure with the local file of a copy of all existing unilateral and bilateral/multilateral APAs and other tax rulings to which the local tax jurisdiction is not a party and that are related to controlled transactions in which the local entity is involved.

The master file and local file are to be provided by the MNE directly to the local tax authority. Consequently, there is a possibility that the disclosure of APAs may have a salutary effect on MNEs’ APA strategies. For instance, if an MNE negotiates a unilateral APA with a required level of profitability higher than regional benchmarking, that unilateral APA would be disclosed in the master file and may encourage tax authorities in other jurisdictions to propose adjustments based on the higher profit level in the unilateral APA. While the unilateral APA will likely be distinguishable on comparability grounds, MNEs must reevaluate the benefits of such a unilateral APA in light of the possible spillover effect on other APA applications.

Unilateral APAs by their very nature do not eliminate or prevent double taxation. The unilateral APA has advantages – for instance, it may be faster to obtain because the taxpayer interacts with only one tax administration. But the advantages of bilateral or multilateral agreements over unilateral agreements are clear. In the EU, state aid considerations also mean that unilateral agreements sometimes bring their own problems.

BEPS Action 14: Dispute mechanism of choice

The increased level of transfer pricing controversy that may arise because of the BEPS guidance may lead to an increase in the number of MAP and APA cases in most countries. Some MNEs have adopted a strategy of negotiating bilateral APAs with select countries to build a portfolio of agreements to use as persuasive authority in other tax jurisdictions. The MNE’s argument would be that “if countries 1, 2, and 3 agree with my proposal, so should country 4.”

The popularity of APAs will further benefit from two items in the BEPS Action 14 guidance that are particularly relevant to address transfer pricing controversy. First, the BEPS Action 14 final report includes a series of “best practices”, one of which calls for countries to develop and include in their published MAP and APA guidance appropriate guidance on multilateral MAPs and APAs. The second item is mandatory treaty arbitration.

While countries have been attempting to negotiate multilateral MAPs/APAs for many years, such efforts have not been resolved quickly. The development and implementation of multilateral MAP and APA guidance would be a welcome development, in light of the static nature of domestic administrative appeals and judicial remedies.

The OECD and G20 countries did not reach consensus on the adoption of arbitration as a mandatory mechanism to ensure the resolution of MAP cases, as many had hoped. While the final report notes that a group of 20 countries has committed to adopt and implement mandatory binding arbitration, it is clear that even within this group of countries there are differing views on the scope of such a provision.

The 20 countries include Australia, Austria, Belgium, Canada, France, Germany, Ireland, Italy, Japan, Luxembourg, the Netherlands, New Zealand, Norway, Poland, Slovenia, Spain, Sweden, Switzerland, the United Kingdom and the United States. These countries were involved in more than 90% of the outstanding MAP cases at the end of 2013, as reported to the OECD. While global experience with mandatory arbitration provisions is not reported publicly, anecdotal evidence in the US indicates that such provisions have been somewhat successful in effecting MAP settlements in a timely manner.

Conclusion

As tax administrations acquire more powers and receive more information as a consequence of the BEPS initiatives, they are likely to use that power and information. As a result, the number of tax disputes is likely to increase. Any approaches that prevent those disputes from arising in the first place should be part of MNEs’ tax strategies. Increasingly, the old dynamic of “file and forget” will become a less viable tactic for dealing with tax administrations. MNEs’ approach to dispute prevention through APAs will become increasingly important over the next few years, as the BEPS changes push transfer pricing to the forefront of governments’ and taxpayers’ agendas.
John Henshall and Philippe G. Penelle, describe the relationship between intellectual property and controversy in tax and transfer pricing.

Transfer pricing of intellectual property (IP) has always been a difficult technical area but, until recently, guidance on the subject was sparse. The 2010 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Chapter VI, deals with special considerations for the transfer pricing of intangibles in just 39 paragraphs. To put that in context, the same edition takes 42 paragraphs to deal with intragroup services.

Now, under Action 8 of the Base Erosion and Profit Shifting (BEPS) initiative, the OECD has published a revised Chapter VI and material to insert into Chapters I and II, which is intended to be adopted as formal guidance once the work on profit splits and financial services is completed, possibly in early 2017. At 612 paragraphs, plus an annex of examples and the proposed changes to Chapters I and II, there is now a substantial body of guidance on the subject.

Before the revised guidance is adopted into the revised version of the transfer pricing guidelines, it is possible that some countries will adopt the current material into their domestic transfer pricing law. For example, the UK could do so by a simple Order of the Treasury.

Even if not adopted into law, the material is considered, in the main, to be a “better explanation” of the arm’s-length principle, and even though it cannot be cited as precedent, the ideas embodied in the guidance may be used immediately. In the authors’ experience, several countries, including Australia, Finland, France, the UK, and the US are currently using at least some of the BEPS concepts in audits.

The time frame for completion of work on the BEPS actions was politically inspired and rather short, whilst the other matters also considered under the BEPS project reduced the resources devoted to transfer pricing work. As a result, the final output from Action 8 lacks clarity and therefore may increase controversy rather than reduce it.

This article examines how to interpret the new guidance in accordance with the stated aim of BEPS Actions 8-10: to align transfer pricing outcomes with value creation by proper application of the arm’s-length principle, and any controversy that may arise because of the new guidance. It focuses on IP definition, contractual positions as compared to actual activity, and the control of activities and risk. However, before looking at Chapter VI, we must consider the arm’s-length principle and the changes proposed for Chapter I of the transfer pricing guidelines.
The arm’s-length principle

The arm’s-length principle is the almost universal tenet used by tax administrations around the world to guide the allocation of income among affiliated members of a multinational enterprise.

Transfer pricing disputes between countries that are parties to a tax treaty typically rely on Article 9 of the Model Treaty Convention, for resolution on the interpretation of the arm’s-length principle articulated in Chapter I of the transfer pricing guidelines. The ability of this “principle” to achieve that purpose depends on its articulation in the transfer pricing guidelines, and the interpretation of the guidelines will be updated substantially as a result of the BEPS process. In this section, we will first distinguish between assessing the arm’s-length nature of a transaction and assessing the arm’s-length price of that transaction. We will then discuss the two different ways the arm’s-length principle can be interpreted insofar as pricing is concerned, and we will comment on its articulation in the expected revision to Chapter I of the transfer pricing guidelines.

Is the transaction arm’s-length?

A frequent comment at the OECD public consultations on transfer pricing matters and in transfer pricing audits is that “third parties would never enter into this transaction”. This statement is typically used to discredit the validity of a transaction that takes place between affiliated members of a multinational enterprise. The implication of the assertion is that the transaction should be recharacterised as one that third parties would actually enter into. Unfortunately, that reasoning is flawed.

Multinationals form because the vertical integration of business assets and the resulting efficiencies, both economic and managerial, from common control provide more value to shareholders than the alternative of fragmented control over the same business assets. As a result, multinational enterprises can and do enter into certain transactions that third parties operating in the open market could not, or would not, enter into. For example, a parent company rich in valuable intellectual property would have a strong incentive to transfer rights to use and possibly further develop all of its intellectual property to an affiliated foreign entity if that transfer of rights increases value to the shareholders. Clearly, this would not necessarily be the case in a third-party context. It is not often that a company licenses all its IP to a competitor. Should tax administrations be allowed to prevent a parent company from transferring various rights to its most valuable IP to affiliated members on the grounds that third parties do not enter into comparable transactions? An affirmative answer would mean that, purely for tax reasons, we are willing to forgo some of the basic economic reasons why multinational companies are socially and economically desirable—they increase the efficiency of the markets and the resulting social welfare.

Statements such as “third parties would never enter into this transaction” are intrinsically subjective and more often than not grounded in an individual’s beliefs, as opposed to thorough empirical research. In that case, the arm’s-length principle should not be invoked to re-characterise a transaction. Indeed, a principle is a “standard” in that the outcome of the application of the principle must be independent from the identity of the party applying the principle. Perhaps the most blatant example of this is the assertion that a party investing in a development project would not agree to take an equity position in the development project unless it exercised control over the risks associated with the project. If this statement sounds familiar; it should. It is the argument used by the OECD under the BEPS initiative to justify providing low-functionality funding entities with a financial return instead of the upside and downside of the intangible return. The problem with that assertion is that it clearly breaches the arm’s-length principle, in that it is easy to find empirical evidence to the contrary. In the movie industry, for example, third-party studios will agree to share all development costs of a movie and share the profit accordingly, with one studio contractually agreeing to relinquish all creative control over the making of the movie to the other studio. So much for exercising control as a prerequisite to share in the upside and downside of the venture.

The revisions to Chapter I of the transfer pricing guidelines may be misinterpreted as empowering tax administrations to test a written contract between affiliated members of a multinational enterprise using their own beliefs and commercial judgment about the rationality of the subject transaction. Specifically, even if one accepts the premise that “control of risk” – at arm’s-length – governs who is entitled to an equity return (an erroneous premise, as demonstrated above), the lack of clear guidance, the ambiguity of what controlling risk really means in the context of a multinational enterprise, and most importantly a very clear reference to the arm’s length principle – what independent parties actually do – are likely going to result in increasing controversy about the real character of controlled transactions.

A behavioural interpretation of the arm’s-length principle

Under a behavioural interpretation of the arm’s-length principle, the price used between affiliated members of a multinational enterprise in a transaction is arm’s-length if it is consistent with the price used by third parties in the open market in a comparable transaction. This interpretation has significant implications on the valuation method used to price transfers of intellectual property. Indeed, to operationalise such interpretation requires that we find comparable transactions in the open market conducted under comparable facts and circumstances. The challenge therefore consists in finding transactional comparables that may not exist in the open market. Because the outcome of third-party transactions occurring in the open market is arguably independent from the identity of those observing such transactions, we have an acceptable standard.
Under US law, the best method rule provides that the most reliable measure of an arm’s length result must be used when determining whether a controlled taxpayer’s results are consistent with those that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances. Although there is no strict priority of methods, recent court cases have affirmed that third-party behavioral evidence of pricing trumps any other interpretation of the arm’s length principle.

A thought experiment interpretation of the arm’s-length principle

Under a thought experiment interpretation of the arm’s-length principle, economic principles are used to divine how third parties operating in the open market would have priced a transaction that takes place within a multinational enterprise. The economic principles used are typically those addressing the forces of supply and demand in the market, or general cooperative or non-cooperative game theoretic principles, including those of bargaining theory. The thought experiment thus consists in a mental exercise of applying well-accepted principles to analyse a subject transaction. Because the outcome of the application of such principles is arguably independent from the identity of those applying them, we have an acceptable standard. However, from a practical standpoint, this is far from the case. Rigorous application of the arm’s-length principle based on a thought experiment requires deep understanding of how competitive markets work, and how cooperating agents and non-cooperating agents reach outcomes. Most transfer pricing practitioners have very little or no training in economics and are either accountants or lawyers by training. Even within the economic profession, most practicing economists have been trained in the behavioural application of the arm’s-length principle, not in the thought experiment interpretation.

One example of a thought experiment-based application of the arm’s-length principle is the use of corporate finance valuation techniques to price transfers of intellectual property. That methodology consists of projecting a probability-weighted forecast (first thought experiment), selecting various valuation parameters that capture opportunity costs, for example (second thought experiment), and adding some version of the risk-adjusted projections into a present value (third thought experiment) under the overall premise that this is the way a third party would have assessed the development activity (speculative assertion). The revisions to Chapter VI of the transfer pricing guidelines introduce such valuation methods for the first time and provide extensive guidance on how to apply them.

The changes to Chapters I and VI of the transfer pricing guidelines substantially tilt the interpretation of the arm’s-length principle from a behavioural interpretation to a thought experiment-based interpretation. Thought experiment-based interpretations of the arm’s-length principle are intrinsically more subjective and arbitrary than behavioural interpretations. Having said that, because multinational enterprises often engage in transactions that uncontrolled participants would not enter into, it may well be the case that a thought experiment is the only choice to interpret and operationalise the arm’s-length principle. However, in cases in which both interpretations are possible, it is likely that under the new guidance of Chapter I of the transfer pricing guidelines a thought experiment interpretation will be used by the tax administrations and thus result in increased controversy.

The revisions to Chapter I of the transfer pricing guidelines and to Chapter VI dealing with transfers of intangibles are voluminous, complicated, and susceptible to accommodating various interpretations that can lead to very different allocations of income. In connection with the transfer of intellectual property, the most telling example of the previous assertion is the guidance providing that a low-functionality entity that controls only the funding risk is entitled to no more than a risk-adjusted return. The guidance, however, is silent as to what a risk-adjusted return consists of, and no examples are provided to help understand how to determine what a risk-adjusted return is. Ask an economist what a risk-adjusted return is and you will hear that it is a risk-free rate of return augmented by a premium reflecting at least default risk and possibly other premiums reflecting other risks, such as the diversifiable or non-diversifiable risks of the investments. The term “risk-adjusted” is so generic and uninformative that it clearly reflects the lack of consensus among OECD member countries as to exactly how much income should be provided to a low-functionality entity controlling the funding and no other risks. When the lack of consensus as to what the outcome ought to be translates into guidance that is so vague that it can accommodate very different views of what that outcome should be, dispute and controversy are the likely outcomes.

If the aforementioned sounds problematic, consider that none of the guidance provided in the revisions to the transfer pricing guidelines (Chapters I and VI) deal with ex-post allocations of income. The revisions address the ex-ante allocation of income but are silent as to who, in the multinational enterprise, is entitled to the realised upside and downside of the business. Certainly the introduction into Chapter VI of measures that match the US “commensurate with income” provisions addresses to some degree the ex-post allocation of income, but it does so to resolve ex-ante informational asymmetries between taxpayers and tax administrations. As such, it is not really dealing with unexpected realisation of upsides and downsides with regard to an ex-ante valuation that was respected by tax administrations.

Although tax administrations are likely to contest allocating unexpected upsides to low-functionality entities that just provide and control the funding, typical multinational enter-
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Training initially with the UK tax authority, John became a Deloitte UK partner in 2001. John represents Deloitte UK to HMRC at the national level on transfer pricing technical matters, and he represents Deloitte globally at OECD’s Working Party 1, dealing with permanent establishment issues, and Working Party 6, dealing with transfer pricing of intangibles.

John is consulted by overseas governments on the modernisation of their approach to international taxation and transfer pricing, including base erosion and profit shifting (BEPS) issues. He lectures on supply-chain reorganisations and the transfer pricing of intangibles both to industry and to tax authorities.


The potential for controversy may be significantly reduced by identifying intangibles “with specificity”, as instructed in paragraph 6.12. To show that the [assumed] intangible is
“owned and controlled” (paragraph 6.6) it is necessary to show that a monopoly exists. The converse is also true: If we show that the [assumed] intangible is not “owned and controlled”, then we have shown that it is not an intangible for purposes of the guidance. By diligent analysis to produce work of evidential quality, the scope for controversy may be greatly reduced. For example, suppose that A, a US business, has a patent over a process that it licenses to overseas group member B. The patent expires, but B has used that process in developing a new product or service with such novelty that a new, valuable patent is granted to B. It is sometimes argued that the original work and expired patent must give rise to “platform IP” from which the new idea was developed, and so a fee must be paid by B to A even though the patent has expired. As we are applying the arm’s-length principle, would unrelated parties pay a fee either as a general matter or because A would include in its original license to B that it must continue to pay even after expiry of the patent? The answer is simply no, no fee would be due. It is a fundamental tenet of US patent law that there is no fee due once a patent expires, and that to contractually provide otherwise is contrary to the intention of IP law. Moreover, such a clause would be unenforceable (see Kimble v Marvel Entertainment LLC (576 U.S. __, 135 S. Ct. 2401 (2015)). Hence, we can prove evidentially that there is no concept of “platform IP” and we can avoid controversy over its existence.

Similarly, items that are not commonly understood by tax specialists to be “owned and controlled” may be identified as intangibles by diligent analysis using the relevant law and commercial practice of the pertinent territory to produce work of evidential quality. For example, a UK waste management license, an exemption from a general prohibition against dumping waste, is an intangible (see National Provincial Bank v Ainsworth [1965] AC 1175).

Valuation methods
The OECD’s new guidance on valuation methods will likely have the effect of increasing the use of the profit split method. The guidance is clear that any of the traditional transfer pricing methods might be useful, or as would be other valuation methods in certain circumstances. However, the guidance dismisses one-sided methods, including the resale price method and the transactional net margin method, as generally not reliable for valuing intangibles. Similarly, the guidance states that cost-based methods are generally discouraged, and points out the difficulty of applying a comparable uncontrolled price (CUP) in practice, leaving only the profit split method available from the traditional transfer pricing methods. In addition, the guidance could be read as favouring income-based methods in the valuation of an intangible asset (as opposed to the license of that intangible).

Comparability issues are likely to arise when considering CUPs. All intangibles that are “owned or controlled” have
the commercial characteristic of intangible property, and the third-party comparable licenses or sales that can be found are only of intangible property. To achieve intangible property status, the item must be “unique”; thus, in many cases the item will fail the test of comparability, other than when internally generated comparables are involved. This can be illustrated by commercial law cases. For example, a UK court in 1975 rejected a “comparables search” of IP licenses in an infringement case because comparability had not been shown (see General Tyre & Rubber v Firestone Tyre & Rubber [1975] 1 W.L.R.). Sometimes, even though the intangible is unique, it performs a comparable economic function. If there are several options to achieve the same end at the same cost and each can be licensed, then these alternatives provide a comparable uncontrolled price. However, in many cases, no CUP evidence will be available.

In applying the arm’s-length principle, it will sometimes be acceptable to use cost-based methods, if that is what happens in unrelated-party transactions. For example, early-stage development intangibles – for which significant risk remains in the development process – are often traded based on the costs incurred to date. When that can be shown to happen between unrelated parties, then the same method must be acceptable for related-party transactions under the arm’s-length principle. However, taxpayers seeking to use a cost-based method should ensure their evidence is on point, because tax administrations may point to the guidance which, read incorrectly, may appear to amount to a general prohibition against the use of cost methods.

The guidance in its current state provides practically no help on how to perform a profit split calculation, but further work on profit splits will be completed during 2016, leading to additional guidance in 2017. However, courts in the US and many other countries have been determining what constitutes a “fair license” for intangibles for many years. That body of case law provides evidence on whether a court judges a method to be acceptable or not. For example, in the 2011 case Uniloc LLC v Microsoft Corporation, the US Federal Court of Appeals found that the “rule of thumb” (a basis for a profit split) was not evidential and refused to accept an estimation of a fair royalty based thereon. Courts in the US and other countries have endorsed the use of profit split methods when more evidential approaches are used. Specifically, the full profit split method – as opposed to the residual profit split method – has found favour in many countries. This body of jurisprudence provides valuable evidence of what methods would be acceptable between unrelated parties, which can form a sound basis for transfer pricing valuation.

### Evidential in nature

The stated aim of Action 8 of the BEPS project was to align transfer pricing outcomes with value creation by proper application of the arm’s-length principle. The combination of a short time frame and high workload (the OECD’s BEPS Action Plan included 15 actions) has resulted in guidance that lacks clarity. Unless transfer pricing professionals keep the arm’s-length principle firmly in mind, it is possible to misconstrue the guidance as supporting non-arm’s-length outcomes. A lack of understanding of what constitutes an intangible, or a failure to adhere to the arm’s-length principle is likely to lead to non-arm’s-length outcomes in practice. This will increase the risk of controversy and, subsequently, the number of claims to enter the mutual agreement procedure of a bilateral tax treaty or similar provision of an applicable multilateral treaty, such as the EU Arbitration Convention.

The easiest way to avoid that risk is through the advance pricing agreement mechanism, whenever possible. Although entering into an APA is unlikely to lead to higher costs for the taxpayer, compared to maintaining documentation and undergoing a thorough tax audit, more tax authority resources are required. As yet there is little evidence outside the US that tax administrations are addressing this staffing need.

Whether taxpayers take the APA option or choose instead to document their intangibles’ transfer pricing and await a tax audit, it is clear that all work supporting the transfer pricing position should be “evidential” in nature. This is by far the most effective way to control the potential for controversy, and indeed to reduce the cost of an APA. In any event, if agreement is not reached with the tax auditor the matter proceeds to appeal and rules in most countries define the standard of material that can be introduced in court as “expert testimony”. In the US this raises the possibility to make a “Daubert motion” against material that is not of “evidential quality” for it to be excluded from consideration.
Transfer pricing controversy and risk management

Cindy Hustad and Keith Reams review the general procedures many tax authorities follow to conduct transfer pricing audits and provides specific examples of the transfer pricing audit procedures in the US.

In recent years there has been a flurry of activity around the world involving international tax and transfer pricing, from legislation and new regulatory rule-making to intensified tax audits and controversy. The OECD’s tax working group has released new guidance in connection with its base erosion and profit shifting (BEPS) initiative, which by all accounts is expected to result in even more scrutiny, with the possibility of more controversy and likely tax litigation.

Transfer pricing and international tax planning have been in the news recently, with the EU’s Competition Commission bringing claims of unfair state aid against certain member states that have traditionally provided rulings and other fiscal regimes to large multinational organisations. Parliamentary hearings have been held in Australia and the UK and executives have been asked to testify about their companies’ international tax planning. The press has even started running stories about companies that have engaged in what historically has been standard international tax planning – all perfectly within the law – yet suggesting potential anti-competitive or, in some instances, nefarious motives.

In an increasingly large part of the world, and in all of the advanced economies, there is legislation and extensive statutory, regulatory, and administrative guidance governing international tax and transfer pricing, as well as procedures the tax authorities follow in their conduct of transfer pricing audits. While transfer pricing audits are part of the general overall audits of multinational taxpayers, because of their complexity and magnitude, they frequently become the primary focus and a major area of tax controversy.

How the tax authority selects transfer pricing audit cases

The selection of taxpayers subject to audit may be guided by risk factors or may be random. Tax authorities typically classify taxpayers according to revenue, asset size, and other relevant factors. The largest corporations are generally under continuous audit by many tax authorities. This is especially true in the US, where IRS examiners are often stationed at taxpayers’ corporate headquarters. Midsize corporations can be chosen for audit at random or after an initial review indicates that some issues are present that warrant specific review. Tax authorities also periodically examine cases from specific economic or industry sectors.

In the US, the IRS recently announced that it will institute issue-focused, strategic audits. Returns will be selected for audit based on the issues they present, and agents will be instructed to focus on specific issues.
Continuous audits of corporations will be replaced by audits of specific issues. Transfer pricing, however, may be expected to continue to be an area of focus of tax audits, and will be an issue that tax authorities will continue to select to audit.

How a taxpayer will find out it has been selected for audit and what the official notification process will be

In the US, the IRS notifies a taxpayer that it has been selected for audit by sending out an opening letter. This letter will relate to a specific accounting period and will be issued to the taxpayer. Generally, standard information document requests (IDRs) are attached to the letter. Once the taxpayer receives the letter, the taxpayer and the IRS will establish a date for the opening conference, at which the IRS will explain the audit process. At this point in an audit, the tax authority will also expect the taxpayer to respond to the initial IDRs, if it has not yet done so. Similar procedures are followed in many other countries.

Procedure on notification of transfer pricing audit

The taxpayer should review the standard initial IDRs and begin to gather the requested information, which includes tax work papers, trial balances board of directors’ meeting minutes, and financial statements. At the beginning of the audit, many tax authorities will request the taxpayer’s contemporaneous transfer pricing documentation as required by local transfer pricing rules. In some countries, that documentation may have been provided at the time of filing the tax return. Time is generally of the essence once a request has been made. In the US, transfer pricing documentation must be provided within 30 days of a request by the IRS. If the documentation is not provided within 30 days, the taxpayer cannot be assured of penalty protection. Under US rules, the documentation must also meet certain requirements under the regulations to confer penalty protection (see discussion below).

Legislative, regulatory, or other procedures applicable to taxpayers subject to a transfer pricing audit

There are a number of legislative, regulatory, and other procedures applicable to taxpayers subject to a transfer pricing audit. Some of the more significant procedures include the following:

- An overview of the relevant business, including an analysis of the economic and legal factors that affect the pricing of its property or services;
- A description of the taxpayer’s organisational structure (including an organisation chart) covering all related parties engaged in transactions potentially relevant under transfer pricing regulations, including affiliates in one country whose transactions directly or indirectly affect the pricing of property or services in another country;
- Any documentation explicitly required by the regulations;
- A description of the method selected and an explanation of why that method was selected;
- A description of the alternative methods that were considered and an explanation of why they were not selected;
- A description of the controlled transactions (including the terms of sale) and any internal data used to analyse those transactions;
• A description of the comparables that were used, how comparability was evaluated, and what (if any) adjustments were made; and

• An explanation of the economic analysis and projections relied on in developing the method.

In addition, the taxpayer usually must maintain and be able to provide the following items:

• A description or summary of any relevant data the taxpayer obtains after the end of the tax year and before filing a tax return, which would help determine if a taxpayer selected and applied a specified method in a reasonable manner; and

• A general index of the principal and background documents, and a description of the record-keeping system used for cataloguing and accessing those documents.

Once the audit begins, there are typically guidelines and various directives that the tax examiners must follow in auditing transfer pricing issues. For instance, in the US, the IRS’s Transfer Pricing Audit Roadmap provides detailed guidance to agents for the conduct of a transfer pricing audit. The roadmap anticipates that the agents will engage in extensive factual development, including interviews of company and non-company personnel.

In addition to the primary agents on the audit, the tax examiners will often request assistance from transfer pricing specialists with experience reviewing such issues. In the US those specialists are now generally part of the Transfer Pricing Practice (TPP). The TPP is comprised of economists and tax law specialists who focus on transfer pricing. The economist, with the tax law specialist’s guidance, will develop the facts necessary to perform a functional analysis and develop the economist’s transfer pricing methodology. For potentially large cases, the IRS may also seek the guidance of IRS counsel.

How the tax authority compiles information on a transfer pricing audit

Tax examiners typically gather information from a number of sources, including tax returns, financial statements, transfer pricing documentation, websites, and other public information. The tax examiners will also request additional documentation and information during the course of a transfer pricing audit. In the US examiners gather information from the taxpayer and seek interviews and site visits during the audit through IDRs. The IRS, in February 2014, released a directive on issuing IDRs that calls for the IRS to discuss the requests and timing of responses to those requests with the taxpayer before issuing them. Generally, the IRS expects a response to its requests within 15 to 30 days. If the IRS does not receive responses, the directive requires the IRS to take steps that can lead to the judicial enforcement of administrative summonses if the taxpayer does not provide the information voluntarily.

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Keith has assisted numerous multinational companies with international valuation and economic consulting services involving mergers and acquisitions activity, international tax planning, and restructuring and reorganization of international operations. Keith is on the global tax management team for Deloitte’s technology, media, and telecommunications practice and is a leader in the area of transfer pricing for newly emerging industries, such as electronic commerce and cloud computing, where he has extensive experience around the world in helping clients extend their business models into new territories.

Keith has testified as a qualified specialist in numerous valuation and transfer pricing disputes. In addition, he is one of only three economists in the US approved by the New York State Department of Taxation and Finance to provide transfer pricing knowledge and testimony in cases involving cross-border transactions within commonly controlled affiliated groups. He has also helped many clients to successfully resolve valuation and transfer pricing disputes before they reach trial.

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In some countries, the taxpayer may withhold documents based on assertions of privilege. Several types of potential privilege exist, including attorney-client privilege, taxpayer-adviser privilege, and work product privilege. Generally, for a document to be privileged, the client must be seeking legal or tax advice, with the intent that the communication be kept confidential. The privilege can be waived if the client discloses the information to another who is not in a privileged
relationship to the client. The privilege can also be waived if the taxpayer puts the advice in issue. In the US, this issue has recently arisen in situations where the client uses the Internal Revenue Code section 6662 documentation report as a defence against the IRS’s imposition of a transfer pricing penalty. If the taxpayer acted with reasonable cause and in good faith in using the transfer prices claimed in its tax return it would not be subject to a section 6662 penalty.

With respect to the section 6662 transfer pricing penalty, however, the taxpayer must show that it had the contemporaneous transfer pricing report prepared at the time it filed its return. In Eaton Corp. v. Commissioner, Dkt. No. 5576-12, the US Tax Court ruled in July 2015 that by relying on documentation reports as a defence to the section 6662 transfer pricing penalty, the taxpayer had placed its subjective belief concerning its transfer pricing at issue. Therefore, it had waived the privilege with respect to other advice it had received concerning the transfer pricing. This order has potentially wide-ranging ramifications.

In many countries, if the tax examiner does not receive the information requested, it may issue an administrative summons. In the US, such summonses are not self-enforcing; if the taxpayer does not comply with a summons, the IRS must enforce the summons in federal district court. Generally, the bar to enforcing a summons is low: The IRS must show that the information requested is relevant, that it complied with the administrative steps for issuing the summons, that the information is not in its possession, and that the summons was not issued for an improper purpose. The IRS cannot force a taxpayer to create a document through the summons process, but it can summon witnesses to give testimony.

Tax authorities often issue summonses to third parties to gather information. They can summon former employees or third parties to a contract, as well as bank and other relevant records from third parties. In recent years, the IRS has used third-party summonses more frequently to interview former employees of taxpayers.

Tax examiners typically have tools to obtain information from foreign parties. In recent years, the IRS has been using the information-gathering tools provided in treaties. In addition, the IRS can ask a US corporation to act as an authorised agent for a foreign corporation that owns at least 25% of the US corporation. In essence, the US corporation becomes an agent for acceptance of service for IRS requests for information and documents from the foreign parent and for any administrative summonses for the parent’s records. If the US corporation does not agree to be the foreign parent’s agent, the IRS may impose significant monetary penalties on the US corporation, and determine the appropriate transfer price based on the information already in the IRS’s possession. The US corporation will not be allowed to introduce any additional information.

The IRS has another powerful tool at its disposal, which it has begun to use more frequently. The IRS can require the taxpayer to provide information by issuing an administrative summons pursuant to section 7602 of the Internal Revenue Code. In addition, the IRS can issue one designated summonses during the course of an audit of a corporation, which will suspend the running of the statute of limitations during any judicial enforcement proceeding of that summons. The IRS can also issue summonses related to that designated summons within 30 days of the issuance of the designated summons. If any one of those summonses is subject to judicial enforcement, the statute of limitations is suspended. This is a powerful enforcement tool, which the IRS has recently used in its examination of corporate taxpayers.

The recently released OECD guidance on documentation, particularly regarding country-by-country, master file, and local file requirements, is intended to provide local tax authorities, particularly outside the US, with increased access to information that was historically available only to tax examiners in the company’s headquarters country.

**Issues that may trigger a transfer pricing audit by the tax authorities**

Items in corporate tax returns that might trigger a transfer pricing audit include cost sharing arrangements, licensing of intangibles, transfers of intangibles, business restructurings, and management charges. Many tax authorities have stated that they look for transfers of intangibles from high-tax jurisdictions to low-tax jurisdictions.

In the US, the IRS continues to focus on cost sharing arrangements, advocating the use of the income method and particularly focusing on the life of the platform contributions. In the case of business restructurings, the tax authorities focus generally on the substance of the operations in the foreign jurisdictions, as well as on the pricing of management services fees. This continues to be the case in many areas of the world, particularly in Latin America and in some parts of Asia, where management fees are particularly frowned upon and deductions for which are routinely denied.

Tax authorities are also increasingly focusing their attention on supply chain restructurings of multinational businesses, whereby some or all of the headquarters activities are transferred to a foreign jurisdiction. In those instances, the tax authorities not only focus on the transfer price for any intangible property the foreign entity receives, but typically they also examine the substance of the foreign operations. More specifically, the tax authorities inquire as to whether the foreign entity can provide, and in fact does provide, the services and supervision claimed. To support its position, the taxpayer may be asked to provide personnel to be interviewed in the foreign jurisdiction, as well as performance evaluations, job descriptions, and other contemporaneous evidence of the foreign entity’s direct involvement and supervision of foreign activities.

Tax authorities also continue to audit local subsidiary corporations of foreign parent entities, examining closely the
services they perform on behalf of the foreign parent. In recent audits, the tax authorities have attempted to determine if such services may be in effect creating intangibles, such as marketing or brand intangibles, in the local country for which the local entity should be compensated beyond a routine return. Similarly, concepts such as location savings are appearing in many tax audits, particularly in places such as China and India.

**Documents by the tax authorities from the taxpayer during a transfer pricing audit**

In addition to the information that would be included in the transfer pricing documentation discussed above, tax authorities often will request any documents and information that may be relevant to the taxpayer’s transfer pricing. The actual information requested will be dictated by the facts and circumstances of the transactions being audited. Tax authorities may request documents and information supporting the assumptions, conclusions, and positions in the transfer pricing documents. They also may request presentations by the corporate board of directors, audit committee reports, or other documents that may concern the transactions under audit, including any meeting notes and interviews with individuals involved in those transactions. Tax authorities also frequently request documents and interviews to perform a functional analysis with respect to the transactions. Some examiners may even request information and interviews from third parties.

In the US, the IRS also examines closely any set-off claims the taxpayer may assert against proposed transfer pricing adjustments. Generally, the taxpayer must file its set-off claim under Revenue Procedure 2005-46 within 30 days of receiving the examination report. However, the IRS is generally requiring earlier notification, so that it may fully examine the basis for the claimed set-off. Therefore, taxpayers who wait until after receiving the examination report to file a set-off claim may risk extending the IRS audit.

**Restrictions on a company’s business during a transfer pricing audit**

Generally there are no restrictions on a company’s business during audit. However, for publicly traded companies that are traded on public exchanges, significant potential audit adjustments and/or risk may be subject to disclosure by regulatory authorities. In addition, in some countries, the tax authorities may seize files and computers of taxpayers during the audit process, which can have the effect of temporarily shuttering down company operations.

**Restrictions on the taxpayer’s advisers during a transfer pricing audit**

Taxpayers’ representatives are generally subject to rules governing their practice before the local tax authorities. In the US, practice before the IRS is set forth in IRS Circular 230. Generally, the rules require that advisers exercise due diligence in responding to information document requests, and that they provide all information requested by the tax authority, unless the information is subject to privilege. Failure to do so can subject a practitioner to discipline for violating Circular 230. In addition, if the adviser knows that information has been omitted from a response, he or she must inform the client of the omission and possible penalties and, if necessary, withdraw from the case. Sanctions for violating Circular 230 include censure, suspension, or disbarment from practice before the IRS.

**Length of a transfer pricing audit**

Timing can vary depending on the tax jurisdiction and the complexity of each case. Typically, a transfer pricing audit may last from six months to four or more years. The length depends on the scope of the issues and whether the taxpayer will agree to an extension of the statute of limitations. In the US, after the IRS Examination Division issues Notices of Proposed Adjustments (NOPAs) and the Revenue Agent’s Report (RAR), the taxpayer may appeal the Examination Division’s adjustment to the IRS administrative Appeals division. Generally, the taxpayer files a written protest setting forth its facts and position. Other countries have similar appeals processes. In the US, the formal appeals protest is often a lengthy, complete, and highly technical document. After a protest is filed, the taxpayer will meet with the appeals officer on one or more occasions to discuss settlement. An appeal can typically take anywhere from six months to three years to reach resolution.

**On close of an audit**

If the tax authority agrees with the taxpayer’s position, it will issue a no change letter and/or accept the taxpayer’s return as filed. If the tax authority proposes adjustments with which the taxpayer disagrees, the taxpayer has several options. If a tax treaty exists between the country where the dispute arises and the country of the affiliate on the other side of the intercompany transaction, the taxpayer may seek double tax relief through a mutual agreement procedure (MAP).

The taxpayer may also appeal transfer pricing adjustments administratively, exercising care to protect the taxpayer’s ability to obtain full double tax relief through any tax treaty MAP if such relief applies, and if the administrative appeal results in a reduction but not elimination of the proposed adjustment.

Another alternative is for the taxpayer to challenge the adjustment judicially. If seeking judicial redress, care must be taken to protect the taxpayer’s ability to obtain full double tax relief through a tax treaty MAP if the relief applies and if the administrative appeal results in a reduction but not elimination of the proposed adjustment.

Most taxpayers choose to appeal the audit adjustment through the local country’s administrative appeals process.
In the US, this process requires the taxpayer to submit a written protest to the Appeals Office, setting forth the facts and the taxpayer’s technical position. The appeals officer has the ability to apply a hazards of litigation standard to resolve the issues. Recently, the IRS has instituted the Appeals Judicial Approach and Culture programme, which reinforces Appeals’ role as a settlement body, not a fact-finder. If the taxpayer introduces new facts at Appeals, the case will be returned to the Examination Division to review those facts. If the taxpayer introduces new legal theories, the Examination Division will generally be provided an opportunity to comment. In practice, this has resulted in longer examinations as the Examination Division strives to develop cases more fully.

Section 6.04 of Rev. Proc. 2015-41 requires taxpayers to sever a competent authority issue from a case in appeals (or use the simultaneous appeals procedure) in order to preserve its ability to request competent authority assistance under MAP.

**Managing audit risk**

The best way to manage audit risk is to establish and follow effective, sustainable transfer pricing policies, prepare annual contemporaneous transfer pricing documentation establishing the appropriateness of transfer pricing results, and provide transfer pricing documentation within 30 days of a tax authority request. To further mitigate audit exposure, companies should confirm that they are fully compliant with the relevant tax laws, file tax returns within the prescribed time limits, pay tax on time, and monitor their transfer pricing results, including key indices, such as industry margin profiles, on an ongoing basis during the year. In the US, a taxpayer can review the Transfer Pricing Audit Roadmap or its equivalent in other tax jurisdictions and maintain the documentation often requested during an audit to confirm that it can support its transfer pricing policies and results. Finally, in an increasing number of countries taxpayers may enter into an advance pricing agreement (APA) with the local tax authority to manage their overall tax examination risk.
Focus on industries: Financial services, TMT, life sciences

Aydin Hayri, Robert Plunkett, and Kristine Riisberg look at how certain industries are being affected by transfer pricing controversy developments.

Financial services

The finalised update to the OECD transfer pricing guidelines under the base erosion and profit shifting (BEPS) initiative has the potential to generate substantial tax controversy for multinational corporations in the financial services industry (FSI). In this section, we focus on three of the issues with the potential to generate increased tax controversy for FSI taxpayers under the BEPS initiative: cash boxes, permanent establishments, and interest expense deductions.

Actions 8, 9, and 10 of the BEPS Action Plan focus on “cash-boxes”, or capital-rich entities without any other relevant economic activities. Footnote 2 in the report states:

“The guidance in this chapter, and in this section on risk in particular, is not specific to any particular industry sector. While the basic concept that a party bearing risks must have the ability to effectively deal with those risks applies to insurance, banking, and other financial services businesses, these regulated sectors are required to follow rules prescribing arrangements for risks, and how risks are recognised, measured, and disclosed. The regulatory approach to risk allocation for regulated entities should be taken into account and reference made as appropriate to the transfer pricing guidance specific to financial services businesses in the Report on the Attribution of Profits to Permanent Establishments (OECD, 2010).”

The rest of Actions 8, 9, and 10 can be read as indicating that the returns associated with risk bearing should be allocated to entities that perform value-creating people functions, rather than to entities that “merely” provide capital, and that “cash boxes” should earn risk-free rates of return.

Individual member states and others implementing BEPS-driven legislation will have some latitude with respect to how much weight they give the footnote, as opposed to the balance of Actions 8, 9, and 10. To the extent that member states try to downplay the importance of capital, tax authority views may be in direct conflict with those of financial regulators, who have different objectives with respect to capital and its remuneration. Under the Basel Accords, financial regulators treat net income and retained earnings as sources of capital for the legal entities that book them. This difference in view between the guidance from financial regulators and from anti-tax avoidance-driven BEPS documents has the potential to generate controversy between tax authorities, as well as conflicts between the remits of taxation authorities and regulators.
The new guidance on permanent establishments may cause strife between FSI firms and tax authorities because they commonly have corporate structures that separate operating and financing functions across legal entities. Before the BEPS initiative, the OECD guidance relied on an objective standard to determine permanent establishments based on whether an entity has “an authority to conclude contracts”. The revised language introduces a more subjective standard based on whether an entity “plays the principal role leading to the conclusion of contracts”. Given that the implementation of this guidance will depend on the facts and circumstances of each case, the subjectivity of this standard may give rise to controversy between tax authorities in specific applications. As an example, the Financial Stability Board has recently introduced a standard for systematically important financial institutions that delineates the capital required to be held by such institutions, as well as its composition and location. This capital requirement will be based on legal ownership, not “people functions”, which could lead to a significant divergence of capital amounts in a given jurisdiction for regulatory and for tax purposes.

Action 4 of the BEPS Action Plan provides guidelines for limiting interest expense deductions. Although the 2015 Final Report defers the issuance of rules specific to the banking and insurance sectors to a later date, these new guidelines broadly aim to mitigate base erosion due to intercompany lending between related affiliates. In an FSI context, multinational corporations often have an economic rationale for the parent company to raise third-party debt and to extend loans to its subsidiaries, because the parent may have a stronger credit profile and a lower cost of capital. In addition, significant economies of scale may exist in external capital raising. Efforts by tax authorities to limit interest expense deductions by subsidiaries may result in parent companies financing their subsidiaries through more equity instead of debt than they otherwise might. Paradoxically, tax authorities governing parent companies may view these efforts as base eroding for their own tax jurisdictions. This difference in view could give rise to additional tax controversy over the appropriate classification of intercompany financing.

**TMT industry**

For the technology, media, and telecommunications (TMT) industry, the BEPS initiative has the potential to create controversy in at least four areas: offshore structures; the change in characterisation of local affiliates; issues related to the elimination of exclusive distribution clauses; and the valuation models for content that have long lead times. This section discusses the implications of BEPS for each of these areas in turn.

With respect to offshore structures, TMT companies will need to pay particular attention to the BEPS language concerning the development, enhancement, maintenance, protection, and exploitation (DEMP) of intangibles. See Actions 8-10: 2015 Final Reports, Changes to Chapter VI of the OECD Guidelines, including the Annex to Chapter VI. In particular, TMT companies will need to make sure they bolster their structures before reporting under BEPS. They should map their current-state global value chain and prepare a complete overview of their on- and off-balance sheet assets. They should also run a global profit split before any of the taxing authorities do.

Another issue that will arise with the advent of the digital economy is the characterisation of local affiliates as service providers rather than as distributors. This will lead to fewer profits being left in the local countries now that there is no longer the need for physical flows of goods or the holding of physical inventory, such as newspapers, movie tapes, etcetera. Because of this, local affiliates are now changing their function, asset, and risk profiles due to digitalisation. This shift in profiles is expected to lead to controversy, as local tax authorities may argue that the same amount of profits should be left in the local jurisdiction as before, even though the new function, asset, and risk profiles may not warrant the same return.

Along with the shift in profiles will be the elimination of exclusive distribution clauses in contracts with cable and telecom content providers. Traditionally, these clauses have limited the rights of the content providers to stream their content via the internet. Elimination of these clauses will increase streaming access by customers and further erode the video segments on the video providers. As a result, this may increase the value of the content and erode the value of distribution in the value chain. This, too, could lead to controversy with local tax authorities.

Finally, the valuation models for some content will be impacted if there is a long lead time before the content is profitable. Under this scenario, the initial launches are more of an investment, and the return on that investment in the form of profits does not arrive until the reruns begin. This return might not be realised for several years, however, and the legal entity earning the rerun revenue might be different than the entity that paid for the initial development. This will affect valuation models, such as valuation models for platform contribution transaction (PCT) payments.

Each of these areas could give rise to significant controversy in light of the new BEPS rules. Companies in the TMT Industry should be aware of them and plan accordingly.

**Life sciences**

For the life sciences industry, corporate taxation may matter more than it does to other industries. Given the long product development cycles, companies strive to keep their cost of capital competitive. A quick glance at the list of companies considering or implementing “inversions” would confirm the presence of many life sciences companies. This may be driven by specific factors.

First, life sciences companies can more easily bolt-on products to their existing supply chain and commercial sales and dis-
transfer pricing and operations to minimise their cost of capital, which means deploying their capital from jurisdictions with lower tax rates. This attempt is met with the scrutiny of the tax administrations. Such scrutiny typically comes because of the relatively high profit margins once a product is approved. The life sciences industry has struggled to educate the general public and policy makers on the long product cycles and significant capital commitments needed for the development of new drugs.

These factors pressure life sciences companies to align their transfer pricing and operations to minimise their cost of capital, which means deploying their capital from jurisdictions with lower tax rates. This attempt is met with the scrutiny of the tax administrations. Such scrutiny typically comes because of the relatively high profit margins once a product is approved. The life sciences industry has struggled to educate the general public and policy makers on the long product cycles and significant capital commitments needed for the development of new drugs.

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Rob has assisted with the transfer pricing of investment advisory functions for registered investment companies, for alternative investment advisors, and captive investment managers working with insurance companies. Transactions covered include the pricing of advisory functions, subadvisory functions, custody functions, and brokerage functions.

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With her international background and experience working in Deloitte TP teams in Copenhagen and London, Kristine has acquired extensive knowledge of global TP matters. She is the global and US TP industry leader, and the Americas TP leader of the TMT industry programme. She is the global lead tax partner for the world’s largest container shipping conglomerate, the global lead TP partner for one of the world’s largest online retail companies, and the global lead TP partner for the largest European-headquartered consumer and industrial goods conglomerate.

Kristine has given numerous speeches and presentations at the American Conference Institute, Tax Executives Institute, BNA, Atlas, Thompson Reuters, CITE, Deloitte Dbriefs, and conferences on transfer pricing issues, including recently as:

- Moderator of panel on ‘Industry’s Impact on Transfer Pricing’, Deloitte’s Global Tax Roundtable, Orlando, FL (November 2014);
- Moderator of panel on ‘Industry matters!’ International Tax Review’s Global Transfer Pricing Forum, Washington DC (September 2014); and

Kristine also regularly contributes comments and article to leading publications including ITR’s Transfer Pricing Industry Guide, Intangible Property Guide and TMT Guide, among others.
Recent developments in transfer pricing in Asia Pacific

Global mobilisation and burgeoning economic activity are undergoing substantial structural shifts as the Asia-Pacific region and other developing markets continue to increase their relative share and importance in terms of global economic output, investment, and consumption. Moreover, many Asia-Pacific markets are expected to become more regular sources of profits for multinational enterprises (MNEs).

Asia-Pacific economies are also anticipated to host more valuable and complex economic activities and, as such, these countries want to ensure that they obtain a fair fiscal share. Transfer pricing has been at the forefront of the tax planning of economies for this region. Here are some of the recent developments in the transfer pricing arena in three significant economies of the Asia-Pacific region.

India
The Indian government has taken several unprecedented initiatives to regain investors’ confidence by taking bold steps, such as not challenging the Bombay High Court ruling in the Vodafone case in Supreme Court, its quick response on the issue of minimum alternate tax (MAT) on foreign institutional investors (FII), and aligning the Indian transfer pricing rules with globally followed practices by introducing the range and multiple-year data concepts, to name a few. Apart from resolving long-drawn issues, the Indian government has also been instrumental in wooing the international business community by introducing new programmes such as “Make in India” and the simplification of tax and regulatory norms for doing business in India.

Going by the numbers, India’s economy has expanded 7% in the first fiscal quarter of financial year 2015, whereas year-on-year increase in industrial production is 3.80%. Further, foreign direct investment reached $43.5 billion in financial year 2014-15.

Transfer pricing has frequently been a focal point of concern for foreign MNEs doing business in India. However, with the simplification of tax and regulatory norms for doing business in India, the Indian government has tried to bring a paradigm shift in the Indian transfer pricing regulations. Below are some recent developments in this space:

Introduction of multiple-year and range concepts
India’s Direct Tax Regulatory Authority – the Central Board of Direct Taxes (CBDT) – recently notified much-awaited rules on “multiple-year” and “range” concepts that were introduced earlier in the Indian transfer
pricing regulations. Before the introduction of these concepts, the Indian rules stipulated the application of the arithmetic mean instead of a range and the use of single-year data instead of multiple-year data for the determination of an arm’s-length price. The use of single current year data and the arithmetic mean had been one of the long-standing conflicts between taxpayers and the Indian tax authorities.

With the introduction of the new rules, along with the self-explanatory illustrations, the Indian transfer pricing regulations finally match up with globally followed best practices. The key highlights are:

- The final rules state that for the purpose of selecting/identifying comparables, if a company’s current year is not available, one-year prior data can still be used for carrying out the benchmarking analysis. Further, while applying multiple-year data, such comparable company’s one or two prior years’ data can be selected for comparability analysis.
- The multiple-year concept and range concept can be applied to the methods shown in Table 1.
- The final rules state that if the price at which the international transaction or specified domestic transaction has taken place is within the permissible range of 35th–65th percentile, the same will be concluded to be an arm’s-length price. There is a slight deviation from the globally followed interquartile (25th–75th) range.
- The range concept may be applied only if there is a minimum number of six comparable companies in the dataset. On this background, any stipulation of minimum number of comparable companies may still lead to uncertainty in the adoption of the range concept or arithmetic mean concept for the purpose of determination of an arm’s-length price.
- The final rules, along with the illustrations on the application of multiple-year data and the 35th-65th range, are expected to substantially reduce litigation, as far as traditional transfer pricing conflicts are concerned.

Success of advance pricing agreement programme
Introduced in July 2012, the advance pricing agreement (APA) programme has become a catalyst in infusing confidence in foreign MNEs. Testimony to the same can be seen in the large number of applications: more than 585 APA applications filed by taxpayers in the last three years. Of those, one bilateral and 19 unilateral APAs (including one unilateral with rollback) have been concluded by the Indian APA Authorities. The 20 concluded APAs pertain to various sectors, ranging from telecommunications, oil exploration, pharmaceuticals, finance, banking, software development services, and ITeS (BPOs). Further, a good number of applications are on the verge of conclusion.

With this kind of response from both taxpayers and the APA authorities, it can be said that the APA scheme has struck the right chord in reducing transfer pricing conflicts and mitigating future uncertainty.

Settlement of cases through mutual agreement procedure
The recent resolution of pending Mutual Agreement Procedure (MAP) cases by arriving at a “framework agreement” has been a major breakthrough for US MNEs operating in India. Historically, pending MAP cases with Indian and US Competent Authorities have been a major concern for MNEs operating in India. However, from the beginning of financial year 2015, MAP has got a boost, with the Indian Finance Ministry announcing the resolution of about 35 India-US transfer pricing disputes, and with another 200 India-US cases expected to be concluded in this financial year. The positive approach of both countries’ Competent Authorities can be witnessed by the fact that the negotiated margin under the decided cases has either deleted or reduced the transfer pricing adjustment substantially, in which case double tax relief is provided by the parent MNE’s tax authorities. In addition to the US cases, there is an expectation of resolution of 15 MAP cases with Japan this financial year, which will bring relief of $1.5 billion to Japanese MNEs in India.

Favourable outcome from litigation front
An analysis of the judgments by the Indian Income Tax Courts reveals that the majority of the rulings are in favour of the taxpayer. Out of approximately 1925 rulings pronounced by the Indian Income Tax Court, the High Court, and the Supreme Court to date, approximately 60% are in favour of

<table>
<thead>
<tr>
<th>Methods in which multiple-year data may be applied</th>
<th>Methods in which range concept may be applied</th>
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</thead>
<tbody>
<tr>
<td>Resale Price Method</td>
<td>Comparable Uncontrolled Price Method</td>
</tr>
<tr>
<td>Cost Plus Method</td>
<td>Resale Price Method</td>
</tr>
<tr>
<td>Transactional Net Margin Method</td>
<td>Cost Plus Method</td>
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<td>Transactional Net Margin Method</td>
</tr>
</tbody>
</table>

Table 1
the taxpayer. Therefore, based on this result, it may be concluded that taxpayers have benefitted from litigation.

These recent developments in the Indian transfer pricing arena have provided some relief to the international business community. A few further steps, such as rationalising the safe harbour rules and aligning audit practices with the APA/MAP approach would go a long way in addressing their concerns, and would further boost their confidence about doing business in India.

**Japan**

Japan’s National Tax Agency issued its 2015 Annual Report in June 2015, in which it described the status of tax appeals and litigation generally (not limited to transfer pricing) for its 2014 business year, which commenced in July 2014 and ended June 30 2015. The NTA reported that, during that year, (a) 2,745 cases were disposed of through the Petition of Exception process, which involves an administrative appeal filed to the tax office that had made the assessment or determination, in which full or partial relief was granted to the taxpayer in 9.3% of the cases; (b) 2,980 cases were disposed of by the National Tax Tribunal, in which full or partial relief was granted to the taxpayer in 8% of the cases; and (c) 280 tax cases were resolved in the civil courts, in which full or partial relief was granted to the taxpayer in 6.8% of the cases.

This data indicates that taxpayers continue to face challenges generally when contesting tax dispositions in Japan (although some experts in the past have observed that the low success ratios to some extent may be attributed to large numbers of individual “tax protest” cases). There has been only a relatively small number of transfer pricing disputes taken to court in Japan (largely because MAP is typically invoked, when possible, in transfer pricing cases), but taxpayers have enjoyed some success in transfer pricing cases in the Japanese courts. Nevertheless, if an intercompany transaction is challenged based on Japan’s domestic law donation rules (rather than the transfer pricing rules), the taxpayer might be denied access to MAP in Japan (based on the dubious argument that this is a domestic tax assessment that is not contrary to the treaty), in which case it then will have to resort to the domestic appeals procedures for relief.

Fortunately, the time required and the domestic appeals procedures are gradually improving from the standpoint of taxpayers. The NTA has set three months in principle as the target period for resolving cases in the Petition of Exception process and, during the 2014 business year, achieved this goal in 96.9% of the cases. The National Tax Tribunal has set one year in principle as the target period for resolving cases brought to it and, during the 2014 business year, achieved this goal in 92.2% of the cases. Litigation in the courts is still time-consuming but even the courts are trying to process cases faster. Consequently, generally speaking, the tax appeals process is taking less time.

Significant changes are also being made to the tax appeals process, and these will go into effect upon the issuance of revised cabinet orders, which are expected in April 2015. As a result of these amendments, taxpayers will be allowed the election to file an appeal of a tax assessment or determination directly with the National Tax Tribunal, rather than always having to first file a Petition of Exception to the tax office making the assessment or determination. The Petition of Exception process is being renamed a “Request for Reexamination”. The deadline for filing an appeal is being extended from two months to three months.
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Eunice has 28 years of experience providing tax service. Before joining Deloitte China in 2010, she was the tax leader of Deloitte Taiwan, where she led the transfer pricing and international tax practice.

Eunice has been providing transfer pricing services for many years. She started up the Deloitte Taiwan transfer pricing practice. She has worked in the preparation of transfer pricing reports, planning for cross-border transactions, mitigation of transfer pricing risks in related-party transactions, negotiating advance pricing agreements and tax adjustments, and tax planning related to cross-border supply chain management.

Eunice is experienced in serving multinational companies’ inbound activities, as well as China- and Taiwan-based multinational companies’ outbound transactions. She is also experienced in providing negotiation strategies for discussions about APAs and audit defence.

Eunice is a Taiwanese certified public accountant (CPA) as well as a Chinese CPA. She has been named a leading transfer pricing adviser by Euromoney/Legal Media consistently. She was also named as a Best of the Best transfer pricing adviser in 2013-2014 by International Tax Review.

In addition, changes to procedures in the National Tax Tribunal will make appeals to the Tribunal much more effective and important than in the past. The right to inspect (etsuran) documents submitted by the assessing tax office in a Tribunal proceeding will be expanded to permit copying of such documents (in the past, this was not permitted). This right will also be expanded to cover documents obtained by the Tribunal reviewing officers pursuant to their authority (in addition to documents submitted voluntarily by the assessing tax office). Taxpayers also will be permitted to submit questions to the assessing tax office (through the Tribunal). Other changes will be made to facilitate the Tribunal review procedures.

Furthermore, commencing in 2011, the Tribunal has adopted a new procedure called “douseki shubon setsuneci” (literally, “joint argument explanations”) for particularly difficult cases, whereby (a) the Tribunal reviewing officers, the taxpayer and its advisers, and the assessing tax office representatives will gather in the same room, (b) the parties will orally present their arguments to the Tribunal, (c) the reviewing officers will ask additional questions to both sides, and (d) each side can directly hear the arguments and responses of the other side. This contrasts with the prior procedure in which written briefs, rebuttals, and surrebuttals are simply passed by the parties back and forth through the Tribunal. That procedure will continue, but the new procedure is a welcome addition to the process for taxpayers. Unfortunately, it is still not possible to take direct testimony (for example, by questioning tax officials responsible for the assessment) before the Tribunal.

Cumulatively, these changes will make the tax appeals process before litigation in the courts much more meaningful. The taxpayer’s ability to engage in effective discovery in the courts in Japan is still quite limited and is subject to wide discretion of the presiding judge. Consequently, it can be difficult or impossible to obtain internal documents or testimony from the assessing tax office. However, asking for a “reexamination” first and then taking the case to the National Tax Tribunal offers significant opportunities to learn more about the basis of the tax assessment and, in particular, the internal decision-making process within the assessing tax office that led to the assessment. Even if the taxpayer is not successful in the reexamination stage, its chances for success at the Tribunal stage may be increased due to its ability to obtain such information and develop enhanced arguments at the Tribunal. Finally, even if the taxpayer is not successful at the Tribunal, such information would assist it to prepare arguments for litigation in court. Consequently, although in the past many advisers would suggest that the pre-litigation tax appeals procedures are of little value (largely due to the low statistical chance of success), in this new environment, it clearly makes sense to carefully evaluate the potential strategic benefits of pursuing such procedures, even if the chances of success in those forums may remain relatively low.

In regard to transfer pricing examination activity, the NTA 2015 Annual Report disclosed that for the year ended June 30 2014 (the most recent year for which data were available as of June 2015), 170 transfer pricing assessments had been made, resulting in 53.7 billion yen in income adjustments.

In October 2015, the NTA also released its 2015 MAP Report, which provides details of the numbers of MAP cases and bilateral advance pricing arrangement (BAPA) cases received and resolved during the 2014 business year (ending June 30, 2015). According to this report, during that year, the NTA received 187 MAP requests, of which 140 were for BAPA and 35 for transfer pricing assessments. This compares with 197 MAP cases (including 152 BAPA cases and 37 for transfer pricing assessments) received in the previous year.

The number of MAP cases closed was 141, of which 121
were BAPA cases and 13 were transfer pricing assessments. This compares with 174 MAP cases and 121 BAPA cases closed in the previous year. “Closed cases” include both cases in which agreement was reached and cases that were withdrawn by the taxpayer.

The average processing time in a MAP case closed that year was 22.4 months, while the average processing time for a BAPA case was 22.2 months. The year-end inventory of cases as of June 30 2015, was 425 MAP cases, of which 330 were BAPA cases and 84 were transfer pricing assessment cases. By region, the year-end inventories were 139 MAP cases (including 129 BAPA cases) for the Americas, 168 MAP cases (including 115 BAPA cases) for Asia/Oceania, and 72 MAP cases (including 58 BAPA cases) for Europe.

By country, the treaty partners with which the NTA has the largest year-end inventories were (in order) the US, China, South Korea, India, and the UK. The NTA also reported that non-OECD economies accounted for 21% of the overall MAP requests received and 31% of the overall year-end inventories. Nineteen MAP cases (including 12 BAPA cases) were closed with non-OECD economies during the year. “Non-OECD economies” refers to China, Hong Kong, India, Indonesia, Singapore, Thailand, Malaysia, and Vietnam.

This information demonstrates that the MAP and BAPA programmes in Japan remain quite active, not only with OECD countries but also with non-OECD economies.

**China**

In practice, the Chinese tax authorities have continued their anti-tax avoidance efforts at the central and local levels through restructuring their teams and work mechanism. The number of anti-tax avoidance human resources at China’s SAT has doubled, and are now divided into two separate teams focusing on different tasks, although the headcount number is still limited, considering the long waiting list for MAPs and bilateral APAs. Furthermore, China’s SAT has standardised its internal work procedures and intends to continue enforcing the so-called “panel review” mechanism, whereby a panel is composed of transfer pricing auditors from different levels of tax authorities across China for major transfer pricing cases.

Procedure-wise, the local tax authorities must file on record all transfer pricing investigation cases with the SAT at the central level, while the initiation and conclusion of a transfer pricing investigation requires the approval of the central SAT officials, who will supervise and support local tax officials at various levels and locations to directly conduct audits, in order to enhance the quality and consistency of transfer pricing audits. Moreover, the Chinese tax authorities have developed a “profit level monitoring” system that utilises a few hundred indicators of risk to identify potential audit targets, leveraging the information and data collected through historical transfer pricing documentation and tax returns. In recent years, it has been observed that the Chinese tax authorities have been encouraging taxpayers to make voluntary “self-adjustments” before conducting formal transfer pricing investigations and imposing adjustment on taxpayers.
China’s SAT and local-level tax bureaus are becoming more aggressive and adopting more sophisticated means to evaluate and challenge the transfer pricing arrangements of both foreign MNEs’ China affiliates and China-headquartered MNEs:

- **Transactions**: Extending from traditional tangible goods transactions to intangible, equity transfers, and intragroup services, among others;
- **Industries**: Extending from traditional industries to the commodities industry, financial services, or other services industries;
- **Locations**: Extending from Eastern/Southern China to Central/Western China; and
- **Industry-wide/nationwide audits**: China’s SAT has continued to strengthen its focus on nationwide or industry audits. An industry-wide audit focuses on taxpayers in the same industry, whereas companies within the same multinational groups are under investigation simultaneously during a nationwide audit.

In addition to the above, China’s SAT already applies location-specific advantages (LSAs) concepts, including location savings and market premium, with the goal of claiming a larger portion of the profit for local contribution, which may sometimes end up with the profit split method for transfer pricing adjustments, if external comparable data do not take LSAs into consideration. It is worth noting that some local in-charge authorities have disregarded or proposed adjustments to transfer pricing policies globally implemented, because, from the standpoint of some Chinese local tax authorities, the existence of a globally consistent policy may provide further justification to modify the policy to account for China’s local market attributes.

Apart from LSAs, the Chinese tax authorities have shown increasing interest on local intangible issues, by examining the economic substance – primarily the location of people, functions, and associated asset, as well as the actual control over risk – to scrutinise the potential creation of local intangibles by Chinese taxpayers and demand a greater portion of the residual profit attributable to China. Particularly in the spotlight are Chinese entities conducting activities that are viewed by the Chinese tax authorities as creating non-routine value (for example, certain R&D, brand-building, or market-penetrating activities), but that are compensated with a routine return. Evidence of China’s SAT’s effort to determine Chinese taxpayers’ profit appropriately is the introduction of the value creation method as an example of other methods in the recent revised transfer pricing rules draft.

The historical statistics of transfer pricing audit cases reveal that the Chinese tax authorities have continued the trend of focusing on larger intercompany transactions for transfer pricing audits, rather than conducting as many transfer pricing audits as possible. This focus on “quality over quantity” has resulted in a significant increase in cases with larger adjustments, and the average adjustment to tax payable per case has increased dramatically since 2005, as shown in Table 2.

In response to the OECD/G20 BEPS recommendations, China’s SAT is currently in the process of revising the transfer pricing rules stipulated in Guoshuifa [2009] No.2 (“Circular 2”) – “Implementation Measures on Special Tax Adjustments (Trial version),” which is expected to be finalised soon. Considering the increased transparency in information disclosure, especially on overseas affiliates’ data, as well as the systematic monitoring of profit levels of taxpayers under the new

### Table 2

<table>
<thead>
<tr>
<th>Year</th>
<th>TP Audit Cases Launched</th>
<th>TP Audit Cases Closed</th>
<th>Tax Income Adjustment (Currency unit: 100M)</th>
<th>EIT Adjustment (Currency unit: 100M)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td>361</td>
<td>42</td>
<td>4.6</td>
<td></td>
</tr>
<tr>
<td>2006</td>
<td>257</td>
<td>177</td>
<td>58.8</td>
<td>6.8</td>
</tr>
<tr>
<td>2007</td>
<td>192</td>
<td>174</td>
<td>89.5</td>
<td>10</td>
</tr>
<tr>
<td>2008</td>
<td>174</td>
<td>152</td>
<td>157</td>
<td>12.4</td>
</tr>
<tr>
<td>2009</td>
<td>179</td>
<td>167</td>
<td>160.9</td>
<td>20.9</td>
</tr>
<tr>
<td>2010</td>
<td>178</td>
<td>178</td>
<td>164.9</td>
<td>26.6</td>
</tr>
<tr>
<td>2011</td>
<td>248</td>
<td>207</td>
<td>N/A</td>
<td>31</td>
</tr>
<tr>
<td>2012</td>
<td>233</td>
<td>175</td>
<td>N/A</td>
<td>46</td>
</tr>
<tr>
<td>2013</td>
<td>159</td>
<td>211</td>
<td>N/A</td>
<td>46</td>
</tr>
<tr>
<td>2014</td>
<td>272</td>
<td>257</td>
<td>N/A</td>
<td>79</td>
</tr>
</tbody>
</table>

Currency: RMB
China transfer pricing regime, it will come as no surprise that Chinese taxpayers will be subject to higher transfer pricing risks, whilst more targeted transfer pricing audits and disputes could be anticipated on a prospective basis.

**New policies**

With the growing importance of economies in the Asian region for MNEs, both from the demand and supply side in their global trade, the introduction and implementation of policies in these geographies is expected to be followed by MNEs with increased interest. Given the BEPS recommendations, MNEs may expect more changes in the future, and the impact of such changes may be seen in the form of increased transfer pricing scrutiny and exchanges of information and cooperation between the tax administrations of different countries. Tax policies that provide certainty and reduce litigation will go a long way to make doing business in this region easier for MNEs.
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- Strategic Transfer Pricing
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- Business Model Optimization (BMO)
  Intellectual Property Tax Planning and BMO Supply Chain

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