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Getting ahead of the next transfer pricing challenge

In collaboration with experts from Deloitte, ITR brings you exclusive insight into how transfer pricing (TP) controversy is evolving as global businesses go through a transformative phase in 2020.

The guide arrives at a pivotal moment as multinationals juggle challenges thrown at them by trade frictions and increasing regulations, amid widespread economic disruption.

The idea of settling into a ‘new normal’ following the COVID-19 pandemic has forced tax authorities and taxpayers to respond. A number of industries are expecting additional scrutiny and detailed documentation requests to become the norm in the coming years.

Businesses also fear that the application of the arm’s-length principle could be altered as governments ramp up efforts to yield tax revenues.

In spite of the challenges, innovation and product development among TP professionals is at an all-time high. The use of data analytics has spearheaded efficiency when it has come to audits, while, with the help of fine-tuning, the number of mutual agreement procedures in the EU are on the rise.

In Latin America, advance pricing agreements are being promoted and will subsequently raise the confidence of investors in the region.

Meanwhile, the OECD continues to lead multilateral efforts to address problematic themes such as the retrospective application of guidelines and the regulations surrounding financial transactions.

As demands and queries progressively become international, global TP controversy frameworks have strengthened. China, India and South Korea have reinforced their models over the past decade by adopting best practices, while a number of developing economies in Asia and Africa continue the process of formalisation. Four landmark cases from the recent past: Adecco (Denmark), Cameco (Canada), Glencore (Australia), and Philips (France), have also helped invigorate guidelines.

Across the globe, Deloitte’s TP controversy teams are well placed to assist companies through their particular challenges. We hope that you enjoy reading the practical insights explored in the third edition of our Transfer Pricing: Controversy guide.
Foreword
Transfer pricing controversy: Settling into the new normal
Paul Riley, Shaun Austin and John Breen preview ITR’s controversy guide, produced in collaboration with global transfer pricing (TP) experts from Deloitte.

The arm’s-length principle
Testing the meaning of the arm’s-length principle in 2020 and beyond
Kerwin Chung and Iva Georgijew assess the impact of the coronavirus pandemic on global transfer pricing and consider how the concept of the arm’s-length principle will subsequently evolve.

Impact of COVID-19
How COVID-19 has transformed the hospitality, life sciences and consumer products sectors
Deloitte’s Jacqueline Doonan, Aydin Hayri, Oscar Burakoff and Clarke Norton explore the impact that the economic disruption has had on transfer pricing (TP) controversy in the hospitality, life sciences and consumer products industries.

Key controversy cases
Exploring four recent transfer pricing cases
Deloitte’s practitioners from across the globe report on four of the most prominent transfer pricing (TP) controversy cases from the recent past: Adecco (Denmark), Glencore (Australia), Cameco (Canada), and Philips (France).

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The rise and rise of mutual agreement procedures in the EU
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Surge in data analytics enhance efficiency of transfer pricing audits
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OECD guidelines
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Going into 2020, observers foresaw continued economic growth. Despite the overarching spread of uncertainty from various directions including Brexit, trade frictions, and proposed digital services taxes, it was expected that cross-border trade – including intra-firm trade within multinational enterprises (MNEs) – would continue to expand. Arising from this, many envisaged that the trend of tax authorities devoting ever-increasing attention and resources to TP matters would continue.

Consistent with this view, statistics issued by the OECD Centre for Tax Policy and Administration indicated an increase in the number of requests for advance pricing agreements (APAs) and mutual agreement procedure (MAP) assistance, indicating that these dispute resolution mechanisms were coming under greater demand than ever.

In early 2020, the OECD issued ‘Transfer Pricing Guidance for Financial Transactions’, the final major guidance under BEPS Action Items 4 and 8 through 10. Moreover, the OECD continued to pursue its work in the digital area, with these ongoing developments expected to increase the levels of TP controversy still further.

Against this backdrop, the appearance of the novel coronavirus (COVID-19) came as a dramatic shock. As national governments took steps to limit the spread of the virus, and as business activity became severely impacted, governments in many countries adopted interim measures to inject cash into their economies. Alongside this, audit, APA and MAP activity either stopped or significantly declined in most countries.

However, such activity, particularly in connection with TP audits, is now restarting or increasing across many countries. As national governments inevitably face pressure to balance their fiscal ledgers, intensified enforcement activity is likely to become more probable in the future. In this environment, MNEs should anticipate an acceleration of the forces
that, even before the pandemic, were pointing toward an increased prevalence of double taxation and TP controversy.

**Insights from Deloitte experts**

In this context, professionals from many Deloitte member firms bring their extensive experience to bear on the challenges posed by the evolving TP environment, and offer strategic suggestions for ways to mitigate controversy and to foster efficient resolution of disputes that do arise.

The first article in this issue discusses the impact of the COVID-19 pandemic on TP compliance and potential disputes. The authors draw parallels with previous economic downturns in order to offer suggestions for practical ways to prevent disputes in an unsettled environment.

The next article considers the impact of recent developments on specific industries, focusing on the hospitality, health care, and consumer products sectors. This article considers how the COVID-19 pandemic has caused disruption to the status quo, as well as tackling broader TP considerations that are likely to emerge going forward.

Apart from the pandemic, there have been several significant judicial decisions in the TP area, which are reviewed, alongside consideration of their potential broader impact on future disputes.

The guide’s attention then shifts to analysing the impact of recent guidance from the OECD. Articles address the guidance concerning financial transactions, including interaction of the recent guidance alongside ongoing developments and
tax authority approaches in this area. A separate article considers whether new OECD guidance should apply to existing TP disputes that pre-date the issuance of that guidance.

A subsequent article considers the impact of the CbCR regime and other information reporting protocols (including DAC6), in the context of the broader availability of information to tax administrations. The practical impact of heightened operational standards and tighter timelines for dispute resolution procedures arising from Action 14 are also considered.

To round out the issue, controversy and dispute resolution developments in specific geographic regions – Latin America, the Asia-Pacific, and the developing environments in Africa, the Middle East and Southeast Asia, are explored.

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Testing the meaning of the arm’s-length principle in 2020 and beyond

Kerwin Chung and Iva Georgijew assess the impact of the coronavirus pandemic on global transfer pricing and consider how the concept of the arm’s-length principle will subsequently evolve.

The COVID-19 pandemic is the defining event of 2020. Countless articles have been and will be written documenting the continuing impact of the coronavirus on the global society and economy. As governments gradually reopen their economies, many countries are concerned that a second wave of infections may slow the economic recovery until 2021 or beyond.

The OECD Economic Outlook, released in June 2020, indicates that regardless of whether there is a ‘single wave’ or a ‘double hit’, the decline in output and the rise in unemployment will be significant. Global GDP is expected to fall by 6% in 2020 and unemployment is expected to rise to more than 9% in the single wave scenario, and even in that case, the global economy is not expected to return to pre-crisis output levels by the end of 2021.

Over the next several years, national governments will likely need to collect additional tax revenues from various sources to pay for the programmes and investments put in place to support the recovery. In light of all this, transfer pricing (TP), which multinational businesses use to calculate their income tax liabilities in the jurisdictions in which they operate, and which is enforced globally based on the application of the arm’s-length principle, may be impacted as governments seek to ensure that they collect the appropriate amounts of tax revenues.

The arm’s-length principle and the impact of COVID-19 on global businesses

Article 9(1) of the OECD Model Tax Convention on Income and on Capital defines the arm’s-length principle as follows:

“[Where] conditions are made or imposed between the two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent...
enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.”

Many multinational businesses have structured their operations to comply with the arm’s-length principle by organising networks of ‘principal’ companies and ‘routine’ companies. In such structures, the principal companies enter into inter-company arrangements requiring that they conduct the important entrepreneurial functions and bear the entrepreneurial risks in return for the entrepreneurial profits and losses of the global business. The routine companies enter into inter-company arrangements requiring them to perform manufacturing, distribution or service functions and do not bear the entrepreneurial risks in return for earning routine profits (or sometimes losses) determined by reference to comparable companies.

Over the past decade of strong to moderate economic growth, it has been our observation that such structures have resulted in principal companies earning the entrepreneurial profits and losses of the business, while the routine companies earned modest profits benchmarked to comparable companies.

The COVID-19 health crisis has caused much of the world to enter a state of social lockdown in an effort to slow the spread of the disease, and this has resulted in a significant decline in global GDP. It is likely that many multinational companies will report losses for 2020. Typically, companies that incur significant losses are expected to cut costs to improve their financial viability.

However, the speed with which COVID-19 spread globally and the suddenness of the resulting lockdowns prevented companies from adjusting their costs. Even though many businesses have temporarily closed or reduced their operations, they are incurring ongoing losses, such as:

- Distributors experiencing significant sales declines but not being able to reduce selling, general and administrative (SG&A) expenses proportionately;
- Retailers shutting down stores due to public health restrictions or reduced demand but still incurring rent, distribution network, and other costs;
- Manufacturers shutting down or slowing operations due to lack of demand, supply disruptions or social distancing requirements but still incurring depreciation expenses, carrying and maintenance costs; and
- Service providers shutting down or working at reduced capacity due to lack of demand but still incurring facilities and staff costs.

Given the above factors, it seems likely that many companies will incur losses in 2020 if their fixed costs exceed their income due to the significant reduction of business volume. Tax authorities seeking revenues to pay for programmes and investments necessary to support the COVID-19 recovery may start TP examinations for 2020 relatively soon and thereby test the application of the arm’s-length principle during a period of extreme economic stress. The statute of limitations on tax assessments in most countries is several years and often longer, suggesting that COVID-19 will likely impact TP examinations for many years after the pandemic has abated.

Testing the arm’s-length principle

On June 3 2020, OECD’s Centre for Tax Policy and Administration, Committee on Fiscal Affairs, Working Party No. 6 issued a questionnaire to businesses (see CTPA/CFA/6WP6/NOE2(2020)6)) requesting comments on the application of the arm’s-length principle in the COVID-19 impacted global economy. The introduction to that questionnaire (page 2) anticipates some of the challenges going forward:

“The COVID-19 pandemic is already, and will continue, to give rise to a unique economic environment to which there are few comparables in publically (sic) available third party data, making it difficult to apply transfer pricing rules. The members of the Inclusive Framework are aware of these challenges and that taxpayers are already turning to national tax administrations for guidance on a wide variety of transfer pricing issues.

In this regard, the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD TPG) continue to represent internationally agreed principles and, irrespective of the underlying economic circumstances, provide guidance for the application of the arm’s length principle of which Article 9 is the authoritative statement. However, members also recognise that in these challenging times it is incumbent on us to consider what additional tools could be provided for greater tax certainty and to mitigate the risks of future disputes between taxpayers and tax administrations.”

Globally, TP examinations conducted over the next few years will likely test the meaning of the arm’s-length principle by raising the following issues:

Can ‘routine’ entities operating at arm’s-length incur losses?

During the past decade of economic growth, tax authorities have become accustomed to routine entities earning a modest profit based on comparable company benchmarks. They may not be willing to accept that the inter-company agreements do not guarantee a modest profit in all circumstances, and that the COVID-19 pandemic is an extraordinary event for which parties transacting at arm’s-length would agree to share losses.

Multinational companies will be looking to prove that uncontrolled companies used for benchmarking report
lower results and even losses in the crisis environment (although the inclusion of such companies as comparables typically has been controversial). The lower than usual results reported by tested entities during the crisis might call for specific considerations on how to allocate those losses within the multinational enterprise.

The OECD TPG do not address directly arm’s-length behaviour in times of crisis. They do provide, however, a well-established approach to the application of the arm’s-length principle and indicate that loss-making comparables that satisfy the comparability analysis should not be rejected on the sole basis that they suffer losses.

In times of prosperity, based on our observations, acceptance of loss-makers as comparables has been problematic. In times of crisis, if companies satisfying the comparability criteria report losses or lower than typical results, it seems reasonable that adjustments should be allowed to reflect those lower results or losses in the benchmarking analysis relevant for the crisis period(s). The important factor for acceptance or rejection of companies as comparables should be whether they are comparable (i.e., meet the comparability criteria) and not whether they are loss-makers.

How much analysis is required to support the arm’s-length nature of losses or to support an assessment?

Taxpayers preparing TP documentation should provide qualitative and quantitative information to explain the reasons for their COVID-19 related losses. Taxpayers should begin assembling this information, because it may be difficult to do so in the future, once a TP examination has start-
ed. Many countries do not allow post-year-end adjustments but the comparables data to support adjustments will not be available until many months after the year-end.

Conducting a benchmarking analysis for the years impacted by COVID-19 may be challenging as the financial data typically used for benchmarking studies only becomes available after a lag period of one to two years. This means that present, financial data for 2018 may be the most recent available point of reference for the taxpayer. As the use of data for years of economic prosperity to conduct analysis for crisis years is intuitively inappropriate, taxpayers may find it difficult when planning and documenting FY2020.

A thorough TP analysis, including reviewing the intercompany agreements, the function and risk profiles, and conduct of the parties during the COVID-19 period may be required by tax administrators to verify any changes in the TP policy and/or the arm’s-length nature of losses. At the same time, it seems reasonable that the authorities should not propose a TP assessment merely because a controlled party classified as routine reported a loss.

In terms of availability of comparable data, the tax authorities might have the benefit of hindsight: as TP audits will be conducted several years after the end of 2020 (and, perhaps, other COVID-19 impacted years), the financial data for those years would be available for conducting the audit-related analyses.

Two important questions will need to be asked in this context:

- Is it appropriate to use – for audit assessment purposes – data that was not available to the taxpayers when they adopted and documented the terms of inter-company agreements?
- Is it appropriate to use data that reflects the situation of only those entities that survived the pandemic? What about entities that either go bankrupt or are taken over, for which data will no longer be available in public databases?

Experience from the 2008-2009 financial crisis showed that many companies with weak financial results went bankrupt or were acquired by competitors. As a result, some profitability ranges assembled in the wake of the crisis did not reflect the expected decline in financial results. Accordingly, adjustments to benchmarking ranges might be required in order to benchmark the crisis. Benchmarking approaches may include:

- Expanding comparables to include loss-makers that satisfy comparability criteria in order to better capture the COVID-19 impact;
- Narrowing comparables to exclude companies with significantly different cost structures (operating leverage/ fixed cost ratio) to improve reliability of data; and
- Adjusting comparable data to reflect the impact of COVID-19 on profitability in 2020 and creating specific COVID-19 ranges.

Should transfer pricing examinations focus only on the 2020 results, or should results be analysed on a multi-year basis?

In the optimistic hope that the COVID-19 pandemic will abate and global society and the economy will recover and thrive, if companies report improved profitability in future years before a TP examination starts, should this post-year end information be taken into account in examining an earlier year?

Paragraph 3.75 of the OECD TPG notes that examining multiple year data is often useful in a comparability analysis, but it is not a systematic requirement. The guidelines go on to note that multiple year data should be used where they add value to the TP analysis.

Should taxpayers that make reasonable efforts to follow an arm’s-length transfer pricing policy be subject to tax penalties if an assessment is made?

Tax penalties are typically enacted to encourage compliance with the TP rules. The OECD TPG make two points regarding penalties that are particularly relevant to the COVID-19 pandemic.

First, the imposition of a sizable “no-fault” penalty based on the mere existence of an understatement of a certain amount would be unduly harsh if the understatement is attributable to good faith error rather than negligence or an actual intent to avoid tax.

Second, it would be unfair to impose sizable penalties on taxpayers that made a reasonable effort in good faith to set the terms of their transactions with associated enterprises in a manner consistent with the arm’s-length principle. (See OECD TPG, paragraph 4.28.)

These notes suggest that tax authorities should exercise restraint in applying penalties when losses are primarily driven by the COVID-19 pandemic. In addition, as discussed below, taxpayers often request Mutual Agreement Procedure (MAP) following a TP assessment to eliminate double taxation. Penalties are generally not subject to MAP relief, however, and the imposition of penalties may unnecessarily complicate negotiations to eliminate double taxation.

Response to audits and adjustments

TP audits and adjustments made for COVID-19 impacted years could result in higher double economic taxation worldwide. An expected response to that would be the increased use of advance pricing agreements (APAs) and MAPs. Competent authority assistance for double taxation is provided under the MAP article of the relevant tax treaty, and in the case of European Union member states, also under the EU Arbitration Convention (AC) or the EU
Dispute Resolution Directive. To provide relief from double taxation, the respective competent authorities must be notified of the proposed TP adjustments, or a request for MAP assistance must be filed, within specified deadlines.

Increased use of MAPs, as well as APAs, are expected as a result of the pandemic, as companies seek to resolve and avoid TP disputes.

**APA experience in the 2007-2008 financial crisis**

During the 2007-2009 financial crisis, the competent authorities considered ‘down economy adjustments’ on a case-by-case basis. Whether such adjustments were made depended on a variety of factors, including:

- Whether the tested party and the comparables experienced similar effects from the downturn;
- The tested party’s historic risk profile and performance; and
- The taxpayer’s willingness to accept a symmetrical adjustment (e.g. in a renewal APA) when the economy improves.

Approaches considered included:

- Changing the APA term;
- Waiting for more up-to-date financial data; and
- Using a different set of comparables, and/or applying a longer testing period.

In an environment reflecting the impact of COVID-19, taxpayers with active or pending APAs may be advised to revisit the critical APA assumptions and to align past years, the COVID-19 period, and future years. Disclosure of relevant facts concerning transactions already covered by an APA and proposing appropriate amendments to the APA would be important to maintain the validity of the APA in 2020 and post-COVID-19 years.

**Conclusion**

2020 is a unique year. Although the pandemic will likely impact the business models of multinationals in all industries in different ways, multinationals across industries need to assess the disruption to their businesses and its impact on their TP policies. Moreover, companies need to consider whether benchmarking adaptations and adjustment of routine returns and profit/loss split allocations are required.

The impact of COVID-19 will likely be much broader than ‘just financial’ and in many businesses that impact will be felt throughout the entire value chain both during the COVID-19 crisis and under the new normal.
How COVID-19 has transformed the hospitality, life sciences and consumer products sectors

Deloitte’s Jacqueline Doonan, Aydin Hayri, Oscar Burakoff and Clarke Norton explore the impact that the economic disruption has had on transfer pricing (TP) controversy in the hospitality, life sciences and consumer products industries.

Transfer pricing experts from Deloitte provide separate assessments of the impact of the COVID-19 crisis, and the potential follow-on consequences for TP controversy, in three key industry sectors: hospitality, life sciences and consumer products.

Each of these sectors has experienced unique repercussions from COVID-19 and in some cases, companies in the same sector have seen highly divergent effects on their specific business operations. Based on their analyses of individual sectors, the authors express the consensus that COVID-19 has the potential to generate serious, transformational change to TP compliance and controversy practices in these sectors.

Impact of COVID-19 on the hospitality industry

The hospitality industry has been hit hard by COVID-19. Many hotels closed and locked their doors for the first time in decades. Room, food and beverage, banquet, wedding, and retail shop revenues plummeted. Hotel companies began the difficult task of identifying how to function in the new normal created by the pandemic.

The hospitality industry thrives on customer loyalty and trust, employee commitment, and property excellence. COVID-19 has set significant challenges relating to all of these: how to engender customer and employee trust around the safety of properties (especially those with high volumes of daily traffic), how to keep employees motivated amid economic chaos, and how to maintain property operating standards while maintaining social distancing mandates.

As hospitality executives focused on these gating survival issues, the tax TP challenges faced by these companies took a back seat temporarily. However as the industry moves steadily, albeit slowly, towards recovery, pre-COVID-19 tax challenges – such as the ongoing BEPS issues around control, risk, and substance; the evolving unified and ‘tax-back’
approaches to taxation; and the ongoing issues around global compliance, reporting, accounting, and recording – and newly emerging challenges stemming from TP changes driven by COVID-19, have put tax planning and controversy readiness back on the priority list.

Hospitality companies are complex businesses with a plethora of inter-company charges between a large group of globally distributed entities. While each company has its own operating model and TP constructs, there are some TP commonalities across the industry. For example, many hospitality multinational corporations (MNCs) have centralised cost allocations. Centralisation, especially of operating costs, brand costs, systems costs, and other similar costs are critical in driving economies of scale, maintaining global brand consistency, and ensuring consistency in customer experience from property to property. Accordingly, costs are often centrally incurred, centrally managed, and allocated to benefiting affiliates based on carefully identified cost driving metrics.

Similarly, globally designed, developed, and owned intangibles (e.g. brand names, loyalty programmes, reservation systems, and training programmes) are commonplace in the industry. The intangibles are often developed under a cost-sharing arrangement or similar arrangement, where regional principals collaborate and contribute market knowledge and resources to develop globally relevant intangibles. Like the centralised support costs described above, intangible development costs are often allocated among regional entrepreneurs based on the benefits reasonably anticipated to be derived by each collaboration partner.

Revenue allocations are also commonplace in the industry. Third-party or related-party hotels are often invoiced for a host of valuable support elements such as management services, brand access rights, loyalty programme operating costs, systems access rights, technical and construction services, financial and accounting support services, design and décor consultation services, and so on. While these charges are often separately negotiated and separately invoiced based on the specific needs of each property, they have collateral aspects that must be considered with the negotiation of multiple contracts with a single property or group.

Prior to COVID-19, these transactions attracted the attention of tax authorities. Tax auditors often scrutinised cost allocations to ensure the activities giving rise to the costs produce a benefit for the transaction counter parties, and to ensure that the allocation metrics used were well supported from an economic and operational perspective. Authorities also scrutinised the profit element on these charges by evaluating the comparable companies used in profit benchmarking analyses. Similarly, authorities scrutinised the revenue streams from properties to evaluate each stream from both an individual and a collateral perspective.

In the midst of the pandemic, tax planning and controversy readiness cannot be overlooked as a critical element in the step plan to recovery. Tax planning may involve suspending pre-COVID-19 inter-company pricing and establishing new pricing to ensure that pricing during the period impacted by COVID-19 can be reconciled with the new and dramatically changed economic reality faced by the industry. New pricing may redistribute limited profits among all entities in the value chain, or more likely, redistribute losses across this group under the equity doctrine. The equity doctrine is often applied by courts when a legal remedy is insufficient or inadequate. In a TP context, the rationale for contravening legally agreed transaction pricing is to ensure that no one contracting party is disproportionately disadvantaged by the unforeseen events, and all transacting parties will, in the long-term, benefit if the impact is borne more ‘equitably’ among them.

Transaction repricing does not have to be based on a reallocation of overall company profits and losses: specific pricing arrangements can be modified. For example, cost plus...
The impact of COVID-19 on the life sciences industry

The life sciences industry has been front and centre in the COVID-19 pandemic. Many companies in the sector have been leading the fight against COVID-19 and accordingly, have witnessed increased demand for frontline products such as ventilators and diagnostic testing equipment, or certain prescription drugs. More significantly, almost all companies in the industry are involved in accelerated research and development (R&D) efforts for vaccines, therapies, diagnostic tests, and other relevant equipment. However, profits will be recovered through remediation pricing after the economy recovers.

It is too early to gauge how governments will evaluate these revised pricing arrangements under audit. Some governments have begun to provide limited unofficial guidance as to how these and other modifications will be viewed. Given the uncertainty of how authorities will react to COVID-19 induced pricing adjustments, companies that decide to suspend their pre-COVID-19 pricing and introduce revised pricing are well advised to have clear documentation detailing the suspension of the pre-COVID-19 pricing arrangements, outlining specifics of the new pricing arrangements, and rationalising the change. These can be documented in a memorandum of understanding (MOU) or other formal legal document drafted contemporaneously with the pricing change.

As part of the tax component of the recovery programme, companies should also consider new transactions and TP opportunities in light of the changes that will inevitably occur in their business operations as a result of the pandemic. In the hospitality industry there will likely be significant investments in major areas of the business including loyalty plan enhancements, touchless systems, revised greeting, cleaning, and service protocols, and more. Decisions around ownership, control, and pricing related to these business changes need to be evaluated and may give rise to new inter-company transactions. Similarly, as the business changes, pre-COVID-19 transactions may no longer be necessary or relevant.

Changes to TP constructs made as a result of COVID-19 will inevitably lead to additional scrutiny and potential challenges on the part of tax authorities, but if taxpayers and advisors perform adequate up-front analysis, stress-testing, and are diligent with regard to fully documenting changes from a qualitative and quantitative perspective, that should reduce the potential for costly controversy and disputes. It may be a year or two before we begin to see TP audits addressing the pandemic period, but with the significance of the impact of COVID-19 on inter-company pricing, thoughtful contemporaneous documentation will go a long way to managing the risk, burden, and results of global audits.
other parts of the industry have also experienced adverse impacts as clinical trials have been disrupted, demand for elective surgeries has collapsed, and sales of prescription drugs requiring infusions or administration in doctors’ offices suffered.

While the life sciences industry was subject to income tax controversy in many jurisdictions pre-COVID-19, the continued uncertainty surrounding the trajectory of the pandemic and its varying impacts across the industry is likely to increase controversy, especially in the areas of accelerated intellectual property (IP) development, supply chain disruptions, and TP changes for routine entities.

Given the critical importance of IP in the life sciences industry, taxpayers must work much faster and under greater uncertainty to ensure the desired IP ownership pattern in an accelerated development timeline. That is, taxpayers must quickly identify the jurisdiction where the IP belongs, arrange the appropriate funding consistent with that ownership, and ensure the consistency of the chain of control of risk.

As an example, companies involved in developing a vaccine could potentially generate IP that becomes extremely valuable in the short-term. This will require immediate attention to determine tax jurisdiction ownership and utilisation, as well as the tax impact of future profits derived from the IP and R&D activities. IP planning that would normally take a year or more will need to be done within months, if not weeks, to ensure new IP developments do not disturb taxpayers’ established IP ownership and funding structures. This will likely be fertile ground for future controversy.

On the other hand, companies that were in the process of IP planning may come under pressure to revisit the assumptions underlying their TP valuations. IP valuations in life sciences rely on three factors: (i) projections of cash flows, which are now highly uncertain; (ii) technical probabilities of success derived from scientific experience, which may not be applicable for the accelerated or delayed development processes; and (iii) the market risk premium, which has been highly variable since the start of the pandemic.

Further complicating IP valuations is the new ‘hard to value intangibles’ (HTVI) concept introduced in the latest edition of the OECD Transfer Pricing Guidelines. Judging by the examples provided, the HTVI concept appears to have particular relevance to the life sciences industry. Taxpayers may be able to prevent application of HTVI by carefully documenting what is known at the time of the valuation, but this area will likely generate controversy.

COVID-19 has also caused severe disruption to life sciences companies’ supply chains. Although the demand for COVID-19-related products has increased, companies have had difficulty getting these products to market because of backlogs in the supply chain. Border closings and social distancing measures have forced production sites to partially or completely close, causing shortages and delays in procurement. These disruptions are generating national security concerns, as companies are re-thinking their supply chains from the perspective of resiliency, as well as cost effectiveness.

Manufacturing footprint and intermediate and finished product flows are critical elements in a multinational’s tax position. Taxpayers may use various arrangements, such as toll or contract manufacturing, or ‘substantial contribution’ or ‘control of risk’ arrangements, which can have the effect of attributing the economic risks and benefits of manufacturing and supply activities within the multinational group, but recent supply chain disruptions could generate uncertainty around these arrangements.

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Oscar is a frequent speaker at a number of internal and external professional seminars and trainings. He has also been recognised on multiple occasions as a Rising Star by Euromoney’s Expert Guides.

Prior to joining Deloitte, Oscar was a principal economist at DLA Piper.
Finally, in view of the business disruptions from COVID-19, some taxpayers in the life sciences industry may want to re-evaluate the target profitability levels for their routine entities. In general, the regulatory frameworks in most tax jurisdictions provide that routine entities should report profits within an arm’s length range, supported by the results of comparable companies that engaged in a similar range of business activities.

With the unprecedented COVID-19 crisis, the most prominent comparability criterion for benchmarking routine entities would be the degree of company’s resilience to demand and supply disruptions. This criterion is likely to outweigh more traditional considerations for building an arm’s length range for 2020. Such a range may potentially support lower levels of target profitability, or even indicate losses for routine entities. Although consistent with the arm’s length standard, a benchmark range with losses may be subject to close scrutiny by tax authorities.

As they try to help governments address critical healthcare priorities, some life sciences companies are receiving direct or indirect government assistance. While TP would normally follow the financial statement treatment of such assistance, governments have started to provide specific guidance concerning how such assistance should be treated for TP purposes. Considering the fungibility of funds within a corporation, any attempt to isolate the government assistance from TP may generate controversy.

As companies consider making changes to their TP policies in this time of economic and social pressures, they should not delay planning decisions or preparation of associated documentation. In lieu of the potentially labourious process of revising existing inter-company agreements, some taxpayers may prefer to adopt a group-wide MOU as an overlay to their existing agreements, or as an interim step toward a substantive revision of those existing agreements. To the extent that taxpayers prepare such an MOU or other contemporaneous documentation to support any TP changes, this may help reduce future controversy.

As it sits at the forefront of the pandemic, the life sciences industry may draw scrutiny from tax authorities. It is therefore critical for taxpayers to act quickly to address open questions on IP ownership and valuation, supply chain reorganisations, and TP changes.

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As a leading authority in the consumer industry, Clarke helps companies drive growth in the rapidly-evolving, customer-centric, consumer products industry. She is a recognised specialist on global sourcing/procurement structures, and has extensive experience assisting multinational corporations with the operational, tax, and TP aspects of their supply chain organisations. She also specialises in intellectual property and consumer goods brand valuations, helping companies and governments understand the unique characteristics of intellectual property for the consumer product industry.

With a history that spans more than 29 years in tax, Clarke first served as the chief economist at the IRS’ APA programme. Her knowledge gained while at the IRS, as well as in other consulting roles, has provided her with a specialised experience that has been very beneficial to clients, particularly in the planning and defense of their tax and TP positions. Her deep consumer industry knowledge has led to her serve as an expert witness for two US Attorney’s Office investigations as well as in numerous other global tax disputes.

Impact of COVID-19 on the consumer products industry
As countries face what will likely be a sharp recession this year due to the impact of COVID-19, a key casualty will be consumer spending as households hunker down and businesses shut shop to prevent further spread of the virus. Analysis of data on real personal consumption expenditure reveals that consumer spending often declines at times of economic contraction. Rising unemployment, slowing incomes, and uncertainty over economic prospects during a recession often force consumers to cut back spending and save more. These trends have been even more pronounced in the global crisis caused by COVID-19. For example, between March 21 2020 and June 30 2020, almost 50 million people in the US filed claims for unemployment insurance.

The global marketplace, already in the midst of a massive transformation, has experienced an acceleration of many of the industry changes. Now more than ever as national...
As economies start to re-open in the wake of the COVID-19 crisis, retail and consumer product (RCP) companies must look in the mirror to evaluate their readiness for the evolution of the industry.

However, questions remain. When will consumers feel safe enough to return to their ‘normal’ lives and what will the ‘new normal’ look like? RCP companies that struggled to adapt to changing consumer preferences pre-pandemic are finding it challenging to navigate the new landscape.

In the midst of the pandemic, tax planning and controversy readiness cannot be overlooked as a critical element in the step plan to recovery. Tax planning may involve suspending pre-COVID-19 inter-company pricing and establishing new pricing to ensure that transfer prices during the period impacted by COVID-19 can be reconciled with the new and dramatically changed economic reality faced by the RCP industry.

As part of the tax component of the recovery programme, companies should also consider new transactions and TP opportunities in light of the changes that will inevitably occur in their business operations as a result of the pandemic. In the RCP industry there will likely be significant investments in major areas of the business, including and especially in technology relating to digital supply chains and omnichannel solutions, as well as in-store safety procedures such as cleaning, and service protocols, and more.

In addition, RCP companies may make changes to their supply chain and vendor bases to prepare for future business disruptions, or make other changes to the functions, assets, and risks of the relevant parties in their supply chain. Decisions around ownership, control, and pricing related to these business changes need to be evaluated and may give rise to new inter-company transactions. Similarly, as the business changes, pre-COVID-19 transactions may no longer be necessary or relevant.

Any changes to TP constructs made as a result of COVID-19 will inevitably lead to additional scrutiny and potential challenges on the part of tax authorities. Still, some governments are signaling that they are willing to take the economic circumstances of the pandemic into account when analysing a company’s TP. Regardless of these signals, companies that change their inter-company transaction pricing in response to COVID-19 should develop clear documentation rationalising the change. The preparation of robust documentation now can significantly mitigate the risk of costly controversy disputes in the future.

It may be a year or two before we begin to see TP audits addressing the pandemic period, but given the significant impact of COVID-19 on inter-company pricing and supply chains, thoughtful contemporaneous documentation will go a long way toward managing the risk, burden, and results of global audits.
Exploring four recent transfer pricing cases

Deloitte’s practitioners from across the globe report on four of the most prominent transfer pricing (TP) controversy cases from the recent past: Adecco (Denmark), Glencore (Australia), Cameco (Canada), and Philips (France).

The following summaries of court cases provide an indication of concerns that tax authorities may be considering globally. The results from the cases indicate an increased emphasis on the alignment of tax arrangements with actual commercial practices. The challenges posed by the tax authorities in these cases reflect the broader concerns of tax administrations regarding the importance of economic substance, as reflected in the mandates of the OECD BEPS programme and adopted via tax legislation in many countries.

Another interesting observation that emerges from these cases involves the critical importance of preparing detailed documentation to support the arrangements with controlled parties. The outcome of the cases has largely depended on the strength of the documentation provided by the taxpayer, underscoring that the tax examiners cannot challenge positions that are thoroughly described in documentation and supported by reference to transactional documents, such as intercompany agreements.

Courts have found in documentation, and arguments presented by the taxpayers, sufficient evidence to support the underlying commercial substance of the arrangements with the TP arrangements under consideration. As a result, the positions put forward by the tax administrations were not sustainable.

Denmark: Adecco
On June 25 2020, the Danish Supreme Court handed down its ruling in a landmark TP case on inter-company royalties. The Supreme Court ruled in favour of the Danish taxpayer, Adecco, thereby setting aside the previous rulings of the National Tax Tribunal and the High Court, respectively.
Summary of facts

Adecco, the Danish taxpayer, a member of a multinational staffing group headquartered in Switzerland, paid royalties to the Swiss parent company of the group pursuant to an inter-company license agreement. This covered the right to use trademarks legally owned by the parent as well as certain services, including know-how and access to referred-in customers through the group’s network. Adecco made losses in the tax years subject to dispute.

Considering the circumstances of the case, including the fact that the taxpayer was loss-making, the Danish tax authorities found that the applicable royalty rate was not in accordance with the arm’s-length principle and, in any event, Adecco should have been remunerated for certain deemed marketing services that would net out any royalty deduction, effectively resulting in 0% royalty rate. The tax authorities further disqualified Adecco’s TP documentation on the basis of deemed flaws and made a discretionary tax assessment accordingly.

During the court proceedings, the Danish Ministry of Taxation reiterated the tax authorities’ position and, further, argued that the royalties did not meet the threshold for deductibility under the Danish domestic statute on deductible business expenses. The High Court agreed with the Ministry that the taxpayer had failed to prove that the royalties were in fact deductible business expenses.
Ruling
The Supreme Court held that the royalties were deductible business expenses. Specifically, the court found that the royalties were sufficiently linked to the business earnings of the taxpayer and, based on the evidence presented before the court, that royalties covered actual and valuable intellectual property being made available to Adecco. The court further noted that the loss-making position of the company could not alter that conclusion.

The court found that Adecco’s TP documentation was not flawed to such an extent that it authorised the tax authorities to disqualify the documentation and make a discretionary assessment, thereby shifting the burden of proof to the Ministry.

The court majority found that the Ministry had failed to prove that the royalty rate did not adhere to the arm’s-length principle. Specifically, the court noted that the Ministry had failed to demonstrate specific insufficiencies in the comparability analysis (CUP) presented by Adecco and, further, did not find any basis for reduction of the rate based on a deemed transaction involving marketing services.

Deloitte Denmark advised Adecco throughout the proceedings. The Deloitte professionals responsible for the case are Kasper Toftemark, Casper Guldhammer Jensen, and Ann Sofie Bisgaard. Please contact us for more information.
Australia: Glencore

On September 3 2019, the Federal Court of Australia decided in favour of the Australian taxpayer in a TP case involving the arm’s-length conditions of a copper concentrate sales arrangement, entered into by Cobar Management Pty Ltd (CMPL) and Glencore International AG (GIAG), related parties in the Glencore Group. The Australian Taxation Office (ATO) has appealed the decision to the Full Federal Court and at the time of writing, the appeal is expected to be heard in September 2020.

Summary of facts

In February 2007, CMPL entered into a new offtake agreement with its related party trading entity, GIAG, for the supply of all copper concentrate produced for the life of CMPL’s copper mine. This offtake agreement, which had a new price sharing formula for certain downstream costs for refining the product, replaced an existing agreement between the parties that had used a different pricing formula.

The Commissioner of Taxation challenged the terms of the new offtake agreement, contending that at the time the contract was negotiated, an independent copper mine operator with a commercial strategy to be as profitable as possible would not have agreed to the new terms.

The commissioner sought to disregard the actual arrangement and constructed a hypothetical arrangement, in which CMPL and GIAG had continued their previous contractual arrangement unchanged. The court heard from expert witnesses and considered evidence from a number of independent copper purchase agreements on market behaviour in the industry.

Ruling

The Federal Court ruled that CMPL’s new offtake agreement was based on similar terms to those evidenced within third-party agreements. Following this confirmation of the arm’s-length conditions in the arrangement, the court confirmed that the consideration provided to CMPL was within an arm’s-length range.

It was recognised by the court that a third-party agreement between independent parties need not be directly equivalent or identical to demonstrate arm’s-length terms. Rather, they can evidence market behaviour and industry practice in arm’s-length arrangements between independent parties in comparable circumstances.

With reference to the Chevron decision in Australia and the OECD Transfer Pricing Guidelines, the court noted that the commissioner’s power to reconstruct an arrangement should only be used in exceptional cases (per the wording in the 1995 OECD Guidelines) and did not extend to completely disregarding the actual transaction and recasting an entirely new one.

Taxpayers who have undertaken or are contemplating amendments to their related party arrangements should consider documenting evidence of similar third-party market behaviour and detailing any negotiations and the commercial reasons for strategic decisions that have taken place.

For further information on this case and the potential implications for your business, please contact Fiona Craig, John Bland, Chris Thomas or Belinda Kiem.
Canada: Cameco

On June 26 2020, the Federal Court of Appeal upheld the September 28 2018 Tax Court of Canada decision in the case of Cameco Corporation (Cameco) vs the Canada Revenue Agency (CRA). The Cameco case in Canada can be viewed as one of the recent prominent TP cases in the global tax community. The CRA has until September 25 2020 to seek leave to appeal to the Supreme Court of Canada.

Summary of facts

Based in Canada, Cameco is one of the world’s largest publicly traded uranium companies. The TP arrangement at issue involved Cameco Europe (CEL), a subsidiary of Cameco based in Switzerland. CEL purchased uranium from Cameco and third parties pursuant to a number of long-term contracts. In general terms, inter-company purchases from Cameco were priced based on the published long-term price for uranium at the time the contracts were concluded (as is common in the industry). CEL subsequently entered into sales contracts for the uranium purchased from Cameco and the third parties. Due to increases in uranium prices, CEL generated significant profits. The case involved Cameco’s 2003, 2005 and 2006 taxation years.

The issues decided in the Cameco case are not confined to any specific area of TP and have broad implications. The key points of judgment in the Cameco case revolved around three topics: sham, re-characterisation and price adjustment.

Specifically, the key principles affirmed by the Tax Court of Canada in the Cameco decision include:

- The traditional principles of what constitutes a sham continue to apply. If the contractual arrangements reflect the underlying transactions and the intention of the parties, the arrangement should not be considered a sham.
- A transaction should not be subject to re-characterisation if it is commercially rational. If it is commercially rational, the TP issue is simply the determination of the correct price.
- If a series of transactions is undertaken primarily for business purposes, it should not be subject to re-characterisation. Unlike the test applied pursuant to the general anti-avoidance rule, the entire series should not be tainted if one aspect is undertaken primarily for tax purposes, provided the overall series is undertaken to achieve a business purpose.

Further, in evaluating transfer prices:

- Absent a re-characterisation, the TP analysis must focus on the actual transactions and respect the contractual arrangements.
- A parent of a multinational group is allowed to provide a business opportunity to a subsidiary.
- Corporations bearing contractual risk will be subject to the resulting profit or loss – it is not critical that the corporation directly employ the individuals that manage the risk.

- There is a strong preference for traditional transactional TP methods that directly test the price of the transactions actually undertaken. Use of methods that effectively re-write the transaction or determine the income that would be realised if the taxpayer had entered into different contractual arrangements, are to be avoided.
- TP analyses should, to the extent possible, be based on objective evidence. Speculation about what parties might have known should be avoided.

The CRA has until September 25 2020 to seek leave to appeal the decision of the Federal Court of Appeal to the Supreme Court of Canada, with a potential extension to November 12 2020 due to proposed legislation related to COVID-19 pandemic measures.

In light of the strong focus on contractual arrangements (which might not align with the approach in other jurisdictions), multinationals should review their TP positions and consider whether all significant inter-company transactions are covered by appropriate legal documentation and whether the relevant parties to such transactions are acting in accordance with the legal arrangements.

France: Philips

Research and development (R&D) tax credits and subsidies are major French incentives that enable companies to reduce R&D costs and help attract multinational enterprises (MNEs) to set-up subsidiaries in France. These arrangements are typically remunerated on a cost-plus basis, with the recharged cost base determined generally net of R&D tax credits and subsidies.

This point is frequently challenged by the French Tax Authority (FTA), which may reconsider whether it reflects the actual cost of performing R&D in France. This issue was raised in the Philips case and the Administrative Supreme Court ruled in favour of the taxpayer.

Summary of facts

Philips France provided R&D services to its Dutch headquarters and was remunerated on a cost-plus 10% basis per their contract. The FTA rejected the deduction of the R&D tax credit/subsidies and adjusted the cost base, concluding that:

(i) The inter-company agreement did not explicitly provide for this deduction; and

(ii) The mark-up percentage calculated on the full cost base (5%-9% depending on the year) was lower than the 10% mark-up specified in the contract and validated by the FTA based on its own benchmarking analysis.

In France, the burden of proof is on the FTA, which must (i) establish that the parties are related and (ii) demonstrate that an advantage has been granted. To show this advantage, a comparability analysis is generally required (advantage by comparison). However, certain decisions
recognised that there are advantages for which, by nature, a shift of profits is deemed to exist, without any comparability analysis (advantage by nature). For instance, waiving a royalty fee, granting interest-free loans or guarantees without a fee, or providing services without a charge constitute advantages by nature.

In the *Philips* case, after the Appeals Court rejected its benchmarking analysis, the FTA modified its strategy and argued that the R&D tax credit/subsidies were wrongly deducted and thus, it constituted an advantage by nature.

**Ruling**
The Supreme Court ruled in favour of the company considering that the deduction of the R&D tax credit cannot be evaluated in isolation, without taking into account and analysing the level of the price of the service, as a shift of profits, even in cases where the agreement does not specify that the deduction is available.

In this respect, the Supreme Court’s decision is clear. The deduction of the R&D tax credit/subsidies does not constitute in itself an advantage by nature. This decision is mainly based on the fact that the R&D services were not provided for free, were even not charged at cost, but, instead, were generating a positive margin according to the calculations performed by the FTA. In such a case, an advantage may exist but only if the margin is deemed insufficient, which should be demonstrated using a comparability analysis.

The Supreme Court also concluded that the wrong application of an agreement does not constitute an advantage by nature. This position is consistent with the ‘substance over form’ principle according to which the conduct of the parties must supplement or replace the contractual arrangement if the contracts are incomplete or not supported by the conduct.

Finally, even if not outlined at the Supreme Court level, it is worth noting that the Court of Appeal requested the FTA to establish whether the cost bases of the companies included in the benchmark were net of R&D tax credit/subsidies, which is likely to be the case in a competitive market.

In the COVID-19 crisis, where significant state supports are granted, the topics addressed in the *Philips* case might become even more relevant in the coming years.

Deloitte France Taj Tax & Legal team advised the client throughout the proceedings. The Deloitte professionals include Marie-Charlotte Mahieu and Thomas Pautrat. Please contact us for more information.
The rise and rise of mutual agreement procedures in the EU

Eddie Morris, Jennifer Breeze and Janelle Sadri discuss how the growth in the number of mutual agreement procedures, coupled with fine-tuning of the process, has affected its themes of access, resolution and implementation.

The mutual agreement procedure (MAP) remains the most utilised and best way of eliminating double taxation. Perfecting the efficient operation of MAPs through various instruments has been of interest to the OECD and the EU for over two decades. Post BEPS, the incidence of double taxation is rising and the number of MAPs are continuing to increase. The focus is increasingly on ensuring better dispute resolution techniques to eliminate double taxation more effectively. This article draws out some features of the instruments now available.

Dispute resolution statistics
The OECD statistics clearly indicate that more MAP cases are being made. One can subsequently infer from this that there are more audits and more adjustments. This has led to more pressure on MAP itself to perfect how it should work, and more pressure on the competent authorities charged with the task of eliminating double taxation.

In September 2019, the OECD released the MAP statistics for 2018. Notably:
- The number of new MAP cases initiated increased in 2018, relative to 2017;
- Transfer pricing (TP) cases increased by nearly 20%, while other cases increased by more than 10%;
- TP cases accounted for more than 51% of total cases in inventory at the end of 2018; and
- Though, the average time to close TP cases increased from 30 to 33 months between 2017 and 2018, the number of cases closed during the period increased relative to the prior period (and it is noted that the OECD is strongly encouraging jurisdictions to resolve MAP cases within 24 months of notification).
In its work on dispute resolution during 2005 and 2006, the OECD identified three broad areas where the MAP needed improvement – access, resolution and implementation. That work also introduced an arbitration clause into the MAP article of the OECD Model Tax Convention. The best part of a decade later, MAP improvements were an integral part of the OECD Inclusive Framework BEPS project and have come to fruition in the Multilateral Convention to Implement Tax Treaty Measures to Prevent BEPS (multilateral instrument, or MLI).

Alongside these developments, EU member state resident taxpayers enjoyed the benefits of the EU Arbitration Convention. Ground-breaking at the time of its formulation in 1990, the convention benefited from a series of updates developed by the EU Joint Transfer Pricing Forum and was enshrined in EU ‘soft-law’ through various codes of conducts agreed to by EU member states. However, the convention always sat uneasily in the EU canon, not being a regular EU instrument. This fundamental issue was addressed in 2019 through the EU Arbitration Directive, a more formal and far-reaching instrument than the convention it effectively replaces.

This article discusses how these developments have addressed the common themes of access, resolution and implementation.

**OECD developments**

Following on from the BEPS reforms, the OECD recognises that there will be an increase in the use of MAPs as a result of increased audit activity by tax administrations across the globe. Over the past five years, the OECD has been committed to strengthening the effectiveness and efficiency of the MAP process, and ensure that it is widely accessible to taxpayers.

The aim of BEPS Action 14 was to develop solutions to address obstacles that prevent countries from addressing treaty-related disputes under the MAP, including the absence of arbitration provisions in most treaties, and the fact that access to MAPs and arbitration may be denied in certain cases. In its 2015 Final Action 14 Report ‘Making dispute resolution mechanisms more effective’ (the Final Report), the OECD emphasised the fundamental importance of the MAP mechanism to the proper application and interpretation of tax treaties, developing a minimum standard for treaty-related dispute resolution, and a set of best practice recommendations.

The OECD has demonstrated continued momentum over recent years, implementing the various measures outlined in the Final Report. For example, the peer review and monitoring process is designed to keep countries accountable in their bid to both streamline the MAP process and conclude more MAP cases. The online Manual on Effective Mutual Agreement Procedures (MEMAP) also signals the OECD’s commitment to continuously improve the MAP process and its functionality, encouraging greater consistency in how MAP issues are dealt with and improving the speed and effectiveness of the process.

The MLI is a vital instrument in the OECD’s ability to deliver on Action 14. The MLI is effectively a multilateral treaty that enables jurisdictions to swiftly modify their bilateral tax treaties to give effect to the relevant recommendations contained in the OECD/G20 BEPS package. As noted by Angel Gurría (OECD Secretary-General), “in addition to saving jurisdictions from the burden of bilaterally re-negotiating these treaties, the MLI results in more certainty and predictability for businesses, and a better functioning international tax system for the benefit of our citizens.”

The MLI was adopted on November 24 2016. There are already approaching 100 signatories and parties to the MLI, which entered into force on July 1 2018. To encourage the widest possible uptake, the MLI incorporates flexible features that are designed to allow countries to tailor their adoption to fit their circumstances and accommodate unique aspects of their treaty network. For the MLI to modify a bilateral tax treaty, both treaty partners must (i) have signed and ratified the MLI and (ii) identified those treaty(ies) intended to be covered by the MLI. While some of the MLI articles are mandatory, most are optional. Jurisdictions can, for example, choose to adopt the minimum standards only, or they can choose to also adopt some, or all, of the optional articles.

Article 16(1) of the MLI replicates Article 25(1) of the OECD Model Tax Convention (2017 update), and it has made an improvement on the 2014 OECD Model Tax Convention by requiring the contracting states to provide taxpayers with wider access to the MAP.

There are clear and often lengthy time limits in which the MAP can be requested. Specifically, the second sentence of Article 16(1) of the MLI provides that the MAP case must be presented within a specific time period, that is shorter than three years from the first notification of the action resulting in taxation, not in accordance with the provisions of a covered tax agreement. This means taxpayers are permitted to present their case within a period of three years from the first notification of the action resulting in taxation, not in accordance with the provisions of the covered tax agreement. The first notification is commonly viewed to be the final assessment at the end of a tax enquiry, or similar.

Furthermore, Article 17(3) of the MLI gives effect to element 1.1 of the Action 14 minimum standard. Access to the MAP is granted for TP cases even where the treaty does not contain Article 9(2) of the OECD Model Tax Convention, especially in those jurisdictions that did not provide access to MAPs in such cases in the past.

Considering MAP resolution, Part VI of the MLI (Articles 18 to 26 inclusive) relates to the mandatory binding
arbitration of MAP cases. Several jurisdictions expressed commitment to implement binding MAP arbitration in their bilateral tax treaties at the time of the Final Report. This section is effectively optional.

Specifically, Article 19 of the MLI stipulates mandatory binding arbitration must take place where the competent authorities are unable to reach an agreement to resolve a case within two years of its commencement. This addresses a key limitation with MAP cases historically, given that competent authorities only had an obligation to endeavour to resolve cases, disputes could remain unresolved indefinitely. Article 19 guarantees that treaty-related disputes will be resolved within a specified timeframe, making MAPs a more attractive option for taxpayers. Furthermore, Articles 20 to 25 stipulate how arbitration proceedings should function in practice. In the past, it was often practical constraints, or a lack of agreement about how to proceed, that blocked resolution.

Overall, it is evident the MLI widens access for taxpayers in terms of both extending the period taxpayers have to initiate a MAP to three years, as well as imposing an effective two year time limit for competent authorities to seek to resolve a case (after which time it can be submitted to arbitration). The MLI has led to greater uniformity in the approach on certain key matters such as arbitration, and importantly, a uniform MAP article for covered tax agreements.

It is clear from the OECD’s MAP statistics that more taxpayers, faced with increased audits and bilateral tax disputes, are using the MAP process. The MLI has helped to enhance the efficiency and effectiveness of the MAP process, consistent with the intentions expressed in the Final Report 5 years ago.

**EU developments**

Within the EU, the EU Arbitration Convention entered into force on January 1 1995 as an instrument that promised to enable elimination of double taxation arising between member states. Importantly, it provides a mandatory and binding arbitration mechanism to allow for the elimination of double taxation by reference to the opinion of an independent advisory body if competent authorities cannot reach agreement after two years. This went beyond bilateral treaties that were in place at the time, which only required that competent authorities use their ‘best endeavours’ to eliminate double tax.

Under the convention, once in arbitration, an opinion of the arbitration panel needs to be delivered within six months, and then the competent authorities have a further six months to agree whether to accept that outcome or to agree on an alternative that eliminates the double taxation.

The Arbitration Convention also enabled taxpayers to present a case to each of the competent authorities of each of the member states concerned, within three years from the receipt of the first notification of the action resulting in the double taxation. In some instances, this allowed cases to be presented that would otherwise have been out of time under then existing bilateral treaty time limits.

The time limits and availability of a mandatory arbitration mechanism in this instrument were welcomed. However, in practice, many stakeholders as well as the EU Commission itself in their review of the instrument recognised that there have been challenges with the application of the convention, including:

- **The scope of the mechanism**: The Arbitration Convention is limited to cases of double taxation which arise following the adjustment of profits of associated enterprises in relation to TP and attribution of profits to permanent establishments, which is more limited than the scope of many bilateral tax treaties. This means that some adjustments made by domestic tax authorities that result in double tax may not be addressed by the convention. For
example, re-characterisation of a payment as a distribution or re-characterisation of debt as equity.

- **Access to the mechanism:** The EU acknowledged that there was a lack of clarity on the terms and conditions for acceptance or rejection of cases. Where a case is rejected by a competent authority, there is no clear pathway for an appeal by a taxpayer.

- **The timing of resolution:** The convention does not provide competent authorities with an unambiguous starting point for the countdown of the two year time limit before arbitration becomes available. In some cases, a competent authority would be of the view that the time limit did not start until they had any and all information that they may request available to them, which is itself not a defined milestone. Furthermore, the time limits can be waived with the taxpayer’s agreement.

Even where arbitration is sought, the EU review noted that there can be many failings in the system including delay in or absence of establishing the advisory commission and lack of agreement on the appointment of the Chair of the Advisory Commission which delays or prevents the process from proceeding.

In practice, relatively few cases have been through arbitration. Figures published in July 2019 by the EU Joint Transfer Pricing Forum providing that the statistics on pending MAPs under the Arbitration Convention at the end of 2018, showed indicated that there were 932 live cases across the member states; however, only two live cases were in arbitration.

Some may argue that the benefit of arbitration is that the existence of that mechanism gives an incentive to member states to resolve disputes prior to the expiry of the two year time limit, which would be a success rather than a failure of the convention. However, the statistics also show that 202 cases had exceeded the two year time limit, although it had been waived with the taxpayer’s agreement. This indicates...
that taxpayers do not always view the arbitration process available to them under the convention as a desirable route for resolving double taxation.

Recognising these shortcomings in 2017, the Council of the EU issued Directive (EU) 2017/1852 on tax dispute mechanisms in the EU the Arbitration Directive to enable faster and more effective resolution of tax disputes between member states. Under the Arbitration Directive, the process for presenting a case (known as a ‘complaint’) is similar to that in the Arbitration Convention. However, it addresses many of the shortcomings of the convention through:

• **A wider scope**: Covering all disputes arising from the interpretation and application of tax treaties. For example, the very existence of a permanent establishment can be decided as well as attribution of profit;

• **Clearly defined and enforceable time limits**: A complaint must be accompanied by prescribed supporting information as specified in the Directive. Competent authorities have three months to request further information, which must be supplied within three months of request. Competent authorities then have a further six months to determine whether they will accept the complaint and can only reject the request on limited grounds which, again, are specified in the Directive.

If no response is given, the case will be deemed to have been accepted. Competent authorities have six months to decide if they will resolve the dispute unilaterally and then the competent authorities have a further two years to resolve the issue before the taxpayers are entitled to request arbitration. The two year period may be extended to three years if requested in writing by the competent authorities and the reason for the request is considered to be justified. The arbitration process is also subject to a strict timetable, and a decision will be required within 18 months from the time of request;

• **Challenging decisions by member states**: To those who refuse access to the mechanism;

• **A role for domestic courts**: To oversee adherence to procedural requirements of the mechanism. This includes where member states fail to set up an Advisory Commission, and the Arbitration Directive enables taxpayers to bring a case before its domestic courts to force member states to act.

The Arbitration Directive came into force on July 1 2019 and applies to disputes arising in a fiscal year commencing on or after January 1 2018 although competent authorities of member states may agree to apply the Directive to cases submitted earlier or to earlier fiscal years. The effectiveness of the Directive will be monitored and assessed by the European Union Commission and will be evaluated by June 30 2025.

The Arbitration parts of the Directive have not yet been utilised but the availability of the Directive has been widely welcomed and an effective arbitration mechanism through the Directive is expected to be another key tool in helping taxpayers avoid prolonged uncertainty and costs that result from double taxation. An obvious factor for taxpayers is its application only to intra-EU disputes but it is nevertheless a welcome addition to the instruments that taxpayers may be able to access to resolve double taxation. Observers will watch with interest to see if it delivers on its promise.

To end on a point of topicality, it has been interesting to note that not only are the UK and its former EU member state partners continuing to address ongoing cases under the EU Advisory Commission, but the UK is also a signatory to the EU Directive and this is not expected to change whatever Brexit finally looks like. A sure sign that the UK, like many countries in the international community, takes its obligations seriously when it comes to dispute resolution.
Surge in data analytics enhance efficiency of transfer pricing audits

Eric Lesprit, Mariusz Każuch and Howard Osawa look at three national case studies and consider whether the increased use of international data improves cooperation among tax administrations.

Information is a key input that enables tax administrations to manage their interactions with taxpayers with respect to both the selection of tax returns for audit, and the conduct of audits that are initiated. Over the last few years, tax administrations have secured expanded access to relevant taxpayer data through various local, regional, and global initiatives. This has in turn enhanced the tax administrations’ ability to enforce compliance with local corporate tax and transfer pricing (TP) requirements. Indeed, the increased standardisation and wider accessibility of information constitutes a fundamental change in the relationship between multinational enterprises (MNEs) and tax administrations. As tax administrations gain broader access to data outside of their own countries, MNEs will need to be more diligent to ensure that the data presented in different jurisdictions are consistent.

This expansion in information sharing is broadly evident in most tax jurisdictions. Historically, tax administrations primarily relied on information provided by local taxpayers during on-site audits, or obtained through other available sources in the specific jurisdiction, for example, other national governmental agencies. Gradually, by requiring disclosure of additional information on tax returns, tax administrations began to collect relevant information before the audits started. They used this information to select audit targets and to obtain a thorough understanding of the target company before the tax audit began.

More recently, with an increase in technology and the relaxation of international information sharing restrictions, information has become even more accessible across borders. As a result, tax administrations can gain a broader understanding of how multinationals organise their international activities. To further their understanding of such activities, tax administrations began to design questionnaires for foreign treaty partners under the treaty procedures and in accordance with OECD guidance.
Furthermore, due to increased international pressure and the OECD-suggested sanctions, the pace of exchange of information, and the overall quality of the information subject to exchange, improved. The most recent development is the mandatory exchange of information in various areas (rulings, bank accounts, TP), which is intended to ensure that tax administrations can access information more efficiently.

The 2008-2009 global financial crisis and OECD BEPS recommendations accelerated the international roll-out of these mandatory exchange programs, which were already part of the tax landscape in Europe. For example, the Savings Directive designed in 2003 asked information from EU member states with respect to interest paid on a European bank account to a European national. Now, tax administrations have access to a wide range of information: bank accounts information (FATCA and AEOI—automatic exchange of information), TP (CbCR—country-by-country reporting), and even more within the EU with directives on the automatic exchange of non-financial revenues, compulsory transmission of rulings, mandatory disclosure of certain cross-border tax planning arrangements, with DAC6 implementation to come before year end of 2020.

The following country-specific examples describe the tendency of tax administrations to seek greater amounts of data, how international initiatives contribute to a more expansive and more liberal exchange of information, and ways in which tax administrations use the newly available data to improve their ability to administer and enforce tax compliance.

France

The French Tax Administration (FTA) has always been keen in the use of information. One example of this commitment is a dedicated data mining department, which was created and funded with more than €20 million ($23.6 million) in 2018. Information from this group is used in more than 20% of tax reassessments. The data used by this group draw on information from a number of different sources.

The recent success of various initiatives against international fraud and hidden bank accounts in tax havens has motivated the FTA to request more information from treaty partners. France was a strong advocate at the OECD for enhanced exchange of information rules and increased quality of information, and it supported the application of stronger sanctions when taxpayers failed to meet heightened standards. According to the Minister of the Economy public statement on July 1 2020, an exceptional increase of roughly 30% in tax reassessments in 2019 compared to those in 2018, resulted from extensive use of information obtained from treaty partners, in accordance with international agreements or EU rules.

Indeed, tax auditors have adopted a standard procedure of requesting information from other countries and territories to clarify specific issues identified during an audit, or to validate information already provided by the audited company or individual. It is common for the FTA to refer to the worldwide TP information report and/or the CbC report prior to setting foot on the premises of an audited company.

Moreover, one might expect the tax audit selection grid employed by the FTA to include all relevant information about the international tax situation of the taxpayers. This comprises information provided by other EU member states on a mandatory basis, for example, specific international transaction rulings that have been granted, unilateral rulings gained in one country, advance pricing agreements (APAs)
A review of such information, in conjunction with other elements obtained through local sources, may increase the possibility that the company will be selected for a tax audit. A similar practice can be anticipated to develop in other European countries:

- In Spain, information from foreign treaty partners is typically included in the 16 risk factors analysis considered in the automated pre-audit investigation. This internationally-sourced information is also used in the annual audit plan to select taxpayers to be audited in the coming year.
- The German tax administration has designed a tool to perform CbCR data analytics and specialised international tax auditors have been trained to best use of these data. Although it is still at an early stage, this analysis appears to include a comparison of important data points, combined with qualitative information on functions performed.
- Similarly, the Italian tax administration is using information gathered from treaty partners to select taxpayers for audit. Moreover, although it lacks a formal agreement for mandatory exchange of information, Italy has participated with Germany in a limited number of joint tax audits, which is another efficient way to gather information on a timely manner.
Based on these observations, it seems that the tendency for tax administrations across Europe to obtain and utilise international data for use in audit selection and in examinations is increasing.

**Poland**

Poland started to work on the active use of available taxpayer information a few years ago, when the decision was made to create a central repository of taxpayer information. This tool already allows for the implementation of advanced IT-based analysis, permitting automated detection of risky behaviour on the part of taxpayers. This became feasible after the introduction in 2019 of the new TPR form, which specifically addresses intra-group transactions. The TPR form focuses on separate transactions that exceed given thresholds, for example two million Polish zloty for services transactions and 10 million Polish zloty for tangible goods transactions, and this may be viewed as the initial step toward the introduction of operational TP in Poland.

Taxpayers are obliged to provide detailed information concerning each transaction, including, among other items: the type and value of the transaction; the TP method applied and the results of the analysis; the jurisdiction where the counterparty is located; the value of TP adjustments; the expected profits of the taxpayer and the counterparty. The accuracy of the information provided on this form is ensured because the management board must sign an annual statement that all transfer prices of the Polish company are arm’s-length, which also commits the management board member to a high level of personal responsibility.

It should be noted that in many cases the data provided on the TPR form have allowed the tax authority to identify questionable transactions for additional, in-depth scrutiny. It is expected that the TPR form data, together with other sources of information, will be actively used by the tax administration for purposes of risk analysis and audit selection. At the same time, since Poland is historically a country where many routine subsidiaries of foreign companies are located, the CbC reports seems to be of relatively less utility for the tax authorities. Fiscal auditors often focus on loss-making routine companies, where simple application of the TNMM may result in a positive assessment for such companies. In such cases, the proper allocation of residual profit, which generally belongs to the foreign principal company in any event, seems to have less importance for the authorities.

This situation may change in the near future, if the tax authority concludes that some of these ‘routine’ subsidiaries have developed their own know-how, and have become recognised in the market because of their own qualities and capabilities, and not solely due to association with a multi-national group. In that event, the focus of the tax authorities may shift to the correct allocation of residual profit, and CbC report data may become more relevant.

The DAC6 directive is a reporting tool that has already been implemented in Poland. The Polish implementation of the directive appears stricter than the original language of the directive, and the Polish implementation also introduced a number of local features, not connected to the prevention of tax avoidance schemes. For example, a dividend payment is considered a reportable scheme under DAC6.

From a TP perspective, it is notable that the DAC6 TP hallmarks are included in the directive. Nevertheless, for local tax administration, the adoption of the DAC6 directive appears to be less useful than the use of the TPR form, which requires similar information, but in greater detail. Under these circumstances, it appears that the Polish tax authority may rely on the TPR form as a more effective source of information for audit selection.

**Japan**

Transfer pricing enforcement in Japan continues to be a key area of focus for the National Tax Agency (NTA), and the importance is rising as the increased transparency of international transactions highlights the significant role that TP has in these arrangements. Historically, TP arrangements have been reviewed by reference to information, data and schedules included in the corporate tax return. Recent initiatives for sharing of information globally have provided additional information sources that the NTA and the field examiners of the Regional Taxation Bureaus (RTBs) can access when evaluating the cross-border transactions of Japanese taxpayers.

For matters relating to TP, the information return, Form 17(4), which is included in the corporate tax returns, provides the basic information from which the tax administration may assess the pricing of inter-company transactions. Among other things, Form 17(4) provides a broad overview of the scale, nature and scope of the inter-company transactions involving a Japanese taxpayer, including information regarding the related parties with which it engages in transactions, the type of transactions (e.g. tangible goods, licensing arrangements, services, or financial arrangements), the amount of those transactions, and the method used to price those transactions. A review of this information, which may include a review of whether the taxpayer engages in transactions with related parties in tax-haven or low-tax jurisdictions, or in transactions involving licenses of intangible property or inter-company services, may generate attention from the tax administration. Persistent losses or significant changes in profits from year to year, including declines in profit, may highlight problems in TP that may trigger an audit.

The NTA and RTBs continue to rely on traditional sources of information available through the corporate tax returns, even as additional and new information made available through the mandates of the international tax community provide new and more granular information concerning...
potential tax risks. While the common reporting standard (CRS) and adoption of the AEOI identify possible instances of tax evasion, for TP matters specifically, the information exchange programs of tax treaties and OECD BEPS TP documentation mandates provide the primary source of new information.

With respect to information exchange under existing treaties, the NTA estimated in its 2019 report that in nearly 300,000 cases, information was exchanged among treaty partners in 2013, and over 800,000 cases in 2017, including cases relating to the AEOI and the CRS. These statistics indicate a significant increase in the flow of information between Japan and its treaty partners, suggesting that the tax authority continues to obtain additional transparency with respect to international dealings of multinational enterprises.

The BEPS TP documentation mandates adopted by Japan allow further transparency concerning international dealings. The automatic exchange among treaty partners of the CbC report provides tax administrations additional data that contribute to the increased transparency of international transactions. The NTA estimates in its 2019 report that it received approximately 550 CbC reports from foreign tax administrations, and itself provided approximately 600 CbC reports.

As the NTA and RTBs have historically expressed an interest in the global application of TP principles, the CbC report helps the administration to assess the correct application of an MNE’s TP policy. While the NTA has not explicitly shared how it uses such data to identify audit targets, or how such data should be used in actual audits, it may be expected that the data from the CbC report, as well as information from the master file, constitute extremely useful information when assessing TP compliance.

In this sense, together with exchanges of information made available through treaty protocols, the NTA and RTBs have available to them a wealth of information that allows them to evaluate a taxpayer’s inter-company transactions. For the taxpayer, this suggests a need for higher diligence in developing, implementing and documenting group TP policies in order to ensure local compliance with the information and data that is now available globally.

Conclusion
Tax administrations historically relied on various sources of data to assess the compliance of taxpayers with local rules and regulations. We see the evolution for the need to have access to more and more data and to better anticipate that sharing of information, through various initiatives introduced from a local and multi-jurisdictional perspective as the focus on international dealings and instances of tax avoidance become more public.

The OECD mandates put forward through the BEPS project have been adopted almost universally by tax administrations, and the recommendations have contributed to a proliferation of data now made accessible to them, under a mandatory sharing as a large part. Together with the focus on international dealings, and the related focus on increased transparency, the new data provide additional resources from which tax authorities may evaluate TP and international tax compliance.

In the three main cases above, we see evidence of the increased use of international data and improved cooperation among the tax administrations to ensure an equitable distribution of income globally. One consequence of this is the need for MNEs to ensure consistency in the explanation of the international tax positions of taxpayers and the presentation of data, and specifically in the execution of TP policies.

For transfer pricing, with tax administrations now having access to a significant amount of data that can be used to assess whether the policies and implementation of policies are applied reasonably throughout the organisation, consistent implementation and appropriate documentation of the inter-company transactions becomes more and more critical.
Financial transactions:
A complex landscape for taxpayers and tax authorities

Mo Malhotra, Ariel Krinshpun and Ockie Olivier evaluate how the OECD guidance on financial transactions will influence an increasingly convoluted transfer pricing environment.

In 2012, the G20 nations called on the OECD to develop an action plan on base erosion and profit shifting (BEPS). A number of actions in the OECD’s BEPS Action Plan can have an impact on financial transactions, and of particular note are Actions 2 (neutralising the effects of hybrid mismatch arrangements), 4 (limitation on interest deductions) and 8-10 (transfer pricing). The potential for complexity, inconsistency, controversy, and double taxation to arise from the interrelation of measures targeted at financial transactions should not be underestimated. Such challenges are created by the BEPS initiative, varying local implementation, and its combination with pre-existing and other anti-avoidance rules in many territories.

Achieving consensus amongst OECD member countries on transfer pricing (TP), in particular, took longer than anticipated. This may have to do with the complexities of seeking consensus amongst member states on what exactly is an acceptable arm’s-length standard, when it comes to a financing transaction. The non-consensus discussion draft released in 2018, prior to the final OECD guidance on financial transactions (the guidance) ultimately released in February 2020, received over 1000 pages of responses. In many cases, commentators expressed concerns about the inconsistency of approaches adopted to date by fiscal authorities, subjectivity inherent within many concepts, and the apparent incompatibility of certain concepts with domestic laws.

The guidance, to achieve the stated aim of contributing to “consistency in the interpretation of the arm’s-length principle and help avoid transfer pricing disputes and double taxation”, needed to address these points.

Overall, the guidance is welcome, in the sense that it is the first attempt at consensus multi-jurisdictional guidance in this space, but sub-
jectivity remains, and the interpretation of the guidance by taxpayers and tax authorities may differ.

We reflect below on some of these aspects, which leaves space for interpretative differences.

**Accurate delineation**
The guidance requires an examination of the contractual terms and the characterisation of financial transactions, the relative functions performed, assets used, and risks assumed by the parties, along with an evaluation of their business strategies and economic circumstances. This helps to evaluate whether a “purported loan should be regarded as a loan”, with the implication that it may be regarded as something else, for example, equity.

An analysis of the conditions that independent parties would have agreed to in comparable circumstances is therefore necessary. The guidance states that where the entity providing funding, lacks the capability to perform, or does not in fact perform, the decision-making functions to control the risk associated with investing in a financial asset, it will be entitled to no more than a risk free return as an appropriate measure of the profits that it is entitled to retain.

In this evaluation, documentation is important. The guidance refers not only to the group’s financial policies, including pre-existing loans, shareholder interests and the actual loan instrument, but also to the behaviour of the parties and the actual conduct and economic principles that govern their relationship.

The taxpayer, however, is left to establish a number of matters, for example:

- How to allocate a risk adjusted return? If the guidance in this context applies to a transaction, it may imply a ‘third’ jurisdiction, not party to the tested transaction, performs the aforementioned lending activities and so may be entitled to a return. This risks income imputation in the ‘third’ territory, and an associated need to seek relief. Traditional treaty relief mechanisms may not prove to be adequate if this eventuality arises.

- What are the counterfactuals, or options realistically available? A recent international tax case concerning a long-term loan highlighted the increasing scope of the economic factors to be considered in pricing inter-company loans, particularly in loan relationships between a subsidiary and its wider group, as well as the borrower’s hypothetical alternatives.

The court held that an independent borrower in similar circumstances could have provided security and operational and financial covenants to acquire the loan, which would have resulted in a lower interest rate. On appeal, the court also considered the availability of an explicit parental guarantee being obtained. Ultimately, in deciding against the taxpayer, the court took into account the group’s policies regarding financing arrangements, among other things.

**Differing perspectives**
The guidance places emphasis on examining not only the borrower’s perspective, but also the perspective of the lender. On the part of the borrower, the relevant functions would usually include ensuring the availability of funds to repay the principal and the interest on the loan on time, providing collateral, if needed, and fulfilling any other obligations derived from the loan contract.

From the lender’s perspective, the guidance requires an assessment of the lender’s decision to make a loan, how much to lend, and on what terms. This will involve an evaluation of various factors relating to the borrower, economic factors, and other options realistically available to the lender for the use of the funds.

This leaves the potential for challenge. For example, it can lead to a scenario where a lender provides funds within a group, marking the best outcome for the group. Cash is moved internally from one entity to another – but in isolation: the lender could have achieved a better outcome, notwithstanding that may have meant that the group or borrower may have had to source funds externally to fulfil the borrower’s need, leaving the group worse off overall.

In this context, there are risks associated with evaluating every option realistically available to the lender outside the group, and there may be points to articulate in defence of the position around why a lender may accept a worse alternative on an individual transaction, to obtain wider benefits of group membership. Subsidiaries are rarely islands, disconnected and alone, and therefore the broader group context may be important.

In the case of cash pooling, and drawing that wider, the treasury function – the guidance is detailed, and international case law may provide helpful precedent. A particular case concerned the arm’s-length pricing policies applicable to cash pooling arrangements and the remuneration for the cash pool operator. That case showed that the appropriateness of an economic analysis turns on the facts of not just one party, but its relationship and interaction with the counterparty and wider corporate group. The tax authority argued that depositing cash with a third-party bank is not comparable to depositing in an inter-company pool. The pool was riskier than the bank, given the group’s weaker credit rating. The court in question upheld this assessment, but reaffirmed the principle that the creditworthiness of the cash pool leader should, in this case, be assessed by reference to that of the group as a whole.

**Recharacterisation**
The guidance conceives a situation where some or all of a debt advance may need to be recharacterised as equity, and
states that “the following economically relevant characteristics may be useful indicators, depending on the facts and circumstances: the presence or absence of a fixed repayment date; the obligation to pay interest; the right to enforce payment of principal and interest; the status of the funder in comparison to regular corporate creditors; the existence of financial covenants and security; the source of interest payments; the ability of the recipient of the funds to obtain loans from unrelated lending institutions; the extent to which the advance is used to acquire capital assets; and the failure of the purported debtor to repay on the due date or seek a postponement”.

In another section, the guidance states that “between associated enterprises the contractual arrangements may not always provide information in sufficient detail or may be inconsistent with the actual conduct of the parties or other facts and circumstances”.

This leaves open room for challenge and interpretation. So going forward – comprehensive documentation of intention, conduct, and the terms governing a relationship are advisable to avoid ambiguity.

On characterisation, case law may again provide insights. The US in particular has a rich history with respect to debt vs equity characterisation. For example, in a case going back as far as 1968, a decision was upheld to recharacterise debt as equity. The opinion cited 16 factors that had been raised by courts and commentators to address the issue, and the case established a framework not inconsistent with the accurate delineation framework within the guidance.

More recently, in a 2018 case, the court presented a 14 factor analysis on this point. The decision upheld that the instrument was debt, and focused on the conduct of the parties and the substance of the transaction. In particular:

- There was a legally binding agreement that had the conventional terms typically observed in commercial loan agreements;
- The lender could reasonably expect repayment at the time of issuance given that the borrower had the capacity to service the debt with internally generated cash flow. In addition, expert witnesses provided testimony supporting the creditworthiness of the borrower; and
- Both parties treated the transaction as debt, as demonstrated by conduct consistent with that of a borrower and lender. In addition, the group demonstrated a history of respecting and treating its intercompany loans as debt.

Challenges around characterisation may be set to increase in the future and lead to risks of double taxation. Furthermore, experience suggests that even where agreements are reached around characterising certain amounts as equity, challenges can arise on subsequent repayments, with tax authorities potentially taking the view that any repayment is first set against the arm’s-length debt proportion of the instrument, unless there is clear evidence to the contrary.

Impacts of association
For the first time, the OECD provides a detailed commentary on the potential impact of group membership on the creditworthiness of a borrower in the context of a financial transaction. This concept suggests that a borrower may be able to obtain preferable commercial terms from prospective lenders as a consequence of being a member of a larger corporate group. This is where, for example, lenders expect that a borrower could call upon other members of the group to provide financial support when facing difficulties, and lenders perceive such support is likely to be forthcoming.

Implicit support may have a significant impact when assessing a borrower’s creditworthiness, and the guidance establishes that qualitative factors, such as the potential

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benefit of implicit support, should be borne in mind when performing a credit rating exercise for the borrower.

The fact that implicit support may influence the pricing of a controlled transaction contrasts with the general TP assumption of mutual independence between related parties, and has thus been a source of differing interpretations. This can be noted by comparing legal cases in different countries which have, for example, demonstrated differing views as to the extent to which the impact of implicit support should be considered in a TP analysis.

Nevertheless, there is an increasing tendency to take implicit support into account in a number of countries where the new guidance is not contradictory to local law, or indeed where law is silent on the point. In such countries, tax authorities may challenge businesses that do not take implicit support into account following the issuance of the guidance, resulting in potential disallowances of financing costs.

It should be noted that a number of jurisdictions have specific domestic legislation which may restrict the ability of taxpayers to factor in implicit support and therefore need to use stand-alone, rather than group, credit ratings.

The degree to which implicit support may be relevant is explicitly recognised as a matter of judgment, which is a helpful acknowledgement, but leaves room for significant interpretation. This, combined with differing domestic legislative approaches, may increase risks of inconsistency and double taxation.

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Conclusion

Overall, the guidance is welcome as it provides a number of helpful clarifications, and in many instances, reaffirms approaches that have historically been adopted in practice or established through case law. However, we have highlighted above just a few of the areas where differences in opinion may arise.

Some multinational enterprises may take the approach of proactively reflecting the guidance, as far as possible, within corporate policies and documentation. However, even this may not fully remove all uncertainties and, in some cases, it may be necessary to resort to mutual agreement procedures (MAPs), if available, following a tax authority audit. For such processes, given the increase in potential points of difference, the process to arrive at mutually agreeable outcomes between tax authorities is likely to become more complex and challenging to navigate.
The challenges of applying the 2017 OECD guidelines to pre-2017 years

Jari Ahonen and Juan Ignacio de Molina discuss global examples and assess the practical impact of retroactively applying the OECD Transfer Pricing Guidelines.

The OECD Transfer Pricing Guidelines (the guidelines) have evolved significantly in recent years since the publication of the final BEPS report in 2015. A question arises as to which version of the guidelines should be, and can be, applied to interpret the arm’s-length principle for a given tax year. In a transfer pricing (TP) audit context, this question involves whether the tax authorities have the right to apply the most recent version of the guidelines retroactively to the detriment of a taxpayer.

This article explores the temporal dimension of the application of the guidelines and discusses certain international case law on the matter.

OECD Guidelines as a source of interpretation

The guidelines provide guidance on the application of the “arm’s-length principle” set forth in Article 9 (associated enterprises) of the OECD Model Tax Convention. Thus, the same interpretive principles that guide treaty interpretation also play an important role with respect to the guidelines.

In tax treaty law, there has long been debate on the relevance of changes to OECD commentaries for purposes of interpreting previously concluded tax treaties. In this respect, the main alternatives are a ‘static approach’ where the tax treaty is interpreted in accordance with the OECD commentaries that existed when the treaty was concluded and an ‘ambulatory approach’, where the subsequently adopted commentaries (if any) are accepted as the source of interpretation.

With respect to which version of the guidelines should be applied, there are different answers in different countries. Many countries, such as the Netherlands, apply a continuous or ambulatory interpretation and thus refer to the most recent version of the guidelines for all open tax years.
Other countries have a specific rule on the matter. For example, in the UK, HMRC tends to view the 2017 guidelines as a clarification and improvement of the existing guidelines, rather than a new set of rules per se. Although the new version is not formally a precedent for interpreting UK TP rules in an earlier period, in practice HMRC audit teams often apply the revised guidelines in tax audits.

In many countries, there are no specific rules regarding the application and these countries typically emphasise the question, to what extent do the revised guidelines merely clarify the existing guidance and to what extent they comprise fundamentally new guidance or change to previous guidance.

Examples of international case law

United States

Retroactive application of OECD commentaries was discussed in US Tax Court case Taisei Fire and Marine Insurance Co. Ltd. vs. Commissioner (May 2 1995). In its decision, the court pointed out that it would normally have reservations about interpreting a convention, ratified in 1971, on the basis of a commentary, adopted in 1977, that contradicts the literal language of the commentary in effect at the time of ratification.

However, in light of the extensive analysis by various commentators and the confirmation of such analysis by the court’s own research, the court concluded that the criteria in the later commentary reflected the original intent of the commentaries available at the time that the tax treaty was ratified. Based on this, the revision was considered a mere ‘clarification’ and the approach taken followed the later commentary.

Finland

In Finland, on the other hand, there is a recent Supreme Administrative Court level decision (KHO 2018:173) where the court ruled that the tax authorities should apply in tax audits the version of the guidelines that was available at the time of filing the corporate income tax returns for the year(s) in question.

In the case, the taxpayer had applied traditional transactional methods – such as the comparable uncontrolled price method (CUP method), the cost plus method (CPM) and the resale price method (RPM) – to price its intra-group transactions. The tax authority concluded in a TP audit that since the group’s activities were highly integrated and the key value driver of the business was technology that was owned by a Finnish entity, the residual profit split method was the correct approach to set arm’s-length prices and imposed TP adjustments accordingly. The court rejected this argument and decided that since it was possible to test the arm’s-length profit of the entity with the methods that the taxpayer had actually chosen and applied (and that were primary methods in the 1995 version of the guidelines), there were no legal grounds to reassess the entity’s taxable income.

Following the KHO 2018:173 decision, the Finnish tax authority released an official statement where it pointed out that the case should be understood to limit the retroactive application of the 2010 OECD guidelines only in terms of method selection that could be considered as fundamental new guidance. The authority pointed out that in an earlier decision (KHO 2013:36), the court had found it possible to apply the newly introduced Chapter 9 in the 2010 version of the guidelines in a location savings case concerning tax years 2004 and 2005. This was because Chapter 9 was not considered as fundamentally new guidance to the principles included in Chapter 1 existing at the time. Based on this, the tax authority concluded that it would also continue to apply the new versions of the guidelines in future cases where the revision can be considered as a mere clarification.

Practical impact of the main changes to the OECD Guidelines

The previous section of the article explained how a tax authority, depending on its country, may apply either a static or an ambulatory approach in the use of the different versions of the guidelines. As mentioned above, in many countries the
The key question is whether the new guidance should be understood as mere clarification to the previous guidelines or a fundamental change or as a completely new guidance.

The following section briefly summarises how the main BEPS changes could impact pre-2017 audits from this perspective.

**Accurate delineation of the transaction and risk**

BEPS made changes to Chapter 1 of the guidelines, involving a significantly more granular functional and risk analysis. From a practical standpoint, taxpayers will have to accurately delineate a transaction by following a five-step process.

In addition, the new guidance provides a six-step process to evaluate and potentially adjust the contractually agreed risk-return allocation between the parties. Both processes provide tax administrations with tools to delineate transactions and risks. The effect on multinational enterprises (MNEs) engaged in activities that allocate routine profits relying on transactional net margin method (TNMM)/CPM, is that they may find that these new rules allocate non-routine returns to those entities.

For pre-2017 years, taxpayers will not have to follow the specific 2017 process to delineate the transaction and/or risk. However, they will most likely have to demonstrate that each entity has the financial capacity to assume and control each specific risk.

**Location-specific advantages**

Location-specific advantages (LSAs) are market features that provide enhanced financial performance relative to alternative locations, resulting from cost savings or other local market features (for example, product preferences and purchasing power).

LSAs are not defined as an intangible but a factor affecting comparability. In a way, LSAs can be deemed to be an extension of the location savings concept codified in business restructuring Chapter 9 in 2010. However, even the 2017 version of the guidelines does not provide detailed guidance on how to split the savings among jurisdictions, which will leave it up to MNEs and tax authorities to determine such allocation.

**Passive association**

Passive association and implicit support can be defined as the effect, within a financial transaction, derived by an entity solely from its affiliation with a broader group. This concept has already been discussed in various court cases but only after 2017 was it clearly recognised in the guidelines. From a practical standpoint, the introduction of the passive association concept has resulted in a need for MNEs, to determine, in a nutshell, the borrower’s stand-alone rating and determine the gap with the parents rating and, thereafter, quantify the extent to which the rating gap should be reduced through adjustments.

The guidance on passive association and implicit support approaches was further extended in the 2020 Transfer Pricing Guidance on Financial Transactions that also includes, for the first time, technical guidance for evaluating credit ratings of group entities. Applying the newly codified concepts to pre-2017 and pre-2020 periods could be problematic, to the extent that the guidance is considered to be fundamentally new, rather than a clarification of existing concepts.

**Intangibles**

The most significant change within the guidelines concerns intangibles, to ensure that pricing of intra-group transactions is aligned with value creation. For this purpose, the 2017 guidelines introduce the emphasis on the return for the DEMPE functions (development, enhancement, maintenance, protection and exploitation). This should prevent the use of ‘cash boxes’ to obtain residual returns.

The new guidance directs the valuation of intangibles to the profit split method and the use of discounted cash-flow techniques. Both the DEMPE analysis and the method preference are new concepts. It may be problematic if tax administrations apply these concepts to test documentation of TP outcomes in pre-2017 years.
When dealing with hard to value intangibles (HTVI), the new guidelines encourage MNEs to include price adjustments or other contingent pricing mechanisms when there is high uncertainty in the value of an intangible. This will for sure be an area of conflict if tax authorities apply these criteria to pre-2017 audits.

Low value-adding services
This is probably the only BEPS report intended to facilitate and simplify TP policies and documentation requirements. However, the adoption of this guidance by tax authorities is still in process in many countries long after 2017. Nevertheless, taxpayers should be allowed to refer to the low value-adding services related guidance in evaluating and documenting the arm’s-length nature of service transactions also for pre-2017 periods.

Profit split
The 2018 paper on profit splits is a clear drive towards intended increased use of the method. Tax authorities had applied the guidelines and recommendations on the use of the profit split in pre-2017 audits. The use of the profit split method has as such become more acceptable and common after the 2010 guidelines due to the abolition of hierarchy of methods, including the preference for traditional transaction-based methods over transactional profit methods.

However, application of the new BEPS profit split guidance to pre-2017 periods may be problematic especially in cases where the application is justified through the shared assumption of risk. After all, that concept was introduced in the 2018 profit split paper as the third condition for applying the method, along with the already existing ‘unique and valuable contributions” and ‘highly integrated operations’.

Conclusion
The application of new TP guidelines to older periods has frequently been an issue of controversy. As indicated above, to date, international case law in the area is scarce, although the topic is complex and widely debated. If we analyse the numerous changes introduced by BEPS within the TP guidelines, the possibility of applying these new guidelines to pre-2017 audits will certainly increase to some extent and MNEs should be prepared to defend their pre-2017 TP policy and documentation.

However, retroactive application of the new guidelines should always be based on detailed analysis of the actual facts and circumstances. Any use of the 2017 guidelines in pre-2017 audits to the detriment of taxpayers will likely be challenged and there will be a need for effective dispute resolution mechanisms. Competent authorities will have to resolve disputes through MAP and arbitration even if they have different approaches to the use of the guidelines.
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Reducing tax uncertainty in Latin America through APAs

Ramón López de Haro and Alejandro Paredes evaluate how promoting the negotiation of advance pricing agreements (APAs) may raise the confidence of potential investors in the region.

We are living in a time of high global instability, when most multinational companies will need to review their strategic plans, reconsider their investment and supply chains across countries, and possibly move back from global to regional structures. In the post-COVID-19 world, online sales, remote working and nearshoring of supply chains will be at the heart of business investment decisions.

Corporate taxation will not be exempt from the consequences of this post-COVID-19 pandemic world. It is likely that all these changes in the way that multinational companies operate their global businesses, together with international tax and transfer pricing (TP) trends, will bring higher uncertainty in the tax and TP field. This is especially expected in those regions and countries where it is not possible to agree *ex-ante* with the relevant tax administrations on the attribution of the business profits/losses to the corresponding jurisdictions.

**Embracing alternate solutions**

Latin America has traditionally been a region of high uncertainty for TP purposes, not only because some countries in the region do not apply the OECD Transfer Pricing Guidelines (e.g. Brazil) but also because the countries that do accept those guidelines, do not always apply them in a consistent and orthodox manner. Furthermore, although the volume of international inter-company flows has grown consistently and vigorously in recent years, almost no APAs have been signed between taxpayers and tax administrations to ensure certainty on the TP methodology used in specific inter-company transactions. This has contributed to an increase in TP litigation, both within the region and among European and North American-capital exporting countries such as Canada, Spain and the US.

An essential factor in the search for tax certainty from a TP standpoint is having the practical ability – as opposed to the theoretical ability – to
execute an APA before making an investment, because this is the sole means of ensuring that a company’s TP policy will not be subject to challenge at a later date, resulting in potential fines or assessments that could affect cash flow.

APAs are agreements between a taxpayer and one or more tax authorities concerning an appropriate TP methodology that will apply to a group of transactions for a determined time period.

A key exception to the general situation in the region, where despite continuous international efforts, it is still not possible to obtain certainty through an APA, is the case of Chile. In the country, the tax administration has only started to grant APAs in the last few months. By inviting companies to submit APA applications, the Chilean tax authority is sending a message to international markets that the jurisdiction respects its TP regulations and applies them in conformity with the OECD Transfer Pricing Guidelines. In addition, the level of sophistication in TP is increasing, which is a relevant consideration for companies that face more complex TP issues. Although an agreement with the Chilean tax authorities in the context of its APA programme is not binding on other countries in the region (e.g. Peru, Colombia, Argentina), it does increase the taxpayer’s credibility and serves as an excellent ‘letter of introduction’ in other countries in the region, in the event that the TP policy of the group is called into question.

**Establishing legal certainty**

Most multinational groups have standardised TP policies, whereby the same policy tends to be applied consistently in...
all the countries within a region, assuming that the overall functional and risk profile is similar. In this context, the signing of a bilateral APA involving Spain and Chile, for example, would likely provide some degree of legal certainty in the case of potential challenges by other jurisdictions in the region.

Some additional advantages for multinational taxpayers of signing APAs with Latin American countries, such as Chile or Mexico, are the following:

- APAs provide an opportunity for the relevant tax administration and the taxpayer to consult and cooperate in a spirit of reaching agreements;
- APAs can avoid long and expensive TP audit processes and possible litigation that may result in the event of an adjustment to the price of transactions between related parties;
- Bilateral APAs eliminate the possibility of double taxation;
- Unilateral APAs, although not binding on another jurisdiction, can help reduce the amount of audit scrutiny given to specific inter-company transactions; and
- TP teams in the tax authority that manage APAs are experts in their fields, whereas in the audit process, the responsible officials may not have the necessary experience or knowledge to address TP issues.

Other potential advantages of entering into APAs relate to timing and cash flows. A TP audit can start at any time and demands time and resources from the company that might not be readily available, potentially distracting the company from its core business, if extensive information must be obtained from operating teams. Furthermore, a TP audit may generate penalties and legal and advisory fees that have a significant impact on cash flows. In the case of an APA, the company selects when to begin the process based on availability of time and resources. An APA will obviously require a commitment of time and resources, but it will likely yield better outcomes, as the taxpayer has greater flexibility with regard to planning and preparation.

From the tax administrations’ perspective, signing APAs can also be very advantageous by enabling them to perform better risk assessment. Indeed, by reaching agreements with taxpayers that are willing to cooperate with the tax administration, and that disclose in detail their business operating model and their TP policies, tax administrations are able:

- To get a better understanding of how multinational taxpayers operate and determine their allocation of global profits (or losses) among their different affiliates, which ultimately allows tax administrations to better assess their compliance with the arm’s-length standard; and
- To concentrate and focus scarce tax audit resources on taxpayers that present a higher risk profile (e.g. using low-tax structures or concealing real substance, etc.)

Based on the above, in order to increase the level of tax certainty and confidence of potential investors in the region, the Latin American jurisdictions should consider actively promoting the negotiation of APAs. At a time when countries are looking to differentiate themselves to attract foreign investment, the ability to align local regulations and tax administration to international compliance standards may provide competitive advantage for specific countries in the region.
The state of transfer pricing controversy in Asia’s leading markets

Aaron Wang, Vrajesh Dutia and Chris In explain how adopting global best practices has proved to be beneficial for the development of dispute resolution procedures in China, India and South Korea.

China, India and South Korea have had formal transfer pricing (TP) regulations in place for more than a decade. Over this period, many multinational enterprises (MNEs) have experienced some form of TP controversy, such as enquiries or audits by authorities in the region, especially in China and India.

The controversy environment in these countries has also undergone many changes – from selection of cases for audit by means of data analytics, to shifts in the type of issues that generate controversy, and the increased use of advance pricing agreements (APAs) and mutual agreement procedures (MAPs) as effective dispute avoidance and resolution tools.

In addition, tax authorities in China are gaining detailed expertise with respect to specific sectors or specific subject matters; in contrast, India has put an emphasis on reducing the plethora of litigation cases by means of settlement schemes, reducing the number of appeals filed by tax authorities, and moving towards more effective use of APAs and MAPs.

The common theme in all three countries is an emphasis on learning and adopting global best practices and putting these best practices to use in APAs and MAPs with developed countries.

China

In the process of combining two former tax bureaus at local level, the central office of the China State Taxation Administration (STA) sought to adopt a more efficient mechanism for TP audits, in part to reflect China’s commitment to the OECD’s BEPS Action 14, which becomes more important in view of the COVID-19 pandemic and global political conflicts.

The STA has deployed many of its MAP and APA resources following the thread of competent authority (CA), aiming to increase the expertise and experience of its personnel, in line with those of its treaty partners, particularly in Asia. This trend can be seen in the annual public statistics...
on concluded APA cases in recent years. For example, bilateral APAs (BAPA), dominate the total number of resolved cases, and over 65% of the 44 BAPA cases that the STA signed during 2005-2018 were with Asian jurisdictions (represented by Japan and South Korea). This, however, does not necessarily mean a reduction on unilateral APAs in China, which can still be instrumental in preventing future TP controversy (for example when an audit for recent years has been concluded) or when difficulties are envisaged in obtaining a bilateral agreement with the other CA.

With respect to TP audits, many cases in China are led by STA using a centrally-driven approach, focusing on specific types of transactions such as services and royalty fee payments. Over the past few years, an alternate approach has been explored, as some audit cases were initiated and led by provincial/local tax bureaus, supported by information and data collection schemes (e.g. ‘global supply chain data’ and ‘1000 enterprises’ schemes).

With an increased number of experienced personnel in the anti-avoidance department, the STA still orchestrates audits on a nationwide basis. Certain initiatives are delegated to specialised anti-avoidance teams at provincial and local level (amid streamlining of taxation administration). Thus, initiating a large TP audit case does not necessarily follow a ‘top-down’ approach.

Having said this, the process used to select TP cases for audit has become more sophisticated, the period of investigation and negotiation have become longer (as long as 10 years, based on the statute of limitations), and involvement of government officials has become more extensive (tax officials from local, provincial and central STA level may participate, in addition to the panel of TP experts). Certain local jurisdictions have started to increase their expertise in specific industry segments (e.g. automotive, pharmaceuticals, etc.), or specific topics such as ownership of intangible property or valuation of equities in relation to transfers, as well as other topics in relation to wider BEPS initiatives.

Value chain analysis continues to be a common thread that runs through national and local initiatives. In the wake of the BEPS initiatives and a recent revision of China’s TP rules, Chinese tax authorities often apply value chain analysis as an empirical test and/or cross-reference for a conventional TP analysis, rather to support application of a one-sided transactional net margin method (TNMM) analysis or a profit split exercise.

Separately, inbound Chinese businesses often experience controversy with the Chinese customs authority with respect to their import prices in the supply chain. Because customs and tax administration are separate functions in China, not surprisingly, there may be divergent views regarding the pricing of related party transfers. As interactions between these two functions increase in the coming years, it may be reasonable to anticipate that a more coordinated approach will evolve regarding cross-border transfers of tangible property between related parties.

India

The TP controversy environment in India has matured in the last decade. The tax authorities have moved from doing en masse audits, selected largely on quantum of international transactions, to using data analytics in identifying high-risk cases. This is being done using an integrated data warehousing and business intelligence platform. The specific risk parameters used are not disclosed, but based on experience they are mostly in line with factors commonly used by other countries, such as the taxpayer’s audit history, presence of transactions involving intangible property, business restructurings, management charges etc. This case selection factors also

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Aaron has served clients across a wide range of industries and has been active in controversy resolutions such as TP assessments, national tax audits, and has helped multinational companies secure certainty on their complex TP issues. As a project leader, he has concluded bilateral APAs, bilateral APA renewals and MAPs for quite a few of his clients.

Aaron started his professional career in Shanghai and has worked in Beijing, Singapore and Suzhou at different stages of his career before his returning in 2014. This experience greatly expanded his professional exposure and network.
incorporate considerations like non/partial-compliance with TP filings, search and seizure cases and prior-year adjustments upheld at the judicial level.

The issues generating controversy have also advanced from selection of comparable companies to more complex topics such as royalties, loans & guarantees, advertising and marketing promotion (AMP) payments, etc.

As a result of these changes, the number of audits has declined in the past few audit cycles. In order to dissuade unnecessary appeals by the tax authorities against favourable orders given to taxpayers, the monetary thresholds for filing appeals have been raised. However, the number of cases pending at various judicial levels continues to remain high. Hence, to bring certainty and reduce the year-on-year litigation burden on taxpayers, APA and MAP remain the most effective solutions.

Under the APA scheme in India, a taxpayer can obtain certainty for up to nine years by applying for an APA with rollback. The average time to conclude an APA in India is about 36 months. Over the past seven years, close to 1,200 APA applications have been filed, out of which 320 agreements have been signed as of December 2019, covering simple as well as complex transactions. However, nearly 90% of the signed agreements are unilateral APAs. The limited number of BAPAs shows that implementation of APAs in India is still at a relatively early stage.

The majority of the BAPA applications are with only four countries – US, UK, Japan and Switzerland. One of the key reasons for the small number of BAPAs and limited to a few treaty partners is that historically the Indian tax authorities insisted that the applicable tax treaty include Article 9(2) or its equivalent. This precondition was eliminated in
November 2017, which came as a welcome step for taxpayers and going forward it is expected that more BAPAs will be signed by India.

MAP has also proved to be a useful mechanism in resolving TP disputes. During the period between April 2014 and December 2019, approximately 660 tax disputes involving about 180 taxpayers have been resolved under MAP. Based on the recommendations of the OECD’s peer review report and India’s commitment to implement BEPS Action 14 point actions, the tax authorities amended the existing regulations on MAP in May 2020, the key highlight being that the Indian CA shall endeavour to arrive at MAP resolution within an average period of 24 months. The OECD MAP Statistics for 2018 show that India has a large inventory of pending MAP cases relating to TP – more than 700. Hence, a time bound commitment would clearly help in resolving taxpayer issues.

Over time, the CA meetings have also become pragmatic; in the past few years we have seen that the CAs are agreeing on lower mark-ups compared to mark-ups imposed at the audit stage. There have also been rulings that APA and MAP results may have some persuasive value before the courts for on-going cases.

Overall, the TP controversy landscape in India is showing signs of maturity which augurs well both for taxpayers as well as tax authorities. This would also help in improving the case of doing business in India; the key will be to sustain the momentum.

South Korea

The South Korean tax regime recognises a number of potential ways to resolve TP controversies and disputes. Such remedies mainly consist of tax appeal procedures available at the conclusion of a tax audit and procedures followed by CAs.

Subsequent to the tax audit but prior to receipt of the tax assessment notice (TAN), a taxpayer may file a request for a review of appropriateness on tax imposition. After receipt of the TAN, the taxpayer has additional remedies available before filing an administrative protest. Specifically, the taxpayer may file an objection to the District Tax Office or a commissioner of the National Tax Service (NTS) in the region that issued the TAN.

Alternatively, the taxpayer may also make a request for an examination to the Commissioner of the NTS or an appeal to the National Tax Tribunal (NTT) without filing an objection. The taxpayer, however, cannot request both an examination and an appeal on the basis of the same disposition. The taxpayer may instead elect to appeal to the Board of Audit and Inspection (BAI) for examination and appeal. Finally, the taxpayer can file an administrative protest only after he has made an appeal to at least one of NTS, NTT, or BAI.

Whereas the above-mentioned procedures involve taking a position opposed to the tax authority, other TP dispute resolution mechanisms rely on a cooperative approach to reduce tax risks. When the tax authority of one country disagrees with the arm’s-length price of cross-border controlled transactions, the tax authority may impose additional taxes, which poses a risk of economic double taxation.

In this situation, assuming a tax treaty is in place, the taxpayer may request the tax authorities to invoke the MAP and resolve the underlying tax dispute, with the goal of eliminating double taxation. In most cases, an agreement between the CA of South Korea and the CA of the treaty partner must be reached within five years from the date of commencement, with the potential to continue for an additional three years. Statistically, the normal MAP processing time in South Korea takes from two to five years, depending on the complexity of the case.

The APA procedure is another way to reduce potential tax uncertainty regarding cross-border related party transactions and to minimise the tax risks occurring from TP audits. The APA procedure is initiated at the taxpayer’s request and any agreement is subject to the approval of the Commissioner of the NTS. Once an APA is concluded between the CAs, the taxpayer can use the approved TP method as the most appropriate method and the taxpayer’s transfer price is accepted as arm’s-length during the APA term, so long as the taxpayer complies with the terms and conditions set out in the APA.

The APA primarily applies to the transfer pricing of future inter-company transactions, but taxpayers may also request that APA results be rolled back to past years. The average time to conclude an APA is one year and nine months for a unilateral APA and two years and six months for a BAPA. One noteworthy change in the APA process is that starting in 2020, a new team was created in NTS to exclusively run pre-filing meetings (PFC). Previously, PFCs were allocated to different teams by territories. Taxpayers may face some delay in securing a PFC, as they will only have a single channel to request a PFC in NTS.

In general, a tax audit is not suspended by an APA request raised by the select tax audit taxpayer. The NTS, however, may suspend the audit on transactions during the APA-covered period if the taxpayer appropriately requests an APA on the transactions at issue before it receives notice of a tax audit.
Building the tax controversy environment in Africa, Southeast Asia and the Middle East

Fred Omondi, Carlo Llanes Navarro, Anil Kumar Gupta, Lenny Saputra and Rabia Gandapur look into how developing economies across the world are embracing increasingly complex transfer pricing framework.

Africa, Middle East (ME) and Southeast Asia (SEA) are fast becoming key markets for multinational enterprises (MNEs) globally. However, the transfer pricing (TP) environment in each of these regions is at a different stage of evolution. In this article, the authors describe local nuances that taxpayers may face while navigating the TP controversy environment in each of these geographies.

Though Africa and SEA have had TP regulations for more than a decade with formal compliance requirements in most countries, the TP controversy rules have evolved differently in each region. In Africa, controversy strategy revolves around local litigation with less emphasis on advance pricing agreements (APAs) and mutual agreement procedures (MAPs). On the other hand, MAP plays a key part in SEA for the dispute resolution process. Formal TP regulations in some ME countries have been introduced fairly recently and it is expected that more countries in ME will follow suit. However, interestingly, TP-related enquiries are already becoming quite common – which is true also for jurisdictions wherein detailed TP rules are yet to be introduced. This shows that taxpayers must face a different set of challenges in each country, reflecting the complexities of local processes and distinct levels of sophistication on the part of the specific tax authority.

Africa

There is pressure on revenue authorities to meet revenue targets against the backdrop of rising fiscal deficits, debt levels and depressed commodity prices. This has increased the frequency of tax audits and compliance checks, resulting in a growing number of tax disputes.

While approaches by revenue authorities differ from country to country, most audits are triggered by perceived risks and the potential for assessment of additional tax. Some of the common triggers include:
The type of industry or sector;
Quantum of related party transactions;
History of low profitability or losses in consecutive years;
Specific transactions such as royalties, management and technical fees;
Inter-company loans, as well as group structures that involve entities in no/low tax jurisdictions.

In some cases, audits are triggered by whistle blowers or by data that are available publicly in various publications and in media reports. Even information in company/group reports and websites can enable the revenue authority to obtain data on the performance of the larger group, as compared to the local entity. It is therefore important for taxpayers to pay special attention to the above risk indicators and develop adequate support for their transactions and policies.

The nature of disputes has continued to evolve with changes in tax legislation and enhancement of the technical capacity of many revenue authorities. While disputes in the past revolved around basic compliance issues, many controversies now arise due to differences in interpretation of legislation and other technical positions adopted by the revenue authority. Disputes in relation to the application of tax treaties has also been witnessed. For instance, many African countries levy withholding taxes on cross-border service type payments, giving rise to disputes regarding the applicability of withholding tax in that context.

Specific to TP, most revenue authorities are adopting a subjective view and challenging the evidence around proof of receipt of services and benefits, as well as requesting documentary support beyond what is expected can be provided in practice. From a compliance perspective, the key challenges involve potential characterisation of the local entities as well as the tendency to disregard critical comparability factors and therefore to reject benchmarking studies provided by taxpayers.

Most countries in Africa provide a formal mechanism for resolving tax disputes. Typically, the first step involves filing an objection to the assessment, which is reviewed within the revenue authority. At this stage, it is advisable to provide as much support and explanations as possible, as many revenue authorities have a tendency to confirm assessments promptly. It is therefore important to file an appeal if the revenue authority does not agree with the objection.

In the first instance, appeals are usually brought before quasi-judicial tribunals or boards and subsequent appeals are in the courts of law. While there is a growing body of precedents in relation to tax cases, challenges still remain, including questions regarding the independence of tribunals, as members of these tribunals/dispute resolution bodies are appointed and assisted by the same revenue authorities who have a direct interest in the outcome of tax disputes. The courts may also face capacity constraints and as a result the amount of time to resolve cases may be lengthy.

Such challenges have led to growth of alternative dispute resolution, which is now taking root in a number of countries including Kenya. This mechanism allows taxpayers to choose to settle cases through structured negotiations with the revenue authority to arrive at an amicable settlement. While this route is useful in some cases, it does have limitations, especially where the dispute is purely on interpretation of the legislation, as the lack of controlling precedents leaves room for future disputes.

Countries like Nigeria, Egypt, Tanzania, Botswana and Uganda have provisions for APA, however, in practice revenue authorities have not concluded APAs mostly due to lack of capacity. Taxpayers may initiate MAP requests as well; though, a limited number of MAP cases have been presented, due to practical difficulties and delays in conclusion of MAP. As such, both APA and MAP have not been very effective in African countries.

As the number of disputes continues to rise, those taxpayers, who are proactively managing their tax risk and engaging with the revenue authorities to mitigate the potential exposure, will do well. On their part, authorities should enhance the clarity of tax legislation through supporting guidelines, practice notes and rulings, and should endeavour to improve the dispute resolution mechanisms in terms of capacity and objectivity.

Southeast Asia
SEA is a significant economic force and driver of global growth. MNEs are transforming industry and business operations to cope with technological progress and demand. Tax authorities in the SEA region are becoming more sophisticated in handling TP controversies. As a result, SEA MNEs are more exposed to TP disputes with tax authorities. Whilst most SEA countries have TP legislation, Malaysia and Indonesia are the most active when it comes to TP audit.

Malaysia
TP audit is a key focus of the Inland Revenue Board of Malaysia (IRBM). The practice continues to evolve in the post-base erosion and profit shifting (BEPS) world.

Further, amid increasing demands for tax transparency, Malaysian tax enforcement agencies are using Big Data and Internet of Things (IoT) for taxpayer profiling, flagging potential issues, and identifying higher-risk cases.

Post-BEPS, Malaysian controversies involve:
- Marketing intangibles: There is increased scrutiny if intensive marketing activities are performed by the distributor. The issue is whether these activities are appropriately compensated as a part of overall distributor returns.
In relation to trade intangibles, the IRBM examines ‘indefinite royalty period pay-outs’. This is to ensure that customisation or technology enhancements are given due consideration when determining royalty rates, especially from the perspective of development, enhancement, maintenance, protection, and exploitation (DEMPE) of intangibles;

- Management fees are increasingly questioned from the perspective requiring documentation of benefits to the recipient. The low value-added services guidelines recently issued by the OECD have not yet been accepted by the IRBM;
- Increased focus on control-over-risk: In a contract manufacturing situation, low margins/losses are always questioned on the basis of which party controls risk (i.e. at whose behest was capacity expanded or the decision taken to introduce a new product line); and
- Berry ratio compensation for sogo shosha entities.

The penalty regime is linked to the amount of underpayment of taxes. It ranges between 30 to 50% and is required to be paid before proceeding with the domestic appeal procedure/MAP.

As a litigation route, after the conclusion of audit and payment of additional demand, the taxpayer can file an appeal before the Dispute Resolution Panel (DRP). Appeal of the DRP decisions may be made to the Special Commission of Income Tax, the High Court and the Court of Appeal. Malaysia has relatively few court rulings concerning TP matters. Moreover, protracted litigation at higher appellate forums involves extensive time and
resources. In most cases, this delay incentivises amicable settlements.

To manage economic double taxation, MAP is available through most tax treaties. The procedure is aligned with BEPS Action 14 (although mandatory arbitration is generally not available).

Indonesia
For the last three years, in reviewing taxpayer’s application of the arm’s-length principle, the Directorate General of Taxes (DGT) has focused on:
- Income tax return overpayment (refund position) which automatically triggers tax audit;
- Intra-group service payments that require proof of existence of services; benefits enjoyed; and the arm’s-length nature;
- Supporting documents including, but not limited to, agreements, curriculum vitae (CVs), timesheets, cost allocation details, copies of correspondences are required.
- The concept of low value-adding intra-group services (LVAS) has not yet been adopted in Indonesia;
- Return on value added costs policy was introduced as part of ‘remuneration based on economic value added’. It questions the extent to which parties bear risks for certain activities in Indonesia.
- For example, an Indonesian limited risk distributor (LRD) is remunerated by reference to a margin on its operating expenses. This is because the sales price of imported goods sold locally is controlled by the group. The taxpayer is often challenged to show tangible aspects of control over risks performed by the group; to show how these differ from other LRDs remunerated for cost of sales and operating expenses; and to demonstrate how the policy is executed and if it is accepted in a third-party situation.
- Similar to Malaysia, and since Indonesia is a prime market, challenges exist on whether the taxpayer has performed significant marketing activities to enhance the value of the intellectual property (IP) owned by the IP owner.
- If it disagrees with the outcome of the tax audit, a taxpayer may pursue further domestic dispute routes i.e. objection.

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Anil has worked on a wide variety of TP issues that include planning, evaluating TP models, supply chain management, operational TP, local and regional documentation, high-end litigation, APA and MAP proceedings.

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and appeal. Through its counterparty, the taxpayer may also initiate MAP simultaneously with the domestic dispute process. However, any MAP that is in process is automatically cancelled once a court verdict is issued.

Middle East
The Middle East (ME) region’s tax landscape has gone through unprecedented changes, with certain countries introducing value added tax, country-by-country reporting (CbCR) requirements, and economic substance regulations, all in the span of two years.

As such, the approach of tax authorities in the region has evolved substantially, and while there remain some areas of development, there is a clear directive from local governments to establish a robust regulatory framework, aligned with international best practice. This is visible through governments investing heavily in the underlying infrastructure of tax departments and regulators, increasing the number of dedicated TP staff, hiring TP specialists from mature markets, and upskilling and increasing the capacity of tax departments, as well as collaborating and cooperating with international organisations such as the OECD and UN.

The ME’s various jurisdictions are at different stages of TP evolution, with some countries like the Kingdom of Saudi Arabia (KSA) and Egypt having detailed TP legislation while others such as the Sultanate of Oman (Oman), Jordan, Lebanon making general reference to the arm’s-length principle. To provide insights across the spectrum, here we focus on KSA, one of the largest jurisdictions in the region, and Oman, which while it does not have detailed TP legislation, does have an increasingly active controversy landscape.

Kingdom of Saudi Arabia (KSA)
As a G20 member state, the KSA continued its efforts to align with the BEPS Action Plan and introduced detailed TP legislation and CbCR rules in 2018. The General Authority of Taxation and Zakat (GAZT) has pursued a transformational path, ramping up its capabilities to capture and analyse data and has significantly increased its audit activities. Its focus has primarily been on MNEs inbound into the KSA, particularly persistent loss-making entities.

Other challenges have included MNEs which have low margins or which pay management, technical or consulting charges to overseas affiliates. Business restructurings and ‘free of charge’ transactions, as disclosed by MNEs in the related party disclosure form submitted with the tax return, are also common triggers for TP audits and controversy. Material high value transactions or those with tax havens as counterparties have also attracted increased attention.

The GAZT has recently introduced MAPs and continues its alignment with the international tax environment. Once fully implemented, the MAP process will help mitigate the risk of double taxation for MNEs operating in the country.

The GAZT is increasingly taking a holistic view of cross-border activities of MNEs, taking into account not only TP but also wider considerations such as permanent establishment (PE) risk, withholding tax, customs and VAT, and bringing together specialists in all these areas when assessing MNEs’ cross-border activity.

Sultanate of Oman (Oman)
While Oman’s income tax law does not contain detailed TP legislation, MNEs are experiencing increased audits in relation to related party transactions. The law refers to the arm’s-length principle and increasingly, the Oman Tax Authority (TA) has been raising enquiries into cross-border activity as part of their tax audits. A number of global MNEs operating in Oman have objections underway with the TA.

The challenges relate primarily to related party transactions with no/low tax countries like the UAE and Bahrain, where many MNEs base their regional headquarters. MNEs in Oman with low margins (or losses) are frequently challenged, specifically with respect to related party purchases,
cross-border funding as well as management fees and other support costs. The challenges from the TA typically include the disallowance of a portion of the above charges, particularly in cases where limited or no TP documentation supports the related party arrangements.

MNEs should be prepared for TP related audits in the ME, even in jurisdictions without comprehensive TP legislation. It is important to ensure that local entities of MNEs are supported by central TP departments to ensure the application of globally consistent, centrally controlled TP policies, which consider the group’s overall strategy and approach. However, this needs to be balanced with the involvement of local TP experts who understand the nuances of operating in the region, the practices and interpretations of the local tax authorities, to ensure that TP controversy can be handled most effectively.
Transfer pricing controversy
Strategic advice and technology-driven tactical support

The continued reform of the international tax landscape has resulted in increased demands for transparency.

Deloitte's transfer pricing specialists advise and deliver a sense of control and confidence over our clients' controversy lifecycle:

**Dispute prevention**
- Planning and preparation to reduce disputes
- Documenting and preparing evidence and defense files
- Reviewing and advising on global strategic controversy awareness policies
- Bilateral and multilateral advance pricing agreements (APAs)
- Advance rulings and unilateral APAs
- Pre-transaction engagement with tax authorities
- Ongoing proactive engagement with tax authorities

**Dispute resolution**
- Transfer pricing inquiry handling and closure assistance
- Global inquiry process tracking
- Assisting negotiation of tax authorities
- Analysis, economic, legal and technical support
- Appeal and litigation support
- MAP and arbitration support

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Transfer Pricing
Resolve your tax controversy issues

Recognized in International Tax Review’s 2020 Tax Controversy Guide as the leading controversy service provider, our global tax controversy network spans 69 countries and is made up of over 3,000 transfer pricing professionals, many of whom are former tax authority officials and lawyers. We have completed over 4,300 controversy projects in the past 3 years, including over 850 Bilateral and Unilateral Advanced Pricing Agreements, 600 Mutual Agreement Procedures, and thousands of TP Enquiries and TP Litigation.

Leveraging our global network’s collective knowledge across tax, accounting, economics, and legal combined with industry expertise, we deliver clarity, consistency, and confidence. We work with you to proactively understand your risk exposure and resolve your tax controversy issues.

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