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A national perspective: TP controversy in France, India, and the US

Transfer pricing (TP) controversies have arisen in all countries. Deloitte's Eric Lesprit, Sanjay Kumar and Joseph Tobin focus on recent TP controversy developments in three: France, India, and the US.

France

Tax audits in France can take a considerable time, with questions raised by auditors often branded as difficult. In the past, it may have been possible to have a discussion with auditors to reach a settlement, but that option is now more complicated, as auditors in France may be less interested in finding a reasonable position to end the audit.

Recent changes in French tax law and jurisprudence

Linked to France's tough audit procedures is a relatively recent provision that allows a formal request (or challenge) of the TP documentation provided by multinational enterprises (MNEs). Under the procedure, it is mandatory for groups to provide any complementary (or specific) information requested by the auditors within 30 days (which may be extended to 60).

If the information provided is incomplete, or if it is provided after the deadline, a penalty may be imposed equal to 0.5% of the total international transactions involved, or 5% of the tax re- assessment related to those transactions (Article 1735 of the French Tax Law).

France's Finance Law of 2018 introduced changes to the design of TP documentation and the information required (Article L. 13 AA of the Procedural Code). Those changes were implemented to comply with the BEPS recommendations, but both the law and the regulations go further than the OECD recommendations, noting that specific information must be included in both the master file and the local entity files.

Navigating a changing environment

To mitigate the risks associated with tax audits, MNEs should double-check whether they have a robust TP method, TP documentation in line with French tax requirements, and ensure that the TP method and targets are fully implemented. Good cooperation, a responsiveness to questions, and close exchanges with auditors are also key to ensure a better audit experience.

The good news is that the French tax authorities are now offering more opportunities for contact to manage audit risks in advance. For instance, it is now easier to ask for a confirmation of the group's tax analysis (in the spirit of the 'right to make mistakes' principle espoused by the newly elected French president). This environment is another reason why the advance pricing agreement (APA) programme is still so popular, even if a concluded APA can take a long time to achieve.

As with APA cases, the French tax authorities have shown a real commitment to properly direct the mutual agreement procedure (MAP) process. They are making a real effort to closing each case, eliminating double taxation, and having regular contacts with all treaty partners.

France's MAP programme is broadly successful in avoiding double taxation, and very few cases (a few cases a year since 2006) are closed without obtaining complete relief for the taxpayer. Despite the recent increase in the MAP inventory (in 2017, the ending inventory was 882 cases, with 474 of those involving TP), MAPs are still a major interest for the French tax authorities.

This direction is also reinforced by the Forum of Tax Administration's (FTA) choice to opt for the arbitration process as often as possible under the implementation of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS (BEPS multilateral instrument, or MLI). France has always been in favour of that arbitration possibility, and has been a promotor of that procedure.

India

India's TP rules are premised on the OECD principle of preventing profit shifts by manipulating the prices charged (or paid) in international transactions, thereby eroding the country's tax base (CBDT Circular No. 14/2001). However, Indian TP rules have their own peculiar flavour.

TP assessments have seen considerable change since 2002-03. Firstly, the Central Board of Direct Taxes (CBDT) has reduced the number of TP audits by shifting the audit selection method from the taxpayer's quantum of international transactions to a risk- based selection process. However, the impact of this change is not yet clear. Past TP adjustments continue to occupy the litigation space, and India's litigation process is tortuously slow. Close to 350,000 tax disputes are pending before the Income Tax Appellate Tribunal (ITAT), and more than 90,000 before the high courts.

A government economic survey for 2017-18 indicates that many disputes do not have a successful outcome for the government. The success rate at the ITAT is 27%, and before the high courts, only 13%. Low success rates suggest that many government cases may not have sufficient merit.

Common TP dispute battlegrounds

Earlier TP controversies involved issues such as the use of multiple-year data, comparability issues, selection of the most appropriate method, location savings, and risk adjustments. Rule 10B(4) of the Indian TP rules allows for the use of current-year data. Data that is two years old could be used, provided it could have an influence on the determination of the arm's-length price. Taxpayers' arguments for using multiple-year data for comparability analysis often focus on a limited availability of data at the time of filing the documentation. Most court cases on this issue were decided in the government's favour.

The determination of an arm's-length price is based on a functions, assets, and risk (FAR) analysis, and the identification of comparables. Often, this is not an easy exercise. Unsuitable analyses lead to controversies. The Indian tax authorities sometimes deny economic adjustments made by taxpayers to the comparables to improve comparability, which is allowed under rule 10b(3). One reason could be the limited guidance available regarding adjustments. A large number of disputes arise due to these denials.

Rule 10C of the Indian TP rules govern the selection of the most appropriate TP method. Indian TP rules do not establish a hierarchy of TP methods. Questions regarding the application of the most appropriate method are another source of TP disputes. The lack of robust segmented accounts creates its own challenges. Courts have generally placed more confidence in the taxpayer's TP study, and ruled against dis-regarding the TP study (provided the study is not flawed and that it is in consonance with the FAR analysis).

Another frequent topic of disputes is location savings. Tax officers earlier argued that taxpayers should allocate location savings to the Indian operations. However, the courts have often ruled in favour of the taxpayers, stating that the large availability of comparable companies reduces the chance of location savings.
The Indian government has accepted this position, and confirmed it in the 2017 UN Transfer Pricing Manual.

The new TP dispute battlegrounds

More recently, Indian TP controversies have involved marketing intangibles, intragroup services, royalty payments, and guarantee payments, among others. Indian TP rules consider the development of marketing intangibles as an international transaction. The tax authorities have challenged advertising, marketing and promotion (AMP) expenditures that were higher than what could be determined based on a bright-line test, arguing that those expenditures promoted the associated enterprise's brand, and that the Indian entity should be adequately compensated for that. This issue has affected a number of fast-moving consumer goods companies. The controversy now has moved to the Supreme Court on the question of whether AMP expenditure is an international transaction.

Controversy on intragroup services or royalty payments often also arises because of the absence of sufficient documentation, necessitating a cost-benefit analysis. These cases move to ITAT after three to four years of tax return filings, only to be pushed back to the tax audit officer for fresh consideration.

Financial and performance guarantees also have been the subject of considerable litigation. Guarantees often do not benefit the taxpayers, and thus create no cost or profits or income/loss implications for them. But the tax authorities contest these arguments. Earlier disputes revolved around the fact that guarantees were not included in the international transaction definition, but in 2012, that definition was amended to include guarantees.

The government's solution

Other issues abound with India's government having taken steps during the past two years to reduce the number of TP controversy cases. One of those steps is to change the method used to select cases for audit. In addition, many taxpayers (close to 1,000) have applied for APAs (both unilateral and bilateral). A total of 240 APAs have been concluded so far. Most APA applicants belong to the information technology and IT enabled services (IT-ITeS) business segment.

The government has also been actively encouraging dispute resolution through the MAP. A framework agreement with the US has resolved more than 200 TP cases for taxpayers in the IT-ITeS segment. Many taxpayers prefer MAP resolution over domestic mechanisms, because the MAP provides relief of double taxation.

However, concerns still remain regarding the functioning of the dispute resolution panel, an administrative dispute resolution mechanism for resolving TP disputes (introduced in 2009).
Specifically, the long period to resolve disputes has been a major concern.

The US

The US completed a major restructure of the Internal Revenue Code (for the first time in more than 30 years) with the 2017 Tax Act. It largely intends to improve the tax competitiveness of the US by reducing the corporate tax rate from 35% to 21%, among others. The act also includes several new international tax provisions that have created complex TP and international tax issues for both US and foreign multinational groups, including:

- The base erosion anti-abuse tax (BEAT), which requires US taxpayers to pay a tax if they make deductible base erosion payments above a specified threshold to foreign persons that are related parties;
- The global intangible low-taxed income (GILTI) category, which requires US shareholders of any controlled foreign corporation (CFC) to pay tax on the US shareholder's aggregate tested income for the taxable year (minus the net tangible income return for that taxable year);
- The foreign-derived intangible income (FDII) category. The effective US tax rate on FDII is 13.125% (2018-2025), and 16.406% from 2026. FDII is available to domestic US corporations. FDII is equal to deemed intangible income (DII), multiplied by the ratio of FDDEI/DEI (where foreign derived deduction eligible income is FDDEI and deduction eligible income is DEI). FDDEI is income from sales of property to persons outside the US, or from services provided to persons outside the US; and
- New language in sections 367(d), 482, and 936(h)(3)(B) of the Code, expanding the definition of intangibles to include: goodwill, going concern value, workforce in place, and all other "items of value" or "potential value" that are not tangibles and not services.

All four of these new provisions will create (and have already created) tensions, pressure, and complexities for treaty partners, and thus increase interest in whether the risk can be mitigated by negotiating APAs or pursuing a MAP following a tax assessment. The answer is potentially yes (with respect to all four areas), but the two developments that may have the most immediate relevance are: BEAT, and the new language in sections 367(d), 482, and 936(h)(3)(B) of the Code.

The base erosion anti-abuse tax

The BEAT has already created difficulties for both US and non-US MNEs. Some MNEs are exploring the use of the exceptions to the BEAT, such as the services cost method (SCM) exception, and the cost of goods sold (COGS) exception. There has been some confusion and ambiguity regarding these exceptions that may be addressed in an APA or MAP setting, if the IRS is granted authority to do so.

Firstly, the SCM exception indicates that payments (that would otherwise be eligible for treatment under the SCM detailed in US Treasury Reg. §1.482-9 pertaining to low-value services) are also eligible for exemption from the BEAT.

However, this eligibility test is applied without reference to the "business judgment rule" in that regulation, which excluded businesses from SCM eligibility if their entire core business was to provide low-value services. Advance pricing agreements, or pursuing a MAP following a tax assessment, may be useful in determining whether a particular service qualifies for the SCM exception.

Secondly, the COGS exception to the BEAT raises issues regarding what qualifies as COGS for the purposes of section 263. This creates a procedural issue because the IRS advance pricing and mutual agreement (APMA) programme historically has been unwilling to go beyond the confines of section 482 of the Code.

The new language of the Internal Revenue Code

The new language in sections 367(d), 482, and 936(h)(3)(B) of the Code may create added pressure to negotiate bilateral APAs (BAPAs) and multilateral APAs (MAPAs), because the new language may be viewed as different from (or in tension with) the 2017 OECD TP guidelines for MNEs. Thus, there may be disputes between the US and its treaty partners regarding what is an intangible, and how much should be paid for it under these rules. MNEs should consider these issues in the context of BAPA and MAPA submissions and renewals involving the US.

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At the international level, Eric was technical advisor for the IMF in Washington DC from 2003 to 2006, focusing on public revenues (taxes and customs duties). He also participated in the definition of the French positions in the context of European and OECD working sessions, especially regarding the fight against tax havens and the negotiation of agreements with non-cooperative countries regarding tax information exchanges.
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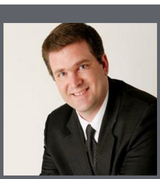

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Joseph Tobin (Joe) is a principal in the Washington national tax office of Deloitte Tax LLP. He specialises in transfer pricing controversy and transfer pricing planning, especially in the area of cost sharing arrangements. Joe serves a wide variety of clients, specialising in intangible-centric industries such as the high-technology industry and the biopharmaceutical industry. Joe was the primary drafter of the US Treas. Reg. §1.482-7 (2011) final cost sharing regulations and the US Treas. Reg. §1.482-7 (2013) final cost sharing regulations. He was previously senior counsel at the IRS office of associate chief counsel (international) (Branch 6) (transfer pricing) in Washington DC, where he was a reviewer for several high profile transfer pricing litigation cases. Joe also advised IRS Exam and Field Counsel on hundreds of contentious transfer pricing audits that went to IRS appeals.

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