

Transfer pricing controversy, strategy and future direction



Transfer pricing controversy has become more frequent and complex following the OECD's BEPS initiative. Deloitte's Shaun Austin, Darcy Alamuddin and Jamie Bedford explore how companies can strategically respond and reduce its associated risks.

The rise of transfer pricing (TP) controversy and its increasing complexity reflects tax authorities' increased sophistication and resources in this area. This is not only creating challenges for multinational enterprise (MNE) groups in terms of time and the potential costs required to resolve these controversies, but it is causing broader concern, given the increased public scrutiny of the tax affairs of large MNE groups.

The increased complexity and challenges in TP controversy in recent years has been due to a combination of factors, many of which have been driven by the OECD's BEPS initiative. These include:

- An increase in the level of information disclosed and available to tax authorities as a result of country-by-country reporting (CbCR);
- Changes to a significant number of the

OECD's TP guidelines (directly resulting from the BEPS initiative);

- Increases in the exchange of information and joint audits between tax authorities;
- Influence of other tax developments, such as permanent establishment changes or the introduction of unilateral anti- avoidance legislation;
- Substantial increases in the level of resources that tax authorities across the globe dedicate to transfer pricing; and
- An increase in the level of public debate and interest in multinationals' international tax structures.

Several of these areas are explored in more detail elsewhere in the 2019 edition of the Transfer Pricing Controversy Guide. However, this article focuses on how businesses may respond to the increased demands, challenges and technical uncertainties that have developed in the area of TP controversy in recent years.

Strategic approach to TP controversy

The primary approach to tackle transfer pricing controversy is the need to develop a strategy and a process. Historically, when TP audits were less common and took place on an ad hoc basis in some larger

jurisdictions, a case-by-case response in those jurisdictions would have been appropriate and sufficient. However, for large multinationals, it is important to have a clear and consistent approach across jurisdictions, preferably with centrally controlled, global management of TP audits.

Ad hoc, local country-driven responses can often lead to an incorrect articulation of positions and inconsistency between countries, particularly on the broader group's value chain. This can result in local settlements being accepted (or signed off) at greater value than would have been the case had the audit been centrally managed, and according to principles that are inconsistent with the group's global views.

This can create significant (but often avoidable) challenges further down the line in a transfer pricing audit in counterpart or treaty partner jurisdictions. Thus, the desire to conclude audits as soon as realistically possible needs to be carefully balanced against potential costs further down the line. Internal processes to ensure that consistency of approach, and the involvement of appropriate personnel from the TP department at an early stage of any audit, are extremely important.

Transfer pricing controversy must be considered on a global basis, while also drawing on local expertise to determine the strategy and approach to each individual audit on key points such as what information is available, and to whom. This also requires global consistency in TP policy, implementation and documentation, as well as the need to not present different technical arguments in different jurisdictions. In recent years, a large number of multinationals have moved to prepare TP documentation on a global basis, while an increasing number have started to move in the same direction for controversy, largely for the same reasons listed above.

Historically, locally driven approaches also focused frequently on considering the return earned by entities within the individual jurisdiction, sometimes ignoring the context of the broader group profile, profits and value chain, particularly when one-sided methodologies such as the transactional net margin method (TNMM) or comparable profits method (CPM) were applied.

While the extent to which the recent BEPS-driven changes to the OECD's TP guidelines should result in the materially greater use of a profit split approach is debatable, an ability to articulate the 'other side of the transaction' (in terms of the wider global value chain), and the substance and control of key risks in jurisdictions where residual profits arise, is relevant and necessary.

Responses in tax audits stating that an understanding across the broader group is not known, or that key information requested is not available, are not readily accepted by the tax authorities in many countries. Tax authorities' greater powers to access taxpayer information, together with the increasing use of exchange of information in practice, often make it difficult to retain a narrow country-only focus in TP controversy situations.

Preparation is key

The above discussion highlights the need for audit readiness on a global basis. There are a number of considerations regarding this, the first of which is understanding how audits work in critical jurisdictions, as well as particular approaches that may be adopted locally.

While the core TP audit process is broadly similar across the majority of jurisdictions – the gathering of information; putting forward technical positions; rebuttal, debate, negotiation, and potential settlement or movement through the court process, or to mutual agreement procedure (MAP) – there are important differences and nuances in such processes across individual countries that need to be understood at the early stages of any audit.

For example, rules on what information can and cannot be requested and obtained by the tax authorities, and when this can happen, vary across countries. Similarly, local governance and appeals processes, and the propensity of the tax authorities in different countries to resort to the courts rather than to negotiate settlements, varies significantly.

The interaction between the later stages of negotiation, and potential resort to the courts and/or the MAP route (including whether these two options can run concurrently, and if not, whether recourse to one option may preclude use of the other) also varies across countries. Understanding the more granular considerations and options in those areas can reduce difficulties in audit situations.

The increasing importance of behavioural aspects of TP, in particular the frequent debate around which options are realistically available, and the balance between contractual and people/functional factors that has emerged from the BEPS process, has created an additional layer of risk and a need for careful consideration of strategy in TP controversy. A clear and broad commercial understanding of the business is essential, as is the need to be able to articulate the taxpayer's business 'story' clearly to the tax authorities. When the responses to questions raised by a tax authority come as a surprise to the TP team dealing with those responses, the level of risk and discomfort in an audit will likely rise.

Another increasingly important aspect regarding preparation for TP controversy relates to the implementation of TP policies. The use of systems-based audits by many tax authorities, often combined with requests for other source documents such as emails, business presentations and agreements, may result in an increase in

inaccuracies in the implementation of transfer that may be uncovered in an audit situation.

Similarly, disconnects between TP policies and how the business operates in practice will likely become apparent in audit situations, potentially creating further challenges. Many operational TP strategies and actions to mitigate the above risks relating to clarity in policies, training and understanding of staff, as well as the integrity of data and systems, are of increasing importance in mitigating risks in this area. It is equally important that remedial action be taken upon closure of a TP audit to ensure that any issues or risks identified in any individual audit are addressed globally on a going-forward basis.

Accordingly, when a TP audit is considered highly likely in one or more jurisdictions, some preparation to reach audit readiness is recommended. This would typically involve compiling and reviewing the primary evidence the tax authorities are likely to request, both on a global basis and considering specific local factors in the larger and more sensitive jurisdictions, and testing the implementation of the TP policy in detail.

Gauging audit readiness may enable the TP team to identify the TP audit defence approach and the key skills that may be required, such as forensic accounting or economic modelling. This approach may provide a head start on the information and document-gathering phase, potentially impacting the taxpayer's ability to analyse risks and exposures, and develop a strategy to deal with the expected key issues subject to audit.

MAPs and APAs

The use of MAPs and advance pricing agreements (APAs), and how they interact with an overall strategy in the area of TP controversy, is also important.

When access to a MAP may be difficult, the potential cost and consequences of TP audits may become much more material, given that double taxation may result. Relevant considerations include ensuring that there is clarity regarding the counterparties to transactions and the margins earned, and that the core TP position is appropriate and supportable (even if adjustments may ultimately arise on audit) so that penalties that may prevent access to a MAP are not imposed.

Similarly, consideration of the interaction between TP and domestic corporate tax provisions and deductibility is also relevant

to ensure that the MAP route, if and when required, remains open. The observation on the need for global consideration and consistency across jurisdictions becomes more important if a MAP claim becomes necessary. Strategic use of APAs, either as part of an audit or to pre-empt future audits, is also relevant in any overall approach, as it may allow the mitigation of material potential risks.

Mitigating risks associated with transfer pricing controversy

The above discussion illustrates the point that there is no 'magic bullet' that can mitigate the risks arising from TP controversy, as there are a number of factors contributing to that risk. However, there are significant steps, many of which are touched on above, that can make the challenges of TP controversy more manageable. These steps may be

particularly important in an evolving environment in which such challenges are very different to those faced by taxpayers only a few years ago, both in terms of the scale and frequency of challenges.

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