

What the tax authorities are up to: Key audit trends globally



Public and political pressure has seen tax authorities play closer attention to transfer pricing. Deloitte's Tony Anderson, Alex Evans, Mariusz Kazuch, Rafal Sadowski and Lian Tang He explore changes in Canada, China and Poland.

Tax authorities around the world are increasingly focusing on transfer pricing (TP) matters, partly due to a combination of public and political pressure, and the transparency afforded by country-by-country reporting (CbCR). This article explores what is happening in Canada, China and Poland in the area of tax audits. Given the close working relationship between global revenue administrations, it is likely that similar trends will spread more broadly.

Canada

The Canadian government continues to make improved tax compliance a high priority, as seen by the proposal to invest C\$91 million (\$69 million) to this area in 2018's federal budget. This brings total investment towards improved compliance to almost C\$1.1 billion since the 2016 federal budget.

In its approach, the Canada Revenue Agency (CRA) recently implemented a risk-based, integrated system to international and large business audits. They have created multidisciplinary teams of specialists to address complex and emerging tax issues, with clear targets to combat aggressive tax

avoidance and TP abuses. The CRA's newly developed IT solutions enable them to assess the compliance risk of the entire large business population annually.

The CRA estimates that during the 2016-17 fiscal year, these initiatives identified a total impact of C\$8 billion. This came from the tax assessed, tax refunds reduced, interest and penalties, and the present value of future federal tax assessable arising from compliance actions.

Recent statistics confirm the CRA's TP compliance activity. A total of 160 mutual agreement procedure (MAP) cases were closed in 2016, and C\$194 million in TP penalties were imposed for the period ending March 31 2017. Furthermore, the number of completed advance pricing agreements (APAs) has been increasing, with 36 completed in 2017, compared to 26 in 2016 and 21 in 2015.

Key focus areas

CRA auditors continue to emphasise substance, real economic activity and the ability of parties to control and manage pertinent risks, while downplaying the significance of contractual risk-bearing and legal ownership of capital and assets. Some specific examples include their focus on low-risk distributors and contract manufacturers.

Auditors are very attentive regarding

joint decision-making, local value-adding contributions to intangibles, and similar factors that justify higher returns to Canadian taxpayers. There is a tendency to reject one-sided methods that limit the Canadian taxpayer to a low routine profit. The disposition of intangible property between international related parties and hybrid financing structures is also a priority area.

Interactions with tax authorities and recent audit and APA trends

A trend observed in recent CRA audits is the auditors' diligent and detailed fact gathering, as demonstrated by multiple rounds of written queries and increase of in-person interviews with taxpayer personnel. Communication with the CRA is reasonably unrestricted, and most auditors are quite receptive to keeping lines of communication open.

At the audit stage, time frames are very case and audit team-specific, but may range from one to three years in most situations. According to the CRA's Advance Pricing Arrangement Program Report (2017), the average completion time for bilateral APAs during 2017 increased to 48.5 months, up from 47.3 months in 2016. This increase in completion time is troubling, given that one of the goals of BEPS Action 14 is to improve international dispute resolution.

Transfer pricing adjustments proposed by the CRA can first be disputed at the audit level. If the dispute is not resolved at the audit stage, a notice of objection can be filed with the CRA Appeals Directorate (appeals process), fast tracking to the Tax Court of Canada, or through the MAP article of Canada's bilateral tax treaties (MAP process).

As a caveat, the appeals process does not resolve double taxation unless the CRA overturns the adjustment in full. For this reason, most TP cases are resolved through the MAP process, which provides a high success rate in alleviating double taxation. In 2016, 72% of closed MAP cases resulted in full double tax relief, according to the 2017 APA programme report.

If relieving double taxation is not the primary concern, taxpayers may prefer the appeals process. This may be relevant in cases in which a (non-resident) corporation is at a loss, or is located in a low-tax/no-tax jurisdiction. The preferred way to resolve audit disputes will depend on a number of factors. There were 160 MAP cases closed in 2016, compared to one tax court judgment in 2018. At the time of this writing, there have been less than 10 TP tax court cases in Canada's history.

Poland

The attitude of Polish policymakers and tax authorities towards transfer pricing and aggressive tax planning has changed significantly in recent years.

Key focus areas

Some of those changes have been legislative, and include the introduction of all internationally recognised standards regarding the exchange of information, anti-abuse and compliance into domestic law (that usually go further than the OECD's BEPS recommendations), the implementation of foreign corporation rules, a general anti-abuse rule (as of 2016), as well as new reporting obligations for tax audit selection purposes or mandatory disclosure rules (ahead of the deadline in the EU directive).

Organisationally, a large number of officials have been re-directed from VAT fraud audits to investigating corporate income tax (CIT) and TP cases. Changes have been implemented across local tax offices, right up to the Ministry of Finance, with the creation of a dedicated transfer pricing department to increase tax officials' TP proficiency. In outlook, the focus of audits has shifted to concentrate on specific, previously identified risk areas.

The resulting impact is that the overall value

of TP/aggressive tax planning assessments in Poland increased exponentially from PLN 10.7 million in 2015 (\$2.8 million), to PLN 650 million in 2016, and PLN 2.3 billion in 2017. The focus areas are consistent with those observed in other EU/OECD countries: restructuring, financial transactions, and intragroup dealings (primary business activities, intangibles and management fees).

Interactions with tax authorities and recent audit and APA trends

The level of professional discussion with auditors has improved, while significant central support from the Ministry of Finance is provided to auditors to properly address issues.

The administrative course of TP proceedings is different in practice (although not formally) to CIT cases. In 'usual' cases, taxpayers appeal the initial assessment (undertaken at the local tax authorities level) to the tax courts, which is followed by a court proceeding.

The outcome of appeals at the tax court level appears quite random in TP cases. Like most other countries, Poland's tax administrator takes the position that the court's decision (irrespective of its conclusion) is binding on the treaty partner's authorities, effectively denying taxpayers the ability to file an MAP request. Therefore, an unfavourable court decision may result in double taxation.

In TP cases, it is highly recommended that taxpayers actively manage the audit process. Once a decision is issued, MAP proceedings are more effective and predictable than the ordinary controversy route. Furthermore, Polish domestic law since 2006 has allowed the use of APAs to manage TP risk, seeing a rise in the popularity of APAs.

This increase in TP risk has been accompanied by the imposition of severe personal penalties on management personnel, and broadened compliance obligations. For example, from January 2019, a Polish company's management board will be obliged to file a statement (under personal penal responsibility) that the company's TP documentation is complete, and the TP charged by the company are at arm's length.

Disputes with tax authorities may arise surrounding the functional profile of parties, rising costs, or the validity of the comparables data used. Even a small change in the parameters of a transaction can translate into a high assessment and become the personal responsibility of the board of directors.

This increased risk has been enhanced by a

new tax law, introduced January 2018, which denies the deduction (for CIT purposes) of any payments for intangible services or property in excess of PLN 3 million, plus 5% of earnings before interest, tax, depreciation and amortisation (EBITDA). The CIT Act provides only two exceptions to this rule:

- The taxpayer is able to prove that the intangible service/intangible property is "directly connected" to the manufacturing of products or to services provided; or
- The transaction is covered by an APA.

Given the second exception, taxpayer interest in APAs may rise, which may potentially lead to an increase in the average completion time for APAs, unless the Polish tax authorities expand the capacity of the APA team.

China

Historically, TP investigations were the core function of Chinese tax authorities and the primary method to enforce tax administration. However, there has been a gradual shift: China's State Administration of Taxation (SAT) now encourages local tax authorities to assist taxpayers in improving their TP compliance in advance, rather than focus on conducting investigations.

In order to identify potential TP risks, the Chinese tax authorities have actively explored the use of computer analytic tools. In 2018, the tax bureau of Jiangsu province launched a risk profiling pilot programme, distributing upstream and downstream financial information request forms to 150 multinational companies. This represented unprecedented access to global information, and enables the local tax authorities to perform an assessment on the allocation of profits within the multinational group.

Based on that assessment, each taxpayer is categorised according to a particular risk profile. Taxpayers assigned a higher-risk profile are identified, and cautioned to revise their related-party transaction pricing policy. This initiative is expected to be rolled out shortly in 10 other Chinese cities, and nationwide within the next three years.

According to China's Advance Pricing Arrangement Annual Report for 2016 (issued December 2017), the Chinese tax authorities signed 14 APAs in 2016. Eight of those agreements took less than a year to complete, and six took three. The number of completed APAs has steadily increased each year, and is expected to continue to rise. As of December 2016, 301 APA applications were being evaluated concurrently, and 139 cases were at the signing phase.

Key focus areas

In recent years, the Chinese tax authorities have focused on issues such as location-specific advantages (LSAs), the local economic ownership of intangibles, and restructuring transactions.

China's tax authorities have particularly emphasised value chain analysis, which advocates function and risk review of all entities involved in related-party transactions, and then assesses the profit allocation among those entities. This may sometimes result in the utilisation of the profit split method for transfer pricing adjustments to account for local non-routine contributions.

The increased focus on intangibles applies not only to technology but also to marketing intangibles. By examining the economic substance of a transaction (primarily the location of people, functions, associated assets, and actual control over risk) the Chinese tax authorities have attempted to scrutinise the potential creation of local intangibles by taxpayers. If the Chinese tax authorities determine that local intangibles have been developed, an appropriately determined portion of the residual profit would be demanded as an allocation to China.

Chinese entities that are compensated with routine returns while creating non-routine value (from the Chinese tax authorities' perspective) in the form of certain R&D, brand building or market-penetrating activities, have been in the spotlight. In those cases, compensation based on the cost plus method would not be satisfactory to Chinese tax authorities.

Interactions with tax authorities and recent audit and APA trends

The Chinese tax system can be depicted as a triangular system:

- District and municipal-level tax authorities deal with day-to-day TP management and investigations;

- Provincial-level tax authorities are responsible for reviews and approvals on local enforcement; and
- The SAT's anti-avoidance division is responsible for the formulation of legislation, national audits and negotiations with competent authorities.

According to recent observations, many local tax authorities have shown a more open-minded attitude when communicating with taxpayers, and encourage taxpayers to make voluntary 'self-adjustments' before the authorities initiate formal investigations and adjustments.

Once a TP audit is formally initiated, the time frame for conclusion is difficult to predict and depends on a number of factors. For cross-border related-party transactions between entities in China and a treaty country, TP adjustments are allowed through MAPs to avoid double taxation. Chinese tax authorities are actively involved in more MAPs, and have not only increased the number of competent authority (CA) meetings, but also the efficiency and effectiveness of the negotiations.

A trend observed recently is the accelerated speed with which TP negotiations have been conducted. According to the APA annual report for 2016, successful APAs in 2016 were mostly concluded within two years of the filing of an application. Unlike other jurisdictions, China does not allow Chinese companies involved in a TP audit to apply for an APA for the years under investigation.

If a taxpayer disagrees with a TP adjustment, disputes may be resolved through an administrative appeal or litigation. In reality, there is limited chance of success in an administrative appeal for TP audit cases, not to mention litigation. Nonetheless, in case of a TP adjustment, a corresponding adjustment is allowed through the MAP process to avoid double taxation.

Looking ahead

Based on the issues discussed in this article, tax authorities are taking a more proactive approach regarding the management of transfer pricing risk. Increasingly, tax authorities are placing importance on the economic substance of related-party transactions, as opposed to the contractual and legal obligations of those transactions.

As tax authorities become more sophisticated in their identification of TP risk through further investment in technology, the importance of ensuring appropriate TP outcomes will become even more prominent. APAs have become an important tool in assisting taxpayers to obtain certainty on future related-party transactions, and the MAP process can be useful to eliminate double taxation.

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Tony Anderson is a partner and economist who leads Deloitte Canada's transfer pricing practice.

Tony has over 22 years of professional experience as a transfer pricing specialist with Deloitte. He has assisted numerous multinational companies across various industries establish and defend their transfer pricing policies before the Canadian and foreign tax authorities through audit defence, appeals, litigation, competent authority and APA cases. Tony has been involved in and led successful dispute resolutions in over 50 transfer pricing controversy cases.

In addition to leading the preparation of both the economic and functional analyses for documentation and tax controversy purposes, Tony has been significantly involved in strategically evaluating, planning and implementing tax and business efficient transfer pricing policies.

Tony is a chartered financial analyst (CFA), and holds MA and BA degrees in economics. He has been a speaker at various transfer pricing conferences organised by the Institute for International Research, CITE, and Acumen, as well as various Deloitte tax and transfer pricing seminars.



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Mariusz Każuch is a director with Deloitte Poland. He has been involved in the negotiation of numerous advance pricing agreements, MAP cases, and controversy cases for multinationals operating in various industries, including the energy, automotive, consumer goods, banks and entertainment sectors.

In 2016 and 2017, Mariusz served as deputy director of the department at the Polish Ministry of Finance responsible for MAP and APA negotiations, and transfer pricing policy and legislation. Before that, Mariusz was deputy director of the tax policy department (MoF) responsible for tax policy, double tax treaty negotiations, and international cooperation. Mariusz supervised the negotiation of more than 50 international agreements, including 36 income tax treaties.

Mariusz is the author of the special petroleum fiscal regime in Poland and co-author of the copper and silver extraction tax law. While with the tax authorities, he participated in many fiscal projects, including training the Zambian and Kenyan tax authorities on the tax policy for extraction of mineral resources.

He gained practical experience in fiscal audits during his years as a tax inspector specialising in the insurance and banking sector.



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Rafał Sadowski is a partner in Deloitte Poland's transfer pricing team. During 18 years of professional career, he has gained extensive experience in fields like business restructuring, risk management, and transfer pricing litigation projects.

Rafał's areas of interest include: intra-group transaction planning, transfer pricing aspects of business restructuring, and transfer pricing litigation. He has significant experience in proceedings on advance pricing agreements (APAs) and mutual agreement procedures (MAPs).

Deloitte Poland's transfer pricing team was awarded International Tax Review's 2014 and 2015 award for Transfer Pricing Firm of the Year. Rafał has been recognised by Euromoney/Legal Media Guide as one of the world's leading transfer pricing advisers. He works for major clients in a number of sectors including: FMCG, automotive, banking, insurance, retail, energy and pharmaceuticals.



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Since joining Deloitte China as a transfer pricing partner, He has served various clients, including large state-owned enterprise groups, private enterprise groups in China, and large multinational enterprise groups from Europe, Japan, the Republic of Korea, the US and other regions. He has assisted those clients in establishing global transfer pricing policies and designing tax risk management systems in response to the challenges and requirement of BEPS, applying for unilateral/bilateral APAs and providing transfer pricing advisory service and MAP services, which has gained him the trust and respect of both tax authorities and enterprises.

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