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It has been a great privilege to edit this second edition of *The Transfer Pricing Law Review*, and in particular to welcome additional contributions from a range of countries including India, Japan and Switzerland.

This publication aims to give readers a high-level overview of the principal transfer pricing rules in each country covered. Each chapter summarises the substantive transfer pricing rules, explains how a transfer pricing dispute is handled – from initial scrutiny to litigation or settlement – and discusses the interaction between transfer pricing and other parts of the tax code, such as withholding taxes, customs duties and attempts to prevent double taxation.

With the notable exception of Brazil, which adopts a formulary approach (discussed in detail in the Brazil chapter), all countries covered in this review apply an arm’s-length standard and adhere, at least to some extent, to the OECD Transfer Pricing Guidelines. However, as these chapters make clear, there remains significant divergence both in countries’ application of the arm’s-length standard (e.g., which transactions does it apply to? Which pricing methods are preferred? Are secondary adjustments required?) and in the documentation requirements imposed. Transfer pricing practitioners, therefore, cannot simply assume that the OECD Guidelines contain all the answers, but must engage with their detailed application in each country.

This review contains contributions from 23 countries, covering four continents and eight of the world’s 10 largest economies. We are very grateful to all the authors for lending their time and expertise to this project.

Transfer pricing rules are, of course, a central plank in governments’ fight against profit shifting, and the application and evolution of these rules will (rightly) continue to be high up the corporate tax agenda for many years to come. It appears that, over the next year or so, there will be three principal areas of focus:

- **a** Tax authorities are beginning to get to grips with the first set of country-by-country reports disclosed to them. This is likely to lead to more disputes in the short to medium term. In particular, many tax authorities will now take a greater interest in businesses’ full value chain, and whether the reward for all of the countries in the value chain is commensurate with their contribution. Merely looking at the provision between the local company and its contractual counterparty will no longer suffice.

- **b** As Edward Froelich and Jessica Stern note in the United States chapter, the sweeping tax reforms passed in the US at the end of 2017 will have a significant impact on transfer pricing worldwide. Many public controversies surrounding transfer pricing have involved US companies that historically have been entitled to leave profits from overseas sales in low- or no-tax countries until the relevant cash was distributed back to
the US, even where those profits were properly attributable to DEMPE functions based in the US. The 2017 US tax reforms have removed the ability to do this, substantially reducing the benefits that US businesses could derive from allocating too much profit to IP owners and too little profit to local distributors. However, this new regime has retained a preferential tax rate for overseas sales through the FDII and GILTI regimes. Given change in law risk, it looks likely that many US businesses will continue to keep their IP offshore and pay tax under the GILTI rules, rather than onshoring it to the US.

Similar public controversies have also driven a number of countries to advocate special tax regimes for digital businesses, which move away from the arm’s-length standard. Digital taxes have already been enacted in India, Israel and Italy, and furthermore, both the European Union and United Kingdom have proposed ‘interim’ tax solutions for digital businesses, which involve some form of revenue-based tax. This has the potential to take some of the political heat out of the transfer pricing debate; equally, however, it could prompt other countries to ask whether, like Brazil, a non-arm’s length standard should be applied for industries outside the digital arena.

Finally, we would like to thank the publishing team at Law Business Research for their diligence and enthusiasm in commissioning, coordinating and compiling this review.

**Steve Edge and Dominic Robertson**
Slaughter and May
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Chapter 1

AUSTRIA

Gerald Schachner, Walter Loukota and Stanislav Nekrasov

I OVERVIEW

The primary domestic provision for the arm’s-length principle regarding cross-border transactions is Section 6(6) of the Austrian Income Tax Act, which is interpreted by the Austrian Ministry of Finance along the lines of Article 9 of the OECD Model Tax Convention. As far as the inter-company economic relationship with the European Union is concerned, it is Article 4(1) of the European Arbitration Convention that requires the application of the arm’s-length principle. Accordingly, transfers of assets or services between related parties must be valued at a price that would be realised if the asset or service was sold to unrelated parties. Exceeding amounts are not tax-deductible with the entity acquiring the asset or service, and amounts below the market value lead to a profit markup with the entity transferring the asset or rendering the service.

Section 8(2) of the Austrian Corporate Income Tax Act provides the general principle (also relevant for mere domestic deals) that hidden profit distributions from a corporation to its shareholders do not reduce the taxable profit of the corporation, and Section 8(1) of the Austrian Corporate Income Tax Act correspondingly provides that hidden contributions by a shareholder to its corporation do not increase the taxable income of the corporation (which is – together with the general rules for dividend withholding tax – the basis for secondary transfer pricing corrections; see Section VIII).

Additionally, the Transfer Pricing Documentation Act and an implementing ordinance were enacted in 2016 on the basis of the Organisation for Economic Co-operation and Development (OECD) and G20’s Base Erosion and Profit Project, which contains special provisions for transfer pricing documentation for large multinational enterprises exceeding certain thresholds of their annual turnovers (see Section II).

The Austrian Ministry of Finance follows the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations for the interpretation of the arm’s-length principle. Additionally, several decrees and the Austrian Transfer Pricing Guidelines 2010 have been issued by the Austrian Ministry of Finance, and are based on a (dynamic) interpretation

1 Gerald Schachner is a partner, Walter Loukota is an attorney-at-law and Stanislav Nekrasov is an associate at bpv Hügel.
3 ‘Verrechnungspreisdokumentationsgesetz-Durchführungsverordnung’ – VPDG-DV.
of the OECD Transfer Pricing Guidelines. The arm’s-length principle interpreted along these lines is applicable for all economic transactions between related parties (i.e., regardless of the assets transferred or services rendered between related parties).

As stipulated in Section 6(6) of the Austrian Income Tax Act, taxpayers holding over 25 per cent of the share capital in a foreign company or foreign taxpayers holding over 25 per cent of the share capital in an Austrian company, as well as taxpayers under the management, control or influence of a third taxpayer, are treated as related parties. Also, the owner is regarded as a related party to its enterprise, and the partners of a partnership are regarded as related parties to the partnership. Individuals and Austrian private foundations can be related parties as direct or indirect shareholders of corporations. The same is true for foreign estates or trusts if they are treated as legal entities for tax purposes (i.e., if they are comparable to a corporation on the basis of a comparability analysis).

II FILING REQUIREMENTS

The Austrian tax authorities require the taxpayer to set up transfer pricing documentation, based on the OECD Transfer Pricing Guidelines and in accordance with the Austrian Transfer Pricing Guidelines 2010 issued by the Austrian Ministry of Finance. Such transfer pricing documentation must be kept by any related party subject to tax in Austria (i.e., whether it is an Austrian corporation, shareholder or partner of a foreign related party, or an Austrian permanent establishment of a foreign corporation). The transfer pricing documentation should enable the Austrian tax authority to investigate in the case of a tax audit whether the transactions of the Austrian taxpayer with its related parties were at arm’s length.

The transfer pricing documentation should contain a function and risk analysis regarding the transactions with related parties. Such documentation should include the main assets concerned, the contractual conditions agreed upon, the taxpayer’s business strategy, the conditions of the market, as far as they are relevant for the pricing, and a chart of the position of the taxpayer in the international group. The taxpayer has an increased burden of proof in international tax cases, which has been implemented in the law, but was formerly based on standing case law of the High Administrative Court. On the basis of this increased duty of care, transfer pricing documentation of foreign related parties can be requested by the Austrian tax authorities from an Austrian enterprise in an Austrian tax audit, if it is relevant for the Austrian transfer pricing question.

Special rules are set out in the Transfer Pricing Documentation Act, as mentioned above. Austrian group companies are submitted to the Transfer Pricing Documentation Act if they have an annual turnover of over €50 million in two consecutive years (or €5 million of commission fees from the principal). Such enterprises must keep the master file or their local file and file it directly with the tax administration if so required by the competent tax authority. As far as the contents of the master file are concerned, an Austrian ordinance based on the Transfer Pricing Documentation Act follows the description contained in Annex I to

6 Ibid., Paragraph 310.
7 Section 115(1) Federal Fiscal Procedures Act.
8 Ritz, Bundesabgabenordnung5 Section 115(10).
Chapter V of the OECD Transfer Pricing Guidelines. Annex II to Chapter V of the OECD Transfer Pricing Guidelines describes which core information is expected to be found in the local file.

Large multinational enterprises with a consolidated group revenue of at least €750 million must take part in the country-by-country reporting for accounting periods beginning on or after 1 January 2016. Austrian enterprises that are required to submit a country-by-country report must do so electronically, using the standardised forms to the Austrian Tax Office of the Austrian company responsible for the report, within 12 months of the end of the accounting year (Section 8(1) of the Transfer Pricing Documentation Act). In general, the ultimate parent company of the multinational must annually file the standardised country-by-country report with its tax administration, which then distributes it to all participating jurisdictions where entities of the multinational have been set up. The Ministry of Finance must communicate the information contained in the country-by-country reports 15 months after the last day of the relevant accounting year at the latest. The first communication must be made within 18 months after the end of the first accounting year starting on or after 1 January 2016 (by June 2018 for an accounting period ending 31 December 2016). The participating jurisdictions are listed on the OECD’s website.9

If the ultimate parent company is not legally obliged to file a country-by-country report in its country of residence, the resident country is not a participating jurisdiction, or a ‘systematic failure’ in submitting country-by-country reports occurs, the Austrian tax administration may request, by formal decree, that an Austrian entity belonging to the multinational takeover the filing responsibility for the multinational, unless another entity of that multinational is prepared to replace the ultimate parent company with regard to the filing obligation (Section 5 of the Transfer Pricing Documentation Act).

III PRESENTING THE CASE

i Pricing methods

According to the Austrian Transfer Pricing Guidelines 2010, all methods as set out in the OECD Guidelines (traditional transaction-based methods, such as the comparable uncontrolled price, resale price, and cost-plus methods; and transactional profit methods such as profit split and transactional net margin methods) are recognised. Other methods are also allowed, but in practice they are not often used.

With respect to the comparability analysis, Austria strictly follows the comparability analysis of the OECD Transfer Pricing Guidelines. The Austrian Transfer Pricing Guidelines describe the relevant comparability factors in Paragraph 50 as concerning the product and service,10 the functions performed,11 the contractual conditions agreed upon,12 the market conditions13 and the business strategy.14

In principle, if all methods are evaluated with more or less the same degree of appropriateness, the ‘traditional methods’ (comparable uncontrolled price in the first place

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10 OECD Transfer Pricing Guidelines, Paragraph 1.39 et seq.
11 Ibid., Paragraph 1.42 et seq.
12 Ibid., Paragraph 1.52 et seq.
13 Ibid., Paragraph 1.55 et seq.
14 Ibid., Paragraph 1.59 et seq.
Austria

and then resale price method or cost-plus method based on gross margin comparisons) should be preferred compared to the ‘profit methods’.\textsuperscript{15} If no reliable data can be identified with respect to the gross margin, the net margin methods should be used.\textsuperscript{16}

The application of the comparable uncontrolled price method faces practical difficulties as it requires a high level of comparability. Where it is, however, possible to identify comparable uncontrolled transactions, especially if services similar to those rendered to associated enterprises are also rendered to independent parties, this method is considered very reliable and is used with respect to goods, IP or financial services.

The cost-plus method is, in principle, applied with respect to goods and services, especially for the delivery of semi-finished products to related parties.\textsuperscript{17} The Austrian Transfer Pricing Guidelines stipulate a markup somewhere between 5 per cent to 15 per cent with respect to routine services.\textsuperscript{18} A markup of more than 5 per cent is applied for high-quality services. Markups should always be determined case by case, taking into account the functions, risks borne and assets employed by the respective tested related party. When using the gross markups, comparable enterprises with the same cost base and functions must be given; for example, a routine distribution function cannot be compared with a distribution based on self-generated intangibles (e.g., owing to self-generated market access).\textsuperscript{19} In some cases, a cost allocation without a profit margin is admissible for ancillary services.\textsuperscript{20}

Whenever a cost-plus method is applied, all costs that are economically related to the controlled transaction (e.g., services rendered or goods manufactured) need to be included in the markup. Hence, in the case of production costs, it is not only all direct costs but also the indirect costs incurred over the course of the production (with the exception of general overheads such as advertising expenses) that need to be taken into account.\textsuperscript{21}

As regards the sale of goods, a distinction must be made between toll manufacturers and distribution companies. Whereas the cost-plus method can be used for toll manufacturers,\textsuperscript{22} the resale-minus method or comparable uncontrolled price method should be used for distribution companies.\textsuperscript{23} Based on comparability factors, benchmark studies are also used to find the appropriate markup. Benchmark studies are, however, usually based on net margins (EBIT) instead of gross margins, and always require an exact documentation of the comparability of the compared enterprises with special focus on functions, assets and risks.

ii Authority scrutiny and evidence gathering

The compliance of a company with transfer pricing rules is reviewed by the tax authorities during ordinary tax audits. The competent tax authorities have the obligation to investigate the tax positions \textit{ex officio}. For the same period, only one tax audit is admissible. The taxpayer has an increased obligation to cooperate and to disclose truthfully any information requested by the tax authorities in cross-border matters.\textsuperscript{24} Therefore, a sufficient and structured

\begin{itemize}
  \item \textsuperscript{15} Austrian Transfer Pricing Guidelines 2010, Paragraph 43.
  \item \textsuperscript{16} Ibid., Paragraph 43.
  \item \textsuperscript{17} Ibid., Paragraph 27; OECD Transfer Pricing Guidelines Paragraph 2.39.
  \item \textsuperscript{18} Ibid., Paragraph 77 et seq.
  \item \textsuperscript{19} Ibid., Paragraph 32.
  \item \textsuperscript{20} Ibid., Paragraph 77.
  \item \textsuperscript{21} Ibid., Paragraph 28.
  \item \textsuperscript{22} Ibid., Paragraph 70.
  \item \textsuperscript{23} Ibid., Paragraph 24, 72 et seq.
  \item \textsuperscript{24} Section 115(1) Federal Fiscal Procedures Act; \textit{Ritz}, Bundesabgabenordnung5 Section 115(10).
\end{itemize}
documentation on transfer pricing is mandatory to provide evidence of arm’s-length pricing. If the taxpayer violates its obligation to cooperate reasonably (e.g., no or insufficient documentation on transfer pricing is available), the tax authorities have the possibility to estimate the tax base on a reasonable basis.

IV  INTANGIBLE ASSETS

There are no special transfer pricing rules as regards intangibles in Austrian transfer pricing legislation. Austria follows the approach stipulated by the OECD Transfer Pricing Guidelines, including for intangible property. In practice, the transactional profit split and comparable price method is most suited for determining the arm’s-length pricing as regards intangible property, whereby the latter can be used only if comparable data on intangible assets exists, which is difficult (i.e., for valuable and unique intangibles). An accepted and widely used means of determining the transfer price for intangibles is the determination of the expected discounted cash flows from the use of the intangible.

As regards the identification of intangible assets (also defined in BEPS Actions 8–10) Austria fully follows the interpretation of the OECD, as it is also laid down in Chapter VI of the Transfer Pricing Guidelines 2017. In this context, it is often an issue in Austrian tax audits in the case of a transfer of a business or business parts between related parties, whether an adequate remuneration was paid for goodwill (including profit potential) to the Austrian enterprise that has transferred its business or business parts. However, profit potential also needs to be remunerated in cases where no business was transferred (e.g., in case of contractual positions).

Austrian tax authorities follow the principle that the economic owner of the IP is regarded as the person to which the income derived from the IP has to be allocated for tax purposes. By the same token, the DEMPE principles, as described in BEPS Action 8, are followed by the Austrian tax authorities (i.e., that the person or persons who control the development, enhancement, maintenance, protection and exploitation of the intangibles are relevant for the determination of the economic owner of the intangible, which should be documented appropriately).

V  SETTLEMENTS

In Austria, the following transfer pricing settlements with the tax authorities exist: the taxpayer may obtain an informal tax ruling that provides protection on a good-faith basis if, inter alia, the tax ruling has been issued by the competent tax authority and the taxpayer has made exactly the dispositions or transactions described in the ruling request that he or she otherwise would or would not have made.

Since 2011, taxpayers have also been able to apply for a legally binding advance tax ruling to determine an appropriate set of criteria (e.g., transfer pricing methods and appropriate adjustments) with respect to transfer pricing matters. Such an application must contain a comprehensive description of the envisaged transaction; an explanation of the applicant’s special interest in the issuance of the requested ruling; description of the legal issue; the concrete legal questions; a legal opinion; and information with respect to the administrative costs. Thus, issued rulings by the tax authorities are unilateral (i.e., with no involvement of the tax authorities of other treaty states) and based on the facts and circumstances presented by the taxpayer with respect to the envisaged transaction. Such rulings must be communicated
in the frame of a mandatory automatic exchange of information system to all other Member States, as well as to the European Commission within the European Union. The fee depends on the size of the taxpayer’s annual turnover (when the turnover exceeds €400,000, the basic amount of €1,500 is gradually increased up to a maximum of €20,000 for a turnover of €40 million). Advance tax rulings as well as informal tax rulings are not released publicly. Only advance tax ruling decrees can be appealed to the Federal Tax Court. Any deviation of the implemented structure from the described facts will have adverse impacts on the binding effect of both the informal tax ruling and the advance tax ruling.

In addition, on the basis of Double Tax Conventions that contain a provision that reflects Article 25(3) of the OECD Model Tax Convention, cross-border advance pricing arrangements can be negotiated by the Ministry of Finance on a bilateral or multilateral basis. In Austria, such agreement procedures are initiated by the Federal Ministry of Finance ex officio or upon request of a taxpayer, and can, for instance, be used to obtain matching (corresponding) adjustments in the other contracting state in the case of primary adjustments in one contracting state.

However, the procedures can also be used to obtain solutions to uncertain questions of interpretation of the law of a tax convention, which can be of generic nature or in relation to a specific case. As far as they are used for international agreements to solve discovered transfer pricing problems in an abstract manner, they can be released publicly. The tax authorities do not charge any administrative fee for the issuance of informal rulings and informal advance pricing arrangements.

VI INVESTIGATIONS

The assessments of corporate income tax and value added tax (VAT) by the tax office, which take place annually based on the taxpayer’s annual tax returns, are audited by the tax office ex post in more or less regular intervals. There are no specific time limits for the tax authorities to conduct an audit. Usually, a period of three years for which tax returns have been filed or tax assessments have been issued is covered by an audit. The taxpayer has to be informed about of a tax audit at least one week before its start, unless the purpose of the audit would be jeopardised by such information.26 Transfer pricing issues are also audited by the tax office in the course of the regular audits of the corporate income tax or VAT returns of a company (i.e., together with other issues of these taxes related to the audited taxpayer). Transfer pricing aspects are usually an important issue in tax audits of international groups of companies. However, in the case of an audit with an individual, a transfer pricing issue in relation to his or her position as a shareholder of a company can also come up in the course of the audit of the individual’s income tax or VAT assessment.

The tax authority has to investigate ex officio the facts that form the basis for taxation, but the taxpayer has a duty to cooperate with the tax office, to clarify his or her standpoint, prove the content of its declarations and supply to the tax authorities all the information that is needed to ascertain the facts alleged that are relevant for taxation. This includes business books, accounts and records, and the information necessary to understand the records, such

as, in the case of a transfer pricing audit, an adequate transfer pricing documentation. The duty to cooperate is stronger in cases of international tax matters, as far as circumstances abroad are concerned.27

At the end of the transfer pricing audit, the auditor discusses his or her findings with the taxpayer in a final meeting. The auditor's final report (a copy of which has to be handed over to the taxpayer) is the basis for the adjusted assessment decrees to be issued. Upon the finalisation of the tax audit, a decree on the re-opening of the original assessment and an amended tax assessment are issued by the tax authority. Unless the taxpayer opted for a waiver of the appeal, the appeal can be lodged by the taxpayer against both the assessment decree of the tax audit and the adjusted tax assessment decrees within a period of one month after the issuance of the decree. The period for the appeal can be extended upon request of the taxpayer. If the period for the appeal elapses without any appeal being lodged, there is the possibility to lodge an extraordinary remedy within one year of the issuance of the re-opening decree or the adjusted tax assessments decrees in case of mistakes on behalf of the tax authority as regards the legal qualification of the decrees (not regarding wrongful fact-finding).

VII LITIGATION

i Procedure

If the taxpayer wants to change the assessment of the tax audit, he or she may lodge an appeal against the assessment decree within one month following the issuance of the contested tax assessment notice by the tax authority. The period for the appeal can be extended by the tax office upon request of the taxpayer.

Upon the filing of the appeal, the tax office has first the possibility to amend or withdraw the contested tax assessment according to the appeal in a pre-decision, unless a direct transmission to the Federal Fiscal Court was requested in the appeal and the tax office transmits the appeal without a pre-decision or in case that the appeal only pleads issues to be raised before the constitutional court (i.e., that a law does not correspond to the constitution or an ordinance does not correspond to a law).28

A pre-decision can be contested by the taxpayer within one month, whereby this period can also be extended. Upon contesting the pre-decision, the case has to be transmitted without delay to the Federal Fiscal Court, where it will be heard. Against the decision of the Federal Fiscal Court, the taxpayer can appeal to the Supreme Administrative Court (regarding matters of interpretation of tax law with fundamental importance) or the Constitutional Court (the latter if the assessment or decision violates a constitutional right or guarantee, or an unconstitutional law was applied when rendering the contested decision).

The Federal Fiscal Court’s decisions are not bound to the reasons of the appeal; it has full power of recognition (i.e., it can either cancel the contested decree or change the contested decree in every direction, including to the detriment of the taxpayer). The Federal Fiscal Court can examine both the fact-finding and the discretion applied by the tax authority for the fact-finding as well as matters of interpretation. However, the Supreme Administrative Court (the second and last judicial instance) will not perform any factual investigations, nor will it review the facts and circumstances provided by the Federal Fiscal

27 Section 115(1); Ritz, Bundesabgabenordnung5 Section 115(10).
28 Section 262(2) and (3) Federal Fiscal Procedures Act.
Court. If facts and circumstances were determined by the Federal Fiscal Court by neglecting fundamental procedural rules, the decision of the Federal Fiscal Court will also be cancelled by the Supreme Administrative Court and the case re-directed to the Federal Fiscal Court.

After an appeal is filed, the tax office must make its decision within a period of six months provided it was not requested that it may refrain from doing so (see above). If the decision is not made within six months, the taxpayer is entitled to file a complaint against the tax office’s inactivity with the competent tax court. If such a complaint is levied, the tax office has three months to make its decision. The same time frame applies to the tax courts, whereby complaints against the tax courts’ inactivity are filed with the Supreme Administrative Court. In practice, it usually takes courts more time to come to their decision than envisaged by the statute. A tax trial may take approximately between six and 30 months, depending on the court and the subject matter of the case. An appeal before the Supreme Administrative Court may take between nine months and 36 months, whereas the Constitutional Court is usually quicker to decide on the claims levied that fall within its scope of competency.

VIII SECONDARY ADJUSTMENT AND PENALTIES

Tax-increasing transfer pricing adjustments are made in a tax audit if a profit shift from an Austrian company to a related party leads to a reduction of profits (e.g., by underpricing services rendered or goods delivered or by overpricing services acquired or goods received). The primary adjustment consists of an increase in profit of the Austrian related party by the Austrian tax audit as far as a deviation from the fair market level was given.

Additionally, the following ‘secondary adjustments’ are made:

a In the case of upstream or side-stream profit-shifting to a shareholder, parent company or sister company, a hidden profit distribution to the direct shareholder or parent company is assumed. Alternatively, the profit adjustment may also result in a transfer pricing receivable:

• the assumption of a hidden profit distribution to the shareholder triggers withholding tax of 27.5 per cent (37.93 per cent, if the withholding tax is borne by the company and not charged to the beneficiary of the distribution); withholding tax amounts to 25 per cent (33.33 per cent) in the case of a parent company being the direct shareholder (and treated as dividend at the level of the receiving parent company). The secondary adjustment can fully or partly be relieved according to a double tax treaty or EU rules like the parent-subsidiary directive, if applicable between Austria and the residence state of the direct parent company or shareholder (if the subsidiary is in Austria) or the residence state of the subsidiary (if the shareholder is in Austria); and

• alternatively, the Ministry of Finance accepts that the profit shift is effectively neutralised by a transfer pricing receivable (in the case of a profit shift made) or liability (in the case of a profit shift received) versus the related party in the balance sheet of the Austrian company, to neutralise the profit shift.

b In the case of downstream profit shifts to the direct or indirect subsidiary, the secondary adjustment is either the assumption of a hidden contribution to the subsidiary that leads to an increase of the acquisition costs of the participation at the level of the Austrian parent company (for tax purposes) if the parent company is in Austria, or
capital reserve (for tax purposes) if the subsidiary receiving the advantage is in Austria. Alternatively, the secondary adjustment can (again) be the booking of a transfer pricing receivable and corresponding liability in the balance sheets of the related enterprises.

c In the case of a profit markup due to a primary transfer pricing correction, a matching corresponding adjustment can be made in the other country in which the related party is resident. This is to avoid international double taxation under a double tax convention (see Section IX.ii. ‘Double Taxation’).

If transfer pricing corrections lead to the assessment of additional amounts of (corporate) income tax, interest for late payment of 2 per cent above the base interest rate (published by the tax authorities) is assessed.29 Interest for late payment is calculated from 1 October the following year, and is assessed for a maximum of 48 months of the tax arrears. Upon request, no interest for late payment is assessed if the taxpayer had a surplus on the tax account during the time in which the arrears accrued.

In addition, late payment penalties of 2 per cent can be assessed for arrears of VAT (or withholding tax for hidden profit distributions), which can be increased by two further percentage points.30 Upon the taxpayer’s request, no late payment penalty is assessed insofar as the taxpayer can prove that the failure to pay the appropriate amounts of tax was not the result of gross negligence. This also speaks in favour of reasoned opinions on the transfer pricing structure to be added to the transfer pricing documentation. In the case of deliberate tax evasion due to non-compliance with the taxpayer’s obligation of truthful disclosure of facts and circumstances in connection with transfer pricing rules, prosecution under criminal law can arise.

IX BROADER TAXATION ISSUES

i Diverted profits tax and other supplementary measures

In Austria, there is currently no diverted profits tax as adopted in the UK (e.g., ‘Google tax’), and no other special supplementary measures for digital enterprises. The governmental programme of the new Austrian government stated in December 2017 that, within the next five years, the issue of a digital permanent establishment shall be addressed (see BEPS Action 1) by the Austrian legislator, but we are not aware of any concrete plans as to how the implementation is planned.

ii Double taxation

In the case of profit adjustments in Austria due to transfer pricing corrections, international double taxation can occur if no corresponding adjustment is made abroad in the country in which the other related party is resident. It may be possible to receive such corresponding adjustment upon request of the related party; otherwise, the parent company can request the initiation of a mutual agreement procedure under Article 9(2) OECD Model Tax Convention with the competent authority of its residence state.31 In the EU, it is possible to obtain a corresponding adjustment by means of the EU Arbitration Convention.

There are no automatic matching adjustments of transfer prices by the Austrian tax authorities in cases of primary adjustments abroad. However, in the case of primary adjustments inflicted to a related party in another contracting state of a double tax convention, the Austrian tax authority in charge is, in principle, willing to reopen the relevant tax assessment of the Austrian related party to make a matching primary adjustment either upon request of the Austrian related party or if the Austrian related party can demonstrate and document the correctness of a transfer pricing markup made in the other contracting state.

Otherwise, a mutual agreement procedure with Austria can be initiated. The request has to be made by the parent company to which a primary adjustment was made in its resident state or in the case of transactions between sister companies in either of the resident states of the sister companies. Based on the EU Arbitration Convention, it should be possible to initiate the arbitration procedure in either of the states.

Double taxation may be unavoidable, corresponding to the Austrian view, if it is based on different interpretations of the double taxation convention by the contracting states and no solution is found in a mutual agreement procedure (unless such mismatch is due to different domestic laws of the contracting states, in which case the residence state of the taxpayer has to relieve according to the method for elimination of double taxation of the applicable double taxation convention).

iii Consequential impact for other taxes
Transfer pricing is mainly a matter of corporate income tax or personal income tax (in the case of individuals as shareholders). Dividend withholding tax of 27.5 per cent (to be relieved according to applicable double tax treaties or EU law) is applied as a secondary adjustment for hidden profit distributions if the taxpayer concerned does not decide for a correction of the profit shift by booking a transfer pricing receivable against the other related party, see Section VIII).

The company’s deduction of input VAT is denied insofar as the price for goods or services obtained from a related party is above the market level. The company’s deduction of input VAT is denied in total for goods, assets or services, which are acquired primarily from third parties (more than 50 per cent) for the benefit of a related party.

In the case of a sale of goods to a related party below the acquisition cost, only the difference between the sales price and the acquisition cost would be regarded as a deemed turnover subject to VAT, whereas, in the case of a sale at or above acquisition cost, the difference to the fair market value is subject to VAT (unless, in both cases, the place of the supply is outside Austria or an exemption applies).

34 Austrian Transfer Pricing Guidelines 2010, Paragraph 352.
36 Ibid., Paragraph 367.
37 Austrian VAT Guidelines 2000 Paragraph 1930; Windsteig, in Melhardt/Tumpel, UStG § 1 Paragraph 300; Supreme Administrative Court 27 May 1999, 97/15/0067.
39 Windsteig, in Melhardt/Tumpel (Ed) UStG2 § 1, Paragraph 297.
40 Ibid.
In principle, a correction of the invoice would be necessary for VAT purposes in these cases. However, for the sake of simplicity, the Austrian Ministry of Finance accepts that increases of the taxable turnover do not need to be assessed at the occasion of a transfer pricing correction if the profit shift and the effect of the additional VAT liability is neutralised.\textsuperscript{41} This is especially the case if the supply is exempt (as export or intra-community delivery)\textsuperscript{42} or the counterparty is entitled to an equal deduction of input VAT.\textsuperscript{43} Regarding goods received from related parties of third countries, the Ministry of Finance normally neglects an assessment of import VAT, so long as such assessment would be neutral because of an equally high entitlement to deduction of input VAT.\textsuperscript{44} For customs-duty purposes, transfer pricing is relevant and has been subject to increased attention by the customs authorities.

\section{Outlook and Conclusions}

Like other countries, Austria has adopted several OECD BEPS recommendations and already implemented most of them, such as BEPS Action 13 on ‘Transfer Pricing Documentation and Country-by-Country Reporting’ in its Transfer Pricing Documentation Act and the respective Ordinance (see Section II). Austria was the first country that signed the Multilateral Convention to implement tax treaty-related measures (MLI) as provided for in BEPS Action 15 and will be one of the first countries for which the MLI will enter into force on 1 July 2018.\textsuperscript{45}

There will be no specific implementations of BEPS Actions 8–10 with regard to transfer pricing rules on value creation. However, these Actions are already respected by the Austrian tax authorities, as they largely reflect the update of the OECD Transfer Pricing Guidelines, which are used by the Austrian tax authorities as a means of interpretation of the arm’s-length principle. It is expected that the government will tackle issues as provided in the BEPS Action Plan for CFC legislation or thin-capitalisation rules; however, the Austrian Ministry of Finance is of the opinion that the existing rule denying the deduction of interest and royalty payments to related parties in the case of low-taxation abroad may already correspond to the requirements of the thin-capitalisation rules.

As regards transfer pricing conflicts between jurisdictions, Austria has opted for the arbitration provision of the MLI. In its double tax treaties, Austria has comprehensive provisions that provide for the mutual agreement procedure between contracting states according to Article 25 OECD Model Tax Treaty, and is ready in treaty negotiations to extend the arbitration further. In this context, one may note a specific feature in the Double Tax Conventions, such as the convention between Austria and Switzerland providing for independent arbitration courts, or in the tax convention between Austria and Germany, where a special provision\textsuperscript{46} provides for the competence of the European Court of Justice according to Article 273 of the Treaty of the Functioning of the EU (ex-Article 239) if the mutual agreement procedure under the Double Tax Convention cannot be solved within three years, which has already been made use of.\textsuperscript{47}

\textsuperscript{41} Austrian Transfer Pricing Guidelines 2010, Paragraph 338.
\textsuperscript{42} Ibid., Paragraph 339.
\textsuperscript{43} Ibid., Paragraph 340.
\textsuperscript{44} Ibid., Paragraph 341.
\textsuperscript{45} Bendlinger, SWI 2018, 172.
\textsuperscript{46} Double Tax Convention Austria-Germany, Article 25, Paragraph 5.
\textsuperscript{47} ECJ 12 September 2017, C-648/15 Austria versus Germany; See also Kerschner/Koppensteiner/Seydl, Österreich erhebt aufgrund einer DBA-Streitigkeit erstmals Klage beim EuGH, SWI 2016, 134.
I OVERVIEW

Although the arm’s-length principle, which forms the basis of the framework of transfer pricing rules, has had a long international history, it was only explicitly introduced into Belgian legislation in 2004. The Belgian legislator used the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations Guidelines (the OECD Guidelines) and the OECD Model Tax Convention as inspiration.

Belgium does not incorporate all OECD principles and guidelines into law. Nevertheless, the tax administration recognises that the latest version of the OECD Guidelines is especially relevant in practice. The tax authorities use continuously revised and updated guidelines whereby the most recent version of the OECD Guidelines was issued in 2017, including the outcomes of the final 2015 Base Erosion and Profit Shifting Reports on Actions 8–10 ‘Aligning transfer pricing outcomes with value creation’ and on Action 13 ‘Transfer pricing documentation and country-by-country reporting’.

Article 185, Section 2 of the Belgian Income Tax Code (ITC) allows for a unilateral adjustment of a company’s taxable basis, both upwards (Article 185, Section 2(a) ITC) and downwards (Article 185, Section 2(b) ITC). This provision is aligned to Article 9 of the OECD Model Tax Convention for transactions whereby conditions are made or imposed between two enterprises in their commercial or financial relations that differ from those that would be made between independent enterprises. Article 185, Section 2 ITC has been slightly revised, applicable as of 1 January 2018, to eliminate the basis to grant excess profit rulings (EPR), which has been considered by the European Commission to be state aid.

The arm’s-length principle is an integral part of Belgian tax legislation and applies to both legal entities and permanent establishments. In addition, Belgian law covers all types of transactions without differentiation of the nature of the transaction between associated companies, including those between two Belgian taxpayers, as Belgium in particular has no
fiscal consolidation concerning direct taxes currently. Some form of fiscal consolidation will only enter into force as of fiscal year 2019. In practice, the tax authorities tend to focus on transactions with related foreign parties.

The Belgian concepts of ‘associated enterprise’ and ‘control’ are not comparable to the terms used in the OECD Model Tax Convention and must be explained by Belgian company law. The definition of associated enterprise in the EU Arbitration Convention requires direct or indirect participation in the management, control or capital of the other enterprise. Control can be described as a power to decide or to have a decisive influence on the appointment of the majority of the directors or managers, or the course of corporate policy, whether legally or factually. Further, reference should also be made to Belgian company law and case law for more guidance on the notion of ‘control’ and other concepts, such as ‘parent company’, ‘subsidiary’, ‘consortium’ and ‘affiliated enterprise’.

In addition to Article 185, Section 2 ITC and the recently enacted transfer pricing documentation rules, other articles of the ITC are relevant when making transfer pricing analysis in Belgium. Reference can be made to Article 26 ITC dealing with the possibility of the Belgian tax administration to add abnormal or gratuitous advantages granted to an individual or enterprise located in Belgium or abroad to the taxpayer's tax base. Article 49 ITC sets general rules for tax deduction of expenses. These rules require, inter alia, that the expenses relate to the taxpayer’s activity and that they are incurred in order to maintain or increase taxable income. Articles 54 to 56 ITC contain specific rules for tax deduction of interest, royalties and some other fees. Article 79 and 207 ITC together form a specific anti-abuse provision preventing that ‘abnormal or gratuitous advantages’ obtained can be offset against certain tax deductions (e.g., carried-forward tax losses). High court case law has confirmed that the non-arm’s length advantage received has to be subject to Belgian corporate income tax in any event. This rule may result in double taxation, both in Belgium or internationally.

Other resources are a Royal Decree and official Circulars, which are administrative guidelines issued by the Belgian tax administration. Such guidelines are not, however, considered a binding source of tax law.

II FILING REQUIREMENTS

Belgium has introduced specific transfer pricing documentation requirements applicable as of 1 January 2016. The Programme Law, which introduced these documentation requirements,
Belgium

includes a three-tiered approach, allegedly (according to the lawmakers) aligned with the OECD BEPS Action 13 Final Report, consisting of a Master File Form (Form 275MF), a Local File Form (Form 275LF) and country-by-country reporting. This section will only deal with Form 275MF and Form 275LF, particularly focusing on the latter as it is to be considered an integral part of a company’s tax return.

Statutory transfer pricing documentation requirements currently exist for Belgian entities or permanent establishments when one of the following thresholds is surpassed based on its annual (unconsolidated) financial statements related to the accounting period immediately preceding the last accounting period:

a operating and financial revenues\(^{12}\) of €50 million (excluding non-recurrent revenue);
b a balance sheet total of €1 billion; or
c an annual average number of employees of 100 full-time equivalents.

Hence, the evaluation of surpassing the statutory thresholds and submission of Form 275MF and Form 275LF is an annual exercise. The content of Form 275MF is similar to the content requirements of the OECD. The Belgian legislator has indicated in additional communication that the form can be filed by referencing to a separate Group Master File to be attached to Form 275MF. Form 275MF is not part of a company’s tax return, but it should be filed to the Belgian tax authorities no later than 12 months after the last day of the reporting period concerned for the respective group.

Form 275LF is considered an integral part of the tax return and, consequently, has a different filing due date than Form 275MF. The Belgian legislator says to follow the OECD three-tiered approach with regard to documentation requirements, notwithstanding the content of Form 275LF, which deviates significantly from the content requirements of the local file under the OECD Guidelines. In particular, Form 275LF consists of three parts: two mandatory (Parts A and B), and one optional (part C).

Questions in Part A comprise general company information including, among others:

a a description of the managerial and organisational structure;
b an overview of the reporting structure with a focus on the reporting lines for fiscal purposes;
c an overview of the activities of the Belgian company based on the identification of business units (relevant for Part B);
d a list of the entity’s most important competitors; and
e key data, such as identification of the entity’s ultimate parent entity.

Part B questions concern the intra-group transactions between the local entity and its foreign affiliates, and includes, in particular, financial data, comparability analyses checkboxes and a selection of the most appropriate transfer pricing method that is mainly presented in table formats. The requirement for completing Part B questions (i.e., the detailed information form) will only apply when at least one business segment of the Belgian group entity has cross-border intra-group transactions exceeding €1 million in total.\(^{13}\)

In the optional Part C, the taxpayer may add any information that ‘may be useful’, such as transfer pricing studies. Looking forward, the benefits of Part C should become apparent

\(^{12}\) Reference has to be made to gross revenues.
\(^{13}\) The Part B questions are mandatory as of 1 January 2017.
in evaluating the level of documentation to be added by a taxpayer, as the requirements currently in place (e.g., completing lists of tables) do not provide sufficient room for the correct amount of ‘storytelling’, which is a key item in the revised OECD Guidelines.

III PRESENTING THE CASE

i Pricing methods

The Belgian legislator does not include specific provisions in tax law as regards the use of transfer pricing methods. As mentioned, Belgium follows the OECD Guidelines and, as a consequence, the five transfer pricing methods as described in these OECD Guidelines (comparable uncontrolled price (CUP) method; resale price method; cost-plus method; transactional net margin method (TNMM); and transactional profit split method) are accepted in Belgium.

For the selection of the most appropriate transfer pricing method, no hierarchy is in place; however, in alignment with the OECD Guidelines, there is preference for the selection of traditional transaction methods given that they are regarded as the most direct means of establishing whether conditions in the commercial and financial relations between associated enterprises are at arm’s length. The CUP method is the most preferred method where it can be applied in a reliable manner, but based on experience, the TNMM is used in many cases since it often proves to be the only method applicable in practice. This is also accepted by the tax authorities, in particular for tangible goods and services transactions.

The tax authorities accept both internal and external comparables provided the degree of comparability can be proven. During a transfer pricing audit, tax inspectors will typically ask for a benchmarking study as underlying support for the compliance with the arm’s-length principle; consequently, comparables are of great importance in Belgium. There is no specific preference to have local comparables; pan-European benchmarking studies are commonly used, even by the tax authorities themselves, who do perform benchmarking studies during an audit to support their position.

The importance of business sense or economic justification in supporting adjustments made to comparables cannot be underestimated, as the tax authorities are open to enter into these discussions to evaluate the appropriateness of the reasons invoked by the taxpayer.

ii Authority scrutiny and evidence gathering

The Belgian tax authorities are increasingly interested in global tax transparency as it would create more opportunities for easy access to relevant information owing to the successful exchange of information between various jurisdictions and the availability of information as included in country-by-country reporting, which is mandatory in Belgium for multinational group companies with consolidated annual group turnover equal to or exceeding €750 million. The impact of the huge data flow that is available at the level of the tax authorities will transpire in the coming years, but an increase in joint or multilateral transfer pricing audits can be expected.

Taxpayers need to be attentive to the information requested by tax authorities, especially in relation to information for which they have no need-to-know basis, such as group information documented outside of Belgium. Tax authorities intend to request group information of a multinational group headquartered abroad or specific company information of a foreign group company that is the Belgian counterparty, for which specific procedures are in existence via the Federal Public Services Foreign Affairs, regulating the exchange of
information between tax authorities. Therefore, in certain circumstances, taxpayers can refuse to provide the requested information to the tax authorities, although the impact of this on the relationship between taxpayer and tax authorities will come under scrutiny.

Further, tax authorities mainly use publicly available information. In addition, they can visit the premises of a company under audit. During this visit, tax authorities have access to the premises and the companies’ information within the boundaries of what is reasonable. Taxpayers cannot be forced to hand over all information; nevertheless, they should think twice as it could affect the relationship with tax inspectors. Likewise, during their visit, tax authorities might have interest in interviewing employees of the targeted company. This may contribute to a better understanding of its business including the relevant functions performed, assets used and risks assumed. There is, however, no obligation for a company to cooperate with such interviews.

Last, based on Belgian tax law, witnesses can be heard. Although hearing witnesses is not common practice in transfer pricing cases, it is possible from a legal perspective.

IV  INTANGIBLE ASSETS

Neither Belgian tax law nor administrative guidelines include specific provisions with regard to dealing with intangibles from a transfer pricing perspective. Nevertheless, the DEMPE\textsuperscript{15} functions, as recently introduced by the OECD in the framework of BEPS, are taking precedence when establishing and evaluating the correct transfer price to be applied, especially given that Belgium closely follows the OECD Guidelines. Therefore, it is highly recommended that taxpayers ensure a transfer pricing set-up with regard to intangibles in accordance with the DEMPE functions. Consequently, purely having the legal ownership of an intangible without being the economic owner significantly involved in the DEMPE functions, will entitle the legal owner only to a relative small (passive) return. The economic owner, having sufficient substance to demonstrate it is actively involved in the DEMPE functions, will be entitled to intangible-related (non-routine) returns.

V  SETTLEMENTS

Settlements outside of a formal advance pricing agreement (APA) procedure with the tax authorities are not commonly used, except during transfer pricing audits as the majority of the audits are closed with a settlement between the local tax inspector and the targeted taxpayer.

The Service for Advanced Decisions, an autonomous service of the Federal Public Service Finances (FPS Finances), provides decisions on all questions relating to the application of tax legislation, including transfer pricing. An advance decision provides legal certainty as it is binding for all services of the FPS Finances (including the inspection services).\textsuperscript{16}

\textsuperscript{14} Article 325 ITC.
\textsuperscript{15} Development, enhancement, maintenance, protection and exploitation.
\textsuperscript{16} For more information on the procedures of obtaining an advance decision in Belgium, see: www.ruling.be.
VI INVESTIGATIONS

A typical transfer pricing investigation in Belgium starts with a written request for information (RFI) issued by the tax authorities, often by the special transfer pricing team (STPT), consisting of subject matter specialists since 2006.

This RFI, consisting of a standard questionnaire, is sent annually to approximately 250 multinational companies, mostly in the first months of each year. To select companies, the Belgian tax authorities perform data-mining techniques and software tools to fulfil a risk-assessment exercise. It is observed that companies incurring structural losses, undergoing business restructurings, having presence in tax havens or low-tax-rate countries, or companies with declining results are potential targets. Nevertheless, all companies might be subject to receive a RFI, going from large multinational companies to small and medium-sized enterprises. The likelihood of being selected as a targeted company increases each year given that the STPT is growing by hiring additional inspectors. Further, inspectors of the Large Companies team will be responsible for both transfer pricing and international tax audits. The STPT trained them in order to get up to speed on transfer pricing-related issues. Finally, the Special Investigation Squad (BBI/ISI) has also been trained by the STPT to cover transfer pricing-related matters.

Going forward, the selection of companies as a target for a transfer pricing audit will remain based on data-mining techniques and software tools. It is, however, expected that this selection process will be further fine-tuned as a consequence of the transfer pricing documentation requirements given the access of the tax authorities to information contained in Form 275MF, CbCR and most notably in Form 275LF being based on the standard questionnaire.

The RFI should generally be replied to within one month. In practice, taxpayers can formally request extension of this period if they are able to provide legitimate reasons for the non-timely provision of the requested information. Normally, an extension of maximum one additional month is granted; however, no formal timing is included in Belgian tax law on this matter, therefore taxpayers should count on the willingness of the tax inspector.

Before formally submitting the requested information, taxpayers can request a pre-audit meeting with the inspector to define and discuss the scope of the transfer pricing audit. Based on past experience, this pre-audit meeting gives an interesting opportunity for taxpayers to set the scene of the audit and to provide an oral presentation of the company and its business. This may help the inspector with interpreting the written reply to the RFI. This pre-audit meeting should take place within the initial term of one month (or the extended period) as it does not suspend this term.

Once the reply is submitted, no fixed time period is included in the Belgian tax law at the side of the tax authorities to take a position in a transfer pricing audit. In general, there is back-and-forth communication between the inspectors and the company under audit consisting of additional information requests, follow-up meetings, etc., before a final position is taken. Typically, this process takes almost one year, but may be longer or shorter depending

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17 A company is considered a large company, and thus falling under the competence of the Large Companies team, when exceeding at least two of the following thresholds: annual average full-time equivalents of 50; annual turnover, excluding VAT, of €9 million; or balance sheet total exceeding €4.5 million.
on the complexity of the file. This can lead to uncertainty for the taxpayer. Again, there is no time limit within which the tax inspectors should take their final position; they are bound only by the Belgian statute of limitations, being three years.\textsuperscript{18}

The next step is the notice of adjustment sent to the taxpayer when considered necessary by the tax authorities after in-depth investigation of the targeted company. Such notice amends the taxable basis as declared in the tax return.\textsuperscript{19} The taxpayer then has one month to react to this notice of adjustment, and extension of that term can be applied if there are legitimate reasons. The final standpoint of the inspectors is made available in the final assessment including the justification on the inspectors’ opinion, taking into account the relevant comments of the taxpayer.

Thereafter, the taxpayer has six months to start an administrative claim by lodging an appeal with the General Advisor of Taxes. The decision of the General Advisor of Taxes, explaining sufficient and sound reasons for the taxation, is addressed to the taxpayer. Notwithstanding the fact that the taxpayer has a strict time limit to lodge the appeal, again, the General Advisor of Taxes is not bound by any time limit. This may cause uncertainty at the level of the taxpayer. In order to avoid further delay, the taxpayer can start a judicial procedure before the Court of First Instance after a six-month term passed without final decision of the General Advisor of Taxes. This step then renders the General Advisor of Taxes no longer competent to decide and submits the case to the opinion of a judge.

\section*{VII LITIGATION}

\subsection*{i Procedure}

There are no specific litigation procedures in place for transfer pricing issues. The general judicial procedures existing in Belgium are available if taxpayers disagree with the decision of the tax authorities. Hence, a dispute can be brought before the Court of First Instance examining the merits of the case, for which the taxpayer has three months. Appeal against this decision can be made to the Court of Appeal within one month from the notification of the contested decision. Appeals against judgments of the Court of Appeal are brought before the Supreme Court, which does not evaluate the substance of the case but is limited to the evaluation of questions of law and procedural questions (i.e., whether the law has been applied correctly). The Supreme Court can refer the case again to a competent Court of Appeal that then re-examines the merits of the case. In contrast, when the Supreme Court is of the opinion that the law has been applied correctly, the judgment under review becomes final and binding for all parties involved.

\subsection*{ii Recent cases}

Belgium does not have a long history of transfer pricing in its tax law and, therefore, existing court decisions on this subject are rather scarce. In the majority of cases, transfer pricing audits are closed by an agreement.

\footnotesize{\textsuperscript{18} Article 354, Paragraph 1 ICT – the period during which the tax authorities are authorised to perform a tax audit and adjust the taxable basis is three years – with the exception in case of fraud, where the statute of limitations is extended to seven years – starting from the first day of the assessment year, at least for companies whose financial year correspond to the calendar year.}

\footnotesize{\textsuperscript{19} Article 346 ICT.}
VIII SECONDARY ADJUSTMENT AND PENALTIES

The Belgian tax authorities cannot impose secondary adjustments, as no such provisions are included in Belgian tax law. Hence, transfer pricing adjustments only affect items actually included in the tax return; no deemed transactions in the form of constructive dividends, constructive equity contributions or constructive loans that might trigger that secondary adjustment can be made. Therefore, in case there is an adjustment requiring an increase or decrease, a Belgian taxpayer may have to consider certain payments as non-deductible expenses or adjust the position of the taxable reserves.

Failure to timely submit statutory transfer pricing documentation may result in administrative penalties ranging from €1,250 to €25,000. These penalties will only apply as of the second infringement, unless it can be proven that the violation is made in bad faith or with tax avoidance purpose. Moreover, it is expected that the likelihood of a transfer pricing audit increases by the non-compliance with these transfer pricing documentation requirements. Further, specific consequences are inherently linked to the non-submission of Form 275LF as it is considered by the Belgian tax authorities to be an integral part of the corporate income tax return. Next to administrative penalties or tax increases that may apply in case of late or incomplete filing, from a procedural perspective, this may have important consequences (i.e., in case the local form would be incomplete, the tax authorities could take the position that the tax return was not filed correctly). In such case, *ex officio* assessments may apply.20

Except for non-compliance with statutory transfer pricing documentation requirements, Belgian tax law does not include specific penalty provisions with regard to transfer pricing. Transfer pricing adjustments imposed by the Belgian tax authorities fall under the general tax penalty framework applicable in case of any violation of the provisions of the ITC. Consequently, additional taxes might be applied by the tax authorities in the form of a penalty generally ranging from 10 per cent to 50 per cent, and even an increase to 200 per cent in exceptional cases of fraud, repeated infringement, etc., depending on the degree of intent to avoid tax or the degree of the company’s bad faith. Further, for late payments, interest is due on additional tax assessments (including assessments resulting from a transfer pricing adjustment). Penalties are not tax-deductible.

Recently, a new measure was introduced as part of the Belgian corporate tax reform. As of financial year 2018, the tax supplements imposed by tax authorities after an audit will be effectively taxed, since the increase of the taxable basis linked to an audit can no longer be sheltered with available tax deductions (e.g., current year losses). This rule applies if a tax increase of at least 10 per cent is effectively applied. However, current-year dividend-received deduction on inbound dividends can still be offset against the increase of the taxable basis.

As a rule, statutes of limitation for tax matters last three years. In the case of fraud, this term is extended to seven years.

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20 *Ex officio* assessment is made by the tax authorities based on the estimated amount of taxable income. The tax authorities estimate the taxable income based on information available to them. It is the taxpayer’s responsibility to prove otherwise if they do not agree with the *ex officio* assessment.
IX  BROADER TAXATION ISSUES

i  Diverted profits tax and other supplementary measures
Belgium does not have a diverted profits tax in its legislation. Notwithstanding this, the recent introduction of controlled foreign company (CFC) provisions in Article 185/2 ITC increases the focus on substance as one of the criteria to determine the application of CFC are relevant key functions.

ii  Double taxation
There is no doubt that transfer pricing adjustments can trigger double taxation in the case of an upward adjustment. Belgian taxpayers facing the issue of double taxation can invoke double tax treaties (DTT), which have been concluded by the Belgian tax authorities with its counterparties explicitly for the avoidance of double taxation. Most of the DTTs entail a mutual agreement procedure (MAP), whereby the treaty partners are encouraged to endeavour to resolve the case by mutual agreement by entering into negotiations with the respective competent authorities. Despite the efforts to which both treaty partners are encouraged, there is no obligation in the majority of DTTs to come to an agreement effectively eliminating double taxation. Some of the DTTs (although more often in exceptional cases notwithstanding the model tax convention of Belgium) include an arbitration clause in cases of disagreement between the competent authorities of the treaty partners, whereby a final and binding decision is being taken by an independent arbiter to eliminate the double taxation. For EU Member States, such arbitration resolution mechanism is regulated in the EU Arbitration Convention, whereby taxpayers can impose the opinion of an independent advisory body that is binding for the competent authorities of the treaty partners.

iii  Consequential impact for other taxes
Despite transfer pricing being related to direct taxation and value added tax (VAT), and custom duties are categorised as indirect taxation, it should be clear that they are inherently linked to each other, especially in the framework of transfer pricing adjustments.

Overall, VAT and customs duties are based on the consideration (i.e., price that is paid) for the supply of goods or services. First, the determination of the correct consideration from a VAT and customs perspective is not necessarily in accordance with how, from a transfer pricing perspective, an arm's-length price would have been established. Second, if transfer pricing adjustments are performed, for example, quarterly or annually, impacting the price of goods or services or create a separate supply of services in itself, VAT and customs duties consequences cannot be ignored with regard to these adjustments and action should be taken. It is recommended that Belgian taxpayers, when planning to perform transfer pricing adjustments, consider upfront the impact on their VAT and customs duties to avoid difficult discussions with the VAT and customs tax authorities, as these issues are gaining increasing attention from the Belgian tax authorities.

X  OUTLOOK AND CONCLUSIONS
The key outlook for future transfer pricing concerns the significantly increased focus of the Belgian tax authorities on: the access to a huge data flow from the exchange of information with foreign jurisdictions and statutory documentation requirements; the additional number of trained members of the STPT; the involvement of the large companies’ team to perform
tax and transfer pricing audits; and the training of the Special Investigation Squad. In respect of the latter, it is therefore crucial to not consider as a (tax-) juridical or economic issue, but consider from the outlook one’s optimal legal-economic position in an integrated manner.

Further, substance will become of incremental importance when evaluating transfer pricing and the alignment with the arm’s-length principle based on, for example, the DEMPE functions as introduced by the OECD, and the CFC provisions with regard to key functions.

Belgian taxpayers are therefore urged to put transfer pricing high on their agenda.
Chapter 3

BRAZIL

João Francisco Bianco and Ramon Tomazela Santos

I OVERVIEW

Brazil introduced transfer pricing rules in 1996 with the enactment of Law No. 9,430/1996, which aims to control the artificial transfer of profits to related parties abroad and to individuals or companies located in low-tax jurisdictions or subject to privileged tax regimes. To achieve this goal, Law No. 9,430/1996 established a set of methods to determine the maximum deductible price for import transactions and the minimum taxable revenue for export transactions.

Consequently, in relation to import transactions, the Brazilian transfer pricing rules state that the costs incurred by Brazilian companies in respect of their imports that exceed certain specified parameters are not deductible for tax purposes. With regard to export transactions, transfer pricing rules establish that, if Brazilian companies charge less for their exports than certain specified parameters, the difference between the revenue recorded in the accounting books and the minimum revenue established by the method is subject to corporate income tax (IRPJ) and social contribution on net profits (CSLL) in Brazil.

The Brazilian transfer pricing rules are unique, departing from the international standard found in the OECD Transfer Pricing Guidelines. The main differences are the following:

a. Brazil has not adopted the arm’s-length standard in full, in primarily opting for the use of predetermined profit margins, subject to some exceptions.

b. Brazil does not adopt the ‘best method rule’, according to which taxpayers should adopt the transfer pricing method that provides the most reliable arm’s-length result. Under the Brazilian transfer pricing rules, taxpayers may choose any method admitted under the law.

c. Brazil does not apply transfer pricing rules to royalties, fees for technical assistance and scientific and administrative fees. These amounts are subject to quantitative restrictions in respect of the deduction of expenses and to a withholding tax on the remittance of the income to the beneficiary abroad.

d. Brazil does not permit the application of transactional profit methods (i.e., the profit split method and the transactional net margin method (TNMM)).

e. Brazil does not provide for correlative and secondary adjustments.

f. Brazil does not enter into advance pricing agreements (APAs).

g. Brazil uses safe harbours that prevent the application of the methods to determine the parameter price if the taxpayer complies with safe harbour requirements.

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Brazilian transfer pricing practice is an alternative for the protection of tax revenues against base erosion and profit shifting. The recent proposals presented in Actions 8, 9 and 10 of the OECD/G20 BEPS initiative to ensure that transfer pricing outcomes are in line with value creation indicate that current transfer pricing rules based on the arm’s-length standard cannot deal with the changes in the global corporative business environment. In the view of the Brazilian tax authorities, it is difficult to achieve significant results with the application of a functional analysis to transfer pricing, while predetermined profit margins, at least, ensure a minimum level of taxation in Brazil.

In addition, the arm’s-length standard as adopted by the OECD may be too complex and costly to be applied consistently by developing countries. Consequently, the adoption of a more straightforward mechanism, such as the predetermined profit margins, permits developing countries to counter the manipulation of profits between related parties.

Also, despite the risk of economic double taxation, predetermined profit margins may bring about greater certainty for taxpayers, as it is possible to know in advance that, once the methods are applied, the amount to be taxed will not give rise to significant litigation.

Pursuant to Brazilian tax legislation, for the purpose of applying transfer pricing rules, the following parties are considered related to a Brazilian company:

- a) its head office if domiciled abroad;
- b) its affiliate or branch domiciled abroad;
- c) an individual or legal entity, resident or domiciled abroad, which is characterised as its parent (controlling) or associated company;
- d) a legal entity domiciled abroad that would be characterised as its subsidiary or associated company;
- e) a legal entity domiciled abroad, if it and the company domiciled in Brazil are under common corporate or administrative control, or at least 10 per cent of the corporate capital of each of them is owned by the same individual or legal entity;
- f) an individual or legal entity, resident or domiciled abroad, that, together with a legal entity domiciled in Brazil, has a holding in the capital of a third-party entity, the sum of which characterises them as controlling or associated companies;
- g) an individual or legal entity, resident or domiciled abroad, that is associated to a Brazilian company in a consortium or condominium, when defined as such in the Brazilian legislation, in any venture;
- h) an individual resident abroad who is a relative or kin up to the third degree, spouse, or companion of any of its directors or of its controlling partner or shareholder in a direct or indirect investment;
- i) an individual or legal entity, resident or domiciled abroad, that is its exclusive agent, distributor, or dealer for the purchase and sale of goods, services or intangible rights; and
- j) an individual or legal entity, resident or domiciled abroad, in relation to which the legal entity domiciled in Brazil is its exclusive agent, distributor or dealer for the purchase and sale of goods, services or intangible rights.

In addition to the above, Brazilian tax laws also provide that transfer pricing rules shall apply to transactions performed between a Brazilian company and foreign persons located in low-tax jurisdictions or subject to a privileged tax regime, regardless of whether there is a relationship between them or not.
II FILING REQUIREMENTS

Article 19 of Law 9,430/96 describes a safe harbour, which, if the taxpayer manages to comply with it, would waive the preparation of calculations and adoption of methods to determine a minimum standard price to be charged.

Under this rule, the taxpayer would not need to calculate the transfer pricing of its intercompany transaction if the amount of revenues it derives under the relevant transaction is greater than 90 per cent of the average price charged on the sale of the same product or the provision of the same service in the Brazilian market. The comparison must take place in the same period and under similar payment conditions.

Brazilian tax legislation also provides for a margin of divergence rule, which states that the minimum standard price determined based on one of the methods described above will be satisfactory, provided that the margin of divergence deviates by up to 5 per cent or less in comparison to the amount found in the import or export documents.

Regarding the documentation requirements, the taxpayer must prove that its import and export transactions comply with one of methods set forth by Law No. 9,430/1996.

Brazilian tax law does not specify the documents required from taxpayers, who are free to use all documents available to prove the conditions of their transactions, such as written agreements, invoices, spreadsheets and payment receipts, among others. Documents in foreign languages must be translated into Portuguese by a sworn translator.

The transfer pricing adjustments must be calculated on an annual basis (on 31 December of any given year) and reported on the annual tax return, which is part of the Tax Accounting Bookkeeping (ECF).

Unlike other countries, in Brazil taxpayers must only inform the transfer pricing adjustments in their tax return, without the formal submission of the documentation package. Thus, the supporting documentation will only be required in case of tax inspection, on which occasion the taxpayer will have to demonstrate that the transfer pricing control has been determined in accordance with Brazilian tax law.

III PRESENTING THE CASE

i Pricing methods

With regard to import transactions, the Brazilian transfer pricing rules provide for four methods in respect of the assessment of the maximum costs that can be deducted by taxpayers. These methods are summarised in the table below:

<table>
<thead>
<tr>
<th>Method</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Compared independent prices (PIC)</td>
<td>The average prices of identical or similar goods, services or rights in the Brazilian or any other market, in purchase and sale transactions and under similar payment conditions</td>
</tr>
<tr>
<td>Cost plus profit (CPL)</td>
<td>The average cost of production of identical or similar goods, services, or rights in the country where they have been originally produced, plus the taxes charged by such country on the exportation, plus a profit margin of 20 per cent of the cost, before the addition of tax</td>
</tr>
<tr>
<td>Resale price less profit (PRL)</td>
<td>The average resale price of the goods or rights less unconditional discounts granted, taxes levied on the sales, commissions paid and a profit margin that may vary between 20 and 40 per cent, depending on the economic sector</td>
</tr>
<tr>
<td>Quotation price on imports (PCI)</td>
<td>The daily average values of the quotation of commodities subject to public prices on internationally recognised commodities exchanges and futures</td>
</tr>
</tbody>
</table>
Except for the import of commodities, in respect of which the application of the PCI is mandatory, taxpayers are free to calculate the standard price on imports according to any of the methods described in the table above. However, the chosen method must be applied consistently throughout the calendar year to each type of product or service imported. If the import price effectively applied exceeds the highest standard price calculated according to the method chosen, any excess is not deductible for corporate tax purposes.

With regard to export transactions, the Brazilian transfer pricing rules state that specified methods must be used to assess the minimum revenue to be taxed in Brazil. These methods are set out in the table below:

<table>
<thead>
<tr>
<th>Method</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Export sales price (PVEx)</td>
<td>The arithmetical average of the sales price on exports of the company itself to other customers or by other Brazilian companies providing similar services, goods and intangible rights in the same tax year, under similar payment conditions</td>
</tr>
<tr>
<td>Production or acquisition cost-plus taxes and profit (CAP)</td>
<td>The arithmetical average of production costs of the services, goods and intangible rights exported, plus taxes imposed in Brazil and a profit margin of 15 per cent on the cost-plus taxes</td>
</tr>
<tr>
<td>Wholesale price in the destination country, less profit (PVA)</td>
<td>The arithmetical average of the sales price of identical or similar goods in the destination country wholesale market, under similar payment conditions, less taxes imposed in that country and a 15 per cent profit margin on the wholesale price</td>
</tr>
<tr>
<td>Retail price in the destination country, less profit (PVV)</td>
<td>The arithmetical average of the sales price of identical or similar goods in the destination country retail market, under similar payment conditions, less taxes imposed in that country and a 30 per cent profit margin on the retail price</td>
</tr>
<tr>
<td>Quotation price on exports (PECEx)</td>
<td>The daily average values of the quotation of commodities subject to public prices on internationally recognised commodities exchanges and futures</td>
</tr>
</tbody>
</table>

In general, legal entities domiciled in Brazil have the possibility to choose, among the methods available in Law No. 9,430/1996, the one that best suits their interests, except for PCI and PECEx, which are mandatory for transactions with commodities.

As can be seen, contrary to what happens in the international practice, Brazilian tax law adopted predetermined profit margins in the control of transfer prices, in a clear concession to the principle of practicability. This means that the main focus of Brazilian tax law is to avoid the base erosion and artificial transfer of profits through the manipulation of prices, to the detriment of the calculation of the wealth effectively manifested in each jurisdiction, according to the assets, risks and functions assumed by each contracting party involved in the legal transaction (functional analysis).

It should be noted that the methods set forth by Law No. 9,430/1996 are strict and objective, which means that the taxpayer is not entitled to apply alternative methods to prove that the price actually practised reflects the market standard, free of interference and manipulation. Likewise, tax authorities are not allowed to use alternative methods to arbitrate the parameter price, with the purpose of avoiding profit shifting.

When it comes to financial transactions, Brazilian tax legislation provides that interest subject to transfer pricing rules will only be deductible for IRPJ and CSLL purposes up to an amount that does not exceed the following rates, increased by a spread based on the market average to be defined by the Minister of Finance:

- market rates of sovereign securities issued by Brazil on the foreign market in US dollars, in the event of transactions at pre-fixed US dollar rates;
- market rates of sovereign securities issued by Brazil on the foreign market in Brazilian reais, in the event of transactions abroad at pre-fixed rates; and
- the London Interbank Offered Rate (LIBOR), for the term of six months, in other cases.
Similarly, in the case of loans granted by a domestic entity to a related party abroad, the lender in Brazil must recognise as minimum interest revenue an amount determined in accordance with the rates established above, increased by the spread determined by the Minister of Finance.

The spread to be determined by the Minister of Finance must be based on the market average. Currently, Ordinance MF No. 427/13 provides for a spread of 3.5 per cent for the deductibility of interest expenses and a spread of 2.5 per cent for interest revenues.

Since the enactment of Law No. 12,715/2012, all loan agreements (registered or not with the central bank) should now comply with the transfer pricing rules. Prior to the amendment, only interest payments performed under loan agreements not registered with the central bank were subject to the transfer pricing rules. These rules are applicable to loan agreements entered into as from 2013, regardless of their registration with the central bank. This registration is still required for regulatory purposes. Loan agreements concluded before the entry into force of the new law (i.e., before 31 December 2012) remain subject to the prior transfer pricing rules.

ii Authority scrutiny and evidence gathering

Brazil has recently introduced the country-by-country report (CbCR), by means of Normative Ruling No. 1,651/2016, for which reason there have been concerns expressed by companies about whether the information they report will be kept confidential and will only be used by tax authorities according to the Action 13 of the OECD/G20 BEPS.

Within the OECD countries, the CbCR is part of a three-tiered structure, along with a global master file and a local file, which together represent a standardised approach to transfer pricing documentation. However, in Normative Ruling No. 1,651/2016, Brazil has only introduced the CbCR in itself, without the global master file and the local file. This is because Brazilian transfer pricing rules are primarily based on predetermined profit margins. Therefore, Brazilian tax authorities will not be able to use the CbCR for transfer pricing purposes.

In the international setting, the CbCR will provide tax authorities with relevant information to start a robust transfer pricing analysis. Nonetheless, as previously mentioned, Brazil does not follow the international standard and the OECD Guidelines for transfer pricing purposes. Therefore, tax authorities in Brazil will probably not rely on country-by-country information to make transfer pricing adjustments, since the methods set forth by its domestic laws are primarily based on predetermined profit margins.

Thus, country-by-country information will probably be used by the Brazilian tax authorities to challenge the lack of substance of legal entities incorporated abroad.

With regard to the protection of confidentiality of the taxpayer information, it continues to be a serious concern relating to the exchange of country-by-country information. The transmission, use and storage of a large volume of information may pose a serious challenge for certain countries, since the management of such information depends on technological development and internal administrative capacity. In this scenario, it may be difficult, especially for developing countries, to implement the requirements for the protection of confidentiality of country-by-country information. Further, the CbCR will not be disclosed publicly in Brazil.

Finally, when it comes to the risk of leaking information, the ideal solution would be the establishment, in international agreements related to the exchange of information, of the joint and several liabilities of both countries involved in case of damages caused to the
taxpayer by the leakage of CbCR information. This is because, if a foreign state discloses, by malice or negligence, confidential information, the taxpayer will probably face several procedural difficulties filing a lawsuit against foreign tax authorities. With this mechanism of joint and several liability, the taxpayer would sue its own state of residence if relevant information from the CbCR is leaked.

IV INTANGIBLE ASSETS

The application of transfer pricing rules to intangible assets gives rise to several difficulties in practice, such as the following:

a lack of comparable transactions, due to the specificities of intangible assets;
b problems related to the valuation of intangibles;
c inexistence of similar assets;
d impossibility of replacement of certain intangible assets;
e difficulty in establishing a relationship between the value of the intangible and the costs associated with its development;
f measurement difficulties regarding its cost of production; and
g the possibility of sale in connection with other tangible products (embedded intangibles).

Brazilian tax legislation does not provide for a specific method for transactions with intangible assets, which implies that the same methods analysed in Section III must be applied by both taxpayers and tax authorities.

In practice, within the Brazilian tax system, the PIC and PVEx methods can only be applied for transfer pricing purposes if there are other transactions with identical or similar intangible assets, under similar commercial and economic conditions.

Similarly, the CPL and CAP methods may be used for transfer pricing purposes if it is possible to measure the cost of production of the intangible asset, in spite of the difficulties arising from the confidentiality involved in its formation.

The PVA and PVV methods may not be used, since these methods are specifically for goods traded in retail or wholesale markets located in the destination country. Along the same lines, PCI and PECEX are specifically for commodities.

As can be seen, the application of Brazilian transfer pricing rules to intangible assets raises difficulties in concrete cases, because the methods are based on predetermined profit margins and the domestic law does not allow the application of transactional profit methods (i.e., profit split and TNMM).

That being said, it should be noted that Brazil does not apply transfer pricing rules to royalties paid in consideration for the use of trademarks, patents, the provision of technical assistance, the transfer of know-how and for administrative assistance. However, the deduction of such expenses for tax purposes is subject to specific limits and conditions, which are intended to counter base erosion and profit shifting.

The fact that the payment of royalties is not subject to the transfer pricing rules reduces the focus of tax authorities on transactions with intangible assets, since these are the most significant intangible transactions carried out by Brazilian companies.

The deduction of royalties is limited to 1 to 5 per cent of the net sales price of the product or services connected to the patent, provision of technology or technical assistance.
The limit varies according to the business activity and the importance of the product or service in question for the Brazilian economy, as determined by Finance Ministry Ordinance No. 436/1958.

The deduction of royalties paid for the use of trademarks is limited to 1 per cent of the net sales price of the products, or the services, bearing the trademark.

Finally, Brazilian tax legislation provides that royalties paid to partners (individual or legal entities) or managers are not deductible for tax purposes.

V SETTLEMENTS

Transfer pricing settlements with the tax authorities and APAs are not applicable in Brazil, in the absence of express legal provisions. However, in special circumstances, Brazilian tax law provides that the Ministry of Finance may change the predetermined profit margins \textit{ex officio} or at the request of the taxpayer.

VI INVESTIGATIONS

A typical transfer pricing investigation starts with the inspection procedure, which involves successive written acts and documents intended to check the taxpayer for its tax regularity and, depending on the case, formalise the tax credit enforcement after all the investigations have been completed. At this point, although the inspection procedure is a public administrative proceeding, the tax authorities have not started tax litigation yet.

After the conclusion of the inspection procedure, the tax authorities may issue a tax assessment notice against the company under investigation to formalise the tax credit to be charged against the taxpayer.

Tax inspections on transfer pricing issues are subject to a five-year statute of limitations, counted as from the taxable event. In cases involving fraud, a malicious act or sham, the five-year statute of limitations should run as from the first day of the year following the taxable event. In practice, it means that, in such cases, the statute of limitations on the tax authorities’ right to issue the tax assessment notice to charge tax differences resulting from transfer pricing adjustments may be extended for up to one year.

After the tax assessment notice is issued, the taxpayer is allowed to submit an administrative defence or to start a lawsuit before the judicial courts. In general, administrative courts are more technically prepared for transfer pricing cases, although their members are less independent than career judges.

VII LITIGATION

i Procedure

As mentioned above, the taxpayer is allowed to submit an administrative defence against the tax assessment notice issued by the tax authorities, which will be initially judged by a first level council (DRJ).

If the DRJ’s first-level decision is unfavourable to the taxpayer, the taxpayer is notified to pay the tax debt upheld by the DRJ or file a voluntary appeal to the Administrative Court of Tax Appeal (CARF) headquartered in Brasilia. On the other hand, if the decision is unfavourable to the federal government, the Attorney General of the National Treasury is required to file a mandatory \textit{(ex officio)} appeal to the CARF.
Against the decision rendered by the CARF, it is possible to file a special appeal to the Superior Chamber of Tax Appeals (CSRF) if the interpretation adopted in the concrete case is divergent from the one adopted in other decisions delivered by other panels.

An ordinary case generally takes from three to five years to be decided at the administrative level. If the administrative defence ends up unfavourable to the taxpayer, a new discussion of the tax assessment before the judicial courts will be possible.

Recent cases

The main transfer pricing disputes between taxpayers and the authorities that have been litigated in courts in recent years are the following:

a legality of Normative Ruling SRF No. 243/2002, whose transfer pricing method seeks to include a proportional calculation in the parameter price determined under the PRL-60, based on the participation of the imported input in the sale price of the final product. This matter is now under discussion before the judicial courts;

b tax authorities are not obliged to prove that the transfer pricing method adopted in the tax assessment notice is the most favourable to the taxpayer;

c the value of the freight, insurance and import tax borne by the importer must be included in the acquisition cost, for the purpose of applying the PRL;

d Brazilian transfer pricing rules, based on predetermined profit margins, are not incompatible with Article 9 of tax treaties based on the OECD Model Convention;

e amounts derived from international credit notes issued to implement transfer pricing adjustments are subject to the levy of PIS and COFINS; and

f the impossibility of choosing the best transfer pricing method within the tax administrative proceeding.

VIII SECONDARY ADJUSTMENT AND PENALTIES

Brazilian tax legislation does not provide for secondary adjustments, which may be defined as a constructive transaction (constructive dividends, informal capital contributions or deemed loans) prescribed to ensure that the actual allocation of profits will be consistent with the primary adjustment determined by the transfer pricing rules.

However, in cross-border transactions, a secondary transfer pricing adjustment determined by the domestic law of the other country may have tax impacts in Brazil, not
only in relation to calculation of the actual price and the standard price for transfer pricing, but also with regard to the potential levy of IRPJ, CSLL, PIS and COFINS over the amounts received by the Brazilian company.

In this respect, it is important to avoid confusion between secondary transfer pricing adjustments and price adjustments.

Secondary transfer pricing adjustments may take the form of a new transaction aiming at reconciling the cash position of the parties with the primary (or correlative) transfer pricing adjustment. In these cases, the tax impacts of such secondary transfer pricing adjustment must be assessed in the light of its legal nature, which basically reflects a new transaction which produces effects over the original transaction undertaken by the parties.

A different situation occurs when the parties of a transaction decide to change the price originally charged for economic reasons.

A price adjustment occurs when the actual price of goods is adjusted by the parties of the original transactions, thereby producing an accounting impact on the selling party’s sales figure and on the purchasing party’s cost of goods sold figure. Unlike a secondary transfer pricing adjustment, which may take the form of a constructive transaction or an actual transaction, a price adjustment always requires an actual transaction that results either in a price reimbursement or in an additional price payment.

It should be noted that secondary transfer pricing adjustments are entirely based on domestic tax law, so that there is no specific treaty provision regulating this subject. Article 9 of the OECD Model Tax Convention does not deal with secondary transfer pricing adjustment, and thus it neither forbids nor requires tax authorities to make such secondary adjustments.

A 75 per cent punitive fine may be applied by the tax authorities against taxpayers who fail to comply with the Brazilian transfer pricing rules. Any punitive fine applied by tax authorities against the taxpayer must be duly formalised through the issuance of a tax assessment notice, because the tax authorities are required to meet the constitutional principles of lawfulness, morality, impersonality and publicity.

In any case, the taxpayer is allowed to submit an administrative defence against the tax assessment notice or to start a lawsuit before the judicial courts.

IX BROADER TAXATION ISSUES

i Double taxation

As mentioned above, due to the use of predetermined profit margins, the Brazilian transfer pricing rules are simpler than the OECD Transfer Pricing Guidelines, as well as more effective in countering base erosion and profit shifting. The problem is that predetermined profit margins can easily result in double taxation, as the other country may well not make a correlative adjustment where the profit allocated to the company located in Brazil does not reflect the arm’s-length principle.

In addition, transfer pricing rules based on predetermined profit margins often over-tax some transactions and under-tax others. This is because the markup required by the method may be higher or lower than the profits derived by taxpayers.

As Brazilian domestic transfer pricing rules are primarily based on predetermined profit margins, with few exceptions, Brazil does not include Article 9(2) of the OECD Model Convention in its tax treaties. Thus, Brazil does not apply a correlative adjustment to avoid economic double taxation derived from transfer pricing adjustments.
The mutual agreement procedure has been recently regulated, for the first time in Brazilian law, with the publication of Normative Ruling RFB No. 1.669/2016. The wording of Article 5, Paragraph 2, of this Normative Ruling suggests that Brazil will grant access to the mutual agreement procedure in transfer pricing cases that lead to double taxation, even in the absence of Article 9(2) of the OECD Model Convention in its tax treaties. This procedure would be the most appropriate in the light of Action 14 of the OECD/G20 BEPS initiative, which introduced a minimum standard for improving dispute resolution mechanisms. In this Action Plan, the OECD stated that countries must provide access to the mutual agreement procedure in transfer pricing cases, even in the absence of a treaty provision based on Article 9(2) of the OECD Model Convention.

However, as countries are only obliged to use their best efforts to resolve the situation of the taxpayer, it remains to be seen whether Brazil will effectively grant tax relief in transfer pricing cases to avoid economic double taxation. This problem highlights the importance of mandatory binding arbitration, since it puts pressure on tax authorities to resolve treaty-related disputes before the arbitration takes place. Nevertheless, within the framework of the BEPS Multilateral Convention, the mandatory arbitration is intended to apply only to countries that explicitly choose to introduce this mechanism in their tax treaties, which is not the case for Brazil. Indeed, the introduction of mandatory binding arbitration in tax treaties is a highly controversial topic in Brazil.

In a nutshell, Brazilian tax authorities argue that arbitration is incompatible with the national tax system, based on ‘the principle of non-availability of the tax credit’, which implies that tax authorities may not dispose of the tax credit properly constituted in accordance with domestic tax laws. For this reason, Brazil has no arbitration clause in its tax treaties.

It is about time for Brazil to change its opinion against mandatory binding arbitration. When there is uncertainty and controversy about the interpretation of a treaty provision that restricts the right to tax of a contracting state, the very existence of the tax credit is no longer absolute and definite. If this is the case, ‘the principle of non-availability of the tax credit’ does not apply and the mandatory binding arbitration is perfectly possible and even desirable. However, from a practical perspective, it is highly unlikely that Brazil will change its position at the signing of the Multilateral Convention. Therefore, the Multilateral Convention will probably improve the mutual agreement procedure in Brazil, but without the introduction of mandatory binding arbitration.

Finally, from an international perspective, Brazilian transfer pricing rules may permit the diversion of profits to foreign jurisdictions, thereby facilitating double non-taxation. Such a situation could arise, for instance, where the extra profit margin allocated to the counterparty abroad is treated as an informal capital contribution in the foreign jurisdiction that is not taxed under the domestic law.

Based on the above, it is fair to say that both the Brazilian transfer pricing rules and transfer pricing rules based on the OECD guidelines have different structural flaws, such as the following:

- the impracticality of producing evidence, as the taxpayer is not allowed to prove that its commercial or financial transactions complied with the arm’s-length standard;
- shortages in the range of predetermined profit margins, which should capture the specificities of each economic segment;
- a high risk of economic double taxation in cross-border transactions;
- a high risk of under-taxation or over-taxation of profits in Brazil;

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the non-application of the transfer pricing rules for royalties and payments derived from administrative assistance, which are subject to quantitative limitations;

- the absence of correlative and secondary transfer pricing adjustments;

- the failure to effectively use the mutual agreement procedure to resolve transfer pricing disputes;

- the lack of tax rulings and advance pricing agreements;

- structural limitations of Brazilian transfer pricing methods to capture certain types of transactions, such as financial investments, sales of equity participations, guarantee agreements and transfer of intangibles, among others; and

b) structural flaws of OECD transfer pricing rules, which include:

- a lack of comparable transactions to use to identify the transfer price;

- the absence of a single correct result, as the arm’s-length price is a range, which admits fluctuations;

- high compliance and monitoring costs;

- the vulnerability of transfer pricing rules to profit-shifting strategies involving intangible assets and contractual risks;

- a lack of legal certainty for foreign investors because the results of the application of transfer pricing rules are unpredictable and the amounts involved in related tax assessment notices have significantly increased;

- the inability of transfer pricing methods to capture synergy and other effects from the integration of legal entities into international corporate groups;

- a lack of effective coordination among countries to align transfer pricing outcomes (for example, mutual agreement procedures, advance pricing agreements and tax rulings);

- the high costs involved in bilateral or multilateral advance pricing agreements;

- the poor and inadequate alignment between existing transfer prices rules and the rapidly changing business environment;

- the absence of a solid theoretical approach for the identification of value creation, as proposed by the OECD during the BEPS project; and

- the increasing complexity of the arm’s-length standard and the functional analysis, which has reached a level that borders on irrationality.

ii Consequential impact for other taxes

As Brazil adopts predetermined profit margins, transfer pricing and customs value adjustments do not affect one another. As the methods used for transfer pricing and customs valuation in Brazil are different, the same transaction may be appraised in different ways, thus producing inconsistent outcomes.

Despite the lack of effective integration between transfer pricing and customs valuation in Brazil, Article 18 of Law No. 9,430/1996 refers to the evidence of the actual price through the import document, which raises the question of whether the customs declaration should be seen as the only accepted evidence.

According to the Brazilian transfer pricing rules, the taxpayer must prove that its import and export transactions comply with one of methods set forth by Law No. 9,430/1996. However, Brazilian tax law does not specify the documents required from taxpayers, who are free to use all documents available to prove the conditions of their transactions, such as written agreements, invoices, spreadsheets and payment receipts, among others. Thus, the customs declaration is not the only evidence accepted. This is because the administrative tax
proceeding is guided by the principle of material truth, according to which taxpayers can prove the facts relevant to the tax assessment notice using any means of evidence. Thus, in contrast to the civil procedure in which the parties are free to decide which facts they wish to put before the courts (the principle of formal truth), the administrative tax proceeding is governed by the principle of material truth, in which the tax judges are also obliged to investigate the facts ex officio. Consequently, the taxpayer has a wide and guaranteed possibility of proving all relevant facts, and by all means, in accordance with the due process of law.

It follows that the pursuit of the material truth prevents unjustifiable restrictions on the probationary freedom granted to the taxpayer by the Federal Constitution, mainly through the right to a full defence.

X OUTLOOK AND CONCLUSIONS

As previously discussed, the Brazilian transfer pricing rules establish objective methods for the definition of the market price, which, by means of a legal presumption, must correspond to the value allegedly used in similar transactions carried out between unrelated parties. The legal presumption serves to render transfer pricing control operational, facilitating its practical application by both the tax authorities and the taxpayers. In the absence of a legal presumption, the tax authorities would be obliged to prove, in each specific case, the manipulation of prices by the taxpayer.

The objective methods set out in Law No. 9,430/1996 are based on the establishment of predetermined profit margins, safe harbours and restrictions on free comparability as a way of reducing subjectivity and uncertainty in transfer pricing control. Even in the comparative methods authorised by the Brazilian tax legislation, such as PIC and PCI in import transactions, as well as PVEx and PECEX in export transactions, the tax legislature has established several restrictions to reduce the sample of comparable prices and the degree of subjectivity in the application of the law.

The merits of Brazilian transfer pricing rules lie in their effectiveness, practicability, reduction in administrative costs and enforceability. These rules are simpler than the OECD Transfer Pricing Guidelines, as well as more effective in countering base erosion and profit shifting. However, these rules may create to economic distortions and affect competition. Moreover, predetermined profit margins can easily result in double taxation, as the other country may well not make a correlative adjustment where the profit allocated to the company located in Brazil does not reflect the arm’s-length principle.

In addition, transfer pricing rules based on predetermined profit margins often over-tax some transactions and under-tax others. This is because the markup required by the method may be higher or lower than the profits derived by taxpayers.

Finally, in an international setting, the Brazilian transfer pricing rules may permit the diversion of profits to foreign jurisdictions, thereby facilitating double non-taxation. Such a situation could arise where the extra profit margin allocated to the counterparty abroad is treated as an informal capital contribution in the foreign jurisdiction not taxed under the domestic law. In turn, this suggests that the realisation of an international consensus on the future of transfer pricing would appear to be unlikely in the short term.
I OVERVIEW

The ‘arm’s-length principle’ has been part of Canada’s federal legislative corpus since 1938, when it was first integrated into the Income War Tax Act to apply strictly to payments made to non-residents by Canadian residents carrying on business. Sixty years later, on 1 January 1998, transfer pricing principles, inspired by and harmonised with the OECD Guidelines, were integrated into the Income Tax Act (ITA or the Act) when Parliament enacted Section 247 of the ITA, which is found in Part XVI.1 of the Act.

Canada’s transfer pricing regime is and has always been entrenched in the arm’s-length principle, and as such, the ITA does not provide for a ‘stand-alone’ transfer pricing regime. Rather, it provides for the application of this principle to all types of transactions between Canadian residents and non-residents. In fact, Section 247 does not levy taxes on its own. It allows the Canada Revenue Agency (CRA), the federal taxing authority, to determine, modify and even recharacterise certain amounts (as to their quantum or nature) for the purposes of computing tax under the ITA so that they arguably reflect arm’s-length conditions.

The Canadian transfer pricing regime is built around three important and integrated components: the Minister’s power to impose adjustments to the quantum or recharacterise the nature of transfer prices, automatic and independent penalty regime where the transfer pricing adjustments are above a certain statutory threshold, and an obligation to contemporaneously document all transfer pricing aspects.

Transfer pricing adjustments determined by the CRA apply for all purposes of the Act and target all types of taxpayers and partnerships. The rules found in Section 247 apply to both income and capital transactions. The charging provision, namely Subsection 247(2), provides that the Minister may adjust any amounts where: a taxpayer and a non-resident

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1 Dominic C Belley is a partner and Jonathan Lafrance is an associate at Norton Rose Fulbright Canada LLP.
2 R.S.C. 1917, c. 97, repealed.
3 R.S.C. , 1985, c. 1 (5th Supp.)
4 Unless provided otherwise, all legislative references in this text are to the ITA.
5 In Canada, taxation is a shared jurisdiction. Certain provinces, such as Quebec, Alberta and Ontario, have enacted tax measures that comprise, inter alia, transfer pricing legislation. However, such measures, which are harmonised with the federal regime, do not provide for distinct or additional transfer pricing penalties, and are solely intended to provide for equivalent transfer prices adjustments for provincial tax purposes.
6 Acting for the Minister of National Revenue (the Minister). The CRA is also the competent authority for the purposes of international tax conventions.
7 Individual, corporations and trusts.
8 For the purposes of this chapter, unless otherwise provided, references to taxpayers in the context of the application of Section 247 ITA will also refer to partnerships.
person with whom the taxpayer is not dealing at arm’s length are participants in a transaction and (1) either the terms and conditions differ from those that would have been made between persons dealing at arm’s length or (2) the transaction would simply not have been entered into by persons dealing at arm’s length and it can be said that the transaction was not entered into primarily for purposes other than to obtain a tax benefit. Subsection 247(3) details the penalty regime applicable. Finally, Subsection 247(4) provides the requirements with respect to contemporaneous documentation.

Since Section 247 does not impose taxes on its own, transfer pricing adjustments are generally followed by secondary adjustments that give rise to tax consequences. From a litigation perspective, both the primary and secondary adjustments are usually subject to disputes, which benefit from various alternative dispute resolution mechanisms at each stage and consequently have generated some case law.

II FILING REQUIREMENTS

Canada has a self-reporting tax system, and taxpayers are expected, pursuant to Section 150, to annually produce a return of income that is in a prescribed form and contains prescribed information. For the purposes of transfer pricing compliance, Section 233.1 requires taxpayers resident in Canada and non-residents who carry on business in Canada to provide information on their non-arm’s length transactions with non-residents for each taxation year (reportable transactions). The information must be provided in form T106 Information Return of Non Arm’s Length Transactions with Non-Residents and filed within the taxpayer’s filing due date for the year, which is typically six months after the end of the financial year for corporations and 90 days from the end of the year for trusts and estates. A different form must be filed for each non-arm’s length non-resident with whom the taxpayer has reportable transactions.

The information return must contain, inter alia, nominal information on the non-resident, whether the ‘reporting person’ controls or is controlled by the non-resident and the various transactions entered into by the reporting person and non-resident. The reporting person must also declare whether it has prepared or obtained contemporaneous documents as described in Subsection 247(4) for the taxation year of filing.

To file complete T106 forms and avoid penalties under Subsection 247(3), taxpayers must prepare complete and accurate contemporaneous documentation with respect to their use of arm’s-length transfer prices and allocations in respect of the transactions entered into. This fundamental element of the transfer pricing regime is discussed in Sections III and VIII.

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9 The ITA does not provide a definition for the arm’s-length concept. Paragraph 251(1)(a) provides that ‘related persons shall be deemed not to deal with each other at arm’s length’. The term ‘related persons’ is extensively defined in Section 251. In addition, Paragraph 251(1)(c) provides a de facto test for determining whether related persons are dealing at arm’s length.

10 Subsection 233.1(4) provides a de minimis exception for reporting taxpayers whose total fair market value of reportable transactions for a taxation year with non-residents is under C$1 million.

11 Because of the scope and degree of detail required in form T106, the CRA will generally use the T106 filed by taxpayers to initiate a transfer pricing audit.
III PRESENTING THE CASE

i Pricing methods

The ITA is silent on the question of transfer pricing methods: it does not provide for the use of a particular method, it does not specifically refer to the OECD Guidelines and it does not require the use of a transactional or year-end analysis. The ITA only requires that the terms and conditions of transactions entered into by non-arm’s-length parties be the same as those that would have been agreed to between arm’s-length parties.

In Canada v. GlaxoSmithKline Inc,12 the Supreme Court of Canada (SCC) had the opportunity to review Canada’s transfer pricing regime and for the first time provide judicial guidelines for its application.13 In that decision, the SCC established that ‘[The OECD] Guidelines are not controlling as if they were a Canadian statute’ and that ultimately, transfer prices must be determined according to the wording of the ITA rather than any particular methodology or commentary set out in the OECD Guidelines.14 The SCC also confirmed that there is no hierarchy of methods in Canada, a position that is in line with the latest OECD Guidelines.

The court further recognised that the ITA and the OECD Guidelines do not require a transaction-by-transaction approach, and that: ‘Where there are no related transactions or where related transactions are not relevant to the determination of the reasonableness of the price in issue, a transaction-by-transaction approach may be appropriate.’15

According to Information Circular IC87-2R, International Transfer Pricing,16 the CRA officially follows the OECD Guidelines for transfer pricing methods and the absence of hierarchy. The CRA has, however, shown a preference for the comparable uncontrolled price (CUP) method and states in Transfer Pricing Memorandum TPM-1417 that:

the Guidelines continue to suggest that there exists a natural hierarchy to the methods, as referred to in Paragraph 2.3. The CRA agrees that the focus of determining the method to use should be the method that will provide the most direct view of arm’s-length behaviour and pricing. IC87-2R states that a natural hierarchy exists in the methods. Both IC87-2R and Paragraph 2.3 of the 2010 version of the Guidelines state that the traditional transaction methods (e.g., CUP) are preferred over a transactional profit method. For the CRA, these changes do not firmly de-emphasise the natural hierarchy but they refocus the topic on what is truly relevant – the degree of comparability available under each of the methods and the availability and reliability of the data.

The court further stated that relevant to the analysis framework are the economic characteristics of the situations being compared and the consideration of other transactions impacting the transfer price should be considered. In Canadian law, it is a well-established principle that economic substance is important but cannot override legal relationships unless it is specifically

13 In GlaxoSmithKline Inc, the appeal concerned the application of former Section 69, which contained the pre-1998 transfer pricing provisions. However, the SCC’s comments with respect to the OECD Guidelines and the Canadian transfer pricing regime are applicable to Section 247.
15 Ibid., at Paragraph 42.
16 At Paragraph 8.
17 Transfer Pricing Memorandum TPM-14, 2010 Update of the OECD Transfer Pricing Guidelines.
provided for in the legislation\textsuperscript{18} and ‘tax consequences flow from the legal relationships or transactions established by taxpayers’.\textsuperscript{19} The transfer pricing regime specifically provides the possibility to depart from those principles.

After reviewing the transactions, if the CRA establishes that the pricing or the terms and conditions used between the parties do not correspond to arm’s-length parameters, it may, depending on the circumstances, use one of two mechanisms specifically provided in Subsection 247(2), namely the adjustment or the recharacterisation. When the terms and conditions made in respect of a transaction differ from those that would have been made by persons dealing at arm’s length, the CRA may adjust the terms and conditions of the transaction to terms that arguably would have been made were the parties dealing at arm’s length.\textsuperscript{20} However, when non-arm’s length parties enter into a transaction primarily to obtain a tax benefit\textsuperscript{21} and the terms and conditions of the transactions do not reflect arm’s-length transactions, the CRA is allowed to recharacterise the transactions to terms that would have otherwise been made between arm’s-length parties.\textsuperscript{22}

All Canadian judicial cases that dealt with transfer pricing rules\textsuperscript{23} involved the adjustment of terms and conditions as opposed to recharacterisation of transactions. According to the OECD Guidelines and pursuant to the CRA’s administrative position,\textsuperscript{24} the recharacterisation of transactions should be done in exceptional circumstances only and should be viewed as a last resort solution. However the wording of the ITA does not provide any limitations, restrictions or guidelines for the use of recharacterisation of transactions by the CRA.

\section*{ii Authority scrutiny and evidence gathering}

The CRA’s audit approach with respect to evidence is largely based on the gathering and analysing of documents required to be kept and produced by taxpayers. In addition to the obligation of filing reportable transactions under Section 233.1 specifically for transfer pricing purposes, the ITA confers on the CRA vast and general audit powers. Under Section 231.1, an auditor may, for any purpose related to the administration of the ITA, inspect, audit or examine the books and records of a taxpayer and any document of the taxpayer (or of any other person) that relates to the information that is or should be in the books and records of the taxpayer or to any amount payable by the taxpayer under the ITA. Furthermore, under Section 231.6, the CRA may request from a person resident in Canada, or a non-resident person carrying on a business in Canada, to provide any foreign-based information, which is defined as ‘any information or document that is available or located outside Canada and that may be relevant to the administration or enforcement of the ITA’.

\begin{footnotesize}
\begin{enumerate}
\item[20] Pursuant to Paragraph 247(2)(a) and (c).
\item[21] The term ‘tax benefit’ is defined in Subsection 245(1). Section 245 provides for the general anti-avoidance rule (GAAR).
\item[22] Pursuant to Paragraph 247(2)(b) and (d).
\item[23] Whether with respect to former Subsection 69(2) or Section 247.
\end{enumerate}
\end{footnotesize}
Section 247 also requires that taxpayers prepare, make available or obtain and, when required, provide contemporaneous documentation with respect to their transfer price. Contemporaneous documentation is the second cornerstone of the Canadian transfer pricing regime. Failure to prepare or provide contemporaneous documentation when requested may lead to the imposition of penalties.

Pursuant to Paragraph 247(3)(c), the CRA may request access to taxpayers’ contemporaneous documentation. Upon written request, taxpayers must provide such documents within three months of the request. The term ‘contemporaneous documentation’ is not specifically defined in the ITA; however, pursuant to Subsection 247(4), documents and records subject to requests are those that provide a description that is complete and accurate in all material aspects of the:

a. property or services to which the transaction relates;

b. terms and conditions of the transaction and their relationship, if any, to the terms and conditions of each other transaction entered into between the participants in the transaction;

c. identity of the participants in the transaction and their relationship to each other at the time the transaction was entered into;

d. functions performed, the property used or contributed and the risks assumed, in respect of the transaction, by the participants in the transaction;

e. data and methods considered and the analysis performed to determine the transfer prices or the allocations of profits or losses or contributions to costs, as the case may be, in respect of the transaction; and

f. assumptions, strategies and policies, if any, that influenced the determination of the transfer prices or the allocations of profits or losses or contributions to costs, as the case may be, in respect of the transaction.

When a taxpayer fails to make or obtain complete and accurate contemporaneous documentation, the taxpayer is deemed not to have made reasonable efforts to determine and use arm’s-length transfer prices for the purposes of the Subsection 247(3) transfer pricing penalty. The CRA’s approach to reasonability is that it needs to be determined on a case-by-case basis, depending on the facts and circumstances of each case, and that inconsistencies in methods, data and factual representations can undermine the reliability of the documentation.25

In addition to the CRA’s broad power to collect information and taxpayers’ obligations, country-by-country reporting was recently introduced in the ITA.26 The country-by-country reporting requirements generally align with the OECD Guidelines, particularly with respect to consolidated revenue thresholds applicable to multinational enterprise groups.27

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26 Section 233.8 was introduced in December 2015 pursuant to Bill C-59.
27 Pursuant to Subsection 233.8(1), multinational enterprise groups with a total consolidated group revenue of less than €750 million during the fiscal year immediately preceding the particular fiscal year will not be subject to the Subsection 233.8 reporting rules.
IV INTANGIBLE ASSETS

The ITA does not provide for distinct or specific transfer pricing rules applicable to intangible assets. In GlaxoSmithKline Inc, the SCC acknowledged that an intangible asset may be attached to a tangible asset and enhance its value, and that therefore the valuation or pricing must take into account all relevant business circumstances and considerable weight must be given to the business relationships.28

The CRA’s position is that arm’s-length pricing for the transfer of intangible property must take into account the perspective of both the transferor of the property and the transferee.29 When comparable data on intangible assets exists, the CRA’s preferred transaction method is generally a traditional one (CUP or resale method).30 However, it recognises that it is difficult to find an exact comparable for valuable or unique intangible assets, especially because intangibles are difficult to value in the first place. The CRA’s recommended approach for non-arm’s length transactions involving unique or highly valuable intangible assets is the transactional net margin method (TNMM).31

A qualifying cost contribution arrangement (QCCA), which is defined in Subsection 247(1), is often concluded by arm’s-length parties for the development of intangible property. A QCCA is ‘an arrangement whereby two or more parties share the costs and risks of producing, developing, or acquiring any property, or acquiring or performing any services, in proportion to the benefits which each participant is reasonably expected to derive from the property or services as a result of the arrangement’.32 A participant’s share of the overall contributions to the QCCA must be in proportion to the share of the overall benefits it expects to derive from the arrangement, taking into account the economic circumstances and its contractual terms. The OECD Guidelines’ DEMPE functions33 with respect to intangible property are, to some extent, integrated in the Canadian transfer pricing regime through QCCAs.

V SETTLEMENTS

Settlements are an essential part of the functioning of a viable tax system.34 The Canadian jurisprudence with respect to transfer pricing is limited, and that is largely because of the various alternative dispute resolution solutions provided to taxpayers, through advance pricing arrangements (APA) and settlements, whether they occur at the audit, objection or judicial stage.

APAs are formal and binding agreements between the CRA and a taxpayer who is carrying non-arm’s length transactions with a non-resident person and therefore subject to Subsection 247(2). The APA programme allows a taxpayer and the CRA to avoid future transfer pricing disputes by entering into a prospective agreement for a term of three to five years.35 By entering into an APA, taxpayers are provided with some degree of certainty on

28 GlaxoSmithKline Inc, at Paragraph 52.
29 IC-87R2, at Paragraph 140.
30 IC-87R2, at Paragraph 143.
31 IC-87R2, at Paragraph 95.
32 IC-87R2, Paragraph 120.
33 Functions of developing, enhancing, maintaining, protecting and exploiting the intangibles.
their transfer prices. Canadian taxpayers may seek unilateral or multilateral APAs. In a multilateral APA, the CRA (the Canadian competent authority) will enter into an APA with the foreign competent authority under the mutual agreement procedure article provided by the applicable tax treaty. APAs generally start with the taxpayer providing information (pre-filing) and involve many steps, which require the CRA to, inter alia, review and take a position on the taxpayer’s file, enter into government-to-government negotiations and document and conclude the APA with the taxpayer, and the foreign competent authority. Taxpayers do not participate in government-to-government negotiations.

The terms and contents of an APA may not be introduced (by the CRA or a taxpayer) as evidence in any administrative or judicial proceeding in relation to any taxation year, transaction or person covered by the APA. Once an APA has been entered into, taxpayers must report accordingly and must maintain books and records that allow the CRA, through an audit, to determine their compliance with the APA. When the parties to an APA disagree on its interpretation, or when the CRA establishes that a taxpayer does not comply with the terms of the APA, for example, because the given transaction is not a covered transaction, or because a taxpayer has not retained the proper records, the CRA may propose certain adjustments. If the taxpayer disagrees with the adjustments, an internal review process is available, pursuant to which the Director General of the International Tax Directorate will issue a decision. Alternatively, the disagreeing taxpayer could file tax returns inconsistent with the terms of the APA, risk the revocation or cancellation of the APA and contest the adjustments through the usual appeals process as if the APA never existed.

During the audit stage, it is possible for settlements to be reached through APAs. APAs concluded are generally prospective in that they apply to future taxation years. Further, when a taxpayer concludes (and complies with) an APA, it is possible to request that the APA cover transactions that occurred in non-statute-barred taxation years (rollback). In addition to certainty of transactions and transfer prices, a rollback provides that the past transactions, now covered by the APA, will not be subject to a penalty under Subsection 247(3).

Settlements may also be reached during the objection stage, when the CRA has issued a notice of reassessment and the taxpayer has filed a notice of objection. Upon receipt of the notice of objection, an appeals officer must, with all due dispatch, conduct an independent review of the file and decide whether to confirm, vary or vacate the reassessment. Settlements through APAs are less likely to occur because generally discussions and negotiations with respect to a possible agreement or APA, if any, have already occurred and have not succeeded.

Settlements often occur at the judicial stage, and they are often reached after examinations for discovery have been held when the parties have formed a more accurate picture of the strengths or weaknesses of their respective cases or how their witnesses will

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36 Multilateral APAs are entered into with more than one tax authority, through the mutual agreement procedure (MAP) included in most income tax treaties. Unilateral APAs are agreements between the taxpayer and the government only.

37 As per IC94-4R at Paragraph 10: pre-filing meeting(s); the APA request; the acceptance letter; the APA submission; preliminary review of the APA submission and establishment of a case plan; review, analysis, and evaluation; negotiations; agreements; the post-settlement meeting; and APA compliance.

38 IC94-4R, at Paragraph 92.


40 When a reassessment has been issued pursuant to the ITA and a taxpayer files a notice of objection within 90 days of the issuance of the reassessments pursuant to Section 165.
stand up under cross-examination in the heat of trial’. There is also an additional incentive for the parties to try to settle at the judicial level. In exercising its discretionary power to award costs, the Tax Court of Canada (TCC) may consider any offer of settlement made in writing. If a taxpayer makes an offer of settlement and obtains a judgment as favourable as or more favourable than the terms of the offer of settlement, it is entitled to party costs and substantial indemnity costs after the date of the written settlement offer.

Independent of the timing or stage at which a settlement occurs, a transfer pricing settlement, and any tax settlement for that matter, must be ‘principled’ in order to be binding to the CRA, meaning that the settlement must reflect the correct application of the law to the facts and cannot be solely based on ‘compromise’ or cost-benefit analysis alone.

In *Sifto Canada Corp v. The Queen*, the TCC found that a settlement agreement entered into under the mutual agreement procedure (MAP) under the Canada–US tax treaty was binding on the CRA and that CRA had to assess the taxpayer in accordance with the agreement. The TCC ruled that CRA was precluded from issuing the subsequent additional reassessments based on an upward transfer price adjustments because they were issued in contravention of the agreement.

**VI INVESTIGATIONS**

Transfer pricing disputes, as with other tax disputes, generally begin with the CRA investigating a taxpayer through an audit, issuing a proposed reassessment and finally a formal reassessment. Transfer pricing investigations will often start with the CRA serving the taxpayer a formal Paragraph 247(4)(c) request for contemporaneous documentation. As previously mentioned, the CRA may also request books, records and documents pursuant to Section 231.1 and 231.6.

By virtue of Subsection 247(11), rules applicable to audits, assessments and objections under Part I of the ITA are made applicable to Part XVI.1 (which comprises Section 247). The period of time within which the CRA is expected to carry out its tax audit and issue a reassessment is the ‘normal reassessment period’, defined under Subsections 152(3.1) and 152(4). The normal reassessment period starts with the issuance of a first assessment, which is usually issued shortly after the filing of an income tax return by a taxpayer pursuant to Section 150. Depending upon the taxpayer’s status and the nature of the transactions under review, the normal reassessment period ends three (for an individual or private corporation), four (for

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41 *The Settlement of Tax Disputes in Canada*, p. 4.
42 Substantial indemnity costs means 80 per cent of solicitor and client costs.
43 Pursuant to Section 147(1) of the Tax Court of Canada Rules (General Procedure) (SOR /90-688a) (the Tax Court Rules).
45 *Sifto Canada Corp v. The Queen*, 2017 TCC 37
46 Tax Treaties Canada has entered into generally provide MAP to assist taxpayers in resolving cases of double taxation involving Canada and a treaty partner, occurring , *inter alia*, as a consequence of unilateral transfer pricing adjustments by Canada. The MAP aims to resolve cases of double taxation that are not in accordance with the Tax Treaties and that are generally occurring because of the international nature of transfer pricing.
a public corporation) or seven (for transactions involving a non-resident) years later. Within the normal reassessment period, the CRA can issue as many reassessments as it sees fit and the subsequent reassessment cancels the previous one, unless it is an additional assessment.

Pursuant to Subsections 152(4) and 152(4.01), the CRA can issue a reassessment beyond the normal reassessment period only if the reassessment can reasonably be regarded as relating from misrepresentation\(^\text{47}\) in the taxpayer’s return attributable to neglect, carelessness or wilful default or fraud. The CRA has the burden of proof with respect to the misrepresentation, which must be proved on the balance of probabilities. Further, the limitation period provided for in tax treaties does not apply to Part XIII reassessments issued for transfer pricing adjustments.\(^\text{48}\)

When a taxpayer disagrees with an assessment issued by the CRA, a notice of objection to an assessment must be served within 90 days of the date of issuance of the assessment pursuant to Section 165. The notice of objection triggers an independent review of the assessment file by a CRA appeals officer.

After March 2018, the CRA does not accept applications relating to transfer pricing matters as part of the Voluntary Disclosure Program (VDP). The VDP provides taxpayers with the opportunity to correct mistakes or omissions in filing tax returns while avoiding in certain cases prosecution or penalties that would otherwise be applicable. Transfer pricing matters are instead referred to the Transfer Pricing Review Committee.

### VII LITIGATION

#### i Procedure

Pursuant to Section 169, where a taxpayer has served a notice of objection to an assessment pursuant to Section 165, the taxpayer may appeal to the TCC to have the assessment vacated or varied within 90 days after the CRA has confirmed the assessment or reassessed. The TCC’s jurisdiction is limited to Section 171, which states that it may dispose of an appeal by dismissing it or allowing it and vacating the assessment, varying the assessment or referring the assessment back to the CRA for reconsideration and reassessment.

An appeal is instituted by a notice of appeal prepared in accordance with Section 21 of the Tax Court Rules. The taxpayer’s notice of appeal must summarise the relevant facts, state the question at issue, list the relevant statutory provisions relied upon, state the taxpayer’s arguments and, finally, the relief sought. Within 60 days (subject to an extension), the CRA has to file a reply to the notice of appeal in accordance with Sections 44 to 49 of the rules. The reply contains the same items as the notice of appeal, in addition to a section containing the assumptions based on which the assessment was made by the CRA. This section is of utmost importance to the whole tax litigation process because the assumptions will determine what the taxpayer will have to demonstrate in order to quash the assessment.\(^\text{49}\)

Once the reply is filed, the parties have to agree on a timetable for the remaining steps of the litigation: the exchange of lists of documents (partial or integral), the examination for

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\(^{47}\) The misrepresentation must take place when filing the return, not at another time. See \textit{Vachon v. The Queen}, 2014 FCA 224.

\(^{48}\) \textit{McKesson Canada Corporation v. The Queen}, 2013 TCC 404, starting at Paragraph 378.

discovery, the satisfaction of undertakings made at discovery and the request for a hearing date. Once the hearing date is scheduled by the hearings coordinator, the parties have 90 days from that date to serve their expert reports, which is common practice in transfer pricing cases.

ii Recent cases

Although the first transfer pricing provisions were introduced to Canadian legislation almost 80 years ago, only five major cases have dealt with transfer pricing provisions. Certain cases have been decided under the former Subsection 69(2), and others under the current Section 247.


GlaxoSmithKline Inc is the only decision rendered by the SCC on transfer pricing and, as such, is significant in terms of the guidance it provides. Pursuant to a licensing agreement allowing Glaxo Canada to sell Glaxo World’s drugs portfolio, Glaxo Canada paid a 6 per cent royalty and was required to purchase ingredients from suppliers chosen by Glaxo World. The issue related to the purchase price paid by Glaxo Canada for a key ingredient necessary for the Zantac drug, under a parallel supply agreement with a supplier, one of Glaxo World’s Swiss subsidiaries. The key ingredient was bought by Glaxo Canada at a price five times higher than the generic drug companies were paying. The CRA reassessed Glaxo Canada and reduced Glaxo’s purchase price to a price closer to the one paid by generic drug companies for the ingredient, pursuant to Subsection 69(2). The SCC concluded that, under the circumstances, the price paid was reasonable given the rights of the parties pursuant to the various agreements they entered into. The SCC allowed Glaxo’s appeal and referred the matter back to the TCC for redetermination, on the basis that the rights and obligations found in all relevant agreements must be considered.

Even if the decision was issued under former Subsection 69(2), the guidance offered by the SCC is particularly relevant, in that the court established the following principles:

a binding agreements between related parties must be considered together;

b the OECD Guidelines are not binding in Canadian law but may be of assistance to the courts; and

c transfer pricing is not an exact science and as long as transfer prices are reasonable, no adjustments should be made.

Canada v. General Electric Capital Canada Inc 2010 FCA 344

The General Electric Capital Canada Inc case is of some importance because of the comments on the weight of expert evidence and opinions in transfer pricing matters. In this case, the issue was whether a 1 per cent guarantee fee paid to GE’s parent (based in the United States) was appropriate, given that without the guarantee from its parent, its borrowing cost would have been higher. The Federal Court of Appeal (FCA) upheld the TCC decision that the guarantee fee paid did not exceed an arm’s-length price. The FCA also concluded that implicit support had to be taken into account because determining arm’s-length pricing ‘involves taking into account all the circumstances which bear on the price whether they arise from the relationship or otherwise’.
The TCC decision provides relevant comments on the role of expert witness testimony and report in determining the outcome of a case.\(^\text{50}\) The TCC judge noted that it is the court’s role to ensure that experts are acting in conformity with their role and ensure that expert opinions are ‘unbiased’ and ‘relevant to the subject matter of the case’, and, ultimately, not prejudicial to the interest of justice.\(^\text{51}\)

**McKesson Canada Corporation v. The Queen, 2013 TCC 404**

*McKesson* was the first decision to have been decided after the *GlaxoSmithKline Inc* case. The primary issue related to the reasonable amount of discount for receivables sold by McKesson Canada to a non-arm’s length corporation pursuant to receivable sales agreement. The secondary issue was McKesson Canada’s liability under the ITA for its failure to withhold and remit to the CRA an amount equal to the Part XIII non-resident withholding tax resulting from the disallowed amounts.

The disagreement between the CRA and McKesson related to the discount rate applicable to the receivables sold. The TCC had to determine whether the discount rate agreed upon in the agreement was different from a rate negotiated under non-arm’s length conditions. The court concluded that the rate used by the parties was outside of what could be considered reasonable for parties dealing at arm’s length, and that the CRA was justified in readjusting the rate. The court also held that the Part XIII secondary adjustment issued by virtue of Paragraph 214(3)(a) and Subsection 15(1) were valid as well. McKesson appealed the decision to the Federal Court of Canada, but the appeal was discontinued.\(^\text{52}\)

**Alberta Printed Circuits Ltd v. The Queen, 2011 TCC 232**

The *Alberta Printed Circuits Ltd* (APC) decision was rendered before *GlaxoSmithKline Inc*. The dispute arose when APC moved its ‘setup operations’ to Barbados, which were to be carried on by a related corporation, APCI. Pursuant to their agreement, APCI charged APC a fixed fee for the setup services and a square-inch fee for non-setup services. The CRA reassessed APC and made an adjustment pursuant to Subsection 247(2) on the basis that the fees paid were not consistent with the arm’s-length approach. The TCC based its analysis on the CUP method as suggested by APC, and rejected the CRA’s proposed transactional net margin method.\(^\text{53}\) The TCC decision is of interest because of its comments on the transaction-by-transaction basis and the importance of unbundling transactions for transfer pricing purposes.

**Marzen Artistic Aluminum Ltd v. Canada, 2016 FCA 34**

In *Marzen Artistic Aluminium Ltd*, the CRA disallowed the markup paid and deducted by Marzen to its Barbados subsidiary under a marketing and sales support agreement. The evidence revealed that the Barbados entity did not perform any marketing or support function, but acted as an intermediary between Marzen and its US affiliate by subcontracting the marketing and sales support to the US entity. The Barbados entity charged a substantial

\(^{50}\) *General Electric Capital Canada Inc. v. The Queen*, 2009 TCC 563.

\(^{51}\) Ibid., Paragraph 226.

\(^{52}\) Files A-48-14 and A-49-14.

\(^{53}\) The decision was based on the 1995 OECD Guidelines, which shows a preference for traditional transaction methods and cites the CUP method as providing the highest degree of comparability.
markup to its costs of contracting out the functions. The TCC rejected Marzen’s appeal and upheld the disallowance of the deduction claimed by Marzen for the costs paid to the Barbados entity. Furthermore, the Court determined that Marzen did not make a reasonable effort to use comparables or to reasonably determine and use arm’s-length transfer prices due to the lack of contemporaneous documentation and upheld the Subsection 247(3) transfer pricing penalty.

VIII SECONDARY ADJUSTMENT AND PENALTIES

i Secondary adjustments

In most transfer pricing cases, when primary adjustments are made under Subsection 247(2), the amount of excess paid by the Canadian taxpayer to the non-resident may result in a secondary adjustment. Secondary adjustments are usually issued pursuant to Part XIII of the ITA, which provides for a withholding tax on payments (and deemed payments) made to non-residents of Canada.54

For example, in the case of primary adjustment resulting in an excess amount paid by a resident corporation to a non-resident, Subsection 247(12) will deem the payment of a dividend by the resident corporation to the non-resident. In fact, the wording of Subsection 212(2) deems the dividend to have been received by the non-resident entity to the transaction. A deemed dividend pursuant to Subsection 247(12) will result in a secondary assessment under Subsection 212(2), which provides for a withholding tax on dividends paid by resident corporations to non-residents.

In circumstances where Subsections 247(12) and 212(2) do not apply,55 a deemed dividend of payment may be triggered by the application Paragraph 214(3)(a)56 in combination with Subsections 15(1) and 15(9) with respect to shareholder’s benefit; Subsection 56(2) with respect to indirect payments and transfers; and Subsection 246(1) with respect to benefits conferred on another person. This would also result in a Part XIII secondary assessment of withholding tax.57

Generally, the CRA’s position is to the effect that there will be no deferral of Part XIII assessments pending the final resolution of the transfer pricing issue. Canadian taxpayers may

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54 Section 212 provides for a 25 per cent withholding tax on payments. Tax treaties entered into by Canada usually reduce the amount of withholding tax. Canada has entered into international tax conventions with the following countries: Algeria, Argentina, Armenia, Australia, Austria, Azerbaijan, Bangladesh, Barbados, Belgium, Brazil, Bulgaria, Cameroon, Chile, China, Colombia, Croatia, Cyprus, the Czech Republic, Denmark, the Dominican Republic, Ecuador, Egypt, Estonia, Finland, France, Gabon, Germany, Greece, Guyana, Hong Kong, Hungary, Iceland, India, Indonesia, Ireland, Israel, Italy, the Ivory Coast, Jamaica, Japan, Jordan, Kazakhstan, Kenya, the Republic of Korea, Kuwait, Kyrgyzstan, Latvia, Lithuania, Luxembourg, Malaysia, Malta, Mexico, Moldova, Mongolia, Morocco, the Netherlands, New Zealand, Nigeria, Norway, Oman, Pakistan, Papua New Guinea, Peru, Philippines, Poland, Portugal, Romania, Russia, Senegal, Serbia, Singapore, Slovakia, Slovenia, South Africa, Spain, Sri Lanka, Sweden, Switzerland, Tanzania, Thailand, Trinidad and Tobago, Tunisia, Turkey, Ukraine, the United Arab Emirates, the United Kingdom, the United States, Uzbekistan, Venezuela, Vietnam, Zambia and Zimbabwe. This list does not include treaties signed but not in force, treaties under negotiations or tax information exchange agreements.

55 Subsection 247(15).

56 Both provisions are found in Part XIII of the ITA.

57 In order to avoid double taxation, Subsection 247(16) provides that Section 15, Subsection 56(2) or Section 246 will not apply when Subsection 247(12) deems a dividend to have been paid.
nevertheless be relieved from Part XIII tax if the amounts are repatriated (i.e., paid back by the non-resident) within 180 days, pursuant to Subsection 247(13). Subsection 247(14) also provides the Minister with the discretion to reduce interest otherwise payable with respect to a Part XIII reassessment.

ii Penalties

The specific penalty regime applicable to transfer pricing adjustments under the ITA is the third cornerstone of the Canadian transfer pricing regime. Subsection 247(3) provides for a 10 per cent penalty to taxpayers when the amount of the transfer pricing adjustment determined pursuant to Subsection 247(2) exceeds the lesser of: 10 per cent of the taxpayer’s gross revenue for the year or C$5 million. The transfer pricing penalty is applicable on amounts of adjustments, save for the de minimis exception, and not on the amount of additional taxes payable with respect to a secondary adjustment. Therefore, it is possible that, in certain situations, transfer pricing adjustments result in a penalty even if there are no additional taxes payable.58

Taxpayers can avoid the Subsection 247(3) penalty if they can prove they have made ‘reasonable efforts’ in determining and utilising arm’s-length transfer prices. The burden that lies on taxpayers is dual: reasonable efforts must be made to determine and use the transfer prices. If a taxpayer is not in a position to prove its compliance with both obligations, it could be exposed to penalties. In addition, for the purposes of the penalty, Subsection 247(4) contains a deeming rule that deems taxpayers not to have made reasonable efforts in cases where the documentation referred to in this Subsection is incomplete, inaccurate or not prepared contemporaneously, or if a taxpayer fails to provide such information in the three-month period when requested pursuant to Paragraph 247(4)(c).

All transfer pricing adjustments in excess of the de minimis threshold are referred to the CRA’s transfer pricing review committee, which decides whether or not the imposition of a penalty is appropriate in the circumstances.59

IX BROADER TAXATION ISSUES

i Diverted profits tax and other supplementary measures

Canada does not have a diverted profit tax per se (neither proposed, nor in force), unlike many common law jurisdictions such as the United Kingdom and Australia. However, certain provisions of specific application found in the ITA are intended to apply in specific cases where tax could be diverted to foreign jurisdictions. These specific rules would generally apply in priority to the transfer pricing provisions. For example, there are specific statutory provisions covering the taxation of foreign affiliates,60 and specific rules for non-resident trusts,61 back-to-back loans62 and unreasonable deductions63 (whether or not with an arm’s-length party).

58 For example, if there are losses, deductions or credits to offset the additional taxes otherwise payable.
59 Transfer Pricing Memorandum TPM-13, Referrals to the Transfer Pricing Review Committee.
60 For example, foreign accrued property income (FAPI) and surplus rules found in Section 95.
61 Section 94.
62 Section 17.
63 Section 67.
ii  Double taxation

Double taxation might arise as a result of proposed transfer pricing adjustments in Canada when there is no corresponding adjustment in the other country. In such cases, taxpayers may request competent authority consideration under the mutual agreement article provided for in most of Canada’s tax treaties. Taxpayers must make a formal application within the notification deadline provided by the applicable tax treaty. Deadlines may vary in different tax treaties.

The CRA will generally answer an initial request within 30 days, letting the taxpayer know whether the request for assistance is granted or not. When the CRA denies a request, written reasons must be provided with the decision.

When a mutual agreement procedure request is accepted by the CRA, it will enter into negotiation with the foreign competent authority. Even if an agreement is reached between the competent authorities, taxpayers may decline the agreement and refuse to comply with it. In such cases, taxpayers will most likely have to argue their case to the TCC following a reassessment. When transfer pricing issues are resolved judicially, the CRA will present the adjustments provided in the court’s decision to the foreign competent authority, which may accept or reject the adjustments provided. In case of rejection, double taxation would likely occur.

iii  Consequential impact for other taxes

Transfer pricing adjustments may have an impact on goods and services tax (GST) otherwise applicable to transactions. GST is a value added tax charged on most supplies made in Canada of goods, services, real property and intangible property. GST is charged at a rate of 5 per cent on the value of the consideration for a given taxable supply. Residents and non-residents who are registered and who make taxable supplies in Canada must collect GST and remit GST net of input tax credits claimed. Transfer pricing adjustments to the price of taxable supply sold will result in a modification of the value of the consideration for a given taxable supply, and may require amendments to GST returns. In a case where transfer prices are increased, there may be additional GST payable on a transaction, which may cause under-collection and result in unremit amounts of GST.

Adjustments to transfer prices may also affect values used for customs duty purposes. Even if the rules governing the customs valuation and the income tax rules are distinct, the Canada Border Security Agency will generally accept a transfer price as the basis for customs valuation if the price is based on an OECD-approved method. However, subsequent to transfer pricing adjustments, taxpayers might be required to amend their customs filings to reflect such adjustment to import prices, which could lead to underpayments, and hence, assessments of duties, taxes interest and penalties.

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64 Details with respect to applications are set out in Information Circular IC-71-17R5.
65 And its provincial equivalents, the harmonised sales tax and the Quebec sales tax.
67 Under the Customs Act (R.S.C., 1985, c. 1 (2nd Supp.).
X  OUTLOOK AND CONCLUSIONS

Canadian transfer pricing is fundamentally composed of three integrated components: the determination or recharacterisation by the tax authorities, a strict penalty regime and an obligation by taxpayers to document the utilisation of their transfer prices. With transfer pricing matters, in most instances, the difficulty does not lie with the application or interpretation of the statutory provisions, but rather with complete, continuous and accurate compliance. As such, the difficulty lies with understanding the legal relationships within a group of interrelated companies in several jurisdictions and as many legal traditions; finding accurate comparables; determining the most accurate method; and establishing reliable and complete contemporaneous documentation on a regular basis. Tax law is notoriously complex\textsuperscript{68} and transfer pricing is no exception.

Transfer pricing disputes are generally lengthy and costly because they are considered to be evidence-heavy and, in most cases, courts generally need extensive assistance from expert witnesses. The limited Canadian jurisprudence in that respect, under both the former and the new transfer pricing regime, is a testament to the complexity of such endeavour, but also to the place and importance given to alternative dispute resolution mechanisms, whether at the audit stage, the objection stage or through mutual agreement procedures and through advance transfer pricing arrangements.

Chapter 5

CYPRUS

Kyriacos Scordis and Costas Michail

I OVERVIEW

Cyprus, as an internationally recognised business centre, is largely an OECD-compliant jurisdiction, as recognised in the latest OECD progress report, and as such follows many of its principles and practices, including the (broadly accepted) international principle of ‘separate legal entity’ (see the OECD definition of the international arm’s-length principle).

Cyprus generally applies the above-mentioned international arm’s-length principle, which essentially requires that conditions and circumstances attached to a ‘controlled transaction’ are consistent with comparable transactions occurred in the open market.

The OECD has, over the years, produced several reports and Transfer Pricing Guidelines refining their application and broadening their scope. The most recent and comprehensive report comprises the Final Report on BEPS Actions 8–10, which largely revises the previous Transfer Pricing Guidelines with the stated aim of taxing profits where economic activities take place and value is created, giving particular weight on the party that is undertaking and managing economically significant risks.

The OECD’s work (Transfer Pricing Guidelines and reports) in the area underpins the arm’s-length principle incorporated in the OECD Model Tax Convention and forms the basis of an extensive network of bilateral double tax treaties; therefore, several jurisdictions are already applying this principle and the underlying transfer pricing methodology either to domestic or cross-border transactions.

1 Kyriacos Scordis is the managing partner and Costas Michail is a tax specialist and senior manager at Scordis, Papapetrou & Co LLC.
2 Cyprus was largely compliant in the Phase 2 progress report of the Global Forum on Transparency.
3 OECD Model Tax Convention, Article 9.
5 Base Erosion Profit Shifting (adoption of 15 points action plan by G20, OECD), Approval of Action 8–10 – 2015 report aligning Transfer Pricing Outcomes with Value Creation.
6 OECD Model Tax Convention, Article 9.
The OECD Model Tax Convention contains the arm’s-length principle under the heading ‘Associated Enterprises’ (Article 9),\(^7\) which states:

Where

a. an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or

b. the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,

and in either case conditions are made or imposed between the two 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.

The relevant Cyprus legal framework giving effect to this arm’s-length principle is replicated below. In particular, the Income Tax Law\(^8\) provides:

(a) a business in the Republic participates directly or indirectly in the management, control or capital of a business of another person; or

(b) the same persons participate directly or indirectly in the management, control or capital of two or more business;

And in either case conditions are made or imposed between the two businesses in their commercial or financial relations which differ from those which would be made between independent businesses, then any profits which would, but for those conditions, have accrued to one of the business, but, by reason of those conditions, have not so accrued, may be included in the profits of that business and taxed accordingly.

(2) The provisions of sub-section (1) apply also in connection with any transaction between connected persons.

The above arm’s-length principle as enshrined by the law covers both physical persons and companies (the definition of which is set out below but includes what is described as ‘corporations’ in other jurisdictions).

‘Companies’ as per the law are defined to include under Article 2.\(^9\)

*any body with or without legal personality, or public corporate body, as well as every company, fraternity or society of persons, with or without legal personality, including any comparable company incorporated or registered outside the Republic and a company listed in the First schedule (comprising a list of several companies registered in other EU members states); but it does not include a partnership.*

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\(^7\) See footnotes 3 and 4.
Additionally, the Income Tax Law and relevant regulations also explicitly stipulate that certain ‘transactions’ should abide by comparable open market terms. Such transactions include, *inter alia*, ‘where the amount of new capital is introduced in the form of assets in kind, the amount of such capital . . . cannot exceed the market value of these assets on the date of their import’.

The reader may appreciate that the Cyprus arm's-length principle is in line with the international ‘arm’s length’ principle purporting to govern ‘controlled transactions’ and facilitate potential compensating adjustments amid examination of the tax affairs of the taxpayer. It should be noted that the arm’s-length principle governs a wide range of trading or business transactions but generally does not apply to transactions involving ‘uncontrolled relations’ or of a capital gain nature involving immovable property located in Cyprus.

Recently, Cyprus issued detailed transfer pricing regulations governing financial back to back (BtB) controlled transactions (the BtB Regulations) (see below). Aside from these regulations, Cyprus has yet to issue detailed transfer pricing guidelines concerning ‘controlled transactions’, although in practice the principles underlying the OECD’s Transfer Pricing Guidelines are commonly cited to support the set ‘transfer price’ in ‘controlled transactions’, amid tax examinations; or to potentially initiate a conventional advance ruling application process (although a sophisticated advance pricing arrangement does not exist).

Briefly touching on empirical tax audit cases involving conditions underlying ‘controlled transactions’ that deviate from open market terms, the authorities do not hesitate in effecting upward adjustments to the taxable income of a Cyprus company, in the absence of satisfactory evidence or economic and commercial rationale underpinning the effected controlled transaction.

As will be illustrated in this chapter, the OECD’s Transfer Pricing Guidelines are generally accepted and widely used in either of the cases mentioned above, with the aim of demonstrating that the selected ‘controlled transaction’ reflects arm’s-length conditions. However, in the process of assessing a ‘controlled transaction’, the authorities weigh the need for a detailed and comprehensive ‘transfer pricing methodology’ against the intention not to interfere with the economic development and growth or undue burdening of the taxpayer, and currently tend towards the latter.

During the process of a tax audit, it is generally essential for the contemplated ‘controlled transaction’ to be underpinned by sound commercial and economic reasoning and the defined ‘transfer price’ to generally fall within a reasonable range of expected prices after considering relevant economic circumstances, functions performed, assets used and risks assumed.

The expectation from the business community is that the Commissioner of the Tax Department will soon issue additional transfer pricing guidelines or enact new legislation to extend the application of transfer pricing regulations to a broader range of controlled transactions. The guidance is expected to be aligned with the OECD’s Transfer Pricing Guidelines (even if in a simplified form). In the interim, the discussion in this chapter is based on the Cyprus arm’s-length principle and how transfer pricing applies in practice as well as the BtB Regulations.

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11 Circular issued by the Authorities, EE 3.
12 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (July 2017 ed.).
II FILING REQUIREMENTS

At present, not least owing to the absence of detailed regulations or legislative provisions requiring specific transfer pricing methodology and documentation, there are no specific filing requirements with regard to documenting or detailing the reasoning or methodology underpinning the set ‘transfer price’ that applies to a selected ‘controlled transaction’, or completing and having in place the related ‘master file’ or ‘local file’ (except with reference to the country-by-country reporting requirement that Cyprus adopted and applies).¹³

As an exception to the above are the rules applicable to financial BtB ‘controlled transactions’, which, as already noted, are explicitly governed by the BtB Regulations. As such, the taxpayer should prepare a transfer pricing study supporting such transactions. Currently, such transfer pricing study should be submitted only if requested by the authorities, amid a future tax audit or if the taxpayer seeks to commence an advance ruling application process.

However, the general rule applies, namely that the taxpayer has a general obligation under the law¹⁴ to maintain evidence, documentation, books and all necessary information (collectively ‘evidentiary documentation’) that supports all transactions and financial data in the audited financial statements of the taxpayer. These legislative compliance provisions are broadly worded therefore implicitly also cover also evidentiary documentation underpinning the effected ‘transfer pricing’ in controlled transactions.

Such evidentiary documentation should be maintained for a period of seven years¹⁵ (including the current year) at the premises of the taxpayer and be available for any tax audit that may be initiated by the authorities.

III PRESENTING THE CASE

i Pricing methods

Currently, Cyprus law does not provide transfer pricing guidance or methodology to be used for determining the transfer price in a selected ‘controlled transaction’. However, the OECD Transfer Pricing Guidelines (albeit in a more simplistic form) will generally be accepted by the authorities if used or relied on by taxpayers.

Thus, at present, and until transfer pricing regulations are issued, taxpayers should expect that the traditional transaction methods¹⁶ would generally apply to transfer pricing cases. Such methodology consists of the comparable uncontrolled price method using comparables or near comparables, the resale price method, and the cost-plus method. Occasionally it may suffice for the controlled transaction to have implicit or explicit underlying economic and business reasoning within the context of the contemplated ‘controlled transactions’.

In this respect, empirical experience on the treatment by the Tax Office of ‘arm’s-length’ transactions suggests the following approach or methodology depending on the subject matter of the transaction.

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¹⁵ Article 30(3), Assessment and Collection Law.
¹⁶ OECD Transfer Pricing Guidelines 2016, Part II: Traditional transaction methods.
Financing arrangements (provision of loans to related parties)

The use, mainly, of the comparable uncontrolled pricing methodology, as comparables are generally available by reference to their economically relevant characteristics. This pricing methodology may be used in conjunction with the business or commercial sense underpinning a selected financing arrangement.

In this respect, in using comparables or nearing comparables, one considers, inter alia, functions performed by the lender such as cash-flow monitoring and assessment of the creditworthiness of the potential borrower, the amount of the principal loan, the maturity of the loan, the currency of the loan and the profile of the borrower. Additionally, the risks assumed by the taxpayer such as credit, currency and cash-flow risk are integral in the process to using a comparable and one would be well advised to demonstrate that the specific financing arrangement has business and commercial rationale.

BtB controlled transactions

As of July 2017, a company in Cyprus that uses borrowed funds to provide loans to related parties should perform a transfer pricing study. At the core of this study lies the:

a functionality analysis, in terms of the functions, assets and risks that the Cyprus company undertakes to perform its financial business; and

b comparability analysis, by which the conditions and circumstances of such BtB arrangement should be consistent with comparable conditions of a BtB transaction occurred in an uncontrolled transaction.

Simplification measures also apply where pure intermediary financing vehicles may opt in and avoid performing a comparability analysis. Notwithstanding this, such intermediary financing company should still perform a functionality analysis demonstrating that it undertakes related functions, assets and risks.

Companies following the simplification route should have a minimum return on the BtB transaction of 2 per cent (after tax), calculated on the face value of the principal loan.

Simplification measures also apply to companies having similar profile or outlook to financial institutions as described in the EU Regulation No. 575/2013. In such a case companies would be required to produce at least 10 per cent (after tax) return on their equity.

Buying or selling of goods or services

The predominant use of a cost-plus or similar method by which one applies a reasonable (nearing arm’s length) gross profit margin or occasionally if these services constitute low value added services, then a thin margin earned on the cost incurred for performing this service may suffice.

If the transaction involves finished or semi-finished products and the profile of the ‘manufacturer’ is that of a limited risk manufacturer, determined by reference to: its functions performed (comprising storing, making minor changes or additions to the end product); undertaking minor business risks relative to the overall creation of value of the group); and minor assets used, the common approach is to apply a reasonable gross profit margin that reflects the average gross profit margin used in the industry or a gross profit margin of nearing comparable.

17 OECD Transfer Pricing Guidelines 2016, Part II: Traditional transaction methods.
Similarly, if the company is a limited distributor, determined by reference to its limited functions, and risks assumed as well as assets used (not creating or owning any intangible), the common approach is to apply a reasonable gross profit margin. Occasionally, a similar to resale price methodology may apply instead.

Regarding services, the cost-plus methodology usually applies. Cost-plus comparables are generally acceptable in these types of transactions, and taxpayers generally use average gross profit margins that apply in the specific service industry or in the broader service industry.

**Transactions involving non-business assets that produce an exempt type of income in Cyprus (such as foreign dividend income\(^{18}\) or capital gain on sale of corporate titles\(^{19}\))**

The underlying business and commercial rationale is very important for the tax impact (and treatment) that may be ensuing on any potential ‘secondary adjustment’ (see below), but not regarding the tax treatment of the transaction itself, as it is exempt.

In this respect, it is advisable that such transactions be underpinned by commercial and sound business rationale relative to the overall context in which they occurred. It may be advisable that the taxpayer obtains an advance tax ruling: an application that by sets out the specific facts and circumstances underlying the transaction and seeking the opinion of the authorities.

**IV  INTANGIBLE ASSETS**

In the absence of transfer pricing guidelines, Cyprus companies that hold intangible assets (trademarks, industrial designs) should expect, for the purposes of determining the ‘transfer price’ on the contemplated income streams, a variety of commonly used valuation techniques such as discounted valuations. Such valuation techniques are especially used for hard to value intangibles for which comparable transactions do not exist. It should be noted that discounted valuation techniques should be based on reasonable forecasts and assumptions.

Notwithstanding this, it is advisable to also test whether available comparables or nearing comparables exist, which would allow taxpayers to use the aforementioned traditional transaction methods. Thus, a taxpayer should be in a position to demonstrate that the anticipated ‘compensation’ on allowing for the use of the intangible reflects the functions the taxpayer performs (by reference to their respective protection and exploitation) and related operating expenses (such as promotional expenses to enhance the value of the intangible) as well as risks assumed (exploitation risk in terms of the uncertainty in the production of income streams). In this respect, taxpayers are expected to set out the income stream prospects along with functions performed and related costs to demonstrate that the overall ‘pricing’ is justified economically and commercially.

The authorities tend to accept the ‘pricing’ on the controlled transaction if the taxpayer demonstrates the reasonableness of the pricing. In the absence of transfer pricing guidelines, it also follows that there are no DEMPE\(^{20}\) specific principles and the general principles apply. It is expected that transfer pricing regulations will be issued by the authorities, which will potentially mark a change in the current approach of both the authorities and potentially

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20 Development, enhancement, maintenance, protection and exploitation of intangibles.
the taxpayers in controlled transactions. In fact, the authorities have issued a recent circular\(^{21}\) stating that for the determination of ‘embedded income’\(^{22}\) arising from ‘qualifying’ intellectual property, the OECD Transfer Pricing Guidelines should be followed.

V SETTLEMENTS

In view of the current absence of regulations or legislative provisions explicitly mandating transfer pricing guidance or methodology, any settlements reached in response to a controlled transaction would be effected amid the broader context of the settlements with the authorities in the context of the examination of the financial (tax) returns of the taxpayer. In this respect, the settlement would involve an agreement, \textit{inter alia}, on the historic treatment of the taxpayer’s affairs (including any transfer pricing issues that may arise). Thus, any settlement reached on a transfer pricing issue would generally be of an \textit{ex post} nature (applying on historic transactions) and not \textit{ex ante}.

In practice, however, such historic settlements may constitute a precedent and be followed for subsequent years, assuming no substantial change in the applicable facts and circumstances (nothing prevents, however, the authorities from revisiting and not adhering to the position taken in prior years), unless a tax ruling can be obtained on the issue (see below).

Currently, no advance pricing arrangement (APA) mechanism exists and the conventional advance tax ruling process is not designed to cover detailed transfer pricing cases. However, it is anticipated that transfer pricing cases will be covered either by the introduction of an APA mechanism or by broadening the scope of the conventional advance tax ruling process. If so, it would be advisable to seek such a ruling or APA to secure certainty of tax treatment.

As it stands, the authorities\(^{23}\) will abide by their rulings if the circumstances and parameters on which the conventional ruling is based remain substantially the same. It is expected that the authorities will soon extend the scope of the conventional tax ruling process to include transfer pricing studies for financial BtoB transactions.

VI INVESTIGATIONS

The law generally grants the right to the authorities to assess a taxpayer’s tax return after the respective submission deadline\(^{24}\) and issue notice of assessment to the taxpayer depicting the authorities’ agreement or disagreement with the tax return submitted.\(^{25}\)

Likewise, the law provides the right to the taxpayer to object a disputed assessment. If so, such objection should be filed by end of the next month and specifying the reason underpinning the objection letter.\(^{26}\) Following submission of an objection the authorities and the taxpayer usually exchange views (at meetings or by correspondence), which invariably involves the taxpayer providing additional documentation to support their case.

In the absence of detailed or specific provisions governing transfer pricing investigations, the general provisions of the law apply also to disputes on a set ‘transfer price’ by which the

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\(^{21}\) Circular issued by the Authorities, 2017/4.
\(^{23}\) TD Circular 2015/13.
\(^{24}\) Article 13(1), Assessment and Collection of Taxes Law of 1978, 4/78, as amended.
\(^{26}\) Article 20(3), Assessment and Collection of Taxes Law of 1978, 4/78, as amended.
authorities on issuing assessment potentially challenge the underlying terms of a ‘controlled transaction’; the taxpayer should be able to demonstrate to the satisfaction of the authorities that the controlled transaction reflects the fair market terms.

In this respect, and as already mentioned above, the taxpayer should have satisfactory evidentiary documentation in place underpinning the method of determination of the price, the economic and commercial rationale underlying the controlled transactions, and furnish these to the authorities. The authorities generally review the documentary evidence produced by which the taxpayers detail the determined ‘transfer price’, and they will accept it if it is reasonable and justifiable in light of the specific economic circumstances or aligned to the OECD reports and guidelines. The authorities generally accept nearing comparables illustrating that the determined transfer price is within a reasonable range.

It should also be noted that the authorities, on examining the evidentiary documentation, will either cancel their original assessments and issued revised or final ones or a final assessment would be issued without the agreement of the taxpayer, in which case the taxpayer may seek recourse to the tax tribunal or to the court (see below).

Finally, as of July 2017, the taxpayer should have a transfer pricing study in place supporting financial BtB transactions, and similarly, the taxpayer should have a functionality analysis if it opts for the simplification measures.

VII LITIGATION

In the event that a taxpayer wishes to challenge the findings, position or tax assessment of the authorities on a specific matter, he or she may apply to the Tax Tribunal or Court, or both.

In this respect, the taxpayer, on receiving the final notice of assessments as issued by the Commissioner without reaching an agreement, should file his or her application to the tax tribunal within 45 days from the date of notification of the disagreement with the authorities (from the issue of the final notice of assessment).

The Tax Tribunal will examine the application of the claimant and request a report from the authorities documenting the facts of the case and their position. At a later stage, the Tax Tribunal will set a hearing with the two sides and decide on the case. The burden of proof falls on the taxpayer.

If either of the parties disagrees with the decision of the Tax Tribunal, they may seek recourse to the Supreme Court. In such case, the taxpayer should pursue this action within 75 days from either final notification of the assessment or the issue of the Tax Tribunal’s decision. The burden of the proof should lie with the taxpayer. Recourse is brought under Article 146 of the Cyprus Constitution, whereby the assessment of the Supreme Court will involve the validity of the decision of the Commissioner, but if this is reasonable, the Court will not quash the decision of the Commissioner.

The following is taken from a relevant ruling of the Supreme Court on its power to quash the Commissioner’s decision under Article 146:

_The Supreme Court has no jurisdiction to go into the merits of the taxation and substitute, where necessary, its own decision. The power of the Supreme Court is limited, as indicated, to the scrutiny of the legality of the action, and to ascertain whether the administration has exceeded the outer limits_

of its powers. Provided they confine their action within the ambit of their power, an organ of public administration remains the arbiter of the decision necessary to give effect to the law; and so long as they make a correct assessment of the factual background and act in accordance with the notions of sound administration, their decision will not be faulted. In the end, the courts must sustain their decision if it was reasonably open to them . . . The approach of the court to the validity of a taxing decision is no different from its approach in respect of any other administrative decision liable to review under Article 146.29

Transfer pricing matters should also be governed under the above rules; therefore, if the taxpayer and the authorities cannot reach an agreement on a ‘controlled transaction’, the taxpayer may find recourse to either the Tax Tribunal or the Court, or both.

VIII SECONDARY ADJUSTMENTS

Currently, the Cyprus arm’s-length principle does not explicitly provide for secondary adjustments, although in the absence of a wording to forbid these, the authorities may apply such adjustments. Such ‘secondary’ adjustments may take the form of deemed dividend distribution (if it involves Cyprus tax-resident and domiciled physical persons); deeming receivable equal to the difference between the actual transfer price and the fair market price on which market interest rate will be imputed; or deemed operating income.

Secondary adjustments may be invoked in response to primary transactions involving tax-exempt assets and could take either of the forms denoted above. If so, a primary controlled transaction that should not have any Cyprus direct tax implications may be ultimately subject to taxation, especially if it lacks commercial or business rationale.

IX BROADER TAXATION ISSUES

i Diverted profits tax

The arm’s-length principle does not apply to transactions where no ‘controlled’ relation exists between the parties or selected transactions that constitute capital transactions.

In such situations, the law provides for separate provisions that may govern such situations complementing the breadth of the arm’s-length principle. We replicate below these legislative provisions:

Where the Director is of the opinion that in respect of any year of assessment the object of the tax of any person is reduced by any transaction which in his opinion was artificial or fictitious, he may disregard any such transaction and assess the persons concerned on the proper object of the tax.30

. . . in case of a disposal between related persons, as such term is interpreted by the Income Tax Law in force, where the disposal proceeds declared is an amount which is less than the market value of the property, there shall be deemed as disposal proceeds the amount of the market value of the property at the date of its disposal, as this is ascertained by the Director.31

30 Article 33, Assessment and Collection of Taxes Law of 1978, 4/78, as amended, CTR Publications Ltd.
31 Article 9(4), Capital Gains Tax Law, CTR Publications Ltd.
ii Double taxation

Cyprus has a very broad tax treaty network and generally applies the mutual agreement procedure (MAP) in response to its obligations under its bilateral double tax treaties (which are mainly based on the OECD Model Convention – therefore giving effect to the specific OECD MAP Article 25, if existing) or the Arbitration Convention32 (90/436/EEC) pursuing the elimination of double taxation.

Prima facie, such procedure may also be invoked in the context of primary adjustments under transfer pricing for the corresponding adjustment to apply and therefore eliminate or mitigate possibility of double taxation.

Currently, there is limited practical experience for invoking an MAP for transfer pricing. In addition, the law33 provides that if the authorities, during their tax audit, effect an upward adjustment in the tax computation of a taxpayer, a corresponding downward adjustment should also apply in the books of a connected controlled party. The resulting corresponding adjustment may be allowed as a deduction for the purposes of determining the connected controlled party’s tax computation if under the normal rules, the subject matter of the corresponding adjustment would have qualified for deduction.

In effecting such corresponding downward adjustment, the law provides a framework for mitigating cases of double taxation, at least within Cyprus.

X OUTLOOK AND CONCLUSIONS

Notably, the arm’s-length principle of the law is in line with the international principle of ‘arm’s length’ as envisaged in the relevant OECD Model Convention and Guidelines and purports to govern ‘controlled transactions’, and indeed the authorities in practice accept transfer pricing studies indicating that the set ‘transfer price’ is not affected by the connection between the parties in a controlled transaction.

However, in the absence of a formal requirement on detailed transfer pricing documentation (except for BtB financial controlled transactions) and specific guidance on the governing methodology, the authorities’ approach is pragmatic, reflecting a balancing exercise of fostering international business, while at the same time not allowing unreasonable controlled transactions deprived of business or commercial rationale to take place.

As a result, the process is relatively less cumbersome from the perspective of the taxpayer with regard to preparing and furnishing adequate evidentiary documentation underpinning a set ‘controlled price’ and from the perspective of the authorities with regard to using their limited resources to rigorously examine a selected ‘controlled price’, especially if the transaction is relatively within the context of a small or medium-sized business.

It is expected that the anticipated issuance of Cyprus regulations stipulating the nature of transfer pricing documentation and methodology to be followed will mark a shift in the current approach of the authorities, which require per se specific documentation to be in place and certain methodology to apply with regard to ‘controlled transactions’.

32 Κ.Δ.Π.161/2016.
I  OVERVIEW

Transfer pricing rules were introduced in Ecuador in 2005 through amendments to the Organic Law of the Internal Taxation Regime (LORTI) and its rules for application (RALORTI). The OECD’s guidelines are legally defined as a ‘technical reference’ regarding anything that does not oppose local standards; however, the Internal Revenue Service (SRI) has issued specific and rigorous standards on the presentation, analysis and establishment of results.

The arm’s-length principle applies for the determination of income tax – personal, corporate or of any taxpayer – provided that the tax declared is less than 3 per cent with regard to income, transactions are conducted with parties domiciled in tax havens, or contracts are held with the state for the exploration and exploitation of non-renewable resources. All other transactions are exempt from the regime.

For tax purposes, even if the relationship is configured indirectly, parties will be considered related under the following conditions:

- they hold permanent establishments, branches and subsidiaries;
- there is shared participation in management and control between the parties;
- there is a linkage of more than 25 per cent capital between the parties;
- familial relations exist between administrators and statutory auditors;
- a relationship exists through beneficiaries of trusts;
- following presumptive cases based on a proportion of transactions between independent parties; and
- owing to the application of different tax rates in local transactions.

The general transfer pricing regime applies to taxable benefits that were not obtained through the application of special conditions with related parties, through the analysis of income and expenses or through assets and liabilities transactions conducted during the fiscal year. Equity transactions, such as dividend distribution, capital contribution, compensations or reclassifications that do not affect the results are not taken into consideration. The adjustments made by the taxpayer or tax authority have no accounting, corporate or other effects. These are exclusive of tax conciliation of income tax, although sometimes the SRI has established that this affects workers’ profit sharing.

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1 José Augusto Crespo is the managing partner at Andestrat Consulting.
2 Article 89 RALORTI.
3 Unnumbered article fifth subsequent to 15 LORTI.
4 Unnumbered article subsequent to 4 LORTI and Article 4 RALORTI.
II FILING REQUIREMENTS

Income tax forms require an itemised report of the transactions and balances of the operations conducted with related parties during the fiscal period. In the specific case of corporations, the form has fill-in fields in which the filer must specify if the transactions are local (in some cases), with related parties abroad or with related parties domiciled in preferential tax regimes.

Transactions with local related parties are under the transfer pricing regime when the taxpayer:

a reports a negative taxable basis for income tax;
b has taken advantage of a tax incentive under the Organic Code of Production, Trade and Investment;
c has a reduced income tax rate due to profit reinvestment;
d is a Special Area of Economic Investment operator;
e is devoted to exploration and exploitation of non-renewable resources; or
f has shareholders domiciled in fiscal havens.

When the total transactions reported is greater than US$3 million, two months after the filing of income tax returns, a new Annex of Transactions with Related Parties must be presented. This consists of a computerised report listing general information (domicile, address, tax ID, relationship) of related parties, the type, amount and number of transactions made, the methods and margins applied and, if pertinent, the amount of transfer pricing adjustments.

The Comprehensive Report on Transfer Pricing must be submitted to the tax administration when the total amount of declared transactions is greater than US$15 million. The aforementioned report must be prepared based on a technical sheet for standardisation. Said sheet consists of a strict content guide, a description of the selection process of databases and comparable data, priority and selection methods, implementation of adjustments and measures to prevent abuse of transfer pricing. Although the report is submitted two months after the filing, its results must appear in the tax determination.

Additionally, the corporations required to file financial statements with the opinion of independent external auditors must include a paragraph on their compliance with the transfer pricing regime and describe all their transactions with related parties in the Tax Compliance Report (ICT).

The aforementioned reports must be filed annually, and even if a taxpayer is not required to file reports before the tax authority, he or she must keep the documents that support their transfer pricing position. Currently, the price analysis must be conducted from the perspective of the Ecuadorian taxpayer; the application of the country-by-country report is not planned.

5 Unnumbered article subsequent to 22 LORTI.
6 Resolution NAC-DGERCGC15-00000455.
7 Idem.
8 Idem.
III PRESENTING THE CASE

i Pricing methods

To analyse compliance with the arm's-length principle in transactions between related parties, Ecuadorian regulations recognise five methods\(^9\) (not including the residual profit split method), which may be applied pursuant to OECD guidelines, except in the following cases:\(^10\)

a Transactions with a broker: when the transactions analysed are conducted with a broker domiciled in a fiscal haven or who is not domiciled in the final destination country of the goods, the transfer pricing methodology will apply without assigning a margin and without considering the price registered by the broker. The international broker margin may be considered only if it is not a related party and meets a series of requirements.

b Oil export: the comparable uncontrolled price is defined as the weighted average of oil exports made by the state in the shipping month.

c Metallic mineral export: the comparable uncontrolled price is defined as the international price and adjustments under the law for the calculation of royalties.

d Banana export: the comparable uncontrolled price is defined as an indexed limit set annually by the tax authority.

Additionally, technical standards have been issued for the application of the transfer pricing regime, which the SRI considers to be a measure to prevent abuse in the application of these methodologies. In order to use the methods for resale price, added cost and transactional margin of operational profit, the following must be taken into consideration:\(^11\)

a the profit indicator cannot have a denominator that contains the transaction being analysed. For example, the transactional margin (transactional profit or sales) cannot be used if the transaction analysed is an export;

b comparables with operative losses cannot be used unless it is demonstrated that the losses are characteristic of the business or industry;

c the financial information of comparables may be used only from the period being analysed, provided that the fiscal closing is after 31 August and that it is available until 10 April the following year;

d to use financial information of comparables from several years requires objective justification indicating that the transaction analysed is part of a business cycle;

e third-party information must not include segments of different businesses that imply significantly different comparability criteria;

f the comparables selected shall not carry out transactions with related parties;

g comparables domiciled in fiscal havens or preferential regimes cannot be used;

b there must be detailed and sufficient information (descriptive and financial) of the comparables selected; and

i the realisation of comparability adjustments should be justified qualitatively and quantitatively; the adjustments should consider restrictions for the justification based on the cash cycle, the economic reality to be adjusted, the interest rates to be used and the specific formulas to be used. If the taxpayer submits financial statements under the IFRS, it is not deemed necessary to make capital adjustments.

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\(^9\) Article 85 RALORTI.
\(^10\) Resolution NAC-DGERCGC16-00000531.
\(^11\) Resolution NAC-DGERCGC16-00000532.
In specific cases, the application of the arm’s-length principle has certain limits or considerations that must prevail over the result of the analysis methods:

- the accumulated payment of royalties, technical, administrative and consulting services to related parties cannot exceed 20 per cent of the tax base for income tax;\(^\text{12}\)
- the transfer pricing method is not applicable, nor is international commercial leasing between related parties deductible;\(^\text{13}\)
- the transfer pricing method does not apply to the income of international transportation companies;\(^\text{14}\)
- the transfer pricing method does not apply when the related party is a public law institute;\(^\text{15}\)
- the indirect expenses assigned from abroad by related parties cannot be greater than 5 per cent of the tax base for income tax;\(^\text{16}\)
- in the sale of fixed assets or shares, the analysis of transfer pricing will only apply to those transactions with profit;\(^\text{17}\) and
- regarding interest for credits granted by related parties from abroad, the evaluation of the arm’s-length principle is realised if the credit is not greater than 300 per cent of corporate equity and 60 per cent of a natural person’s assets (sub-capitalisation limits).\(^\text{18}\)

In general, the regulation provides that establishing the methodology must always start with the assessment of the uncontrolled comparable price (particularly in goods imports or exports); if it is not possible to apply this method, the resale price or added cost will be used, as pertinent. The application of profit distribution and the transactional margin of the transactional profit is considered to be extraordinary and those are the methodologies most observed by the taxation authority.

### ii Authority scrutiny and evidence gathering

The Ecuadorian regulation has anticipated that the reports on transfer pricing, which are to be filed before the tax authority, must enclose all the information that supports the conclusions of the analysis, such as contracts, reports or any other document relating to the transaction.

Generally, the SRI uses a local approach to the analysis of transfer pricing without considering the global taxation position. When transactions are conducted with local related parties, the authority may require any information, almost without limitation. In transactions with related parties from abroad, it may exclusively request information about the local taxpayer. In order to obtain information about related parties from abroad, generally the SRI uses public or private databases, public information from stock exchanges, or directly requires tax administrations with which information exchange and international cooperation agreements are in force.

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\(^{12}\) Numeral 16, Article 28 RALORTI.

\(^{13}\) Numeral 9, Article 13 LORTI.

\(^{14}\) Resolution NAC-DGERCGC15-00000455.

\(^{15}\) Idem.

\(^{16}\) Without numeral, Article 10 LORTI.

\(^{17}\) Article 11 LORTI.

\(^{18}\) Numeral 2, Article 10 LORTI.
IV  INTANGIBLE ASSETS

Ecuadorian law has not provided for a specific treatment or methodology to analyse intangibles. The current provisions focus on providing detailed information of the features of the transactions, such as the form (concession or sale), type of intangible assets (patent, trademark, know-how), the duration and degree of protection, the anticipated benefits and contractual terms (exclusive rights or sublicensing). However, the transfer pricing method applied must consider a limit of 20 per cent of the tax base for income tax for royalties plus other services paid to related parties.

According to the law, OECD guidelines are considered as a technical reference. Consequently, it may be expected that the DEMPE principles be accepted by tax authorities in practice.

V  SETTLEMENTS

As of 2015, taxpayers may make a consultation about the prior valuation of transfer prices\(^{19}\) to the highest authority of tax administration; this consultation is in nature an advance pricing agreement (APA) and has an effective time of up to five taxation periods.

The process is divided into two stages. The first stage is to carry out a prior action, which basically consists of identifying the related parties, describing the transactions and basic elements of the assessment proposal. The purpose of this preliminary procedure is to assess the consultation’s feasibility.

Once its feasibility has been established, a formal previous assessment consultation must be filed, which must include the following information:

\(a\) general data: identification of the consulting party and transactions subject to assessment, which must be established if the application realm is unilateral or bilateral, or if there are any APA (current or ongoing) in any other jurisdiction regarding the transactions consulted;

\(b\) information of the intervening parties, which consists of a detailed description of the related parties’ information; among others, the main requirements are comparability and functional analysis, the process to obtain comparables and the financial information of the last three years of all intervening parties;

\(c\) proposal of the assessment methodology; and

\(d\) critical assumptions: identifying the circumstances that may affect the assessment.

The absolution consists of the approval of the proposed methodology or establishment of a binding alternative methodology. The taxpayer will be exempt from submitting the Annex of Transactions with Related Parties and the Transfer Pricing Report of the transactions contemplated. However, the taxpayer shall submit an annual results report and application of the APA.

The consultation would be less effective if there are variations in the critical assumptions or conditions established in the agreement or when the annual application report is not submitted.

Considering the tax authority has a term of two years to answer an assessment consultation, and that once approved, the results of the application must be reported.

\(^{19}\) Resolution NAC-DGERCGC14-00001048.
annually, it is not practical to apply this procedure except as a mechanism to increase the limit of 20 per cent on the tax base of accumulated royalties payment, technical, administrative and consulting services to related parties. According to SRI’s public information, by 2017, 62 consultations were submitted, of which 46 were admitted and 26 absolved.

VI INVESTIGATIONS

Ecuadorian law has not provided a special or specific mechanism to inspect transfer prices. To this effect, the tax administration must apply the general rules of a tax audit on income tax; this regulation provides that the SRI might establish the taxable income and the deductible costs and expenses, thus establishing the price of transactions between related parties, in the following cases, among others:

- sales at cost or lower than cost;
- exports at prices lower than those in effect in foreign markets; and
- imports at prices greater than those in effect in international markets.

The powers of the tax administration allow it to carry out information or documentation requests of up to seven years prior. However, the power to carry out tax audits on income tax (including transfer prices) has a duration of three years counted from the date when the tax return is filed; this term may be extended to six years when the taxpayer has failed to file or has omitted income.

A process of inspection normally begins with a request for information or previous inspections; if the administration considers that there are grounds to execute a tax audit – within the aforementioned term – a notice with an order of determination must be issued to formally start the audit process. The SRI has a one-year term to issue the determination record with the results of the audit.

Prior to the issuance of the final result, the authority must serve a draft and grant a term of 20 days for the taxpayer to make remarks or submit additional documentation that dispels or justifies the economic liabilities. In practical terms, these remarks are not considered.

The tax audit is considered to be a final act subject to a claim through the administrative track before a regional SRI director within a 20-day term or a judicial challenge before the Contentious Taxation District Court (TDCT) within a term of 60 days.

The administrative claim may be considered an inefficient appeal alternative, considering that the tax administration in its resolutions tends to defend or reinforce the position of the audit department. This procedure has a maximum duration of 120 days.

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20 Resolution NAC-DGERCGC15-00000571.
21 Article 23 LORTI.
22 Article 94 of the Tax Code (TC).
23 In taxation matters the terms are always counted in business days.
VII LITIGATION

i Procedure
As mentioned in the previous section, the judicial challenge is the recommended alternative to appeal the results of a tax audit. As of 2016, the General Organic Code of Procedures (COGEP) radically amended the challenge procedure in Ecuador, establishing oral litigation as the base of the system.

In the 60-day term that the taxpayer, affected through an act of determination, has to file the claim, he or she must gather or process all the documentary or expert evidence because it must be enclosed with the initial plea. Once filed, the TDCT has a five-day term to qualify the claim. For its part, the tax authority – upon being served with a notice of a claim – has a 30-day term to respond and submit its own documentary or expert evidence.

Upon expiration of the deadline to answer the claim, within a period not exceeding twenty days, the TDCT will arrange for a preliminary hearing to be held in which the parties must present their claims and grounds and broadly announce the evidence that will be produced in the trial for the judges to accept or reject. Once this preliminary action has been completed, the TDCT will order that the trial hearing takes place within a term no greater than 30 days.

A significant aspect that must be taken into consideration is the participation of expert witnesses at the trial hearing. These should be qualified as experts by the Judicial Council (CJ) and must defend the methodology, analysis and conclusions contained in their reports, as well as answering the questions asked during the hearing. Once the trial hearing is completed, the judges must issue their resolution through an oral statement that must be notified in writing afterwards and that is subject to appeal before the National Court of Justice (CNJ) through a cassation appeal, which must be filed no later than 10 days after.

ii Recent cases
Article 90 of the rules of application of LORTI establishes the power of the tax administration to use information on secret comparables for the application of the arm’s-length principle.

Through Judgment No. 024-17-SIN-CC of September 2017, the Constitutional Court of Ecuador (CC), in Claim No. 0024-13-IN, ruled on the claim of public action of unconstitutionality of the standard that allows the use of secret comparables which was used, arguing that it restricts the taxpayer’s right to defence, below an abstract of the sentence:

> ... the second interpretation of the provision contained in article 90 RALORTI is inapplicable. That is that the use of secret comparables of third parties or companies in determining a possible tax evasion of the taxpayer under scrutiny necessarily implies providing the information used by the tax authority, in order to carry out the defence deemed adequate. On the contrary, if the information used by the tax authority is reserved, and thus cannot be shared with the taxpayer under investigation, it may not be used to establish tax evasion in a specific case.

Consequently, the CC has resolved that the SRI may use secret comparables to establish strategies, assess risks, implement requirements and other activities for the selection of auditable cases. In the event adjustments are made to transfer prices through particular audits, secret comparables cannot be used because that would leave the taxpayer defenceless.
VIII SECONDARY ADJUSTMENT AND PENALTIES

Ecuadorian regulation has not provided for secondary adjustments to modify the taxpayer’s financial position with regard to shareholders or its related parties. In other words, the adjustments or economic liabilities of transfer prices, established through a tax audit, are effective only in the tax conciliation of income tax.

The Ecuadorian transfer pricing regime considers some penalties. Not filing a statement, annex or operations report with related parties, or filing one with errors is considered a regulatory failure punishable with a fine of up to US$15,00024 to be imposed through a resolution that may be challenged through the administrative or judicial track.

On the other hand, when the tax administration has ascertained that the arm’s-length principle was not met and carries out an audit, the transfer price adjustment is made by applying the median of the range of full competence. Additionally, a 20 per cent surcharge must be added to the total amount of the adjustment25 and interest equivalent to 1.5 times the referential active rate.26 These penalties must be established in the determination record of the income tax and are challenged along with the main obligation.

If it was established that the transactions between related parties have been simulated or lack economic grounds, criminal liability might arise.

IX BROADER TAXATION ISSUES

i Diverted profits tax and other supplementary measures

There is no provision for tax on deviated profits or any other similar tax that complements or interacts with the transfer pricing regime.

ii Double taxation

Ecuador has in place Agreements to Avoid Double Taxation (CDT) with 21 countries. However, maximum amounts and requirements were established as of May 2016 for the automatic application of benefits under the CDT.

To make a payment abroad without source withholding or with a withholding at a preferential rate under a CDT, a cumulative annual payment amount per supplier must be taken into consideration; it should not exceed 20 basic fractions of income tax for natural persons (for 2018: US$225,400).27 Above this amount, taxpayers must implement the withholding at the source of income tax for payments abroad (25 per cent) without consideration of benefits under the CDT. Additionally, a certificate of tax residence issued by the competent authority of the country of domicile of the foreign supplier is a requirement to automatically apply the benefits of a CDT.

If the withholding at the source is not made after exceeding the amount to apply the CDT, the local taxpayer must undertake the withholding at the source plus a 100 per cent surcharge and interest for tax arrears.

To avoid infringement of CDT provisions, the tax administration has established a procedure to refund the amounts corresponding to income tax withholding implemented

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24 Unnumbered article subsequent to 22 LORTI.
25 Article 90 TC.
26 Article 21 TC.
27 Resolution NAC-DGERCGC16-00000204.
with regard to non-residents in application of the CDT. The non-resident subject may file for monthly reimbursement by enclosing the withholding slips, the settlement of the purchase of goods and provision of services issued in Ecuador, the agreements and invoices that support the transaction, the SWIFT voucher for bank transfers, the legal representative’s identification and enabling documentation, the certificate of tax domicile, and the password for SRI online services. The procedure must be accepted and an electronic notice must be issued within a 60-day term.

For this restriction the SRI does not foresee going to a mutual agreement procedure (MAP) or arbitration because it considers that the benefits under the CDT are not eliminated, rather only their automatic application is limited.

In Ecuador, a unilateral measure has been planned to avoid double taxation. It consists of treating the income earned abroad that was subject to taxation in another state as tax-exempt income. If the income comes from jurisdictions with lower taxes, the tax paid will be used as tax credit.

### iii Consequential impact for other taxes

The transfer pricing regime applies exclusively in the settlement of income tax; it does not affect the value added tax or customs taxes.

### X OUTLOOK AND CONCLUSIONS

In Ecuador, the transfer pricing regime is applied whenever the income tax is lower than 3 per cent of income or transactions are conducted with parties domiciled in fiscal havens. Although the system is based on OECD guidelines, the extensive and rigorous legal, regulatory and administrative system focuses on establishing limits for the application of the arm’s-length principle and, above all, on standardising the methodology that taxpayers must use to establish the taxation position of their transactions with related parties. The strict analysis and reporting parameters are considered by the author as technical measures to avoid abuse in the use of subjective elements in comparability analysis in which quantitative factors must prevail over qualitative ones.

The tax administration’s priority is previous control, applied by the taxpayer and validated by independent external auditors. Thus, there are not that many cases of transfer pricing audits. However, when conducted, the administrative challenge is a scenario with a low probability of success. A similar expectation may apply to the APA consultation or any other process before the tax authority. Although judicial challenges were not effective refutation mechanisms, with the enactment of COGEP, the expectation is that the procedures against the results of tax audits will be more efficient and transparent than they were under the previous system. With regard to the standard that restricts the automatic application of CDT benefits, the filing of a constitutional action to guarantee taxpayers’ rights is necessary.

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28 Resolution NAC-DGERCGC16-00000388.
29 Article 49 LORTI.
Chapter 7

GERMANY

Stephan Schnorberger and Lars H Haverkamp

I OVERVIEW

In German tax law, there is not one integrated section of statutory rules on transfer pricing, but several provisions in different legislative acts. The rules on constructive dividends and Section 1 of the Foreign Tax Act (FTA) are most influential for the tax treatment of transfer pricing. The concept of constructive dividends and Section 1 are interpreted by case law and are supplemented by various legislative directives and administrative circulars.

German transfer pricing rules and principles cover all sorts of business transactions concluded between German taxpayers and related parties abroad. In a nutshell, all related-party transactions not based on the statutes of association between (direct and indirect) shareholder (or partner) and company (or partnership) are subject to the arm’s-length standard. This is regardless of whether the transactions are ‘income’ or ‘capital’ transactions. In addition, all transactions between a head office and its permanent establishment (PE) are covered, whether they are explicitly declared dealings or not. The term ‘dealing’ refers to fictitious cross-border transactions between a head office and its PE. Examples are inter-company sales (also investments) and services, loans or guarantees and IP licensing arrangements, as well as the transfer of functions between related parties.

The definition of a ‘related party’ goes beyond mere group companies, family members and relatives. Based on statute, a related party can be any party that is in a position to exert influence on a taxpayer or that has a special interest in the income generated by the taxpayer going beyond a regular business interest.

In practice, however, German tax authorities focus on transactions between group companies with direct or indirect shareholdings of at least 25 per cent (Section 1(2) FTA), as well as on transactions between members of a family.

In German transfer pricing law, there is a double theme of the arm’s-length principle and the concept of the prudent and diligent managing director of an independent enterprise. In general, the classic arm’s-length principle must be applied to cases where empirical data to determine arm’s-length prices is available (the ‘fact-based’ or ‘factual’ arm’s-length test). The concept of the prudent and diligent managing director is used, in particular, to obtain an arm’s-length transfer price for inter-company transactions where empirical data with appropriate costs cannot be found (the ‘hypothetical’ arm’s-length test).

Germany has started to implement OECD BEPS Action Reports, such as Action Report 13 on documentation. As long as OECD guidance or papers are not passed into law, neither the German tax administration nor the German tax courts are legally bound by them.

1 Stephan Schnorberger is a partner and Lars H Haverkamp is a senior associate at Baker McKenzie.
This also applies to the OECD Commentary on the Model Convention and to the OECD Transfer Pricing Guidelines. Nevertheless, OECD guidance constitutes a relevant source of interpretation that can be used to determine arm’s-length prices. In 2013, in response to the Authorised OECD Approach (AOA) to the allocation of profits between a head office and its PE, the German legislature adopted the AOA into German law with certain deviations. Even though specific AOA language on head office–PE profit allocation has only been included in a few German double tax treaties, the administration holds that the AOA takes precedence in the majority of cases, in particular when the contracting state is an OECD member. In addition, the German AOA rules generally prevail over profit allocation rules in the applicable double tax treaty.

II FILING REQUIREMENTS

In 2003, the German legislature introduced a statutory obligation to document transfer prices and their arm’s-length nature.\(^2\) The statute provides that taxpayers are required to prepare documentation on cross-border transactions with related parties.

In line with OECD BEPS Action Item 13, the German legislature expanded the transfer pricing documentation requirements. The taxpayer must not only prepare a local file, but also a master file, unless the enterprise’s annual revenue is less than €100 million. Transfer pricing documentation for ordinary business transactions must be submitted within 60 days upon request by the German Tax Authority, usually in the course of a tax audit. Contemporaneous preparation is not required but is recommended as the taxpayer has to document a number of facts regarding the price setting. There is no legal obligation to prepare annual documentation on ordinary, ongoing related-party transactions. Under general principles, documentation has to be updated or recreated when changes to conditions occur that significantly affect prices or margins.

An exception is that extraordinary business transactions have to be documented contemporaneously, that is, at the latest, six months after the end of the business year in which the transaction took place, and documentation has to be submitted within 30 days upon request. According to legislative regulations, extraordinary transactions are, in particular, transfers of functions, the conclusion and amendment of significant long-term inter-company agreements and the conclusion of cost allocation agreements.

The documentation regulations (GAufzV) were updated in 2017 to further reflect OECD recommendations. The new rules also put more emphasis on value chain analyses and economic substance requirements. Domestic rules on the preparation of a local file (opposed to the group master file) are generally in line with the OECD Action 13 recommendations. Additionally, the new law requires taxpayers to document the time of transfer price setting as well as detailed information on the database and search strategy used in determining an arm’s-length price or margin. Master file requirements are also in line with the OECD Action 13 recommendations, and the revised GAufzV is applicable as of fiscal year 2017. It is expected that the Administrative Principles – Procedure (Verwaltungsgrundsätze-Verfahren) will also be amended accordingly.

\(^2\) Section 90 General Tax Code, complemented by Gewinnabgrenzungsaufzeichnungsverordnung, GAufzV.
According to Section 6(2) GAufzV, enterprises with inter-company provisions of goods of no more than €6 million (paid or received) per annum or inter-company provisions of services of no more than €600,000 per annum (paid or received) are exempt from the documentation requirement.

The documentation requirement also covers head office–PE dealings and the allocation of assets between head office and PE.

A German-based entity with a PE abroad and non-German entities with a PE in Germany are to prepare an ‘auxiliary and complementary statement’. In principle, this is in addition to annual statutory and tax accounts.

The auxiliary and complementary statement has to be set up at the latest before the deadline for submission of the annual tax return. It is, however, not part of the tax return; it only needs to be submitted upon request. The auxiliary and complementary statement includes (tangible and intangible) allocated assets, allocated free capital, allocated liabilities, associated payables and receivables, and constructive income from internal dealings as well as opportunities and risks transferred from the head office to the PE. In line with OECD guidance, the auxiliary and complementary statement has to record intangible values that are not assets in the tax accounting sense of the term.

In addition, annual country-by-country reporting (CbCR) is required where certain criteria are met. German group parent companies recording consolidated sales revenues of at least €750 million have to prepare annual CbCRs on the group’s sales revenues, income tax paid during the fiscal year, equity capital, number of employees, tangible assets, etc. On the other hand, foreign group parent companies are not required to disclose this information in Germany; however, assuming the foreign group parent records revenues of €750 million or more, and the Federal Central Tax Office has not received the CbCR from the country of residence of the parent, German subsidiaries are required to disclose the CbCR. In this case, each German group subsidiary is obliged to submit the CbCR, or at a minimum any CbCR data to the extent available (Section 138a(4) GTA).

To sum up, according to Section 138a GTA, there are three scenarios whereby German companies become obliged to file the CbCR in Germany:

a the company is the ultimate holding company of the group preparing consolidated financial statements according to German or foreign GAAP (Section 138a(1) GTA) (‘resident group holding company’);

b a foreign parent company employs the German company for surrogate filing (Section 138a(3) GTA) (‘appointed resident group entity’); or

c the German company should be included in the foreign parent company’s CbCR filing, but the Federal Central Tax Office has not received CbCR data; the German company is obligated to submit the CbCR for the group or at least CbCR data that it has access to (Section 138a(4) GTA) (‘included resident group entity’).

In its annual tax filing, the German company will have to declare into which of the above categories it falls (Section 138a(5) GTA). With regard to the procedure, it is important to note that preparing and submitting a CbCR is a reporting or notification obligation, but not a documentation obligation.
III PRESENTING THE CASE

i Pricing methods

In line with the OECD Transfer Pricing Guidelines, Section 1(3) FTA provides for the statutory priority of the standard methods, being the comparable uncontrolled price (CUP), the resale minus and the cost-plus method. If the data available is fully comparable with the tested transaction prices, the full range of such arm’s-length values is used. As the application of the CUP method requires very strong comparability, it is only seldom applied. Typically, the CUP method is applied for the sale of fungible goods, taking place at the same level of the commercial chain as well as for financial transactions. The resale minus method is frequently applied for sales and marketing transactions as well as distribution activities. The cost-plus method is mostly applied for the sale of goods by a manufacturer who does not contribute valuable and unique intangibles and does not assume significant risks. The same is true with regard to the provision of services.

If fully comparable arm’s-length values cannot be determined, the transfer price method must be based on partly comparable values. In such case, appropriate adjustments must be made, provided they improve comparability, and the resulting range of arm’s-length values must be narrowed down, usually to the interquartile range. If the actual transfer price is outside of this range, adjustments are made to the median of the range.

Methods other than the standard methods are the transactional net margin method (TNMM) and the residual profit split method. These methods are regarded as transactional profit methods. Based on administrative regulations, the German tax administration will only accept TNMM if used to price a limited risk ‘routine’ transaction (e.g., low-risk service provider or manufacturing activities). The residual profit split method is said to be accepted only where standard methods cannot be applied (reliably). The regulations exemplify such a situation by the global trading of financial products and, more generally, by two or more market-facing entrepreneurs making unique and valuable intangible contributions, which are highly integrated.

Transfer pricing methods that are based on global profit allocation, such as the comparable profits method (CPM), are not accepted by German tax authorities.

If neither fully nor partly comparable arm’s-length values can be determined, the taxpayer must apply a hypothetical arm’s-length range. The range is derived from the maximum price acceptable for the payer (buyer) and the minimum price to be charged by the payee (seller). Once a range between maximum and minimum prices has been established, the price that is most likely to be at arm’s-length should be applied. The default value within the range is the midpoint value between the maximum and the minimum price.

Special valuation rules apply for determining a hypothetical arm’s-length price for the transfer of a function (business restructurings in OECD terminology). According to these rules, the hypothetical arm’s-length transfer price is determined as a ‘transfer package’. The transfer package consists not only of the individual assets associated with the production and the sales or service function transferred, but also includes business opportunities, risks and potential location savings, as well as synergy effects.

In line with international standards, German regulations do not provide for safe havens. Arm’s-length transfer prices have to be determined case by case, taking into account all applicable facts and circumstances.

Although disputed in lower tax courts (Local Tax Court Münster, 14 February 2014, 4 K 1053/11 E.), the ‘Knoppe formula’ is a common ‘method of last resort’ to cross-reference royalty rates. According to the rule, royalty rates should not exceed 33 per cent and should not
be lower than 25 per cent of the incremental licensee operating profit. As tax administrators can be expected to rely more and more on profit splits as a result of the BEPS approach of the OECD, and as comparability expectations increase, reliance on the Knoppe formula can be expected to become a more challenging position.

**ii Authority scrutiny and evidence gathering**

The German tax authorities do not usually conduct special transfer pricing audits but examine transfer prices during the normal course of regular tax audits, which are conducted at regular intervals.

There are specific administrative regulations regarding the selection of companies for an audit (tax audit regulations – Betriebsprüfungsordnung or BpO).

According to the law, German tax authorities have the duty to investigate facts and circumstances neutrally, be they detrimental or favourable for the taxpayer.

The taxpayer has the duty to cooperate and to assist the tax auditor by answering the auditor’s questions in written or oral form, and by making available relevant information, notes and documents for inspection. In addition, taxpayers are obliged to submit transfer pricing documentation upon request and provide documents and evidence for cross-border transactions.

In general, the burden of proof that transfer prices are not at arm’s length is on the tax authorities. But, if the taxpayer does not fulfil its duties to cooperate or if the transfer pricing documentation is deemed essentially unusable, the tax authorities may in many cases estimate the taxpayer’s income based on a rebuttable presumption that the transfer prices as declared in the tax return are not at arm’s length. Thus, failure to present appropriate documentation may de facto result in a shift of the burden of proof.

German tax authorities keep expanding their resources in the area of transfer pricing. Many local tax offices have dedicated audit teams specifically trained in transfer pricing and international tax matters. Recently, tax authorities have started building up teams of valuation experts. These focus aggressively on valuations of intangibles, functions and businesses, among others. Within the course of a tax audit, the local tax auditor may refer a valuation question to such an expert acting as an adviser to the tax auditor. In matters of international importance, specialised tax auditors of the Federal Central Tax Office may come in. Typically, transfer price auditors of the Federal Central Tax Office have particular industry expertise.

At the level of the Federal Central Tax Office, extensive statistical information on international tax matters and transfer prices is collected. This information is confidential and is only available to the tax authorities. In a 2001 decision, the German Federal Tax Court ruled that the use of anonymous data does not, per se, violate German tax procedures if the data is presented in a way that allows the taxpayer to assess and comment on the data. This requirement effectively eliminates the tax authorities’ ability to rely on anonymous comparables in tax administrative and tax court proceedings. Nowadays, German tax authorities routinely use publicly available databases to cross-check benchmark studies presented by the taxpayer or to conduct their own analyses. Benchmark studies are often used for price-setting purposes. However, the application of benchmark studies as a price-testing approach is recognised in practice.
Transfer price findings continue to be a significant issue in tax audit practice. Key areas of fiscal interest are, in particular, the following:

a. German distributors or routine-manufacturers reporting low profits or incurring significant losses: in this context, there is a trend among German tax auditors to argue that a loss-making, business-wise autonomous German subsidiary renders market penetration services to the group leading to a cost-plus remuneration;

b. business changes, transfers of functions and intangible migrations;

c. royalty charges: fuelled by recent court decisions, German tax authorities increasingly focus on outbound licences for the use of corporate group names;

d. transfer prices in the context of principal structures (in particular limited risk distributor and intellectual property structures);

e. remuneration of non-routine service activities and allocation of synergies (i.e., in the context of central procurement companies);

f. PEs and profit allocation between head office and PE;

g. remuneration in line with DEMPE functions, arm's-length intangibles remuneration and the economic nexus approach;

h. trademarks;

i. intra-group financing; and

j. recharacterisation of transfer pricing models to profit split models.

IV INTANGIBLE ASSETS

In line with OECD BEPS Action Item 5, Germany introduced regulations on the limitation of the deduction of royalties ('licence barrier'), effective as of 31 December 2017. The statute is intended to focus on foreign IP boxes incompatible with the OECD nexus approach. The licence barrier limits the deduction of licence fees as expenditures provided the licensor is a related party; the royalty income of the licensor is taxed under a special regime deviating from the standard rules (preferential regime); and the royalty income is subject to low taxation (below 25 per cent). Two major exceptions are made if the preferential regime is in line with the OECD nexus approach as set out in Chapter 4 of the Final Report 2015 on Action Item 5, or if income is subject to controlled foreign company taxation in Germany. Currently, the Federal Ministry of Finance is reported to analyse whether the US FDII regime triggers limitations of royalty deductions.

Apart from this recent legislative development, tax audits have always focused on the substance underpinning major foreign income abroad and the respective deductions taken in Germany. Against the background of the OECD BEPS project, the aggressive scrutiny of substance has already increased and can be expected to increase further.

V SETTLEMENTS

Bilateral or multilateral advance pricing agreement (APA) procedures are available, based on double tax treaty rules for mutual agreement procedures (MAPs).

In principle, both unilateral rulings and bilateral and multilateral APAs are available in Germany. However, the Federal Ministry of Finance issued administrative regulations stipulating that in cases where a double tax treaty contains a clause on MAPs, the German
taxpayer should not be granted a unilateral ruling. However, where no double tax treaty exists, the tax authorities may, on request, provide the taxpayer with a unilateral APA, provided that the specific case is deemed appropriate and the taxpayer has a _bona fide_ interest.

An APA request does not prevent tax audits. On the contrary, it rather provokes such. In fact, there is a standing administrative practice of cooperation between the Federal Central Tax Office and the local tax audit units.

The APA request has to be filed with the Federal Central Tax Office, it being the competent authority. The scope of application in terms of both content and period has to be defined in the application request. The applicant has to explain the request in detail and provide all the necessary records. The tax authorities may make additional queries at any time and demand further information and documents. In addition, the applicant should also suggest critical assumptions.

For each covered fiscal year, the taxpayer must submit a report to the Federal Central Tax Office stating compliance with the critical assumptions of the APA.

In practice, APAs are usually granted for a period of three to five years. Their term generally commences at the beginning of the fiscal year in which the formal request is filed. An earlier commencement may be allowed if, on the date when the APA request is filed with the Federal Central Tax Office, a tax return has not yet been submitted and the statutory deadline for submitting the tax return has not yet expired. The Federal Central Tax Office may also grant a rollback under certain circumstances, especially if the other country consents.

Further, the EU Mutual Assistance Directive (Directive 2011/16/EU) has been implemented into domestic German tax law (EU-Amtshilfegesetz). The supplement to the Directive provides for the automatic exchange of cross-border tax rulings and APAs on transfer prices between multinational companies (‘tax rulings’). In this function, the Federal Central Tax Office provides certain information on tax rulings issued, changed or renewed as of 1 January 2017, to the respective authorities of the Member States (‘receiving authority’) and the European Commission automatically.

VI INVESTIGATIONS

German tax audits are notorious for taking a very down-to-earth approach, focusing on details of facts and accounting. German audit offices do not employ university-trained economists but rely on internally trained specialists, so that proposed transfer price adjustments are regularly short on fact-based, empirically grounded economic theory. This contrasts with the advanced technical and methodical approach of tax audit valuation specialists.

Transfer pricing disputes have traditionally been settled by negotiation and compromise in the audit or in post-audit administrative appeals. This is the reason why there used to be only limited case law on transfer pricing in Germany; however, in view of the increasing aggressiveness of German tax authorities in transfer pricing matters, taxpayers are becoming more willing to take their cases to court. Indeed, the number and frequency of court decisions on transfer prices has increased.

VII LITIGATION

i Procedure

Generally, the following appeal options are available in Germany. The taxpayer can file administrative or court appeals. There are only two court instances. Whereas the local tax
court (first instance) both investigates the facts and finds on the law, the Federal Tax Court strictly focuses on a revision of questions of law, be they substantive or procedural in nature (second instance). Where questions of European law are critical for a decision on the case, local tax courts may and the Federal Tax Court is obliged to involve the European Court of Justice. Once legal court instances are exhausted, the taxpayer may raise a complaint to the Federal Constitutional Court for violation of constitutional rights. The Court decides whether to admit the complaint.

In addition to this, MAPs and Arbitration Procedures according to double tax treaty or the EU Arbitration Convention are used successfully to resolve double taxation.

ii Recent cases

The following are some of the most important transfer pricing rulings of the Federal Tax Court since 2000:

a There are several decisions relating to the question of whether or not a group subsidiary can deduct royalty fees for a licence to use a branded corporate group name. In 2000 (I R 12/99), the Federal Tax Court ruled that royalty charges for the use of the corporate group name may be tax-deductible if it is a protected trademark or brand name whose use affords valuable benefits to the licensee. However, a later decision by the Local Tax Court of Munich (6 K 578/06) demonstrates that deducting a royalty charge requires effective legal and practical benefits of the licensee. In a recent decision (4 K 1053/11 E) the Local Tax Court of Münster decided that the arm’s-length principle requires a licence to be implemented for the use of a foreign entity of a corporate group name when the trademark has value in itself. In 2016 (I R 22/14), the Federal Tax Court reversed this controversial lower court decision. In essence, the court decided that a usage of name rights does not establish a business relationship within the meaning of Section 1(4) FTA, if the right to use is given to the subsidiary on a corporate level (e.g., in consideration of shares).

b In a landmark decision of the Federal Tax Court in 2001 (I R 103/00), the court clarified important procedural aspects of transfer pricing rules and regulations, in particular on the burden of proof, transfer pricing documentation, the taxpayer’s duty to cooperate with the tax authorities and the use of secret comparables. As a reaction to the ruling, the German legislature introduced important changes in German transfer pricing law (transfer pricing documentation, penalty rules and refinement of the arm’s-length principle in Section 1 FTA) that partly supersede the court’s decision.

c A 2004 decision of the Federal Tax Court (I R 87/02) addresses the arm’s-length principle and states that to define an arm’s-length price, the positions of both (theoretical) contracting parties, their profit expectations and alternative actions (similar to ‘options realistically available’ in the 2010 Chapter IX of the OECD Transfer Pricing Guidelines) have to be considered.

d In 2005 (I R 22/04), the Federal Tax Court confirmed the principles established in prior rulings that losses incurred by a distribution entity over a certain period of time trigger a rebuttable presumption that the transfer prices are not at arm’s length.

e In a decision of 2011 (X B 37/11), the Federal Tax Court confirmed the statutory authority for the tax office to assess penalties between €2,500 and €250,000 in the event a taxpayer does not timely fulfil its cooperation duties (e.g., provision of records or documentation) in a tax audit.
In 2012 (I R 75/11), 2014 (I R 23/13) and 2015 (I R 29/14), the Federal Tax Court prescribed the prevalence of double tax treaty rules over Section 1 FTA. In both decisions, the Federal Tax Court decided that based on double tax treaty rules similar to Article 9 of the OECD Model Tax Convention, the arm’s-length analysis should be restricted to the testing of the transfer price applied by the parties involved. On 30 March 2016, the Federal Ministry of Finance issued a ‘non-application decree’ stating that Article 9 of the OECD Model Tax Convention does not refer to a transfer price adjustment but to a profit adjustment instead.

In 2016 (13 K 4037/13 K F), the lower tax court of Münster confirmed that standard transfer pricing methods (CUP, resale minus, cost-plus) are, in general, equal to one another. It is up to the taxpayer and the German tax authorities to determine the most appropriate method for each individual case. To determine arm’s-length interest rates on loans within the group, according to the court’s assessment of the case, cost-plus shall be the best method. The ruling is currently subject to revision by the Federal Tax Court.

VIII SECONDARY ADJUSTMENT AND PENALTIES

The following penalties for the provision of transfer pricing documentation apply alternatively. They apply both to master files and local files:

If the file is not submitted or is ‘essentially unusable’, German regulations establish the rebuttable presumption that the income of the German entity has been under-reported and allow German tax authorities to rely on estimated figures and adjust transfer prices at the upper end of the arm’s-length range. Further, the tax authorities impose a penalty amounting to at least five per cent, but not exceeding 10 per cent of the income adjustment. The minimum penalty amounts to €5,000.

If the file is ‘essentially usable’ but submitted late, tax authorities may impose late fees or penalties of up to €1 million with a minimum penalty of €100 for each late day after the due date. Penalties may be waived if the taxpayer is not responsible (or has only limited responsibility) for the lack of appropriate documentation. Separate penalties may be imposed if the taxpayer fails to submit the CbCR at all or on time, or in the event the CbCR is deemed insufficient. Penalties may amount to up to €10,000.

Where adjustments result in an increased tax burden, non-deductible interest will be assessed at a rate of 6 per cent per annum for the period commencing 15 months after the end of the calendar year in which the tax liability arose.

IX BROADER TAXATION ISSUES

i Diverted profits tax and other supplementary measures
A diverted profits tax is not applicable under German domestic tax law.

ii Double taxation
The EU Arbitration Convention is a potentially useful mechanism to avoid double taxation within the EU. It is also a helpful argument in the course of negotiations with the tax auditors. The Federal Central Tax Office as competent authority has issued administrative regulations offering guidance on both the MAP and the procedure under the EU Arbitration Convention, which clarifies existing practices and the approach of the Federal Central Tax Office in these matters.
If the transfer pricing adjustment leading to double taxation has been initiated by the Federal Central Tax Office, for example, as a result of a transfer pricing audit, the taxpayer may also file a protective action with the local tax court. Usually, legal proceedings can be suspended until after the conclusion of the MAP.

On 3 November 2017, the EU Tax Dispute Resolution Directive entered into force. It will be adopted into domestic law by 30 June 2019. The mandatory dispute resolution rules apply to any double taxation of profits arising as of 1 January 2018. The new dispute resolution mechanisms shall be based on the EU Arbitration Convention and extend its scope beyond transfer pricing disputes. The directive is of particular interest in cases where it is in dispute whether local activities from a permanent establishment are for the non-resident entity.

### iii  Consequential impact for other taxes

In practice, transfer price adjustments generally neither affect value added tax nor import and customs duties. At the same time, it has become more common for customs auditors to refer to transfer pricing documentation in their investigation.

### X  OUTLOOK AND CONCLUSIONS

German tax and transfer pricing law has been complex and rich in detail for some time. Current and future measures of anti-tax avoidance will create further complexities and uncertainties in interpretation. Aggressive audit scrutiny and proposed adjustments of transfer prices will likely continue to rise. Factual representations in audit may meet with considerable scepticism. Strong factual documentation as well as precautionary monitoring of compliance with transfer price policies are cornerstones of audit defence. In view of the growing intensity and size of transfer price disputes, knowledge of their procedural specifics becomes vital for successful defence. Tax controversies on transfer prices are becoming more frequent and often involve more than €100 million in adjustments. Transfer price planning continues to be possible but requires more business interaction by the in-house tax function and a higher level of preparatory analysis.
OVERVIEW

Transfer pricing provisions were initially introduced in Greece, in a simplified form, in 1980 (Article 50 L 1041/1980, which was later incorporated in Article 39 of Law No. 2238/1994, the previously applicable income tax code). The rules were subject to regular revisions, gradually extending their scope of application and aligning them with international taxation trends. However, transfer pricing rules were not commonly referred upon by tax authorities, which, until 2008, were known to scrutinise related-party transactions primarily on productivity grounds, with a particular focus on royalties and service fees charged to domestic enterprises. Isolated transfer pricing audits up to that time mostly concerned transactions performed between domestic related parties.

2008 was a milestone in the field of transfer pricing, as it was the first year that domestic enterprises were required to comply with transfer pricing documentation rules in Greece (Article 26, Law No. 3728/2008). Since then, the scope of transfer pricing provisions has been gradually revised and extended, leading to the currently applicable backbone transfer pricing provisions (Articles 50 and 51 of Law No. 4172/2013, the Income Tax Code (ITC)). The current legal framework fully endorses the arm’s-length principle, as defined in Article 9 of the OECD Model Tax Convention and interpreted by the OECD Transfer Pricing Guidelines, following the revisions introduced as a result of Actions 8–10 of the OECD BEPS project. Article 50 adopts the arm’s-length principle with respect to all types of related party transaction, whereas Article 51 refers exclusively to business restructurings involving related parties.

Transfer pricing provisions apply as regards corporate income taxation, whereas indirect taxes are not impacted from transfer pricing readjustments. There are no separate transfer pricing rules with respect to the taxation of capital.

Transactions between legal entities and individuals fall within the scope of transfer pricing, but may lead to the readjustment of the taxable basis of the legal entity only.

According to Article 2 of the ITC, an individual or legal entity participating directly or indirectly in the capital or management of an enterprise, is defined as a related party for transfer pricing purposes. A 33 per cent (instead of the previously applicable 50 per cent) threshold applies with respect to the minimum direct or indirect participation in the capital or the exercise of voting rights, above which entities are defined as related. The exercise of managerial control or decisive influence over an enterprise is also an element to define related
parties, irrespective of any participation in the controlled enterprise’s capital or voting rights. According to tax administration guidelines (POL 1142/2015) the exercise of managerial control or decisive influence is a matter to be assessed case by case. The leverage ratio of an enterprise is identified as an indication of the exercise of decisive influence of the lender (excluding financial institutions), over the borrowing enterprise. The same is noted with respect to enterprises entering into supply arrangements on an exclusivity basis, including an end price setting mechanism.

Deals between a foreign head office and its domestic permanent establishment also fall within the scope of transfer pricing provisions.

II FILING REQUIREMENTS

Transfer pricing reporting and documentation requirements are set out in Article 21 of Law No. 4174/2013 (the Code of Tax Procedures (CTP)). The content of local transfer pricing files is set out in Ministerial Guidelines that predate the OECD Report on BEPS Action 13. Therefore, the minimum required content of domestic transfer pricing documentation is not yet fully aligned with BEPS Action 13, particularly in relation to value chain analysis.

As regards documentation, domestic enterprises, including Greek permanent establishments of foreign enterprises, should annually draft local transfer pricing documentation. The deadline for drafting documentation is concurrent with the one for filing of the annual corporate income tax return. De minimis thresholds apply, namely an overall value of related-party transactions of up to €100,000 per annum, for enterprises with an annual turnover of less than €5 million. The transaction value threshold rises to €200,000, for enterprises with an annual turnover exceeding €5 million. In the event of a tax audit, the local transfer pricing file should be submitted in Greek, within 30 days following request.

Enterprises bearing the obligation to prepare a transfer pricing file are also subject to annual reporting of the related-party transactions performed during the reported fiscal year. The deadline for annual reporting expires concurrently with the deadline for filing of the annual corporate income tax return.

Finally, Greece has enacted legislation introducing the automatic exchange of country-by-country reports among EU member states and OECD Multilateral Competent Authority Agreement signatory jurisdictions. Country-by-country reporting obligations apply to multinational enterprise groups of an annual consolidated turnover exceeding the amount of €750 million. The first reporting year is the one starting after 1 January 2016. Surrogate reporting and local notification requirements have also been adopted.

III PRESENTING THE CASE

i Pricing methods

All OECD acceptable transfer pricing methods are applicable in the Greek transfer pricing environment, as confirmed by Article 50 ITC, which explicitly refers to the OECD Transfer Pricing Guidelines as the appropriate tool to interpret and apply domestic transfer pricing rules. Traditional methods (the CUP, resale minus and cost-plus method) are preferable compared to transactional methods (the transactional net margin method and profit split method (Ministerial Decision POL 1097/2014, as amended by POL 1144/2014). Rejection of traditional methods should be appropriately justified in local transfer pricing documentation, prior to selecting the application of one of the transactional methods.
Both internal and external comparables are acceptable. Contemporaneous comparables are required upon application of a CUP method. As regards one-sided methods referring to profit level indicators, reference to external comparables should cover a three-year test period and should include a set of at least five comparables. Specific guidance is provided on the use of databases for the selection of external comparables. The tax authorities use the Amadeus database (Bureau van Dijk), as do most of the documenting enterprises. Financial data of selected external comparables should be refreshed annually, whereas a new search for comparables should take place once every three years.

Profit level indicators ranging between the lower, median and upper quartile of an interquartile range are, in principle, acceptable, without an obligation for the taxpayer to apply the median. However, if the tax authorities reject the external comparables presented by the taxpayer and conduct a new search for comparables, they would in practice apply the median of the interquartile range defined as a result of the new search.

As regards business restructurings in particular, pursuant to Article 51 Subsection (c) ITC, consistency with the arm's-length principle in the context of a business restructuring should be proven 'by means of reference to other comparable cases', therefore by application of a CUP method. However, according to the same provision, if the application of a CUP method is not feasible, application of business valuation methods is also suggested, with a preference towards the discounted cash flow method with reference to the future profits that are expected from the going concern being transferred and are linked with the relevant functions and all related underlying assets. According to Subparagraph (d), the two methods are not meant to be the sole options available to the taxpayer, who may apply any other method in order to prove consistency with the arm's-length principle.

IV INTANGIBLE ASSETS

Information on the ownership of intangible assets in the group as well as related-party transactions for the licensing of rights on intangible assets form part of domestic transfer pricing documentation.

The role of each related party in the development, enhancement, maintenance, protection and exploitation (DEMPE) functions of intangible assets is an element of increasing significance, in the scrutiny of related-party transactions between domestic licensees and foreign IP-holding entities. There are no explicit restrictions on the tax deductibility of royalty payments, although Greek tax authorities have traditionally placed an increased focus on the audit of such payments. According to Article 23 ITC, payments made to enterprises resident in preferential tax regimes (regimes offering an income tax rate that is lower than 50 per cent of the one applicable in Greece) are subject to increased scrutiny, although the arm's-length principle prevails as regards their tax deductibility.

V SETTLEMENTS

Taxpayers may apply for a unilateral, bilateral or multilateral advance pricing agreement (APA), which comprises a decision of the Director of Independent Authority of Public Revenues on the appropriate set of criteria for the determination of transfer prices over a fixed period of time, that may not exceed four years (Article 23 CTP and Ministerial Decision POL 1284/2013). Rollback of the APA is not allowed under Greek law. Greek tax authorities have introduced the option of a preliminary procedure that should allow the taxpayer to discuss
the case with the competent authority on an informal, non-binding basis. The purpose of the preliminary procedure is to explore whether the initiation of a formal APA procedure would lead to the intended result. Entering into an APA with the Greek tax authorities may require anything between 18 months (as regards a unilateral APA) and 36 months (as regards a bilateral or multilateral APA). The Independent Authority of Public Revenues has the right to further extend the timeline, if necessary.

A predecessor of the APA, focusing particularly on domestic enterprises or branches providing services to their foreign related enterprises or their foreign head office, is the cost-plus regime set out in Articles 27 to 35 of Law No. 3427/2005. Qualifying entities may obtain a licence for their operation in Greece, confirming a fixed markup to be applied on their total costs. The licence is renewed every four years, whereas during its term, qualifying entities are exempt from transfer pricing documentation and reporting requirements.

VI INVESTIGATIONS

Greek tax procedure rules do not set out a stand-alone framework for transfer pricing audits. Transfer pricing is therefore part of the items assessed by tax authorities in the context of an ordinary tax audit.

A tax audit commences with the issuance of a tax-audit order along with a request for the taxpayer to present a full copy of the local transfer pricing file for each fiscal year under audit, translated in Greek, within a 30-day deadline.

While processing the transfer pricing file and related supporting documentation, tax authorities may raise questions and request additional material, particularly in relation to external comparables.

Once the tax inspectors have completed the review of the submitted transfer pricing file and related supporting documentation they draft a preliminary tax audit report presenting their findings, the proposed transfer pricing readjustment and the corresponding amount of income tax to be assessed.

The preliminary tax audit report is officially served to the taxpayer along with the preliminary tax assessments. The taxpayer is entitled to respond to the preliminary tax audit findings in writing, within a 20-day period. This is an evidence-intensive stage of the dispute, whereby the taxpayer’s arguments should be supported by pertinent documentation, particularly in relation to the selection of transfer pricing methods, the reliability of external comparables and any proposed adjustments to the financial results of the selected set of comparables. The final tax assessments, upholding or disregarding the taxpayers’ views, are issued within up to one month following this.

Tax audits should be carried out and tax assessments should be issued within a five-year period starting at the end of the year within which the relevant corporate income tax return should have been duly filed (Article 36, Paragraph 3 CTP). Greek tax law does not lay down different time limits for each stage of the tax audit process. The applicable statute of limitation, as of 1 January 2014, is extended to 20 years, should the tax audit findings result in tax evasion (Article 36, Paragraph 3 CTP). However, according to recent ministerial guidance, transfer pricing readjustments should not be treated as resulting in tax evasion (Ministerial Decision POL 1209/2017).
VII LITIGATION

i Procedure

Transfer pricing dispute resolution is governed by the same procedural rules that govern all tax disputes in Greece.

Once the final tax assessments are served to the taxpayer, the latter is entitled to challenge them by lodging an administrative appeal with the Dispute Resolution Directorate of the Independent Authority for Public Revenue (Article 63 CTP and Ministerial Decision POL No. 1064/2017). The latter should review the taxpayer’s administrative appeal on both the law and the merits. Said remedy should be lodged within a 30-day deadline from the service of the final tax assessment to the taxpayer (i.e., within 60 days for taxpayers seated abroad). The above administrative agency ought to review the case within a 120-day period. Within the aforementioned period, the Dispute Resolution Directorate should either deliver a decision in writing, or otherwise it is deemed that the administrative appeal is tacitly rejected on the expiry of the above deadline.

Filing of an administrative appeal suspends payment of 50 per cent of the amount of tax and penalties assessed on the taxpayer. However, default interest, calculated at an 8.76 per cent annual rate, accrues up to the time of payment of the full amount to the state. Further, depending on the amount of the tax assessment, safeguarding measures may be imposed on the audited legal entity and the managing directors. Taxpayers may therefore opt, from a practical perspective, to pre-pay 100 per cent of the income tax and penalties assessed upon filing of the administrative appeal.

If the administrative appeal is sustained, the tax assessment is repealed, whereas any amount of tax and penalties already paid to the state is refunded to the taxpayer. In the event of full or partial rejection of the administrative appeal, the taxpayer has the right to seek a review of the case before the administrative courts. The deadline to institute the legal proceedings is within a 30-day period (i.e., within 90 days for taxpayers seated abroad) (Article 64, Paragraphs 2 and 6 of the Code of Administrative Procedure) starting either from the date that the 120-day period has expired, or after the notification of the rejecting decision of the Head of the Dispute Resolution Directorate.

In tax disputes, the judicial competence of the administrative courts is contingent to monetary thresholds; should the tax assessed exceed the amount of €150,000 the case will be heard by the Administrative Court of Appeal. Otherwise, where the amount of the tax assessed does not exceed the amount of €150,000 the case is submitted to the jurisdiction of the Administrative Court of First Instance. Surcharges, penalties, fines on any other amount additionally assessed do not count in measuring the above thresholds (Article 6 of the Code of Administrative Procedure).

Irrespective of the court in which the case will be introduced, the judicial review consists of the lawfulness and the merits of the case. Only the decisions of the Administrative Courts of First Instance could be reviewed by the appellate court, should specific requirements set forth in law.

In terms of timing, transfer pricing disputes exceeding the €150,000 monetary threshold should be resolved at the level of the Court of Appeals within 18 to 24 months following filing of the judicial appeal. The decision of the Court of Appeals is immediately enforceable.

Finally, once all court instances are exhausted, the case may be brought to the Supreme Administrative Court, should specific procedural requirements set forth in the law be met (Article 53 PD No. 18/1989). The revision proceedings before the Supreme Administrative Court strictly involve the review of the lawfulness of the lower court’s judgment.
Recent cases

Case law on related-party transactions is built around two pillars: the tax deductibility of intra-group charges, which was a matter commonly raised by tax authorities until 2008; and application of the arm's-length principle and related compliance with transfer pricing documentation rules for fiscal year 2008 onwards. Owing to the considerable duration of judicial proceedings, a significant number of decisions refer to regimes that are not currently applicable as such. However, certain decisions of the Supreme Administrative Court still serve as valuable reference for the interpretation and application of currently applicable rules.

A number of Supreme Court cases deal with the matter of defining related parties, with a particular focus on elements establishing a relation of managerial control or economic dependence or control.\(^2\)

Other cases that remain relevant refer to the benefit test conducted for purposes of substantiating the tax deductibility of intra-group royalties, service fees charged to domestic enterprises\(^3\) and domestic branches of foreign enterprises.

A number of decisions have dealt with the question on who bears the burden of proving compliance with the arm's-length principle. Prior to the introduction of transfer pricing documentation rules, the burden lay with the tax authorities. Intention to evade the payment of taxes was at that time also an element that should be proven by tax authorities for a transfer pricing readjustment to be valid.\(^4\) Following introduction of transfer pricing documentation rules, the burden of proof has been shifted to the tax authorities. However, as long as the taxpayer produces the appropriate transfer pricing documentation, the burden is shifted back to the tax authority, which is required to justify any challenge of the taxpayer's position (e.g., by proving the inappropriateness of the selected transfer pricing method or the non-reliability of the selected comparables). The Administrative Court of Appeals verified that the tax authority may not proceed to creating a new set of comparables without justifying the reasons for rejecting the one selected by the taxpayer.\(^5\)

Although fragmented, recent decisions of the Court of Appeals seem to set the focus on documentation and engage in analyses of comparability, but to also touch upon issues regarding the proportionality of documentation-related penalties that were imposed under previously applicable regimes.\(^6\)

VIII SECONDARY ADJUSTMENT AND PENALTIES

Greek law does not provide for secondary adjustments in the field of transfer pricing. Any transfer pricing readjustment resulting from a tax audit shall lead to the increase of the taxpayer's taxable profits and the assessment of corporate income tax (currently applicable at a 29 per cent rate). Penalties are also imposed for the initial filing of an inaccurate tax return at a rate of up to 50 per cent over the amount of income tax assessed. Default interest accrues at an 8.76 per cent annual rate, from the time of filing of the initial income tax return for the audited fiscal year and up to the time of full payment of the tax assessed.

\(^5\) Administrative Court of Appeals of Athens decision 3677/2017.
\(^6\) Administrative Court of Appeals of Athens decision 2436/2017, 4171/2017 and others.
Without prejudice to the penalties for inaccuracy of tax returns filed, documentation related penalties also apply, as follows:

- delayed or inaccurate reporting of intra-group transactions triggers a penalty ranging between €500 and €2,000, calculated at a rate of 0.1 per cent over the value of relevant intra-group transactions. In cases of inaccuracy, the penalty is only imposed provided the inaccuracy affects more than 10 per cent of the total value of the reported transactions;
- revisions to the initial reporting of intra-group transactions are not sanctioned and do not impact the value of the reported transactions. Revisions of values exceeding €200,000 trigger a fine of between €500 and €2,000;
- failure to report intra-group transactions triggers a penalty of up to €10,000, calculated at a rate of 0.1 per cent over the total value of intra-group transactions that should have been reported;
- failure to submit a transfer pricing file in the event of a tax audit is sanctioned by a fine of €20,000. The same fine applies if the file is submitted later than 90 days following a relevant tax authorities request;
- delayed submission of the transfer pricing file in the event of a tax audit is sanctioned by a fine of €5,000 if the file is submitted up to 60 days following request. The fine rises to €10,000 if the file is presented between the 61st and 90th day following a tax authority request;
- the non-filing of a country-by-country report triggers a penalty of €20,000, whereas a penalty of €10,000 applies in the event of inaccurate or late filing; and
- criminal liabilities may arise in the event that a transfer pricing readjustment is classified as criminal tax evasion within the scope of Article 66 CTP. Tax evasion is defined as the intentional concealment of income or capital leading to the non-payment of taxes exceeding specific thresholds.

A €100,000 threshold applies with respect to corporate income taxation. However, the Greek tax authorities have recently clarified by way of Ministerial Decision POL 1209/2017 that the assessment of corporate income tax of an amount exceeding €100,000 does not constitute tax evasion to the extent that such assessment results from transfer pricing readjustments.

IX BROADER TAXATION ISSUES

i Diverted profits tax and other supplementary measures

There is no diverted profits tax provision applicable in Greece. However, the ITC and the CTP set out a number of rules that aim to effectively combat artificial arrangements aiming at tax avoidance.

By way of indication, Article 38 of CTP sets out a General Anti-Abuse Rule, according to which tax authorities may reclassify any artificial arrangement that aims to the avoidance of taxes. In the same context, according to Article 4 of ITC, the place of effective management is a key element to define a legal entity’s state of tax residence.

According to Article 23 ITC, payments to entities established in non-cooperative jurisdictions or preferential tax regimes are not recognised as tax-deductible, unless the taxpayer proves that such payments are made in the ordinary course of business and do not aim in the avoidance of taxes. Preferential tax regimes are defined as the ones offering an
income tax rate that is lower than 50 per cent of the one applicable in Greece. Payments to related parties established in preferential tax regimes are eventually tested under the arm's-length principle.

Article 66 of the ITC introduces a Controlled Foreign Corporation (CFC) rule, pursuant to which undistributed profits earned by a CFC are added to the taxable profits of the shareholder, under the following conditions:

a a shareholder directly or indirectly controls the foreign corporation;

b the CFC is tax-resident in a non-cooperative jurisdiction or in a jurisdiction with a preferential tax regime;

c more than 30 per cent of the income earned by the CFC is classified as passive income (e.g., interest, royalties, dividends); and

d more than 50 per cent of such passive income derives from related-party transactions.

Article 49 of the ITC sets out an earnings-stripping rule. As applicable from 1 January 2017, net deductible interest, which is the amount by which interest expenses exceed interest revenues is limited to 30 per cent of EBITDA (earnings before interest, taxes, depreciation, and amortisation) under Greek accounting principles. Moreover, this limitation applies only if the net interest exceeds €3 million per year. The disallowed interest expenses can be carried forward indefinitely, whereas credit institutions are exempt from such rules.

Finally, interest expenses paid to independent entities, other than financial institutions and limited companies issuing bond loans, are deductible to the extent that the interest rate agreed does not exceed the interest rate that would have been payable on revolving lines of credit provided to non-financial institutions.

ii Double taxation

Although Greece has incorporated Article 25 of the OECD model on most of its bilateral tax treaties and has ratified the EU Arbitration Convention, application of mutual agreement procedure (MAP) processes has been stagnating, as demonstrated by relevant OECD statistics. This has mostly been due to the lack of legal and procedural framework.

Greece, having committed itself to the implementation of the OECD BEPS Action 14 minimum standard, enacted legislation required to establish clear procedural rules on access to and use of the MAP. Application of the aforementioned legislation has been rendered possible after several procedural details (the competent authority, form and substance requirements, compatibility with cases pending before court, legal type and results of MAP decision, communication requirements, etc.) were determined by means of administrative guidelines. All matters stipulated are applicable to MAP applications filed after the issuance of these guidelines; pending cases shall be updated appropriately to fulfil the conditions set therein.

Despite these developments, certain issues concerning the implementation of an MAP decision leading to tax refund for a Greek tax resident remain formally unaddressed by tax authorities, such as the type of administrative act that may allow a tax refund for a fiscal year that has previously been finalised, following completion of an ordinary tax audit.
iii Consequential impact for other taxes
Transfer pricing adjustments do not have an impact on the taxable base for VAT purposes according to Greek law.

However, retrospective price adjustments may impact the value of goods used for customs purposes. On the basis of relevant administrative guidelines concerning the determination of customs value, customs authorities should examine in the context of their audits whether post-import amendments of prices invoiced to importers by related (non-EU) suppliers have taken place. Further, the decision of the Court of Justice of the European Union in the Hamamatsu case (C-529/16) may give rise to arguments of the customs authorities that the customs value declared upon import does not reflect the actual transaction value (due to the retrospective price adjustments). In this respect, the prospect of filing simplified customs declarations upon import of goods supplied between related parties should be considered in situations like the above.

X OUTLOOK AND CONCLUSIONS
During the past few years, and mostly since January 2014, when the currently applicable ITC and CTP came into force in Greece, transfer pricing has become an area of primary focus for the tax authorities. Enterprises doing business in Greece, including branches of foreign enterprises, are required to comply with a detailed legislative framework, which is mostly aligned with the OECD Transfer Pricing Guidelines and the Reports on Actions 8–10 of the OECD BEPS project.

Inconsistencies of local transfer pricing documentation rules with the Report on Action 13 of the OECD BEPS project may, however, still trigger additional compliance costs for multinationals doing business in Greece, as they still need to localise their transfer pricing documentation.

Tax authorities are developing a more sophisticated approach in dealing with transfer pricing audits. Disputes have moved into matters concerning the reliability of comparable data, the reasonableness of comparability adjustments and lately the appropriateness of selected transfer pricing methods. Court jurisprudence may, therefore, be expected to also gradually focus on substantive transfer pricing matters in the near future.

An increase of transfer pricing disputes is likely to also lead to an increase of MAP proceedings involving the Greek tax authorities, although there is still room for improvement in this field, primarily by securing appropriate resources to handle the proceedings and providing guidance on practical matters to ensure enforceability of MAP outcomes. It is also expected that the number of APA proceedings will increase in the near future, particularly in relation to new activities or isolated transactions, as enterprises seek to ensure certainty with respect to the tax treatment of their operations in Greece.

Finally, the new rule on business restructurings (Article 51 ITC) may gradually become of primary significance, as tax authorities move their audits into fiscal years 2014 and onwards. These have been years of restructuring from the side of enterprises doing business in Greece, as a reaction to the economic downturn and related adverse conditions of the Greek economy, including the capital controls introduced in June 2015. Compliance of such restructurings with the arm’s-length principle is a matter that is likely to be assessed in the course of future tax audits.
Chapter 9

INDIA

Mukesh Butani

I OVERVIEW

Transfer pricing law in India was introduced in April 2001 following the Income-tax Act 1961 (ITA), which covered intra-group cross-border transactions, and from April 2013, the provisions were extended to specified domestic transactions between related enterprises. The law broadly aligns with Organisation for Economic Co-operation and Development (OECD) Guidelines, and definitions of international transactions and associated enterprises are broad and expansive.

The law provides methods to compute the arm's-length price, extensive annual requirements of transfer pricing documentation and penal provisions for non-compliance. Although the law covers both income and capital transactions with similar rules, it only covers capital transactions that have an incidence of income that is enshrined in the charging provisions.

Section 92B of the ITA defines the term ‘international transaction’ to mean a transaction between two or more associated enterprises involving:

a. the sale, purchase or lease of tangible or intangible property;
b. the provision of services;
c. cost-sharing arrangements;
d. lending or borrowing money; or
e. any other transaction having a bearing on the profits, income, losses or assets of such enterprises.

A relationship between associated enterprises can involve:

a. the direct or indirect holding of at least 26 per cent voting interests;
b. controlling the board of directors;
c. common control;
d. a significant dependence on intangibles, raw materials or consumables;
e. supplier lending or guaranteeing a loan for the substantial percentage of total assets from one enterprise; or
f. any other relationship of mutual interest.

The above definition includes deemed international transactions in third-party situations, particularly when the terms of the contract are determinable.
The 2001 Law remained largely unreformed until 2012, when substantial changes were introduced. In particular, the definition of international transaction was retrospectively expanded to cover an array of other transactions, such as the purchase or sale of tangible and intangible assets, and capital financing. The definition of ‘intangible property’ was given a broad scope at a time when the debate on intangibles at the global level was gathering momentum (see Section IV).

A wave of reforms gathered momentum in 2013, 2014 and 2015 with the following changes introduced:

- the introduction of safe harbour;
- the choice to use ‘sixth methodology’;
- an eligibility for seeking a five-year unilateral or bilateral advance pricing agreement (APA), which subsequently covered rollback up to four years;
- the use of multiple years of data for benchmarking purposes; and
- an Indian version of an interquartile range.

Although the law in terms of its applicability only applies if there is ‘income arising from an international transaction’ and subject to the arm’s-length principle, the debate regarding its applicability on issuance of shares or a capital transaction is now settled. The disclosure rules were, however, amended in 2013 to disclose such capital account transactions. Dividends are not ordinarily subject to arm’s-length pricing principles because they are an appropriation of profits and exempt from tax at the shareholder level.

Though Section 188 of the Companies Act 2013 prescribe for consent of the board of directors for specified related-party (domestic and international) transactions under Indian company law, there are no direct implications of not transacting at arm’s length, such as deemed dividend implications, as other jurisdictions have. However, the ITA was amended to provide for a secondary adjustment (see Section VIII).

II FILING REQUIREMENTS

Taxpayers are required to annually maintain extensive information and documents relating to international transactions undertaken with their associated enterprises. Rule 10D of the Income Tax Rules 1962 (ITR), which has been widely interpreted by the courts, prescribe that such documentation requirements may be broadly divided into two parts. The first part lists mandatory information a taxpayer must maintain, namely:

- information on the ownership structure (e.g., group profile and business overview);
- whether in writing, implied in action or acting in concert: the associated enterprises’ contractual nature, terms, quantity, value, etc., of an international transaction; and
- relevant financial forecasts or estimates that form part of a comprehensive transfer pricing study.

The documentation includes functions performed; risks assumed; assets employed; details of relevant uncontrolled transactions; comparability analysis; benchmarking studies; assumptions; policies; details of economic adjustments; and explanations as to the selection of the most appropriate transfer pricing method. The second part necessitates documentation that authenticates the information and analysis documented under the first part.

Such documentation must be contemporaneous, maintained for a period of nine years from the end of the relevant tax year and presented to the tax authority on request, at the
audit, assessment or dispute resolution stage. The annual documentation has to be updated to reflect the latest financial data for comparability analysis and changes, if any, in transactions, as regards functions, assets, risks or terms of arrangements between associated enterprises.

A mandatory accountants report for all international transactions between associated enterprises is to be obtained from an independent accountant, who would certify the existence of transactions (in the books of accounts) based on the documentation and supporting information. The report has to be furnished in Form 3CEB by the due date of the tax return filing (i.e., on or before 30 November, following the close of the relevant tax year). The report requires the accountant to give an opinion on the proper maintenance of prescribed documents and information by the taxpayer, and to certify the correctness of an extensive list of prescribed particulars including methodology of such transactions. Failure to supply this report would lead to a penalty of 100,000 rupees. A penalty of 2 per cent of the value of the international transaction may be levied for failure to maintain a prescribed documentation report of a transaction or providing incorrect documentation.

India is committed to implementing the OECD’s recommendations, contained in Action Plan 13 of Base Erosion and Profit Shifting (BEPS). In pursuance thereto, India amended the ITA in 2016 to introduce a requirement of furnishing of a country-by-country report (CbCR) together with the transfer pricing documentation for the year ending 31 March 2017.

The CbCR information related to the master file has to be filed electronically in forms 3CEAA and 3CEAB. The key requirements are:

- filing of the master file is applicable to every constituent entity, whether having its parent entity resident in India or outside India; and
- regarding the threshold for the master file:
  - the consolidated revenue of the international group as per the consolidated financial statements for one accounting period must exceed 5 billion rupees;
  - the aggregate value of international transactions of the constituent entity during the accounting period must exceed 500 million rupees or;
  - the aggregate value of international transactions in respect of purchase, sale, transfer, lease or use of intangible property during the accounting period, must exceed 100 million rupees.

The master file in Form 3CEAA has two parts: Part A specifies the generic information about constituent entities in India, and Part B specifies details relating to the business structure, policies, etc.

Where an international group has multiple constituent entities operating in India, the group may designate one of its constituent entities as an alternate reporting entity to fulfil the requirement of filing 3CEAA on behalf of the group. Since the final CbCR rules were notified on 31 October 2017, the deadline for filing for financial year 2016–17 was extended to 31 March 2018. Strict penalties have been prescribed for the failure to maintain CbCR documentation.
III PRESENTING THE CASE

i Pricing methods

The term ‘arm’s-length price’ is defined under Section 92F of the ITA and applies to transactions between persons other than associated enterprises in uncontrolled conditions. The following methods have been prescribed by Section 92C of the ITA for the determination of the arm’s-length price:

- the comparable uncontrolled price (CUP) method;
- the resale price method (RPM);
- the cost-plus method;
- the profit split method;
- the transactional net margin method (TNMM); and
- an unspecified method (the unspecified methodology was introduced from financial year 2011–12).

On the choice of methodology, the statute prescribes the use of the ‘most appropriate methodology’. The transfer pricing rules on this choice of methodology is in line with OECD regulations, with the exception of methodologies being ranked in a hierarchical manner. Having said that, it is appropriate for taxpayers to choose the most appropriate methodology. If, however, it is believed that the taxpayer’s choice of methodology it deems most appropriate does not arrive at the correct arm’s-length price, it may disagree and recalculate the arm’s-length price using an alternative methodology.

In the initial years of transfer pricing audits, the appellate authorities took a liberal view and allowed the default use of TNMM ‘most appropriate methodology’ due to the difficulty of obtaining comparable data for benchmarking unique or complex transactions in which the choice of methodology has become debatable. Though there is a tendency on the part of the tax authorities to use the CUP method, inadequate availability of comparable data with significant economic adjustments has been reasoned by taxpayers to reject CUP, the taxpayer’s view has found acceptance in several judgments of tax tribunals. In the context of research and development (R&D) centres, the tax authorities’ tendency to use the profit split method was put to rest by issuing administrative guidance, by virtue of which R&D centres were characterised either as ‘full-risk entrepreneurial’, cost-sharing arrangements or simple contract R&D centres. Choosing the most appropriate methodology in these situations is dependent on the characterisation of R&D centres.

ii Authority scrutiny and evidence gathering

In accordance with prevailing internal administrative guidelines, all taxpayers with an aggregate value of international transactions with associated enterprises in excess of 50 million rupees are referred to a transfer pricing officer (TPO) for detailed audit or assessment. The threshold of 50 million rupees may be reviewed on an ongoing basis. Cases were selected for detailed audit issuing a notice under Section 143(2) to the taxpayer within six months from the end of the financial year of the compliance calendar mentioned above. There is a statutory requirement for the assessing officer (AO) to make reference under Section 92CA of the ITA of such transactions to the TPO for an audit, with prior approval of the jurisdictional commissioner such that only select cases or transactions are audited. However, past experiences suggest that such cases are referred and notices issued in a fairly mechanical manner. Typically, the TPO specifies the records, documents and details that are required to
be produced for such an audit. There is no statutory mandate to follow a risk-based process to choose cases for audit, subjecting most if not all taxpayers to an audit or assessment process. The TPO has wide assessment powers requiring the production of necessary evidence and material information to support the computation of the arm's-length price of the international transaction. Audit cases are scrutinised in detail to ensure that all relevant factors such as appropriateness of the transfer pricing method applied and correctness of data is verified. After taking into consideration all the information available, the TPO is required to determine the arm's-length price.

TPOs are vested with powers of inspection, discovery, enforcing attendance, examining a person under oath and compelling the production of books of account and other relevant documents and information as part of the assessment function. The powers were further widened from 1 June 2011 to conduct surveys for spot inquiries, verification for subsequent investigation and collation of data. Such powers are enshrined in Sections 133A and 133B of the ITA, which empower the TPO to enter any premises to inspect such books of accounts, cash, valuables, or he or she may require any information that may be useful or relevant for such proceedings. Investigative powers of the tax authority in general, including for Transfer Pricing Law, is discussed in Section VI.

A penalty of 2 per cent of the value of international transaction has been provided for either failure to report transactions or furnishing incorrect documentation at the audit stage (S.271AA).

IV INTANGIBLE ASSETS

The definition of international transaction is laid out in the Section 92B. The explanation to the law specifically covers the expression 'intangible property' to include:

a marketing-related intangible assets, such as trademarks, trade names, brand names and logos;
b technology-related intangible assets, such as process patents, patent applications, technical documentation (e.g., laboratory notebooks) and technical know-how;
c artistic-related intangible assets, such as literary works and copyright, musical compositions, maps and engravings;
d data processing-related intangible assets, such as proprietary computer software, software copyrights, automated databases, and integrated circuit masks and masters;
e engineering-related intangible assets, such as industrial design, product patents, trade secrets, engineering drawing and schematics, blueprints and proprietary documentation;
f customer-related intangible assets, such as customer lists, customer contracts, customer relationships and open purchase orders;
g contract-related intangible assets, such as favourable suppliers, contracts, licence agreements, franchise agreements and non-compete agreements;
h human capital-related intangible assets, such as a trained and organised work force, employment agreements and union contracts;
i location-related intangible assets, such as leasehold interest, mineral exploitation rights, easements, air rights and water rights;
j goodwill-related intangible assets, such as institutional goodwill, professional practice goodwill, personal goodwill of professional, celebrity goodwill and general business going-concern value;
methods, programmes, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists or technical data; and any other similar item that derives its value from its intellectual content rather than its physical attribute.

The definition of the term ‘international transaction’ was broadened retrospectively in 2012 to cover transaction in the purchase, sale, transfer, lease or use of intangible property. It expanded in 2012 with retrospective effect to practically cover every direct or indirect transactions in relation to intangible property. The disclosure requirements of international transaction relating to intangibles changed in 2017 by making it mandatory for taxpayers to disclose details of such transactions, having aggregate value exceeding 100 million rupees in respect of lease or use of intangible property. Such details are to be filed by the taxpayer in Form No. 3CEAA and it shall be furnished to the Director General of Income Tax (Risk Assessment) on or before the due date for furnishing the tax return.

The debate on intangibles in general, particularly marketing intangibles, has reached the Supreme Court. It started with the tax authority carrying out mechanical adjustments based on ‘bright line theory’ to advertising, marketing and sales promotion expenses (incurred towards third parties) in excess of comparators. Such adjustments were held as invalid by the first appellate forum, the Tax Tribunal (special bench in LG Electronics as the lead case); instead what was allowed for adjustment were expenses that were not directly related to sales activity (without spelling out the concept of non-routine brand promotion expenditure). The Delhi High Court (in Canon as the lead case) granted further relief by negating the bright line theory and prescribing basis for use of methodology and adjustments, etc. Under the same High Court in Maruti-Suzuki case, a manufacturer struck down the entire adjustment on the ground that there was no international transaction and hence the question of adjustment was academic. All the cases are currently before the Supreme Court awaiting a final outcome.

Tax authorities have, in general, maintained its position on adjustment due to intangibles, and though it has not spelled out a formal policy as to how to undertake such adjustments, an informal guideline (using the intensity adjustment principle) is used by TPOs to carry out adjustments on marketing intangibles. Similarly, India has not specified any formal policy in response to DEMPE principles articulated in the BEP Action Steps other than the 2017 disclosure requirements. The CbCR reporting requirement now mandates listing all multinational enterprise group entities engaged in the development of intangibles and the description of a multinational enterprise’s strategy (TP policy) for development, ownership and exploitation of intangible property.

Well before the BEP initiative was underway, given the growing disputes for R&D captives, the Central Board of Direct Taxation (CBDT) issued guidelines (Circular 06/2013) to TPOs with regard to characterisation of R&D units based on functions, assets and risk assumed. A set of qualitative criteria was laid out to drive decision-making on characterisation with an emphasis on the substance of an arrangement and not the contractual arrangement between the centre in India and its foreign associated enterprise. This guidance has classified R&D centres under the following three categories:

- entrepreneurial in nature;
- based on cost-sharing arrangements; and
- undertaking contract R&D.

Based on these categories, suitable methodology is prescribed as either the profit split method or cost-plus method, and the most appropriate methodology is forensically applied.

V SETTLEMENTS

Unlike other jurisdictions, there is no mechanism for the settlement of transfer pricing disputes with Indian tax authorities. For settlements, safe harbour provisions, unilateral and bilateral APA mechanisms are viewed as avenues to mitigate risks in advance, and the mutual agreement procedure (MAP) under the treaty is considered, post adjustment, to settle disputes. The rollback provision under an APA also enables settlement of past disputes given its binding nature.

In a move to reduce litigation and boost investor confidence, India introduced unilateral, bilateral and multilateral APAs with effect as of 1 July 2012. The APA guidelines were finalised in the latter part of 2012 and eligible taxpayers were entitled to apply for APAs for transactions from 1 April 2013. Further, India’s APA programme has matured and received an overwhelming response in the past five financial years, ending 31 March 2018, with over 800 applicants. As part of the APA process, taxpayers are required to file an annual compliance report containing detailed information of actual outcome to demonstrate compliance with the terms of the APA.

The APA programme allows multinational enterprises to agree inter-company prices or margins in India (and overseas) methodology, etc. As at 1 December 2017, India had concluded 171 unilateral and 15 bilateral APAs. The APAs covers various transactions such as software services, IT-enabled services, intra-group payments, business support services commission or indent.

The MAP has often been resorted to as a credible avenue for settling transfer pricing-related disputes. Under the MAP process, the Indian competent authority allows the foreign associated enterprise, a resident of the treaty country, to submit its MAP plea via its country’s competent authority. India has concluded several MAPs with its treaty partners, including the United States, United Kingdom and Japan. Under various administrative directions, tax demands arising out of adjustments with foreign associated enterprises who are residents of the US, UK, South Korea and Denmark are frozen until the MAP process is concluded, subject to the submission of suitable bank guarantees.

Until recently, India held a position that, unless the treaty contains Article 9(2), it would not settle disputes via MAP. By virtue of this stand, India did not resolve transfer pricing disputes with several of its treaty partners, including Singapore, South Korea, France and Germany. The position has, however, been restored with CBDT vide press release, dated 27 November 2017. India has received most MAP requests from the US, UK, Japan and Canada. Over 100 cases between the US and India entailing $800 million have been resolved under MAPs.

India introduced safe harbour rules in 2009 for resolving disputes for specific industries or transactions, particularly in the area of IT-enabled services, software development R&D, exports of goods in the auto ancillaries industry, inbound offshore loan or debt transactions, etc. The 2009 safe harbour limits were set with a higher threshold, and as a result there were fewer takers in the initial years. The safe harbour limits were revised downwards and tweaked further in 2013 to encourage taxpayers to avail of safe harbour, particularly for inbound low value-added services. Tax authorities will accept the transfer price declared by taxpayers
opting for safe harbour within the limits set out without question or scrutiny. The latest guidelines on coverage of transactions limits and procedures were set out in Rule 10TD and Rule 10TE.

VI INVESTIGATIONS

There is currently no concept of transfer pricing investigation other than the audit or assessment process, as discussed in Section III.

The tax authorities, however, have broad powers for assessment (e.g., reopening of past year assessments, investigations), as follows:

a Section 143 – for regular audit or assessment;
b Section 144 – best judgement assessment, where a taxpayer does not file a tax return or fails to comply with requests from tax authority;
c Section 147 – reassessment of income escaping assessment, where the tax authority have reason to believe any income chargeable to tax has escaped assessment;
d Section 153A – assessment or reassessment in situations of search and seizure, where the tax authorities have reason to believe that the taxpayer's accounts do not reflect the true picture or the taxpayer has failed to produce the accounts.

In the course of an assessment, audit or reassessment, the TPO is empowered to carry out an adjustment if it forms an opinion that:

a the price charged in an international transaction is not at arm's length;
b any information and documentation relating to an international transaction has not been maintained by the taxpayer;
c the information or data used in computation of the arm's-length price is not reliable or correct; or
d the taxpayer has failed to furnish any information or documentation that was asked to be furnished within the specified time.

It can arrive at an arm's-length price on the basis of information or documentation gathered over the course of assessment or audit. A show cause notice has to be issued to the taxpayer to explain the basis of such adjustment. The order of the TPO shall be binding on the AO, who shall incorporate in the taxpayer’s main assessment and issue a draft order.

The transfer pricing assessment or audit is mandatorily required to be completed by 31 January and the AO is expected to incorporate the TPO’s order for an adjustment within the next two months by 31 March such that the period does not exceed 36 months from the end of the relevant tax year.

The primary onus is on the taxpayer to maintain documentation to demonstrate that the price charged in an international transaction complies with the arm's-length price, and the method followed to ascertain the price is the most appropriate method. The taxpayer discharges such onus by maintaining the documentation and the onus shifts to the tax authority. In the event the tax authority disagrees with the taxpayers’ view and seeks additional explanation, the burden of proof again shifts (to the taxpayer) to prove why the APA or method applied by the taxpayer is correct.
VII LITIGATION

Once the TPO proposes an adjustment, it directs the AO to pass a draft assessment within the time limit described above. It is mandatory for the AO to issue a draft assessment before issuing the final order at which stage, the taxpayer has the following options:

a accept the draft assessment and adjustment proposed;
b file an objection before the dispute resolution panel (DRP) by communicating its decision to the AO within 30 days of the draft order;
c not file an objection and instead, allow the TPO or AO to convert the draft order into a final order and thereafter file an appeal before the Commissioner (Appeals) within 30 days of the final order.

DRP as an alternative dispute resolution mechanism was introduced in the law by the Finance Act 2009 to expedite resolution of disputes in transfer pricing. Once the taxpayer chooses to opt for the DRP process, no tax demand can be raised given that the order is in a draft form. Such DRP objections have to be filed within a period of 30 days. The DRP, comprising three commissioners, shall have to decide the taxpayer’s objections within nine months from the date of reference by issuing written directions to the AO. Such directions are binding on the AO, which it is expected to incorporate in the final order. Alternatively, if the taxpayer does not communicate its decision to refer the draft order to the DRP within 30 days, the AO shall finalise the assessment order without modification of the draft assessment order. In summary, the tax demand is finalised only upon passing of the final order by the AO, which is appealable to the appeals commissioner (if the taxpayer does not file an objection) and to the Income-tax appellate tribunal (ITAT), if it is passed in pursuance to the DRP directions.

The taxpayer has the right to appeal to the ITAT within a period of 60 days from the final order in pursuance to DRP directions or the order of the appeals commissioner. The ITAT, being the last fact-finding authority, examines the dispute threadbare and adjudicates most transfer pricing disputes. It has broad powers to decide a question of law or facts including setting aside an assessment or restore the order of the TPO or AO for fresh examination, including admitting additional evidence.

The ITAT orders selectively travel to the jurisdictional High Court and from there to the Supreme Court. The High Court has to satisfy itself that a ‘substantial question of law’ arises from the ITAT order before admitting an appeal.

Landmark cases

The Bombay High Court in the Vodafone case

An Indian subsidiary entity of Vodafone and Shell issued shares to its foreign associated enterprise. The TPO formed an opinion that the shares were issued at an undervalued price. Hence, they treated the shortfall in premium of issue on shares as ‘income chargeable to tax’ in the hands of the Indian entity and made a transfer pricing adjustment. The TPO held the same to be deemed a loan given by the Indian subsidiary to its foreign associated enterprise. Hence, a notional interest on arm’s-length pricing on the deemed loan was charged as interest income by way of secondary adjustment.

The issue before the court (under a writ jurisdiction) was whether the alleged shortfall in share valuation constitute ‘income’ in the hands of the Indian entity, and was hence chargeable to tax.
The High Court held that transfer pricing provisions provides to recalculate the arm’s-length price to determine the real value of the transaction but not to recharacterise. Hence, there was no question of the transaction resulting in income and there could be no transfer pricing adjustment.

VIII  SECONDARY ADJUSTMENT AND PENALTIES

To align with the BEPS, India has amended the ITA to provide for secondary adjustment. Secondary transfer pricing adjustments are applicable for primary adjustments if made in one of the following situations:

a  voluntarily adjustment by the taxpayer;
b  adjustment made by the TPO and accepted by the taxpayer;
c  adjustment determined by an APA;
d  adjustment determined as per the safe harbour rules; and
e  adjustment resulting from an MAP;

As a consequence of primary adjustment if such sums are not repatriated to India within the prescribed period, it would be deemed as an advance by the Indian associated enterprise and interest would be imputed on such advance, as per the arm’s-length price standard. Secondary adjustment has to be applied where the primary adjustment is above 10 million rupees and it relates to primary adjustment for fiscal years 2015 to 2016 onwards.

For adjustments, the penalty is either 50 per cent of the adjustment (for under reporting) or 200 per cent of the adjustment for misreporting.

IX  BROADER TAXATION ISSUES

i  Diverted profits tax and other supplementary measures

India amended the ITA in 2012 to counter offshore indirect transfer of shares with underlying assets in India. Section 9(1)(i) provides that if any entity registered outside India derives its value from an entity situated in India in the form of shares or interest, then the former entity is deemed to be situated in India and liable for capital gain tax. Accordingly, transfer of interest in such foreign entity would attract capital gains, subject to exceptions and valuation norms.

In line with the OECD’s BEPS action plans to tax e-commerce transactions, India in 2016 introduced ‘equalisation levy’ to provide for a charge of 6 per cent in the form of tax from amounts paid to a non-resident, not having any permanent establishment in India, for specified services, which includes services such as online advertisement and provisions for digital advertising space. In 2018, India introduced the concept of significant economic presence test to tax non-residents on profits generated through non-PE traditional rules under the treaty.

ii  Double taxation

CBDT has clarified that MAP and bilateral APA applications can be applied by any taxpayer operating in India (regardless of residence) with which India has a double taxation avoidance agreement even though the agreement does not contain provisions for corresponding adjustment in matters of TP.
iii Consequential impact for other taxes
Indirect tax implications (under goods and service tax and customs tax) with regard to transfer pricing adjustments are independent. Hence, a related-party transaction may be subject to tax and customs adjustments.

X OUTLOOK AND CONCLUSIONS
As an active member of the G20, India has signed multilateral instruments, is a key contributor to the OECD’s BEPS initiative and has actively pursued changes in its domestic law policy. A significant step has already been taken to adopt the OECD’s recommendations of mandatory filing of a master file and CbCR. India introduced the General Anti-Avoidance Rules on 1 April 2017 and concluded revised tax treaties with Mauritius, Singapore and Cyprus with the ‘limitation of benefits’ clause, aligned to these rules and the Principal Purpose Test.
I OVERVIEW

The legal basis of the arm’s-length principle in Indonesia is provided in Article 18(3) of the Income Tax Law (ITL), where it is stated that Directorate General of Tax (DGT) is authorised to recalculate the taxable income or deductible costs of related-party transactions in accordance with the arm’s-length principle.

According to Article 18(4) of the ITL, the definition of related parties applies to circumstances where:

a a taxpayer owns directly or indirectly at least 25 per cent of the equity of the other taxpayer, or a relationship exists between two or more taxpayers through ownership of at least 25 per cent of equity of two or more residents;
b a resident ‘controls’ another resident or two or more residents directly or indirectly; or
c a family relationship exists through either blood or marriage, within one degree of direct or indirect lineage.

DGT Regulation PER-22 further specifies the types of transactions covered under Indonesian transfer rules, which include transactions on:

a sales, purchases, alienation and exploitation of tangible assets;
b rendering intra-group services;
c alienation and exploitation of intangible assets;
d loan payments of intra-group loans; and
e sales or purchases of shares.

In general, Indonesian transfer pricing regulations have adopted the OECD Transfer Pricing Guidelines; however, there are several principles related to specific circumstances not detailed in Indonesian regulations, including cost contribution agreements and transfer pricing aspects of business restructuring.

The ITL also authorises the Minister of Finance to prescribe the expected ratio of a company’s liabilities to its equity, which shall be valid for tax purposes. Further, on 9 September 2015, the Ministry of Finance released Decree Number 169 (MoF 169) regarding the ratio of debt and equity for income tax purposes. The decree provides that the acceptable debt-to-equity ratio for Indonesian companies must not exceed 4:1, which means that this provision will deny the deductibility of the interest in connection with the portion of debt that exceeds the 4:1 ratio. In addition, debt-related deductions that could

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1 Romi Irawan is a partner and Untoro Sejati is a senior manager at DDTC.
also be denied include fees and charges incurred in respect of the debt. Exclusions from the prescribed debt-to-equity ratio are provided for banks, financial institutions, insurance companies, mining companies, oil and gas companies under production-sharing contracts, taxpayers from the infrastructure sector and taxpayers subject to final income tax.

II FILING REQUIREMENTS

Since tax year 2016, Indonesia has adopted a three-tiered transfer pricing documentation obligation, in line with agreed standards as set out in BEPS Action Plan 13. Transfer pricing documentation obligations are now governed under Minister of Finance Regulation No. PMK-213/PMK.03/2016 (MoF 213). Transfer documentations now consist of master file, local file, and country-by-country report (CbCR).

Master and local file documentation obligation is imposed to taxpayers that have related-party transactions in the current tax year and fulfil the following criteria:

a taxpayers with a gross revenue of more than 50 billion rupiahs in the previous tax year; or
b taxpayers with related-party transactions in the previous tax year exceeding 20 billion rupiahs or exceeding 5 billion rupiahs if the related-party transaction concerns intangible assets, services and interest payments; or
c if the related-party transaction is conducted with low-tax countries (i.e., jurisdictions with a statutory tax rate lower than 25 per cent).

Master and local files are not required to be filed at the same time of tax return filings. Reporting entities must, however, provide, along with the tax return, a checklist that confirms the availability of such master and local files, including the date of when such documentation is made available. When requested by the DGT, reporting entities are required to file the master and local files within one month of the request.

CbCR reporting obligations are imposed to taxpayers that fulfil the following criteria:

a taxpayers that are considered the ultimate parent entity of a group with a consolidated gross revenue in one tax year of at least 11 trillion rupiahs;2 or
b taxpayers that are not ultimate parent entities but are member entities of a group with an ultimate parent entity that is tax resident in a country that:
   • does not impose an obligation to file CbCRs;
   • does not have an exchange of information agreement with Indonesia; or
   • despite having a CbCR reporting obligation and an exchange of information agreement in place with Indonesia, cannot have its CbCR obtained by the DGT.

CbCR reporting taxpayers or non-reporting taxpayers are all required to file an online notification to the DGT via an online platform. The online notification must identify which entity in the group has a CbCR prepared, including the country where this is submitted. In addition to the online notification, CbCR reporting entities must file the actual CbCR via the same online platform. Taxpayers that have completed the online notification or online submission of the CbCR will receive a receipt. This receipt must be filed along with the tax return.

To provide legal certainty of CbCR reporting obligations by domestic taxpayers that are not ultimate parent entities, the DGT will release a list of treaty partner countries that

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2 This is in line with the BEPS Action Plan 13 required minimum threshold of €750 million.
have a treaty in place containing an exchange-of-information clause, qualifying competent authority agreements (QCAA) and have QCAA, but CbCRs are unobtainable by the DGT. Upon the announcement of the list of such countries, domestic taxpayers delegated with the CbCR obligation have three months to submit a CbCR. If within that period, the taxpayer fails to submit a CbCR, the DGT shall send a formal request letter to said taxpayer, and grant a 30-day extension since the date of the request letter.

III PRESENTING THE CASE

i Pricing methods

In line with the guidance provided in the OECD Guidelines, Indonesia has adopted the ‘most appropriate transfer pricing method’ principle in selecting the transfer pricing method that will be used in analysing affiliated transactions.

There are five transfer pricing methods stipulated in Indonesia’s transfer pricing regulations:

a the comparable uncontrolled price (CUP) method;

b the resale price method;

c the cost-plus method;

d the transactional net margin method (TNMM); and

e the profit split method.

In general, both taxpayers and the DGT have a preference for applying the CUP method if an affiliated transaction is made in connection with the commodity sector. In addition, the CUP method is also generally applied in royalty and interest payment on loan transactions.

If the CUP method is not applicable, the taxpayers and DGT will usually apply the TNMM. The use of other traditional transaction-based methods, namely resale price method and cost-plus method, are rarely used in practice due to the limited availability of detailed gross margin data in commercial databases. The transactional profit method (i.e., profit split method) is also rarely used because of the extensive information requirements regarding the taxpayers’ group as a whole. Generally, this is because multinational companies (MNCs) that run their business in Indonesia are subsidiaries, and thus the information concerning the MNC group as a whole is not owned by the subsidiary.

ii Authority scrutiny and evidence gathering

The DGT have specifically issued guidance on audits in relation to transfer pricing disputes.3 One of the procedures that must be performed by the DGT in conducting transfer pricing audits is to identify the risks in the affiliate transaction performed by the taxpayers. In the risk analysis, the following parameters measuring the risk of transfer pricing are considered by the DGT:

a the significance of the affiliated transaction, perhaps measured based on its proportion of sales or net profit;

b affiliated transactions with entities located in low-tax jurisdictions;

c specific affiliated transactions, such as the transfer of intangibles, payment of royalties, performance of intra-group services and payment of interest;

the taxpayers’ net profit being less than that of other companies in a similar industry;

- the significance of affiliated transactions that are not included in the taxpayers’ net profit component, which could be measured based on their proportion of net profit:
  - interest expense;
  - gain or loss on the sale of an asset; and
  - gain or loss from foreign exchange;

- non-routine affiliated transactions, such as business restructuring that involves or does not involve an intangible asset, as well as sales of intangible property; and

- the taxpayers suffering losses for several years.

Since 1984, Indonesia has applied a self-assessment system under which taxpayers are required to calculate, pay and report their own taxes in accordance with prevailing tax laws and regulations. In connection with affiliated transactions, taxpayers are expected to prepare a transfer pricing report containing the information required by DGT. The role of the taxpayers in any tax audit is to assist in the process by appearing for investigation and producing books of accounts, documents or other relevant records as requested by the DGT for inspection within the specified time limit.

The DGT starting point of analysis is based on the information provided in the transfer pricing documentation as prepared by the taxpayers. However, if taxpayers do not provide transfer pricing documentation and its explanation, the DGT may establish the facts and analysis based on information available to the DGT. If this is the case, the DGT have the authority to propose a transfer pricing adjustment by way of issuing an *ex officio* tax underpayment assessment letter, and the burden of proof is on the taxpayers to demonstrate that such assessment letter is not correct.

### IV INTANGIBLE ASSETS

According to Indonesia’s transfer pricing regulation, the transactions involving intangible assets between related parties is considered to be at arm's length if:

- the utilisation of intangible assets has actually occurred;
- there is an economic or commercial benefit received by a licensee; and
- the royalty rate applied in related-party transactions should be comparable with the royalty rate applied in independent transactions in comparable circumstances.

Further, in line with recent developments on the issue of transfer pricing on intangible assets, in practice, DGT also emphasised the analysis of the development, enhancement, maintenance, protection and exploitation (DEMPE) functions of intangibles. The party performing the DEMPE function in this regard shall be deemed as a party that is entitled to the remuneration of income derived from the DEMPE functions.

In identifying and determining which party performs the DEMPE functions, generally, the DGT will consider which parties:

- booked research and development expense as well as marketing expense;
- performed research and development and marketing functions;
- had borne research and development risks as well as marketing risks;
- had employees or personnel with specific capabilities, employed in marketing or manufacturing functions, who contribute to the success of a product in the market; and
- had a distribution channel and customer list.
Concerning the determination of arm’s-length royalty payment for the licensing of intangibles, DGT and taxpayers commonly use the CUP method. However, in the application of the CUP method, both taxpayers and DGT face the same limitations regarding the availability of reliable comparable, including the comparability of the type of intangible itself and the exclusivity rights; therefore, in some cases of dispute resolution, the TNMM is also commonly used.

In addition, several other issues surrounding intangibles that often cause the risk of disputes between taxpayers and DGT concern the taxpayers who make royalty payments but recorded losses, or taxpayers who booked an increase in the rate of royalty payments.

V SETTLEMENTS

There are three instruments that may be used by the taxpayers in transfer pricing disputes: the advance pricing agreement (APA), the mutual agreement procedure (MAP) and appeals to the tax courts, which can extend to Supreme Court civil review requests.

The process of tax litigation in Indonesia takes 12 months for objection or appeal and six months for civil review. However, in appeals and civil review processes, some time periods are longer than stipulated.

As an alternative dispute resolution, the MAP may be used by taxpayers in accordance with the rules contained in the tax treaty clauses between Indonesia and each partner country included in the transactions, and can be initiated by the taxpayers or the DGT. As a general rule, an MAP could be commenced if an action of the contracting state results or will result in taxation not in accordance with the provision of a tax treaty. In practice, taxpayers can initiate an MAP procedure following the issuance of notification of tax audit letter; therefore, the exhaustion of domestic dispute resolution remedies is not necessary for commencing an MAP process.

In domestic proceedings, it is possible to request the commencement of an MAP when the taxpayers are involved in a litigation process (i.e., filing an objection or tax appeal) against the DGT in court (i.e., a simultaneous MAP request). However, if the tax court has made a decision on an appeal case, the DGT would terminate the MAP. Any mutual agreement request does not postpone obligations of taxpayers to pay the assessed tax if they have received an assessment notice, regardless of whether the taxpayers request an MAP.

Further, according to current MAP regulation, the implementation of an MAP carried through consultation between the Indonesia’s tax authorities with the tax authorities in the tax treaty partner country may take a maximum period of three years commencing from the first consultation. However, the time period may be extended following an agreement between the Indonesian tax authorities and the tax authorities in the tax treaty partner country if the MAP process does not yield a mutual agreement.

In addition to appeals and MAPs, APAs can be used by the taxpayers to prevent transfer pricing disputes. In Indonesia, APAs could be concluded unilaterally or bilaterally, while a multilateral APA is not specifically stated. Unilateral APAs could cover a maximum of three tax years, while bilateral APAs could cover up to four.
VI INVESTIGATIONS

Tax audits concerning assessment of the arm’s-length nature of related-party transactions falls within the normal tax audit procedure. A tax audit is automatically triggered for taxpayers that file a tax return claiming a refund position. A tax audit may also be triggered as a result of risk profiling conducted by the DGT to identify transfer pricing risks. The risk profiling takes into account, among others, perpetual losses; significance of related-party transactions; transactions with low-tax countries; and industry profitability benchmarks. Tax audits that include assessments on transfer pricing issues are conducted by the DGT through a field audit, which has a time limit of six months. This six-month period could be extended a maximum of three times.

During the tax audit process, the DGT have broad authority to request for information. Taxpayers are required to provide the documents and information requested by the tax auditors within one month. Failure to provide the documents and information within this time limit may cause the tax auditor to assess tax liabilities on a deemed profit basis. Where documents and information are not supplied within the one month period, they cannot be used as evidence at the later stages.

Although tax audits are conducted in relation to overall tax compliance and not specifically subject to transfer pricing transaction, the DGT has issued an audit guideline specifically for transfer pricing. The stated purpose of the audit guideline is to provide ‘simplicity and uniformity to DGT in performing audits on taxpayers with a special relationship to ensure the quality of the audit’. The audit guideline serves as best practice toolkit for tax auditors, which is especially necessary since tax auditors within the country may have different level of expertise in handling transfer pricing cases.

The audit procedure ends with a closing conference meeting. During closing conference stage, the tax auditor will provide the taxpayer with written notification of the tax audit findings. The taxpayer must state whether it agrees or disagrees for each item of audit findings. Taxpayers who disagree with the proposed tax audit findings can request for quality assurance to the regional tax office. The quality assurance procedure will re-examine the tax audit findings. The end result of a tax audit is an issuance of a tax assessment letter (SKP-letter). There are three types of tax assessment letter: the overpaid tax assessment letter (SKPLB-letter), the underpaid tax assessment letter (SKPKB-letter) and the nil tax assessment letter (SKPN-letter).

VII LITIGATION

i Procedure

Disputes will typically arise following the issuance of a tax assessment letter by the DGT with items of adjustments that the taxpayer does not agree with. A taxpayer who does not agree with a tax assessment letter can submit an objection to the tax office within three months of the issue date of the assessment letter. In accordance with the General Provisions and Tax Procedure Law, as far as the SKPKB-letter is concerned, the taxpayer must at least pay the

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4 Ministry of Finance Regulation number 17/PMK.03/2013 as latest amended by Ministry of Finance Regulation number 184/PMK.03/2015.
amount agreed during the closing conference before filing the objection. Within 12 months, an objection decision letter must be issued by the DGT; if not, the objection is automatically deemed accepted in favour of the taxpayer.

The next stage of the dispute resolution process is the appeal (banding). Taxpayers that do not agree with an objection decision can file a letter of appeal to the Tax Court within three months of the receipt of the objection decision letter. To be eligible for the appeal to be heard at the Tax Court, the taxpayer must pay at least 50 per cent of the total tax due (i.e., the tax due that is agreed by the taxpayer during the closing conference). Therefore, if the taxpayer has not agreed to any items of the adjustments imposed during the closing conference, there is no obligation to pay tax before having the appeal heard by the Tax Court.

As Indonesia adopts a civil law system, the court does not operate on the basis of precedence and their decisions are not fully published. Instead, the Tax Court provides a summary of a court decision, which is available on its website. However, the decision of the Tax Court is final with full legal force. The only legal remedy left for a taxpayer is to file a civil review request to the Supreme Court.

Recent cases

One of the examples of Tax Court decisions with regard to transfer pricing is the court decision in the case Put-70118/PP/M.IA/15/2016 (18 April 2016). In this case, the royalty payment made by the taxpayer was challenged by the DGT, who argued for the existence and benefit of the intangibles. In the Tax Court hearing, the taxpayer had proven that the use of intangibles had occurred, such as the use of trademark attached to the product, technical know-how and the actual conduct of technical assistance rendered by its affiliated company in Japan. Further, the judges stated that, since the DGT argued for the existence and benefit of the intangibles and the taxpayer could provide significant evidence that their transactions had actually occurred, the judges concluded that the adjustment proposed by the DGT regarding royalty payment could not be upheld.

VIII SECONDARY ADJUSTMENT AND PENALTIES

The authority of the DGT to impose a secondary adjustment is not clearly stipulated in the law. Nevertheless, the concept of ‘secondary adjustment’ is recognised in audit guidelines in connection with related-party transactions, which the DGT often refers to when conducting audits on taxpayers. The guidelines state that ‘if a primary adjustment has been conducted by the DGT, then a secondary adjustment may also be implemented’.

In practice, secondary adjustments are imposed on deductible payments to related parties (e.g., royalties and services), where the excess of the arm’s-length amount will be considered as deemed dividends. The amount considered as deemed dividends is not deductible, while still subject to withholding tax at the applicable rates according to domestic tax law or tax treaties. As there are no further specific regulations and guidelines, the application of secondary adjustments by the DGT is quite rare in practice. If applied, then this concerns mostly transactions of the taxpayer with its direct or indirect shareholder, and not for transactions with subsidiary or sister companies.

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6 Available at www.setpp.kemenkeu.go.id/risalah (accessed at 9 April 2018).
7 The concept of secondary adjustment is explained only in DGT Regulation PER-22/PJ./2013 and Circular Letter SE-50/PJ./2013.
There is no specific penalty regime for transfer pricing. Penalties imposed as consequence of transfer pricing adjustments follow the general applicable laws on taxation.⁸ In transfer pricing cases, generally, penalties are imposed when, as consequence of a tax audit, an underpaid tax assessment letter (SKPKB letter) is issued by the DGT. In this case, a penalty of 2 per cent per month of the underpaid tax amount is imposed for a maximum of 24 months.⁹ An additional 50 per cent penalty will apply if the taxpayer files an objection; the taxpayer has not paid the underpaid tax prior to filing an objection; and the objection decision does not rule in favour of the taxpayer.¹⁰ A 100 per cent penalty will be applied instead of the 50 per cent penalty if the taxpayer files an appeal to the Tax Court (after objection); the taxpayer has not paid the underpaid tax prior to filing an objection; and the Tax Court decision does not rule in favour of the taxpayer.¹¹

Further, failure to maintain a transfer pricing documentation could be regarded as a failure to maintain appropriate bookkeeping. In accordance with the General Provisions and Tax Procedure Law, failure to maintain appropriate bookkeeping could be imposed with a 50 per cent penalty of the underpaid tax.¹²

IX BROADER TAXATION ISSUES

i Diverted profits tax and other supplementary measures
A diverted profit tax is not applicable under domestic tax law.

ii Double taxation
Taxpayers seeking to resolve double taxation issues as a result of transfer pricing adjustments can make use of MAPs. All Indonesian income tax treaties contain an MAP article, similar to that contained in the OECD and UN models (without, however, an arbitration clause, except for in the tax treaty with Mexico). The Ministry of Finance has issued detailed regulations on how taxpayers could apply for the MAP process.¹³

There have been a number of tax cases that have been resolved through MAPs. Since 2017 (for reporting period 2016), Indonesia has released its MAP statistics via the OECD website.¹⁴

X OUTLOOK AND CONCLUSIONS
Indonesia is actively changing its regulations on transfer pricing to be more in line with the OECD BEPS package. As a result, transfer pricing documentation requirements in Indonesia have become more comprehensive and applicable to almost every taxpayer that is part of a

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¹⁰ Article 25(9) General Provisions and Tax Procedure Law.
¹¹ Article 27(5d) General Provisions and Tax Procedure Law.
¹³ MoF Regulation PMK-240/PMK.03/2014.
Indonesia

multinational group. It is, therefore, expected that the role of transfer pricing documentation will become even more critical for the following year when the first tax audits under the new documentation rules will take place.

Taxpayers should consider transfer pricing documentation as the first defence line in case of audit. In the end, robust transfer pricing documentation could serve well to reduce disputes with the DGT. A major change in the approach of tax audits is that the DGT will now also focus on intercompany pricing policies (ex ante approach) and not only on testing the arm’s-length principle after the transaction has occurred.

Alternatively, APAs are increasingly trending in Indonesia to avoid disputes or reach settlements considering that the number of tax audits is still high in the past three to four years. Although the APA programme is relatively new, the prospect of APA is nevertheless promising since it is reported that Indonesia has already, on many occasions, successfully concluded bilateral APAs with major trading countries.
I OVERVIEW

Formal transfer pricing legislation was introduced in Ireland for the first time through the Finance Act 2010 for accounting periods commencing on or after 1 January 2011 in respect of transactions, the terms of which were agreed on or after 1 July 2010. Ireland’s transfer pricing legislation is set out in Part 35A of the Taxes Consolidation Act 1997 (TCA).2

Before the introduction of transfer pricing legislation in 2010, there were limited circumstances in which an ‘arm’s length’ or ‘market value’ rule applied in Irish tax legislation. However, there was certainly some familiarity with the concept. For example, capital gains tax rules always required the imposition of ‘market value’ on certain transactions undertaken otherwise by means of a bargain and arm’s length;3 interest in excess of a ‘reasonable commercial return’ may be reclassified as a distribution;4 and, historically, income or losses qualifying for the (no longer applicable) 10 per cent corporation tax rate for manufacturing operations were calculated as they would for ‘independent parties dealing at arm’s length’.5

The transfer pricing legislation introduced in 2010 certainly broadened the scope of application of transfer pricing in Irish tax legislation. As might be expected, where the transfer pricing rules apply, an arm’s-length amount should be substituted for the actual consideration in computing taxable profits. The arm’s-length amount is the consideration that independent parties would have agreed in relation to the arrangement in question.6 The transfer pricing legislation applies equally to domestic and international arrangements but does not apply to small and medium-sized enterprises.7

Irish tax legislation requires that the profits or gains of a trade carried on by a company must be computed in accordance with generally accepted accounting practice subject to any adjustment required or authorised by law.8 Therefore, Irish transfer pricing legislation may result in an adjustment to the accounting profits for tax purposes. Where a transaction is undertaken at undervalue this may be a deemed distribution by the company for Company Law purposes, and if the company does not have distributable reserves this may be an unlawful distribution by the company.

1 Joe Duffy and Catherine O’Meara are partners at Matheson.
2 Taxes Consolidation Act 1997 (as amended up to Finance Act 2017).
3 Section 547 TCA.
4 Section 130 TCA.
5 Section 453 TCA. Deleted by Finance Act 2012 section 54.
6 Section 835C TCA.
7 Section 835E TCA.
8 Section 76A TCA.
However, there are a number of unusual aspects to the Irish transfer pricing rules that are worth noting.

First, the transfer pricing legislation applies to any ‘arrangement’ involving the supply and acquisition of goods, services, money or intangible assets. For these purposes, ‘arrangement’ is very broadly defined and it captures any kind of agreement or arrangement whether it is, or is intended to be, legally enforceable. However, the transfer pricing legislation does not apply to any arrangement that was agreed before 1 July 2010.9 This grandfathering of existing arrangements is not limited by time and as long as the terms do not change then an arrangement in place before 1 July 2010 may be excluded from the Irish transfer pricing legislation, potentially indefinitely. Practically, the expectation of the Irish Revenue Commissioners (Irish Revenue) is that this grandfathering of pre-1 July 2010 transactions will be lost through the passage of time where actual trading relationships change, even where contractual terms may not.

Second, the transfer pricing legislation applies where the supplier and acquirer in question are ‘associated’. Two persons are associated if one person participates in the management, control or capital of the other, or the same person participates in the management, control or capital of each of the two persons. However, the first person is participating in the management, control or capital of the other person only if that other person is a company controlled by the first person. The transfer pricing rules will, therefore, necessarily involve at least one corporate entity.10 However, the transfer pricing rules do not apply in a single corporate entity. Therefore the transfer pricing rules do not apply in determining the pricing as between the head office of a company and a branch of that company.

Third, the transfer pricing legislation will only apply to profits or losses arising from the relevant activities that are taxed as the profits of a trade or profession.11 This is an unusual aspect of the Irish transfer pricing rules that is worth considering in the context of the Irish corporation tax rates. In Ireland, corporate trading profits are taxable at 12.5 per cent while other non-trading or passive income (e.g., interest income) is typically taxed at 25 per cent. Rather unhelpfully, ‘trading’ is defined in Irish legislation as including ‘every trade, manufacture, adventure or concern in the nature of a trade’. While there is extensive case law on the meaning of trading, the case law is typically very old and originates from a time when trading profits were taxable and non-trading profits were not taxable (in the absence of a capital gains tax). Typically, a trade in Ireland involves regular activity conducted in Ireland by persons engaged in the revenue generating part of that business. Very often, it is clear whether a particular activity constitutes a trade; however, it is not always clear in the context of intra-group loans or an intra-group licence arrangement which can have trading and non-trading characteristics depending on the facts. This means it is possible for an Irish company to make an interest-free loan or grant a royalty-free licence where the level of activity does not rise to the level of a ‘trade’. The Irish transfer pricing rules will not apply to the non-trading arrangement and the Irish company is not obliged to charge interest on the loan or charge a royalty on the licence. However, where the company is making a number of loans or granting a number of licences, this may increase the likelihood that the company is actually trading and that the transfer pricing rules will apply requiring the imposition of an interest charge or royalty. Other noteworthy consequences of the rule,

9 Section 42 Finance Act 2010.
10 Section 835B TCA.
11 Section 835C TCA.
whereby transfer pricing legislation only applies to trading transactions, include the fact that capital transactions are not covered by the transfer pricing legislation (though the market value rule mentioned above may apply) and non-trading shareholder transactions are not captured either.

Fourth, the Irish transfer pricing legislation can only operate to increase the Irish taxable profit. Therefore the rules can only increase understated income or reduce overstated expenses.

Fifth, the Irish transfer pricing legislation should be construed to ensure, as far as practicable, consistency with the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. However, the relevant OECD Transfer Pricing Guidelines referenced in the Irish transfer pricing legislation are the guidelines approved by the Council of the OECD on 13 July 1995, as modified by the updates of 16 July 2009 and the revision of 22 July 2010 (being the 2010 transfer pricing guidelines). The 2017 OECD Transfer Pricing Guidelines have not yet been incorporated into Irish law. This is more relevant in respect of dealings between Irish companies and persons resident in non-double tax treaty partner jurisdictions. The 2017 OECD Transfer Pricing Guidelines are considered to already apply to the interpretation of the arm’s-length principle for the purposes of Ireland’s double tax treaties.

These unusual aspects of the Irish transfer pricing rules have raised questions as to whether the rules are still fit for purpose. As a result, the transfer pricing rules are under review and changes to the transfer pricing rules can be expected over the coming years. Possible future changes to the transfer pricing rules are considered in Section X.

II FILING REQUIREMENTS

There is very little legislation detailing the documentation requirements for transfer pricing purposes. Quite simply, the legislation requires the taxpayer to have available, on a timely basis, such records as may reasonably be required for the purposes of determining whether the trading income has been computed in accordance with the requirements of the transfer pricing legislation.

Irish Revenue have issued guidance on the expectations regarding transfer pricing documentation. The guidance issued by Irish Revenue notes that there is no requirement for documentation to be kept in a standard form. The legislation does not require that the taxpayer itself must prepare the documentation or that the documentation must be in Ireland. Furthermore, if appropriate documentation has been prepared by an associated company for tax purposes in another country, it should be sufficient that the documentation can be made available if required. Although not binding, Irish Revenue accept the EU Council code of conduct entitled ‘EU Transfer Pricing Documentation’ and Chapter V of the OECD Transfer Pricing Guidelines as representing good practice.

12 Section 835C TCA.
13 Section 835D TCA.
14 Section 835F TCA.
The actual documentation required will depend on the facts and circumstances and the documentation maintained should be commensurate with the risk involved whereby complex and high value transactions would generally require more detailed documentation than simple high volume transactions.

The guidelines issued on documentation (without being prescriptive) suggest that the relevant documentation maintained should clearly identify:

a. the associated persons for the purposes of the legislation;

b. the nature and terms of transactions within the scope of the legislation;

c. the method, functional analysis and comparables used;

d. how this has resulted in arm’s-length pricing;

e. relevant budgets or forecasts relied upon; and

f. the terms of the relevant transactions.

It is best practice that the documentation is prepared or available at the time the terms of the transaction are agreed. There is no obligatory time frame for review and updating of transfer pricing documentation; however, it should be reviewed at regular intervals to determine whether the pricing remains at arm’s length.

Ireland has introduced legislation to implement country-by-country reporting requirements. The Irish country-by-country reporting closely mirrors the OECD model legislation and relies on it for certain definitions. It should be noted that there are some differences between the OECD model legislation and the Irish country-by-country reporting legislation. Primarily in relation to options to appoint a surrogate parent entity or EU designated entity to provide the country-by-country report on behalf of the multinational group. Where there is a conflict, the Irish legislation takes precedence. Currently, there is no Irish legislation in respect of public country-by-country reporting, though this is an area of interest to the European Commission and ultimately may be introduced as an EU directive.

III PRESENTING THE CASE

i Pricing methods

As mentioned above, the Irish transfer pricing legislation states that in computing the taxable profits and losses of a taxpayer, the legislation shall be interpreted to ‘ensure, as far as practicable, consistency’ with the OECD Transfer Pricing Guidelines. The Irish transfer pricing rules do not prescribe any preferred transfer pricing methodology or methodologies. Provided the methodology is appropriate in the circumstances and adheres to general OECD principles, it should be acceptable. Therefore the identification of the most appropriate transfer pricing method, either traditional transaction methods (CUP, resale price and cost-plus) or a transactional profit method (transactional net margin and transactional profit split), and the application of that method should be in accordance with the OECD Transfer Pricing Guidelines.

Irish Revenue has recently published guidance on a simplified approach in respect of low-value intra-group services. In summary, where a cost-based method is determined to be the most appropriate transfer pricing method for determining an arm’s-length price for low
value intra-group services, Irish Revenue is prepared to accept a markup of 5 per cent of the relevant cost base without the need for a benchmarking study. The guidance also sets out the documentation requirements for the taxpayer in order to avail of this simplified approach for low value intra-group services.

Low value intra-group services are services performed by entities within a multinational group for other entities within the same group and are typically administrative, routine and supportive services that are ancillary to the main business and do not involve valuable intangibles or risk for the service provider. Irish Revenue is prepared to accept a markup of 5 per cent of the cost base without the need for a benchmarking study to be carried out by the taxpayer to support this rate.

However, supporting documentation is required and must include the following information:

- a description of the services provided or received;
- the identity of the recipient or provider of the service;
- an explanation of why the services are considered to be low-value services;
- the rationale for the provision or receipt of such services;
- a description of the benefits of each category of services;
- an explanation and justification of the allocation key chosen;
- confirmation of the markup applied;
- written contracts, and any amendments to the same, for the provision of services;
- calculations of the final fee charged showing the calculation of the cost base, the application of the allocation key to that cost base and the application of the markup to the apportioned cost base;
- confirmation that shareholder costs and duplicate costs have been excluded from the cost base; and
- confirmation that no markup has been applied to pass-through costs.

Irish Revenue accepts that the EU guidelines on low-value added intra-group services represent good practice.

ii Authority scrutiny and evidence gathering

On transfer pricing matters, Irish Revenue does not typically engage in dawn raids. The taxpayer will be provided with reasonable notice of an upcoming visit or intention to initiate an audit. This is typically followed by a series of written request for further information or explanations. This may be supplemented by requests for meetings with representatives of the taxpayer and interviews with relevant persons employed by the taxpayer.

While Irish Revenue will seek to understand the taxpayer’s business and obtain an overview of its global business, in the normal course of events the primary focus is typically on the direct intra-group relationships to which the Irish resident taxpayer is a party. Irish Revenue does not typically consider arrangements to which the Irish taxpayer is not a party or seek to allocate profit share per jurisdiction throughout a multinational group.

Irish Revenue may also serve notice on a financial institution and other third parties to make books, records or other documents available for inspection, if they contain information relating to a tax liability of a taxpayer, even if the taxpayer is not known to the officer but is identifiable by other means. The officer authorised must have reasonable grounds to believe that the financial institution or other third party is likely to have information relating to this liability.
Ireland

Irish Revenue is a strong advocate for international cooperation on tax matters. Ireland has entered into a more than 70 double taxation treaties and numerous tax information exchange agreements under which Irish Revenue cooperates with foreign authorities in the exchange of tax information. Irish Revenue has information exchange obligations arising from Ireland’s membership of the European Union and the OECD, both of which involve automatic exchange of information relating to cross-border tax rulings and advance pricing agreements.

IV INTANGIBLE ASSETS

There are no particular rules in Ireland addressing transfer pricing in respect of intangibles. However, Ireland has strongly endorsed the outcomes of the BEPS project, including the report on Actions 8–10.

The 2017 OECD Transfer Pricing Guidelines have not yet been incorporated into Irish law. Therefore in non-double tax treaty transfer pricing cases the DEMPE principles should not have direct application. This is particularly relevant from an Irish perspective in the context of royalty payments from Irish resident companies to IP holding companies resident in a non-double tax treaty jurisdiction. However the DEMPE principles are relevant in double tax treaty cases.

V SETTLEMENTS

There is no publicly available information on transfer pricing settlements concluded with Irish Revenue. However, in practice it is clear that Irish Revenue places great importance on reaching settlements that can be supported by appropriate evidence and are based on OECD principles. Under Irish Revenue’s internal quality assurance programme a selection of audits and ultimately settlements are monitored to ensure quality.

A taxpayer may make a voluntary disclosure of an underpayment of tax before an audit has commenced in order to benefit from reduced penalties. Once an audit has commenced, and through the appeals process, the opportunity to settle remains open, though the level of penalty mitigation may be reduced.

Once a settlement is agreed, the outstanding tax plus interest and penalties is paid and the audit is closed. In certain circumstances, where significant penalties are imposed as part of the settlement, Irish Revenue are obliged to publish the name and address of the taxpayer along with the default amount and applicable tax head.18

As Irish Revenue will endeavour to conclude a transfer pricing settlement based on OECD principles, they will generally accept a similar methodology going forward as long as the facts and circumstances have not changed. While a settlement discussion may be broadened and extended into a bilateral advance pricing agreement Irish Revenue will no longer agree to a unilateral advance pricing agreement in any circumstances.

18 Section 1086 TCA.
VI INVESTIGATIONS

Irish Revenue maintains scrutiny on the transfer pricing matters within the framework of the existing tax compliance infrastructure with support from a team of economists. Separately Irish Revenue's competent authority team manage international transfer pricing disputes and bilateral or multilateral advance pricing agreements.

Upon the introduction of the transfer pricing legislation in 2010, it was recognised that there was not a significant level of experience or understanding of the transfer pricing policies of multinationals operating in Ireland. Therefore within the context of monitoring transfer pricing compliance, in November 2012 Irish Revenue initiated a system of transfer pricing compliance reviews.19 This comprised a non-audit intervention whereby the tax inspector would make a request for information on the transfer pricing policy within a multinational group. The information requested would include:

- the group structure;
- details of transactions by type and associated companies involved;
- pricing and transfer pricing methodology for each type of transaction;
- the functions, assets and risks of parties;
- a list of documentation available or reviewed; and
- the basis for establishing how the arm's-length standard is satisfied.

This initial non-audit intervention could lead to a more traditional audit. Over time, as experience has grown, transfer pricing audits are more common and are handled in a similar manner to audits under other tax heads. Irish Revenue have noted that the deployment of their resources will take into account risk factors and, therefore, it is unlikely that transactions between persons that involve no overall loss of revenue will be targeted.

An authorised officer can require a taxpayer to deliver, or to make available for inspection, books, records and other documents (including transfer pricing documents) or to furnish information relevant to the taxpayer's tax liability under the legislation. An authorised officer can also apply to the High Court for an order directing the person concerned to comply with the officer's requirements in respect of books, records and other information.20

The statute of limitation for raising an assessment is four years from the end of the accounting period in which the relevant tax return is delivered.21 This typically means the accounting period remains open for audit for five years from the end of the accounting period in question.

Once an assessment is raised the taxpayer has 30 days to lodge an appeal to the assessment in writing. The case then moves forward to the Tax Appeals Commissioners for determination. Further appeal on points of law may be made to the High Court, Court of Appeal and ultimately the Supreme Court through the regular court system. It is worth noting that settlement negotiations can continue during the period following the issuing of an assessment and lodging an appeal.

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19 See Revenue Operational Manual 35A-01-01.
20 Part 38 TCA.
21 Part 41A TCA.
VII Litigation

i Procedure

To make an appeal to an assessment the taxpayer must submit a formal notice of appeal to the Tax Appeals Commission, along with a copy of the notice of assessment or the letter of notification containing the decision to be appealed. The notice of assessment or the letter or notification will state the time limit for making an appeal but it is generally 30 days from the date on the notice of assessment or the letter or notification.

For the Tax Appeal Commissioner to accept the appeal, the taxpayer must have submitted a tax return and paid the amount of tax declared on the return. It is not necessary to pay the tax assessed by Irish Revenue in the notice of assessment. If this condition is not satisfied, Irish Revenue may object to the leave to appeal and will notify the taxpayer of such objection. While Irish Revenue can object to the acceptance of the appeal, it is a matter for the Tax Appeals Commission to accept or refuse to accept the appeal.

Most appeals end up being settled by an agreement between taxpayers and Irish Revenue rather than being decided by the Tax Appeals Commission. The appeal to the Tax Appeals Commission will remain open for the duration of any discussions with Irish Revenue. However, the Tax Appeals Commission may decide to proceed with the appeal if it thinks that it is unlikely to be settled by agreement or it is unlikely to be settled within a reasonable period of time.

Most appeals that end up with the Tax Appeals Commission are decided following an oral hearing before an Appeal Commissioner. A hearing involves the Appeal Commissioner listening to arguments and evidence presented by the taxpayer and an Irish Revenue official. Both parties may be represented by a tax adviser or lawyer. Before an oral hearing takes place, the Tax Appeals Commission may ask the taxpayer or Irish Revenue to provide additional information about the matter being appealed. The Tax Appeals Commission can decide not to have an oral hearing but, instead, to make a decision based on written material provided by the taxpayer and Irish Revenue. This is more likely to happen where the matter being appealed is straightforward.

Whether your appeal is decided with or without an oral hearing, the taxpayer is given a detailed written decision that explains why the Appeal Commissioner made the decision. All decisions are published on the Commission’s website but do not identify the particular taxpayer involved. To date, there have been no transfer pricing decisions published.

Either party may appeal a decision of the Appeal Commissioners to the High Court on a ‘point of law’ but this is not a complete re-hearing of the appeal. Therefore, the ability to appeal will depend on the decision made by the Appeal Commissioner and the reasons given for making that decision.

ii Recent cases

There has been no case law or Tax Appeals Commissioners decision on Ireland’s transfer pricing legislation. In a case that pre-dated the transfer pricing legislation, Belville Holdings v. Cronin, the High Court considered whether a parent company was obliged to charge for services provided to subsidiaries in circumstances where it was otherwise incurring losses as a result
of expenses incurred. The High Court held that the parent company should be obliged to charge expenses incurred managing its subsidiaries but only to bring the transaction within the realm of being a *bona fide* transaction in the ordinary course of business.

**VIII SECONDARY ADJUSTMENT AND PENALTIES**

Irish Revenue are not entitled to impose secondary adjustments under transfer pricing legislation where those adjustments do not relate to an understatement of trading profits.

The transfer pricing legislation does not contain any specific penalties. Therefore, normal taxation and penalty provisions will apply. Therefore both fixed and tax-geared penalties may apply. The applicable tax-geared penalty can be as much as 100 per cent of the underpaid tax. Irish Revenue is prepared to mitigate penalties to an amount as low as 3 per cent of the underpaid tax. The applicable percentage will depend on whether there has been a qualifying disclosure, it is a first offence, it is careless behaviour or deliberate behaviour and whether consequences are significant.\(^24\)

Where the taxpayer does not agree on the liability to a penalty then it is a matter for the court to determine whether that person is liable to a penalty.

**IX BROADER TAXATION ISSUES**

**i Diverted profits tax and other supplementary measures**

Ireland has not introduced a diverted profits tax or other measures to supplement transfer pricing rules.

**ii Double taxation**

To avoid double taxation on transfer pricing matters, taxpayers may request mutual agreement procedure assistance under the terms of the relevant double tax treaty or the EU Arbitration Convention.

The legal basis for a mutual agreement procedure request falls under the equivalent of Article 25 of the OECD’s Model Tax Convention on Income and on Capital in the relevant double tax treaty. In international transfer pricing matters it is typically advisable for each affected taxpayer to make a separate request for mutual agreement procedure assistance to the competent authority of the country in which it is resident. Under the multilateral instrument agreed as part of the BEPS process Ireland has opted to allow a taxpayer approach the competent authority of either jurisdiction. The mutual agreement procedure request must be submitted in writing within the time limit applicable in the relevant double tax treaty (which is typically three years, but may vary by treaty) or the EU Arbitration Convention (which is three years from the first notification of the action which results or is likely to result in double taxation). The time period typically begins from the date of the first tax assessment notice or equivalent.

The minimum information to be provided as part of a mutual agreement procedure request under a double tax treaty includes details of the relevant tax periods, the nature of the action and the names and addresses of the relevant parties. For a valid request under the EU

\(^{24}\) See Code of Practice for Revenue Audit and other Compliance Interventions, February 2017.
Arbitration Convention, the request should also include details of the relevant facts, copies of assessments, details of litigation commenced and an explanation of why the principles of the EU Arbitration Convention have not been observed.25

Double taxation can also be avoided by means of settling an advance pricing agreement. Importantly Irish Revenue is prepared to conclude a multilateral or bilateral advance pricing agreement with double tax treaty partner jurisdictions. Irish Revenue will not conclude unilateral pricing agreements. Irish Revenue has issued detailed guidelines on the processes for advance pricing agreements.

A request for mutual agreement procedure can be distinguished from a request for a correlative adjustment where a foreign associated taxpayer has settled a case unilaterally with its foreign tax administration with regard to a transaction with its Irish associated taxpayer, and the associated Irish taxpayer subsequently makes a claim to Irish Revenue for a correlative adjustment. Irish Revenue will consider the appropriateness of such claims and will only allow a correlative adjustment to the profits of the Irish taxpayer to the extent that it considers the adjustment to be at arm’s length.

Double taxation may be unavoidable in a situation where a non-negotiable tax settlement has been agreed in one jurisdiction and Irish Revenue do not consider the settlement reached to reflect an arm’s-length position.

iii Consequential impact for other taxes
Where a transfer pricing adjustment is simply booked as an adjustment to taxable profits and there is no adjustment to the actual price charged and invoiced as between the associated entities then there should be no VAT impact. Where the adjustment is charged and invoiced then VAT returns should be amended as appropriate. The VAT recovery consequences will then depend on the VAT profile of the entity in question.

For customs purposes the price paid or payable is taken as the transaction value for customs purposes. So a transfer pricing adjustment that results in a change in the price paid may be relevant to any market valuation used as part of customs reporting. In light of the recent decision of the European Court of Justice in Hamamatsu Photonics Deutschland,26 the impact of pricing adjustments on the customs valuation declared on the importation of the goods is unclear. Irish Revenue has not published guidance or otherwise commented on the decision to date.

X OUTLOOK AND CONCLUSIONS
The Irish transfer pricing rules were only introduced in 2010, but following the BEPS process, some aspects are already looking outdated. On 2 September 2016, the government decided to arrange for a review of Ireland’s corporation tax code by an independent expert to be appointed by the Minister for Finance. In September 2017, following extensive consultation, the relevant report was published.27

26 C-529/16.
The report included a number of specific recommendations in respect of transfer pricing, as summarised below:

a) Ireland should provide for the application of the OECD 2017 Transfer Pricing Guidelines incorporating BEPS Actions 8, 9 and 10 in Irish legislation;

b) Irish domestic transfer pricing legislation should be applied to arrangements, the terms of which were agreed before 1 July 2010;

c) Consideration should be given to extending transfer pricing rules to small and medium-sized enterprises, having due regard to the administrative burden and risks;

d) Consideration should be given to extending domestic transfer pricing rules to non-trading income and capital transactions;

e) There should be a specific obligation on Irish taxpayers who are subject to domestic transfer pricing legislation to have available the transfer pricing documentation outlined in Annex I and II of Chapter V of the OECD 2017 Transfer Pricing Guidelines to ensure implementation of BEPS Action 13; and

f) If it is decided to implement any or all of the above recommendations, this should take place no later than the end of 2020.

Irish Revenue has recognised transfer pricing as an important tool for raising tax revenues and defending the existing Irish tax base. The number of domestic and international transfer pricing disputes is increasing. In the meantime, the Irish transfer pricing rules are ready for modernisation and we are likely to see important changes over the coming years. It remains to be seen whether the changes to the rules will help alleviate the potential for disputes in this area.
Chapter 12

ISRAEL

Eyal Bar-Zvi

I OVERVIEW

Israel’s transfer pricing regulation is provided under Section 85A of the Israeli Tax Ordinance (Section 85A), which came into effect on 29 November 2006. Guidance regarding transfer pricing is incorporated under Tax Circular 3/2008. A recent update regarding the operations of foreign multinationals in Israel via the internet is included in Tax Circular 4/2016. This new Circular, inspired by the OECD’s BEPS Action 1 concerning digital economy, provides new guidelines and rules under which foreign companies’ income derived from selling products or providing services through the internet to Israeli residents (digital activity), will be deemed the income of a permanent establishment (PE) in Israel for tax purposes. The Circular distinguishes between foreign enterprises that are residents of a treaty state (treaty resident companies) and foreign enterprises that are residents of a non-treaty state (non-treaty resident companies) and provides different rules for determining the attributed income to the Israeli PE for either of the aforementioned companies.

The regulations promulgated under Section 85A (the Regulations) adhere to the arm’s-length principle and incorporate both the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the OECD Guidelines) and Section 482 of the US Internal Revenue Code (Section 482) approach towards determination of the correct analysis methods for examining an international transaction between related parties.

The scope of transfer pricing regulations in Israel is limited to cross-border transactions in which a special relationship (as defined below) exists between the parties to the transaction. Normally, transfer pricing issues arise in relation to transactions carried out by companies that are part of a multinational group; however, the Israeli Tax Authority (ITA) has recently been implementing the principles of Section 85A on an unofficial basics in relation to related-party transactions within Israel. According to Section 85A and the Regulations, the tax-assessing officer may issue an approval that certain one-time transactions may be excluded from the scope of the Regulations; however, such approvals are rare.

The term ‘special relationship’ includes the association between an individual (including an entity) and their relative, the control of one party to the transaction over the other or the control of one individual over the other parties to the transaction, whether directly or indirectly, individually or jointly with other individuals.

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1 Eyal Bar-Zvi is a partner at Herzog Fox & Neeman Law Offices. The author wishes to thank Yariv Ben-Dov and Annette Cohen for their contribution to this chapter.
‘Control’ means holding, directly or indirectly, 50 per cent or more in one of the indicators of control. An indicator of control is defined as:

- the right to profits;
- the right to appoint directors or the general manager or other similar positions;
- the right to vote in the general shareholders’ meeting;
- upon liquidation of the company, the right to a share in the equity after all debts are paid; or
- the right to determine which party will have one of the above-mentioned rights.

A relative is a spouse, sibling, parent, grandparent, child, spouses’ child and the spouse of each of these.

However, the ITA can often perform a qualitative test for the above threshold, and look at a transaction even if the threshold itself is not met.

The Regulations cover various types of transactions including: services (such as R&D, manufacturing, marketing, etc.); the use or transfer of tangible and intangible goods (i.e., distribution); the use or transfer of intangible assets (e.g., know-how, patents, trade name or trademark); and financing2 (e.g., capital notes, guarantees, captive insurance, loans) transactions, which are required to be carried out at arm’s length.

Due to the nature of the Israeli market, the ITA gives special attention to R&D services provided by Israeli subsidiaries and matters relating to intangibles, which may also involve governmental support.

Application of the arm’s-length principle is generally based (when the comparable uncontrolled price (CUP) method is not applicable) on a comparison of the conditions in a cross-border controlled transaction with conditions in similar transactions entered into between independent companies (comparable companies). To determine if a cross-border controlled transaction has been carried out in accordance with the arm’s-length principle, the following steps need to be taken:

- identify the cross-border controlled transactions within the group;
- identify the tested party for each respective transaction;
- perform a functional analysis with special emphasis on comparability factors such as business activity, the characteristic of the property or service, the contractual conditions of the cross-border transaction and the economic circumstances in which the taxpayer operates;
- select the appropriate transfer pricing method or methods;
- select the comparable companies and establish an arm’s-length range, determined by the comparable companies; and
- examine whether the tested party’s results fall within the arm’s-length range.

According to the Israeli transfer pricing rules, the initial burden of proof lies with the taxpayer. As such, companies not transacting at arm’s length, or which do not hold the required transfer pricing documentation (proving their compliance with the arm’s-length principle), are exposed to penalties and change of pricing according to the ITA’s discretion with a narrow

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2 Concerning financing transactions, the provisions of Section 85A explicitly address inter-company credit transactions (loans) and capital notes. However, in practice all types of financial arrangements between related-parties must be transacted at arm’s length.
arguable position, and would be required to adjust their net income to incorporate the appropriate transfer prices for their intra-group transaction. This unilateral adjustment could lead to double taxation regarding income that was taxed in other jurisdictions.

In rare cases where a transaction between related parties lacks any commercial rationality (namely, the same transaction under similar economic circumstances would not be agreed between non-related parties), the ITA may choose not to recognise the transaction in its original form, and may treat it as an entirely different type of transaction that in its view would reflect the business reality of the transaction in a more adequate manner. Such re-classification of transactions can relate, *inter alia*, to the treatment of inter-company loans or cash pooling or non-repayment of inter-company debts, as dividends, as well as to the ownership of intangibles. Non-recognition can be contentious and a source of double taxation, and, while derived from Section 85A, is based also on Section 86 of the Israeli Tax Ordinance.

With regard to accounting treatment of transfer pricing positions, the main issue currently under discussion in Israel relates to the recognition of expenses with regard to employee stock option plan (ESOP) matters (see Section VII.i), where the matters of vesting, exercise and cancellation of options granted to the employees of an Israeli subsidiary by the parent corporation are being considered; some of these aspects are currently in discussion in the Israeli Supreme Court (see Section VII.i).

II  FILING REQUIREMENTS

Taxpayers engaged in a cross-border controlled transaction or transactions are required to include in their annual tax return a special form (Form No. 1385), specifying their intra-group dealings (such as the volume of the transactions, transaction type, terms and conditions and the parties thereto) and declaring that their international transactions between related parties are conducted at arm’s length and in accordance with the Regulations. In practice, this means that taxpayers in Israel are expected, and in fact required, to hold up-to-date transfer pricing documentation, which includes, as a minimum a transfer pricing study and an inter-company agreement relevant for the fiscal year end. Form No. 1385 is signed personally by an officer of the company (usually the company’s chief financial officer), and although no personal liability has yet been claimed by the ITA in cases where the form was inaccurate, the ITA is debating internally on this matter.

In addition, the ITA is entitled to demand full transfer pricing documentation within 60 days of such request. The ITA often asks to receive the documentation within a shorter period, usually 30 days or less; however, this can usually be extended to the 60 days prescribed under the Regulations.

Since, as noted above, by signing Form No. 1385 the taxpayer’s officer declares that the company is compliant with the arm’s-length principle and that it maintains up-to-date transfer pricing documentation (i.e., transfer pricing study, inter-company agreement and also, where applicable, a transfer pricing policy), it is advisable to have in place an updated transfer pricing study on an annual basis. Penalties may be imposed on a taxpayer for not preparing and submitting transfer pricing documentation on time or at all. In addition to preventing penalties and fines, holding a transfer pricing study and other related transfer pricing documentation shifts the burden of proof to the assessing officer (AO) and
enables the taxpayer to hold an arguable position regarding any determination made by the AO concerning transfer pricing adjustments. The deadline to prepare transfer pricing documentation is 31 May of the year after the tax year.

Full documentation includes the following:

\( a \) a transfer pricing study that includes:

- a description of the parties involved in inter-company transactions, including a description of the management structure of the parties and functional organisational charts;
- a description of the inter-company transactions;
- a description of the business environment and the economic circumstances in which the parties operate;
- a functional analysis of the parties involved in the inter-company transactions (including functions performed, risks assumed and resources employed);
- selection of the pricing method or methods and the reasons behind such selection;
- an economic analysis (determination of arm’s-length prices); and
- the conclusions that may be derived from the comparison to uncontrolled comparable companies; and

\( b \) additional documents that corroborate the data described above such as:

- inter-company contracts;
- any disclosure made regarding the controlled transactions to any foreign tax authority including any request for an advanced pricing agreement (APA);
- a transfer pricing policy, if applicable;
- any differences between the prices reported to the foreign tax authority and the prices reported in the Israeli tax returns; and
- any opinion from an accountant or lawyer, if such were given.

It is recommended to update the transfer pricing study on an annual basis. Where the facts of the transaction or transactions under review have not changed materially (or at all), the entire transfer pricing study can remain the same except for the benchmark results, which need to be updated every year. As best practice, it is recommended to conduct a new search every two years and update the results of the original search on an annual basis. From time to time, due to a lack of local comparables, the search may be broadened to a more global search, so long as it abides by the Regulations and the instructions of the ITA.

On 4 January 2017, a proposed legislation, which amends the Israeli Tax Ordinance (ITO), including new transfer pricing provisions with respect to Action 13 of the OECD’s BEPS Action Plan, passed the first reading (out of three) in the Israeli parliament. The proposed legislation updates the provisions of Section 85A of the ITO and adds sections 85B and 85C to the ITO. The applicable effective date of the proposed legislation has not yet been determined.

In light of the new proposed legislation regarding the adoption of new transfer pricing documentation provisions to be included in the ITO, the burden of transfer pricing documentation will grow as taxpayers will be required to submit further documentation, reports and data in order to comply with the new ITO documentation requirements.

Accordingly, in addition to the regular local file (i.e., the transfer pricing study) Israeli taxpayers that are part of a multinational group will also be required to submit data at the corporate level: a master file accompanied with related data of the multinational group.
In addition, an Israeli taxpayer who serves as the ultimate parent of a multinational group whose consolidated turnover exceeds 3.4 billion new Israeli shekels will be bound to submit a country-by-country report as well.

III PRESENTING THE CASE

i Pricing methods

Regulations incorporate both the OECD Guidelines and Section 482’s approach towards determination of the correct analysis methods for examining an international transaction between related parties. As such, the regulations require that the arm’s-length result of a controlled transaction be determined under the method that, given the facts and circumstances, provides the most reliable measure of an arm’s-length result, where there is a preference of transactional transfer pricing methods over profit-based transfer pricing methods.

According to Section 85A, the preferred method is the comparable uncontrolled price or transaction (CUP/CUT) methodology, because this method can produce the most accurate and reliable arm’s-length results. When the CUP/CUT cannot be used, then one of the following methods should be employed:

a resale price method (RPL);
b cost plus;
c profit split methods (comparable or residual); or
d transactional net margin method (TNMM, similar to the comparable profits method (CPM) in Section 482).

If none of the above methods can be applied, other methods should be used that are most suitable under the circumstances. However, this should be justified both economically and legally, and the application of a different method cannot normally be justified when one of the above-prescribed methods is applicable.

When applying a certain transfer pricing method, an adjustment is sometimes required to eliminate the effect of the difference derived from various comparison characteristics between the controlled and comparable uncontrolled transactions.

According to the Regulations, a cross-border controlled transaction is considered to be at arm’s length if, following the comparison to similar transactions, the result obtained does not deviate from the results of either the full range of values derived from comparable uncontrolled transactions when the CUP method is applied (under the assumption that no comparability adjustments were performed), or in the interquartile range when applying other methods.

In a post-base erosion and profit-shifting (BEPS) area, where the adoption of BEPS measures has not yet been formalised in Israel but has been expressed by the ITA, the ITA places great focus on business or economic substance when mainly analysing value chains and transactions involving the transfer or use of intangible properties. This means that functions contributing to the creation of value, as well as where people are located, constitute important criteria when determining the appropriate attribution of profits among group members in multinationals. This may lead, according to the ITA’s approach to declaring a transfer pricing analysis as not appropriate, and to the application, for example, of a profit split method

3 The full range is spread between the minimum and maximum prices or percentile.
instead of the TNMM. In other cases, the ITA has retroactively applied different methods from those used by the taxpayer, shifting between CUP and TNMM, in cases where profit split was not applicable.

As mentioned above, where a transaction between related parties lacks any commercial rationality, the ITA may not recognise the transaction in its original form, and may treat it as an entirely different type of transaction that in its view would reflect the business reality of the transaction in a more adequate manner. Non-recognition can be contentious and a source of double taxation.

**Financing transactions**

The Israeli transfer pricing regulations do not provide specific guidelines for evaluating the arm’s-length nature of inter-company financing transactions and thus follow a broader transfer pricing approach provided under the OECD Guidelines and Section 482 of the United States’ regulations.

Specifically for inter-company loans, the evaluation of the arm’s-length nature is done by establishing an arm’s-length interest rate based on interest rates applied in comparable third-party transactions. According to the OECD and Section 482, the transfer pricing methodology usually used when setting arm’s-length interest rates is the CUP method, applying internal or external CUP analysis. The approach preferred by the ITA is the External CUP Method, which is in fact a market-valuation method, as it relies on market yields of publicly traded corporate bonds that are comparable to the assessed inter-company loan in terms credit-rating and loan terms when establishing the arm’s-length interest rate.

Since the ITA has expressed its endorsement of OECD’s BEPS Action Plan, inter-company loan transactions will be the focus of increased scrutiny by the ITA. Therefore, Israeli taxpayers are advised to apply a new approach when establishing arm’s-length interest rates for their inter-company loan transactions in accordance with the BEPS Actions 8–10 guidelines. This will combine the synthetic rating approach backed by audit trails and empirical evidence,\(^4\) such as a description of people functions involved, and evidence demonstrating the management and control of risks by relevant parties to the inter-company loan.

In addition to the above, the fact that there are no thin-capitalisation rules in Israel will also contribute to the trend of increased tax audits relating to inter-company loan transactions. As no thin-capitalisation rules are in place, this enables Israeli borrowers in controlled loan transactions to be highly leveraged and assume high interest payments deductible for tax purposes in Israel. This issue will be resolved when Israel implements the recommendation prescribed under BEPS Action 4 and limits the interest payment amount deductible for income tax by applying a ‘fixed ratio’ (which equals a borrower’s net deduction for interest or EBITDA to 10 per cent to 30 per cent) or a ‘group ratio’ (which equals a group’s net deduction for interest or EBITDA).

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\(^4\) Audit trails or empirical evidence may include the number of FTEs on the payroll of the lender; a creditworthiness analysis of the borrower conducted by the lender; evidence of negotiation of the clauses to the inter-company loan agreement, etc.
Application of profit split

The Regulations incorporate the OECD Guidelines’ approach towards the application of the profit split method. In general, the employment of the profit split method in documentation is quite limited. However, the profit split can be a method of choice for dispute resolution. The Regulations stipulate two profit split methods:

a. Comparable profit split method. Transfer prices are based on the division of combined operating profit between uncontrolled taxpayers whose transactions and activities are similar to those of the controlled taxpayers in the relevant business activity. Under this method, the uncontrolled parties’ percentage shares of the combined operating profit or loss are used to allocate the combined operating profit or loss of the relevant business activity between the related parties.

b. Residual profit split method. This method involves two steps. First, operating income is allocated to each party in the controlled transactions to provide a market return for their routine contributions to the relevant business activity. Second, any residual profit is divided among the controlled taxpayers based on the relative value of their contributions of any valuable intangible property to the relevant business activity. This method is best suited for analysing the transfer of highly profitable intangibles.

The Regulations do not contain specific guidance for the application of the profit split method. Nevertheless, this method is acceptable to tax administrators mainly when it is mostly used in cases where both entities contribute or own significant intangibles, and has recently been advocated by certain officials of the ITA. The profit split method is most often applied in the context of global value chains, where the global operations of a multinational corporation are significantly integrated.

In Israel, following the OECD’s BEPS Action Plan, tax practitioners are currently assessing the applicability of the profit split method in service transactions, which include the provision of significant services that contribute to the creation of profits and value (e.g., R&D, marketing, management) as a result of increased challenging by the ITA of cost-plus models and recharacterisation to profit splits. The ITA is implementing people-oriented analysis when conducting tax audits and, therefore, can in certain cases determine management services as a non-routine activity for purposes of profit splits.

Concerning R&D services, in cases where R&D activity is considered a non-routine activity by the ITA, it will be recharacterised to profit split. The ITA’s determination concerning the non-routine nature of the R&D is based on several factors:

a. whether the R&D relates to the development of a whole new product or the continuing development of an existing product;

b. how many employees are involved in the development; and

c. whether the Israeli R&D contractor is free to determine on its own the R&D budget or whether is bound to the authorisation of the entity financing the R&D activity.

Concerning marketing services, the ITA challenges cost-plus models for marketing activity and recharacterises to distribution models. This means that an Israeli company who acts as a marketing services provider could be characterised as a distributor by the ITA, and thus be subject to an appropriate profit derived from revenue concerning the sales of the products in Israel.
The characterisation of marketing service provider to a distributor is dependent on the involvement of the marketing activity in the creation of revenue for the group in terms of, but not limited to:

a. which entity oversees the engagement with customers, and where contracts are signed;
b. which entity oversees the negotiations with customers;
c. which entity is seen by the customers as the one responsible for sales;
d. the entity who approves discounts or unusual credit terms for customers; and
e. whether the employees of the marketing service provider are compensated by a certain percentage from sales of promoted products.

Concerning management services, the ITA determination of management services as an intangible is based on the nature of the services. It means that management service incorporating strategic decision-making functions may be considered as an IP for recharacterises to profit split.

Further, ITA officials have also recently noted that as the OECD suggests a safe harbour for non-value adding services of ‘cost plus 5 per cent’, it would not make sense that R&D services are priced similarly. In Israel, there are currently no specific regulations regarding non-value-adding services, as in the United States, for example, and the ITA is keen on analysis where the ‘people’ are located, according to their statements, when looking into the right method to be implemented.

**Application of the cost-plus method**

The cost-plus method compares gross margins of controlled and uncontrolled transactions. The cost-plus method is most often used to assess the markup earned by a service-providing entity who engages with related parties.

The arm’s-length price is measured by adding an appropriate gross profit (i.e., markup) to the controlled taxpayer’s cost of producing the services involved in the controlled transaction.

The cost-plus method applies where internal data is available, in which a service renderer provides the same or similar services to both controlled and uncontrolled parties and where it provides detailed information concerning comparable transactional costs.

In practice, this method is usually not applicable for evaluating the arm’s-length nature of intra-group services mainly because external data (i.e., transactions between two third parties) found in public databases cannot be reliably used when applying this method due to inconsistency among companies’ financial data arising from the fact that companies allocate their costs using different accounting methods.

The degree of consistency in accounting practices between the controlled transaction and the uncontrolled comparables materially affects the gross profit markup and the reliability of the result.

**Comparables**

When performing comparability analysis, the goal is to reach the most accurate pool of potential comparable companies. In doing so, the search process usually includes a quantitative screening followed by a qualitative screening.

It is first essential to apply Standard Industry Classifications (SIC) codes, NACE (Nomenclature des Activités économiques dans la Communauté Européenne) codes, or
both, as well as specific industry classifications employed by certain databases, which classify companies by the type of economic activity in which they are engaged and the types of products or services they sell.

Following the application of the aforementioned industry codes, additional screening criteria are also applied, including geographic location, company status (i.e., active companies), company type, exclusion of operating subsidiaries from the search, years of available accounts, limitations regarding operating losses, etc.

Depending on the nature of the tested transaction under review, in certain cases, additional quantitative screening criteria are also applied to yield a more accurate set of comparables. This mainly includes the application of different financial ratios such as R&D expenditure–sales, intangible assets–sales, inventory–sales, or property, plant and equipment (PPE)–sales.

The next step is a qualitative screening, which focuses on examining the business descriptions of all remaining companies and then establishing a set of comparable companies.

The Regulations do not provide a reference to a specific number of comparables required for the establishment of interquartile range results. In our opinion, between 10 and 20 comparables should suffice and the minimum is around five comparables. There is no quantitative limit; however, the credibility of a range composed of a large number of comparables may be brought into question.

Regarding the locations of selected comparables, local (Israeli) comparables are preferred but are not often available. Practice has shown that the use of European or US comparables is also accepted by the ITA, as well as global benchmarks, so long as applicable adjustments were made (when required). However, this is examined case by case.

ii Authority scrutiny and evidence gathering

Tax scrutiny

There is a dedicated Transfer Pricing Department (TPD) within the ITA, which is responsible for performing audits and the economic analysis to determine the arm's-length price for a taxpayer's transactions. Further, the TPD has been given full authority to review (and tax) previously approved assessments, and to reopen final assessments that were approved up to three years before their inspection. The TPD also gives guidance and instructions to local tax assessment officers to screen and initiate audits on a wider level. In case of an audit by a local tax assessment officer, certain disagreements may be handed over to the TPD.

In Israel, the tax authorities' transfer pricing unit audits both Israeli subsidiaries of multinational enterprises (MNEs) and local corporations in all matters related to transfer pricing. However, when it comes to the pricing and taxation of employee benefits such as ESOPs, the focus is naturally on the Israeli subsidiaries of MNEs. Taxpayers can dispute the proposed transfer pricing adjustments of the tax authorities by means of appeals, courts and through the use of treaties (when relevant).

The matter of ESOPs has gained specific attention in audits performed by the TPD, involved other departments of the ITA and has generated three recent district court decisions, two of which are currently under appeal to the Israeli Supreme Court. Those Israeli district court decisions have ruled that an Israeli subsidiary working on the 'cost-plus basis' (i.e., utilising the TNMM/CPM methods) should include within the cost-plus model expenses associated with employees' social security payments, as well as options granted by the foreign parent corporation. Those rulings affected the activities of certain R&D subsidiaries in Israel significantly.
**Evidence-gathering process**

The ITA does not usually interview persons outside the company undergoing an audit, although this is not prevented by legislation. It is common, however, to allow the professionals who consult the company to be interviewed by the ITA with regard to their work and to present them to the ITA as part of a ‘hearing’ held for the company. Such meetings occur both prior to and following the issuance of a transfer pricing tax assessment.

With regard to intra-group information requirements, the ITA may request such information even if such information is held outside of Israel. If the company fails to present the requested information, it will most likely be negatively considered throughout the process, including in court, if the case is brought before it, potentially preventing the company from providing such information at a later stage.

In January 2017, a proposed amendment to the Israeli Tax Ordinance that includes transfer pricing provisions, adopting anti-BEPS measures, passed the first reading (out of three) in the Israeli parliament. The proposed legislation aligns with Action 13 of the OECD’s BEPS Action Plan and follows a formal resolution by the Israeli government to adopt the BEPS.

In addition, on 12 May 2016, Israel signed the Multilateral Competent Authority Agreement for the automatic exchange of country-by-country reports (CbCRs), which allows all participating countries to bilaterally and automatically exchange CbCRs with each other. These steps constitute an indication that Israel is expected to change its documentation requirements to also include the creation and filing of CbCRs as well as legislation regarding surrogate filing.

Adoption of the CbCR may imply the ITA’s intention to implement a global tax position when assessing profit attribution among companies in a multinational corporation. It is important to note that the CbCR in itself could not alone be used by the ITA for determining transfer pricing adjustments.

**IV INTANGIBLE ASSETS**

When pricing a transaction involving the right to exploit or the transfer of intangible assets, the Regulations adopt the OECD Guidelines’ approach.

In general, the most common transfer pricing methodology implemented in cases of exploitation of intangible assets (such as know-how, proprietary technology, patents, trade name or trademark and unique business model) is the CUP/CUT method using external data concerning comparable agreements entered into between independent parties, or when available, internal data provided by the taxpayer regarding its comparable uncontrolled transactions with third parties, for comparing the compensation terms stipulated in such agreements and accordingly establishing a royalty benchmark.

The process of evaluating arm’s-length pricing for the transfer or exploitation of intangibles is more complex and requires the valuation of the expected return derived from intangible assets at their present value. This *ex ante* pricing is based on the assessment of the taxpayer regarding the expected return. As such, it will most certainly deviate from the actual return of *ex post* outcomes. Recently, the ITA has demonstrated an implementation of the hard-to-value intangibles (HTVI) principles published by the OECD, in which it was willing to agree with *ex ante* assumptions as the *ex post* result could not have been anticipated by the (related) parties to the transaction under review.
However, it is important to note that in certain cases the ITA will impose a tax adjustment based on ex post outcomes as it sees fit, although there is no specific regulation concerning such adjustments and each case is individually examined.

The ITA has noted on several occasions that it intends to adopt the recommendation promulgated under Actions 8–10 of the OECD’s BEPS project, with respect to intangibles. Therefore, it is expected that Israeli tax practitioners will conduct their inspections of transactions involving intangibles in accordance with the new HTVI rules, with greater emphasis regarding the attribution of profits based on value creation.

Therefore, it is recommended, when conducting a transfer pricing study for transactions involving intangible assets, to delineate the transaction in an appropriate manner that reflects the business reality of the transaction, as well as performing a detailed functional analysis with emphasis on important functions contributing to the creation and value of the intangible assets under review as well as related risks.

The ITA’s audits into the commercialisation of intangibles that originate in Israel are growing; however, holding supportive documentation has proven to be an effective way to rebut and mitigate any assumed ITA adjustments.

i DEMPE

The matter of DEMPE functions has been ‘on the table’ of the ITA in recent years, mainly with regard to the exploitation of R&D originating in Israel and R&D subsidiaries established in Israel by foreign entities.

According to ITA officials, DEMPE is one of the matters considered by the ITA when auditing a transfer pricing case, but not necessarily the only one. Moreover, these aspects have been relevant to ITA audits even before BEPS. Due to the extensive R&D functions carried out by Israeli companies, DEMPE is a tool used by the ITA and thus should be considered by any transfer pricing practitioner.

V SETTLEMENTS

Transfer pricing cases rarely go into court in Israel. Since the adoption of the Regulations 10 years ago, very few transfer pricing cases have been submitted to the courts, with most cases being settled in discussions with the ITA.

APAs are not common in Israel, although they exist, and settlement can sometimes also be carried forward as part of an APA. However, settling a past audit cannot guarantee that the same treatment will be awarded in the future, unless an APA is reached.

VI INVESTIGATIONS

Investigations usually stem from either a local tax assessment officer’s review or specific audits by the TPD. The process is normally initiated by a request for the applicable transfer pricing study or studies, and the inter-company agreements.

The current legal time limit for the presentation of a study is within 60 days; however, often the ITA requests to receive the study within a shorter period. If this is the case, the taxpayer can request to present the study within 60 days, and not within the shorter period.

5 Development, enhancement, maintenance, protection and exploitation of intangibles.
However, this already signals to the ITA that the study may have not been prepared in time, and may indicate that an audit is required. This time frame normally cannot be extended beyond 60 days.

Following the presentation of the study and review by the ITA, it is likely that if the ITA has any remarks or questions, it will summon the company for a meeting, usually prior to the formalisation of an assessment by the ITA.

Assessments are usually followed by meetings between the ITA, the company and its transfer pricing consultants, to rebut the assessment (and if successful then the assessment is adjusted). It is important to note that audits often are wider than just transfer pricing, and also involve permanent establishments and controlled foreign companies; however, transfer pricing methods and tools are usually acceptable in such audits.

VII LITIGATION

i Recent cases
Very few transfer pricing cases make their way to the courts in Israel, with all recent cases having to do with the inclusion of the expenses related to ESOPs in the cost-plus basis of Israeli companies providing R&D services to their foreign parent corporations.

In these cases, the district courts in Israel have reaffirmed that options granted to employees are related to their employment benefits, and thus should be included as part of the ‘cost’ of their employment. The courts rejected the analogy to the Xilinx case in the US, as it was irrelevant to the providing of R&D services on a cost-plus (TNMM) basis, and the claim that this grant of options dilutes the shareholders (and thus already acknowledged) has also been rejected by the courts, as such grant is supposed to increase the value of the company, and thus of the shareholders’ holdings.

Important takeaways from those court rulings are the facts that the court was somewhat reluctant to take into consideration (although eventually it did) a transfer pricing study that was performed retroactively, well after the date on which it was supposed to be in place, and thus may not have correctly reflected the Regulations; and that the court was also reluctant to accept results that were not segmented properly.

Additionally, the court rejected the inter-company agreement between the parties, since it did not abide by the requirements of the Regulations and the OECD.

VIII SECONDARY ADJUSTMENT AND PENALTIES
The ITA is entitled to impose secondary adjustments and, in fact, does so in practice. For example, if the taxpayer had performed an adjustment (the first adjustment) according to its transfer pricing policy and determined its profit to a certain percentage (based on its transfer pricing study or transfer pricing range), and the ITA did not agree with its policy or benchmark analysis, the ITA can perform a secondary adjustment in such a case.

Penalties are not common in Israel, and although discussed as a possibility, have not yet been enacted. Adjustments, linkage, interest and statutory fines on assessments, which already appear in the Israeli Tax Ordinance, currently apply also to transfer pricing.

It is also important to note in this respect that ITA officials have in the past indicated that signing a Form No. 1385, which includes a personal affidavit by a company’s officer, when such affidavit is wrong, can lead to criminal liability where the affidavit is incorrect, although such liability has not been imposed to date.
IX BROADER TAXATION ISSUES

i Diverted profits tax and other supplementary measures
As noted above, the ITA may use either Section 85A and the Regulations, or other means such as Section 86; however, no specific measures relating to transfer pricing matters have been enacted, since, among other reasons, the current measures (i.e., Section 86) are general enough to be implemented (also with regard to transfer pricing).

ii Double taxation
Double taxation would seem to be unavoidable in such cases where the other jurisdiction has taxed the company due to transfer pricing issues. For example, in the event a related party in a foreign jurisdiction is characterised as a permanent establishment, is accused of not having adequate transfer pricing documentation or did not implement it, the foreign jurisdiction will tax it accordingly and the ITA will not take this into consideration, which will result in double taxation.

iii Consequential impact for other taxes
VAT and inter-company transactions have been the focus of several recent ITA audits and of a recent court ruling, which imposed VAT on sales performed from Israel. Although this matter is tied heavily to transfer pricing, the matter of transfer pricing itself was not argued by the parties in this case and was not decided by the court.

Customs are also of relevance when the sale of tangible goods takes place between related parties. However, since transfer pricing cases rarely reach the courts, any use of transfer pricing rules is usually part of the discussion with customs.

X OUTLOOK AND CONCLUSIONS

In a post-BEPS era, the ITA announced that it would adopt the BEPS principles as an amendment to the Income Tax Ordinance with respect to transfer pricing matters. At this stage, the amendment has already passed the first of three readings in the Israeli parliament. The applicable effective date of the proposed legislation has not yet been determined.

We can see measures carried out concerning several subjects:

a The signing of Multilateral Competent Authority Agreement for the automatic exchange of CbCRs as well as the steps being taken regarding proposed regulation, implementing Action 13 of the OECD’s BEPS Action Plan, indicating the adoption of the three-tier documentation approach of CbCRs, master files and local files supplemented with additional relevant material: although we do not expect a large number of Israeli MNEs to be subject to CbCRs due to the size of the Israeli market, we do expect that subsidiaries of foreign MNEs may be required to file where their parent is obligated to file it in its jurisdiction.

b The increased focus of the ITA towards business or economic substance when mainly analysing value chains and transactions involving the transfer or use of intangible properties: this means that functions contributing to the creation of value, as well as where people are located constitute important criteria when determining the appropriate attribution of profits among group members in multinationals. We see this also affecting the grants granted by the Israeli government to R&D centres in Israel.
The ITA’s intention regarding the adoption of the recommendation promulgated under Actions 8–10 of the OECD’s BEPS project, with respect to intangibles, should be taken into consideration by Israeli tax practitioners while conducting their inspections of transactions involving intangibles in accordance with the new rules for HTVI, with greater emphasis regarding the attribution of profits based on value creation, also taking into consideration the DEMPE principles. Therefore, taxpayers are recommended to conduct transfer pricing studies in a manner that is in line with the OECD’s recommendation. Special importance and emphasis should be devoted to appropriate delineation of the tested transaction in a manner that reflects the business reality of the transaction, as well as the performance of a detailed functional analysis, emphasising important functions contributing to the creation and value of the intangible assets under review as well as related risks.

The ITA’s intention regarding the adoption of the recommendation promulgated under Actions 8–10 of the OECD’s BEPS project, with respect to inter-company financing transactions, should be taken into consideration by taxpayers when constructing their intra-group financing. It is therefore advised that financing transactions be properly constructed and documented in accordance with the BEPS Actions 8–10 guidelines, focusing on a detailed description of people functions involved and empirical evidence demonstrating the management and control of risks by relevant parties involved in a controlled financing transaction.

The current assessment by the ITA concerning the applicability of the profit split method in service transactions that include the provision of significant services that contribute to the creation of profits (e.g., R&D, marketing and management).

Still, this is more of an evolution than a revolution, as due to the significant level of R&D activity in Israel, the ITA has already been focusing, inter alia, on lines similar to those presented by the BEPS, and thus we do not expect the nature of the audits to change, but rather their intensity and scope.
I OVERVIEW

Statutory rules on transfer pricing are set out in Article 110 of the Italian Corporate Tax Act (CTA). Transfer pricing rules apply to corporation tax (IRES) as well as regional tax on productive activities (IRAP), pursuant to Article 1, Paragraphs 281 to 284 of Law No. 147/2013. There are no separate rules for capital transactions.

Article 110, Paragraph 7 has been recently reinstated by Law Decree No. 50/2017 and it presently states that items of the income statement of an enterprise derived from operations with non-resident corporations that directly or indirectly control the enterprise, are controlled by the enterprise or are controlled by the same entity that itself controls the enterprise are valued on the basis of the conditions and prices that would have been agreed among third parties, at arm’s length and in similar circumstances, if an increase in taxable income would arise. Reductions in taxable income are allowed only in the specific cases expressly indicated by the new Article 31 quater of Presidential Decree No. 600/1973:

- on the basis of mutual agreement procedures (MAPs) or the European Union Arbitration Convention (Convention 90/436/EEC of 23 July 1990);
- after the tax inspections carried out upon international cooperation activities whose outcomes are shared by the participating countries; or
- by filing a specific request of the taxpayer, if the transfer pricing adjustments involved a state with which Italy has in force a tax treaty to avoid double taxation that provides an adequate exchange of information.

Former guidelines from the Ministry of Finance were issued in 1980 with Circular Letter No. 32/9/2267, which provided principles and methods, based on the OECD Transfer Pricing Guidelines applicable at that time (‘Transfer Pricing and Multinational Enterprises’, OECD 1979), to be used in determining arm’s-length prices.

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1 Franco Pozzi is a partner, and Lisa Vascellari Dal Fiol, Stefano Grossi and Valentina Bertolini are associates at Studio Legale e Tributario Biscozzi Nobili. The information in this chapter was accurate as of 21 May 2018.
2 Transfer pricing rules apply to resident companies and permanent establishments of foreign companies resident in Italy.
3 Please note that entities controlled by the same individuals are within the scope of the provision.
4 Introduced by Law Decree No. 50/2017.
5 The Ministry of Finance released for public consultation a draft that contains a guidance to implement the new aspects delineated under letter (c). Further aspects regarding this new regulation are discussed under Section IX.ii.
After a process of public consultation, the Ministry of Finance issued on 14 May 2018 a new document with regard to Italian guidelines for transfer pricing. The document aims at making Italian tax practice consistent with the 2017 OECD Transfer Pricing Guidelines and, among the issues covered, provides a specific definition of associated enterprises, a brief description and priority of the methods to be used, provides a definition of low value-adding services and introduces a definition of the arm’s-length range.

In relation to transfer pricing documentation, the relevant provisions were included in Law Decree No. 78 of 31 May 2010, which was subsequently regulated by the Decision of the Commissioner of the ITA of 29 September 2010 and by Circular Letter No. 58/E of 15 December 2010. The latter expressly refers to the OECD Guidelines in the version issued in 2010 (‘Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations’).

In Italy, where a transaction is found not to be compliant with the arm’s-length principle, there are no specific corporate law implications; however, this could trigger legal or judicial actions aiming to protect the stakeholders’ rights (e.g., due to overpayment of goods or services, or accounting fraud).

As a general rule, the ITA requires the use of data from the public balance sheet and profit and loss (P&L) account. However, taxpayers carrying on several activities can use management data (taken from enterprise resource planning systems) for transfer pricing documentation purposes, as this allows them to develop a breakdown of the P&L for areas of business. This approach can be challenged by the ITA if the taxpayers are not able to produce a reconciliation with the statutory data.

In addition, Italian accounting principles, as amended by Legislative Decree No. 139/2015 in line with IFRS standards, had an impact mainly on financial transactions as a direct consequence of the application of the amortised cost method. Additional work is also required for the proper identification of the relevant profit level indicator in respect of transfer pricing analysis because of the new representation of the extraordinary (positive and negative) items of incomes, now included in the operating income.

II FILING REQUIREMENTS

In Italy, there are no specific transfer pricing returns and there are no mandatory reports to be prepared, but transfer pricing documentation is recommended as evidence of compliance with the arm’s-length principle in inter-company transactions. Further, if the documentation complies with specific regulations, it allows the taxpayer access to the penalty protection regime provided for by Article 1, Paragraph 2 ter of Legislative Decree No. 471 of 18 December 1997. In this regard, documentation is composed of a master file and country-specific documentation.

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6 The public consultation of the draft ended on 21 March 2018 (further information available at: http://www.mef.gov.it/focus/article_0040.html). The public consultation regarded both a draft decree about Italian guidelines and draft regulation on unilateral downward corresponding adjustments (see Section IX.ii). On 8 May 2018, the Ministry of Finance organised a meeting between contributing authors of the draft documents, including Studio Legale e Tributario Biscozzi Nobili. During this meeting, new draft documents concerning Italian guidelines and regulation on unilateral downward corresponding adjustments circulated between the participants, its implementation regarding the original version. Participants were required to not divulge these draft documents as they are subject to further possible amendments. On 14 May 2018, the final decree regarding Italian Guidelines was issued (the publication in the Official Journal is still expected), whereas the regulation on unilateral downward corresponding adjustments is still being drafted.
(country file). However, the documentation requirements change depending on the taxpayer (i.e., subsidiaries are only required to prepare the country file, while sub-holdings and holdings are required to prepare both the country file and the master file).

If taxpayers wish to take advantage of the penalty protection regime, they must communicate the availability of the transfer pricing documentation in their annual income tax return. To obtain penalty protection, the documentation must be compliant from a substantial point of view and it must follow the structure required.7

As a general rule, documentation for penalty protection must be updated annually, including the economic analysis, before filing the tax return for each financial year (e.g., by 30 September for companies with financial year ending 31 December).

Small and medium-sized enterprises, defined as enterprises with an annual turnover of less than €50 million, are entitled to update the economic analysis included in their documentation every three years, provided that no significant modifications in the comparability factors have occurred.

The filing of the documentation to the ITA must be executed within 10 days upon request. Tax auditors may also request additional information or documentation; in this case, the supplementary information must be provided within seven days upon request or within a longer time period depending on the complexity of the transactions under analysis, to the extent that the above period is consistent with the time of the audit. Once these terms have elapsed, the ITA is not bound to apply the penalty protection.

On 23 February 2017, the Italian government issued a ministerial decree that sets out the terms and conditions for filing the country-by-country report (CbCR); implementing provisions were published in the decision of the Commissioner of the Revenue Agency, dated 28 November 2017. In particular, the CbCR must be filed within the end of the 12th month following the end of the taxpayer’s financial year (consolidated accounts). The information required is aligned to OECD standard, except for some minor issues, due mainly to mismatches in Italian translation. The deadline for the filing of the CbCR for fiscal year 2016 was exceptionally postponed till 9 February 2018.

### III PRESENTING THE CASE

#### i Pricing methods

Acceptable pricing methods are those recommended by the OECD. The selection of a transfer pricing method requires an explanation of the reason for choosing such method, also arguing why the results are consistent with the arm’s-length principle. Transaction-based methods are usually preferred over profit-based methods and the comparable uncontrolled price (CUP) method, if applicable, is preferred over the resale price and cost-plus method.8 However, the ITA is aware of the difficulties of the CUP or the resale price method application met by the operators and so the profit-based methods (especially the transactional net margin method (TNMM)) are accepted.

From a practical point of view, proof of the consistency of the method chosen is not possible without a careful selection of comparables. The approach of the ITA is often to

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8 This approach is consistent with the draft regulation mentioned above, presently under consultation.
perform a new benchmark analysis in order to check the results obtained by the taxpayers, and the tax challenges are usually based on the median value of the set of comparables resulting from the benchmark analysis.

Since the ITA uses the databases provided by Bureau van Dijk, taxpayers also tend to use them, except for financial transactions or operations involving intangibles (royalties, etc.) for which different databases are used in addition to or instead of the databases provided by Bureau van Dijk.

In addition to the above, the ITA has expressly stated in Circular No. 25/E 2014 that activities scrutinising transfer pricing matters must always be carried out with the primary aim of establishing a deeper understanding of the facts and circumstances of the case, also considering the actual economic conditions that characterise intra-group transactions. This approach is also required for managing the possible relationships with foreign tax administrations within MAPs.

ii Authority scrutiny and evidence gathering
The ITA consists of two ‘entities’: the Italian Revenue Agency and Guardia di Finanza (the Tax Police), and they are both entitled to carry out inspections aimed at detecting the infringement of tax law.

In recent years, the ITA has increasingly been carrying out inspections of companies that belong to multinational groups, with the aim of checking the consistency of the transfer prices applied in inter-company transactions.

The approach of the ITA during tax audits is mainly oriented towards understanding the role of the Italian companies under scrutiny in the group's value chain, but also through requests for clarification about the activities performed by their foreign related counterparts. This is to check the consistency of the transfer pricing methods applied and the results of the benchmark analysis. The procedure for acquiring the information usually starts from the analysis of transfer pricing documentation, agreements in force and a breakdown of their figures. Face-to-face interviews can be held with the heads of the relevant departments, also for the purposes of tax rulings or advance pricing agreements (APAs).

If necessary, additional information may be requested from the employees of the Italian company. However, in complex cases, and when the audit is carried out by the Tax Police, the tax auditors can look for evidence of the information provided by the company by asking for confirmation from third parties, such as customers or suppliers, and through access to and inspections of the premises of the taxpayer.

For confidentiality reasons, audit results are not published.

The possibility to ask questions or request documents from taxpayers outside the Italian tax jurisdiction is, however, limited to cases of joint tax audits with the foreign tax authorities.

Nevertheless, attention paid to the group is expected to increase following the implementation of the CbCR.\(^{10}\)

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9 This approach is expected to be revised in accordance with 2017 OECD Guidelines once the implementing provisions related to the new Italian guidelines on transfer pricing will be finally released.

10 See BEPS Action 13.
IV INTELLIGIBLE ASSETS

As a general rule, intangible assets held by each single company involved in inter-company transactions must be considered when setting the correct pricing. To this aim, when taxpayers prepare the transfer pricing documentation (master file), they are required to provide a complete list of such assets with a separate indication of any royalty received and paid, also specifying the licensor’s and the licensee’s names. Further, the list of the assets used in a specific transaction must also be reported in the country file, together with the contractual terms.

Given the importance of intangible assets, for completeness, taxpayers are also required to describe any intangibles not reported in the financial statements (e.g., the know-how, the positive impact from synergies and the positive effects of networks). Any business restructuring that involves a reallocation of intangibles must also be included, in addition to the analysis related to the legal ownership and the time of creation of the assets.

Recently in Italy, growing attention has been paid to matters concerning intangible assets from both sides (taxpayers and the ITA), with particular focus on the DEMPE functions. Such functions are key issues in determining prices for controlled transactions and in determining which entity or entities ultimately will be entitled to returns derived by the multinational enterprise group from the exploitation of intangibles.

These functions are also subject to an in-depth analysis by the ITA when taxpayers apply for rulings, or in the case of MAPs.

Additional to transfer pricing regulations, from 2015, Italian taxpayers may elect for a ‘patent box’ regime; taxpayers that apply for the patent box tax relief are required to explain to the ITA the contribution of the intangibles owned to the value creation to establish the tax benefit. To this aim, taxpayers must show both the costs incurred in creating, developing and protecting the intangibles, and the extra profits deriving from such intangibles. The methods deemed to be acceptable by the ITA for the calculation of the tax relief derive from transfer pricing criteria (CUP or profit split). Even if the ITA has not issued specific internal guidelines regarding intangible assets for transfer pricing purposes, further to the introduction of the patent box relief, it is reasonable to expect a more analytical approach even during ordinary tax audits on transfer pricing matters.

It must be considered that, for new applications filed since 1 January 2017, trademarks are no longer included in the tax relief, according to the implementation of the OECD recommendations. It should also be considered that Circular Letter No. 32/1980 (see Section I) provides for ‘safe harbour’ ranges with respect to royalties paid by Italian companies for intangibles (royalties higher than 5 per cent must be justified by legal and economic conditions of the relevant agreement).

V SETTLEMENTS

General rules regarding settlements among taxpayers and tax authorities are applicable to transfer pricing assessments too. The typical settlement process, according to Legislative Decree No. 218 of 19 June 1997, takes place following a tax audit: after the notification of an assessment notice,12 the taxpayers have 60 days to challenge the assessment before

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11 Developing, enhancing, maintaining, protecting and exploiting intangibles.
12 After investigation activities are concluded, and before the notification of an assessment notice, tax authorities usually issue a preliminary report (PVC) addressing the proposed adjustments to taxpayer
the tax court or to submit a request to the ITA to reach an agreement. During the 90 days subsequent to the settlement request, taxpayers and the ITA can meet several times to discuss their positions and to exchange proposals. In the event an agreement is reached (before the deadline for the filing of the appeal against the assessment before the competent tax court), the settlement agreement is signed by both the taxpayer and the ITA; the taxpayer is then obliged to pay the related liability immediately. The settlement involves the years and matters applicable under assessment. If there are multiple years under assessment, they can be dealt with either together or separately. Normally, in the case of unvaried conditions, it is in the interest of both the taxpayer and the ITA to settle all the years under assessment in the same manner.

Where an agreement is not reached, litigation continues before the tax court (see Section VII). However, a settlement can be reached even after the beginning of the judicial procedure, until the hearings take place before the second instance tax court.

Applicable penalties are reduced in case of settlement; the reduction varies depending on the timing of the agreement (reduction to a third of the original amount before the beginning of the judicial procedure; to 40 per cent before the first instance tax court hearing; and to 50 per cent before the second instance tax court hearing).

After the signature, the settlement cannot be disregarded either by the ITA or by the taxpayer. On the other hand, settlements are not binding for future years or different matters and are not automatically incorporated into an APA; they can only represent a starting point for future discussions. Settlements are generally confidential, as well as their contents; in some cases general information about the settlements reached by large multinational groups are made available.

In the above-mentioned framework, APAs are recommended to reduce the risk of future assessments. The ITA is currently encouraging APAs in order to prevent litigations and to avoid recourse to MAPs (which are not effective at present, due to lack of human resources; for further details see Section IX.ii).

VI INVESTIGATIONS

Tax auditors involved in transfer pricing investigations have ordinary and broad audit powers provided by law (see Section III.ii).
Law No. 212 of 27 July 2000 provides taxpayers subject to tax audits with several rights and protections (see Article 12).

A tax audit could take several months to be completed; there is a time limit, but this is often surpassed by tax inspectors.¹⁸

A common issue that is deeply investigated during multinational enterprises' tax inspections relates to management fees and intra-group services; in particular, in cases where costs are borne by the Italian entity in respect of such types of services, the ITA often questions the deductibility in respect thereof, based on the general principle of inherence¹⁹ rather than on the basis of transfer pricing provisions (consequently with a higher risk of non-recognition of the full costs borne by the Italian entity, rather than restatement of the pricing of the transaction).

The opportunity for tax authorities to challenge costs related to intra-group services or management fees based on the general inherence principle gives rise to three main negative consequences for taxpayers; in particular, the penalty protection regime is not granted; access to MAPs and arbitration is excluded; and, under certain conditions, criminal penalties could be applicable.²⁰

Therefore, it is very important to keep adequate documentation regarding the detailed activities performed by foreign group entities for the benefit of the Italian entity (e.g., emails, meeting reports, flight tickets, hotel bills, contracts).

The Tax Police issued the operative internal instructions applicable starting from 2018 related to tax inspections (Circular No. 1/2018). Among other aspects, the Circular provides specific guidelines that regard transfer pricing assessments, such as the acquisition of information regarding the method followed by the taxpayers for drafting the TP documentation, for instance by looking in the emails regarding the previous versions of the documentation, etc., to find out any possible omission or fraud.

As a general rule,²¹ a tax assessment must be issued by the end of the fifth year of the date of filing of a tax return;²² as a practical example, the assessment for a tax year ended on 31 December 2017 has to be completed by 31 December 2023 (since the tax return must be filed by 31 October 2018).²³

VII LITIGATION

i Procedure

Tax assessments may be settled by reaching an agreement with the ITA (see Section V) or directly challenged before the tax court.

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¹⁸ In principle, investigations based on physical access to the taxpayer's premises cannot last more than 30 days – even when not consecutive. This can be extended for an additional 30 days only, in case of particular needs.

¹⁹ As a general rule, the CTA allows deductions of costs only to the extent they are connected to the taxpayer's activity and to the extent they refer to services that have actually been rendered.

²⁰ However, it must be noted that different tax offices could assume inconsistent positions on such matter.

²¹ Reference is made to Article 43 of Presidential Decree No. 600 of 29 September 1973.

²² In the event the filing of the tax return has not been done, the deadline for the tax assessment is the end of the seventh year of the date in which the tax return should have been filed.

²³ For previous fiscal years different terms are applicable.
The typical litigation process involves the following steps (briefly described):

- **a** challenge before the tax court of first instance (usually represented by the provincial tax court of reference for the taxpayer’s domicile) within 60 days of the notification of the tax assessment;

- **b** first instance tax court hearing: it usually takes place several months (at least six months but up to two years, depending on the workload of the specific court) after the presentation of the petition to the court;

- **c** first instance decision: it is usually issued between three months and one year after the hearing;

- **d** the losing party can then appeal the first instance decision with the tax court of second instance (usually represented by the regional tax court of reference for the taxpayer’s domicile); the deadline to file the appeal is six months after the decision has been issued;

- **e** second instance tax court hearing and decision: the procedure and timing are similar to the first instance hearing and decision; and

- **f** the losing party can then apply to the Supreme Court for the final decision on the litigation; the deadline for filing an appeal is six months after the second instance decision has been issued.

Tax litigations usually take at least five years. Decisions of the courts of first and second instance are based on facts, while the Supreme Court’s decisions can only refer to matters of law. Before assuming their positions, the tax courts are allowed to engage independent experts in order to analyse the case, although it is not a very common practice.

After the decision of the Supreme Court, in principle there are no further opportunities to discuss the litigation. Partial payments are imposed by law during the judicial procedure; in the event the taxpayer is the winning party, such payments are reimbursed by the ITA.

### ii Recent cases

Generally speaking, transfer pricing litigation by the Supreme Court in Italy has been limited; the reason is that the tax courts do not have specific and in-depth knowledge of transfer pricing matters and consequently taxpayers often prefer to settle the assessment (before or during the judicial procedure) with the ITA, rather than bear the risk of an adverse decision.

The main issues related to transfer pricing dealt with by the Supreme Court in recent years are:

- **a** Transfer pricing regulation as an anti-avoidance provision and burden of proof in transfer pricing assessment: the main position of the Supreme Court is to consider transfer pricing regulation as a safeguard of the principle of fair competition among

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24 The relevant provisions regarding the tax litigation procedure are contained in Legislative Decree No. 546 of 31 December 1992.

25 Summer holiday suspension (from 1 to 31 August) should also be considered.

26 The term is reduced to 60 days in the case of formal notification of the decision by the winning party.

27 Ibid.

28 In exceptional and specific cases identified by law, even the decision of the Supreme Court could be reviewed.

29 Under certain conditions, a petition to suspend the collection of the partial payments can be submitted either to the competent court or to the ITA.

30 For example, Supreme Court No. 2805, 5 February 2011; Supreme Court No. 11949, 13 July 2012; Supreme Court No. 10739 and No. 10742, 8 May 2013; Supreme Court No. 22010, 25 September 2013; Supreme Court No. 15282 and No. 15298, 21 July 2015; Supreme Court No. 16398, 5 August 2015;
countries, rather than as an anti-avoidance provision (regardless of the tax rate of the foreign country involved in the case). As far as the burden of proof is concerned, the Supreme Court, in the latest cases, stated that it shall be fulfilled by the tax authority. However, the burden of proof can be reversed and may be transferred to the taxpayer, based on the assumption that the latter has a closer and deeper knowledge of facts, with particular reference to the deduction of cost.

b The scope of domestic transfer pricing provisions: the main position of the Supreme Court in the past was to consider transfer pricing provisions as general rules, applicable even to transactions among resident entities; the issue has finally been clarified by Legislative Decree No. 147 of 14 September 2015, which expressly excludes the application of transfer pricing provisions to domestic transactions.

c Intra-group services and shareholders’ loans: the Supreme Court position confirms that costs deriving from intra-group services (i.e., in application of a cost sharing agreement) are deductible provided that the benefit for the receiver is proved by the taxpayer. With regard to interests on inter-company loans, the Supreme Court (as well as Provincial and Regional Courts) took different positions about the applicability of transfer pricing provisions to non-interest-bearing loans.

The positions of the provincial and regional tax courts are very fragmented and do not represent reliable precedents since Italy is a civil law country; however, some recent tax courts’ decisions make reference to transfer pricing methods, validating the use of the TNMM where transactional methods are not applicable.

VIII SECONDARY ADJUSTMENT AND PENALTIES

In Italy, there are no specific provisions for secondary adjustments and, in practice, they are not applied.

On the other hand, if, in the event of a tax assessment, the documentation provided (master file or country file) is considered not to be compliant with Law Decree 78/2010 by the ITA, ordinary administrative penalties are applied, ranging from 90 per cent up to 180 per cent of the assessed higher income. Taxpayers can submit preliminary comments on the results of the tax audit before their formalisation in a tax assessment. After the notification to the taxpayer of the tax assessment is made, penalties can be challenged during a subsequent litigation (see Section VII).

Regarding criminal law, penalties are applicable to any director signing the relevant tax returns if certain conditions, set out in Article 4 of Law 74/2000, are jointly met. In principle, provided that transfer pricing documentation complies with the Italian regulations, criminal

Supreme Court No. 6311, 1 April 2016; Supreme Court No. 6656, 6 April 2016; Supreme Court No. 7493, 15 April 2016; Supreme Court No. 13387, 30 June 2016; Supreme Court No. 26545, 21 December 2016.

31 For example, Supreme Court No. 17955, 24 July 2013; Supreme Court No. 8849, 16 April 2014; Supreme Court No. 13475, 13 June 2014.

32 See, in particular, Article 5, Paragraph 2.

33 For example, Supreme Court No. 16480, 18 July 2014; Supreme Court No. 27087, 10 December 2014; Supreme Court No. 15005, 17 July 2015; Supreme Court No. 7493, 15 April 2016; Supreme Court No. 13387, 30 June 2016; Supreme Court No. 9466, 12 April 2017; Supreme Court No. 11094, 5 May 2017; Supreme Court No. 25566, 29 October 2017.
consequences should be excluded. Thus, the wording of Article 4 is somewhat unclear and some tax offices are still giving notice of criminal offence to the competent public prosecutor. However, in the event of an agreement with the ITA before starting a formal litigation before the competent tax courts, it is becoming common practice for public prosecutors to stop any criminal law procedures.

IX  BROADER TAXATION ISSUES

i  Diverted profits tax and other supplementary measures

Profits that are deemed to be realised in Italy (even by non-resident entities)\(^{34}\) are subject to IRES and – to the extent they are related to activities performed in Italy – to IRAP.

There are also specific additional anti-avoidance provisions aimed at addressing possible profits shifted to foreign countries, such as: controlled foreign corporation rules; presumptions regarding the residence of foreign incorporated entities; and permanent establishment provisions.\(^{35}\) These provisions have a broader scope than transfer pricing regulations, since they are enforceable even in the absence of controlled transactions.

ii  Double taxation

Double taxation represents a very important issue for multinational enterprises in Italy, since international dispute resolution instruments are not effectively implemented. In principle, there are two different applicable procedures: the EU Arbitration Convention,\(^{36}\) in the case of disputes concerning cross-border issues involving other EU countries; and MAPs provided by bilateral treaties (mainly based on Article 25 of the OECD Model Tax Convention) in cases involving non-EU countries.

The two procedures differ in several aspects, among which the most important are:

- **a** scope of application: the procedure under (1) is applicable with reference to transfer pricing litigations only, while the procedure under (2) is applicable to all the matters covered by the specific treaty (including transfer pricing); 

- **b** mandatory result: in principle, in the procedure mentioned in (1) there is a mandatory arbitration phase, after two years of unsuccessful negotiations among the litigating countries; on the other hand, in the majority of the present tax treaties signed by Italy\(^{37}\) there is no mandatory arbitration, consequently the dispute might not be resolved if the litigating countries are not able to reach an agreement; and

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\(^{34}\) With the exception of individuals.

\(^{35}\) Domestic definition of permanent establishment was recently amended to make it consistent with BEPS Action 7; moreover, a new specific tax provision regarding digital transaction (so called ‘web tax’) has been introduced by the budget law for 2018. The web tax is imposed at a rate of 3 per cent on the value of the taxable digital transactions, i.e., the amount of consideration paid (net of VAT) in exchange for the provision of digital B2B services supplied electronically. It is applicable both to resident and non-resident enterprises and it is expected to become effective from 1 January 2019.

\(^{36}\) Reference is made to EU Convention No. 90/436/CEE, which has been implemented in Italy with Law No. 99 of 22 March 1993.

\(^{37}\) Only a few treaties in force among Italy and foreign countries include an arbitration phase, which can be either discretionary or mandatory (e.g., Armenia, Canada, Chile, Croatia, Hong Kong, Jordan and the United States).
interactions with domestic litigation procedure: the procedure mentioned in (1) is an alternative to domestic litigation, meaning that the result is binding both for the taxpayer and tax administrations; on the other hand, in principle any agreement reached pursuant to the procedure under (2) is not binding for the taxpayer, who can decide to refuse it and go through the domestic litigation procedure.

In both cases (1) and (2), a recent provision regarding suspension of the domestic litigation procedure should apply.

Further guidance is expected after the actual implementation of OECD multilateral convention. Italy was a member of the group that developed the OECD Multilateral Instrument (MLI) and signed the agreement on 7 June 2017. The process for ratifying the MLI has not started and the timetable for the ratification is not yet scheduled. As far as options are concerned, Italy has for the moment adopted a minimalist position, limited mainly to accepting the minimum mandatory changes, and during the ratification process the choices made may be still subject to amendments.

A reduction of double taxation cases is also contemplated, according to the new Article 31 quater of Presidential Decree No. 600/1973 (see Section I). More specifically, letter (c) of the new Article applies when a foreign taxpayer that is associated with an Italian taxpayer is subject to a taxable adjustment deriving from the challenge of the transfer pricing criteria applied in a controlled transaction.

In February 2018, the Ministry of Finance released the draft regulation on unilateral downward corresponding adjustments regarding the filing of the request sub letter (c). The conditions needed to commence this procedure are the following:

a. the primary adjustment in the foreign country must be compliant with the arm’s-length principle;

b. the primary adjustment in the foreign country must be at a final stage; and

c. the jurisdiction where the primary adjustment is set must have entered into a double tax treaty with Italy with an adequate exchange of information.

After 30 days, the request is declared admissible by the Italian Revenue Agency, provided it contains all the elements indicated in the regulation, including information and documentation specifically regarding the adjustment set by the other jurisdiction. The Italian Revenue Agency may invite the relevant company to further discuss the aspects examined. The procedure has to be concluded within 180 days of the receipt of the request. When necessary, the Italian Tax Authority has the faculty of requiring, through specific international cooperation tools, information to the other jurisdiction regarding the adjustment. In this

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38 The matter is analysed in depth in Circular Letter No. 21/E issued by the Italian Revenue Agency on 5 June 2012.

39 In such cases, particular attention has to be paid to the expiry of terms to challenge the assessment and to discuss the controversy before the national courts (for more details, see Section VII).

40 Reference is made to Article 39, Paragraph 1 ter of Legislative Decree No. 546/1992.

41 The process of public consultation (see footnote 6) regarded the draft regulation on unilateral downward corresponding adjustments, but further steps are expected before the document is finalised.

42 The fact that the primary adjustment in the foreign country must be at a final stage was an aspect further discussed during the meeting (see footnote 6) that followed the public consultation, since it would limit the application of MAPs in cases of expiration of their deadline. The Ministry of Finance is working on a solution that makes both instruments compatible.
case, the period of 180 days is suspended. If the request is accepted, the Italian Revenue Agency determines the downward adjustment\(^{43}\) of the corresponding adjustment, as set by the other jurisdiction.

If the request is rejected, the taxpayer may apply for MAPs according to international tax treaties in force or for the EU Arbitration Convention. Thus, final provisions in respect of draft regulation can be expected in the coming months. An alternative way to prevent double taxation is represented by bilateral or multilateral APAs; the ITA is currently encouraging such agreements and the number of cases submitted to the competent revenue office has recently increased. It is worth remarking that in the current framework there are countries with which a bilateral agreement cannot be reached according to ITA feedback (e.g., China) and that bilateral and multilateral APAs take a longer time to be concluded than unilateral APAs.\(^{44}\)

Following the entry into force of Legislative Decree No. 32/2017, Italy is engaged in the exchange of advance pricing arrangements with other foreign tax authorities. To this aim, ‘new rulings’ (issued, modified or revised from 1 January 2017) are automatically exchanged and ‘old rulings’ (issued five years prior to 1 January 2017) are exchanged under certain conditions only.\(^{45}\)

iii Consequential impact for other taxes

Italian legislation does not expressly address the value added tax (VAT) impacts of adjustments made for transfer pricing purposes; pursuant to the applicable law, the VAT-taxable base is represented by the contractual consideration.\(^{46}\) In general, adjustments made by the tax authorities can take either the form of price adjustments (difference affecting the prices of specific products or services sold, purchased or rendered by the company) or profitability adjustments (difference on the companies’ margins so as to align them to the benchmark profitability). In the first case, the adjustment can have an impact on VAT (both in case of products sold and services rendered) as well as regarding customs; in the second case (profitability adjustments), the adjustment should be excluded from VAT and from the customs-taxable base, in line with the VAT Expert Group working paper VEG No. 071 REV2.

From a customs perspective, on 6 November 2015, Circular 16/D was issued by the Italian Customs Authority to reconcile the OECD transfer pricing methods used for tax purposes with the methods provided by European customs legislation. After summarising the main provisions concerning the determination of customs value to declare, the circular states

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\(^{43}\) The technical modality through the downward adjustment is still a point under discussion.

\(^{44}\) Based on the last official report on international rulings, issued by the Italian Revenue Agency on 19 March 2013 (reference is made to ‘Bollettino del Ruling di standard internazionale – II edizione’), there were 19 bilateral APAs under discussion as at 31 December 2012; the countries involved were: the United States (four requests), Germany and Switzerland (three requests each), Japan, the Netherlands and Sweden (two requests each), France, Spain and the United Kingdom (one request each).

\(^{45}\) ‘Old rulings’ are exchanged only if they meet specific requirements as reported in Directive 2011/16/EU:
- if they are issued, amended or renewed between 1 January 2012 and 31 December 2013, the exchange shall take place under the condition that they were still valid on 1 January 2014; and
- if they are issued, amended or renewed between 1 January 2014 and 31 December 2016, the exchange shall take place irrespective of whether they are still valid.

\(^{46}\) Reference to the ‘arm’s-length principle’ for VAT purposes is provided in exceptional cases only (Article 13, Paragraph 3 and Article 14 of the VAT Code).
that the OECD methods are deemed to be acceptable by customs especially with reference to the traditional transaction methods. However, profit-based methods (i.e., the TNMM) could also be acceptable should specific conditions be met.47

Further, the circular proposes the use of two alternative procedures provided by European customs legislation (i.e., the European Customs Code and its implementing provisions) in order to handle the transfer pricing adjustments problem. In particular, the analysed procedures are contained in:

a Article 76(a) of the European Customs Code Customs Code and Article 254 et seq. of Council Regulation (ECC) No. 2454/1993, according to which the business operator can file a customs declaration, both for import and export transactions, omitting some elements or documents to be transmitted a second time and within a specific term; and

b Article 156 bis of Council Regulation (ECC) No. 2454/1993, stating the possibility for the business operator, only in import transactions, to make a lump-sum payment.

Both procedures are to be authorised by Customs.

X OUTLOOK AND CONCLUSIONS

The increasing attention that the ITA is paying to multinational groups and cross-border matters has entailed a greater focus on the tax risks deriving from transfer pricing matters. The ITA has become more skilled in matters concerning transfer pricing IT and OECD Guidelines, and moreover, particular attention has been paid to intangibles since the introduction of the patent-box regime. As such, transfer pricing assessments have improved in terms of technicality and precision of the challenges. New guidelines and implementing provision to be issued should realign Italian tax practice with the 2017 OECD Guidelines, replacing the old Circular Letter 32/1980.

On the other hand, domestic judicial procedures remain lengthy and uncertain, and international dispute resolution instruments are still ineffective; consequently, multinational groups often face a high risk of double taxation. The actual impact of the new Article 31 quater of Presidential Decree No. 600/1973 is still unknown since the draft regulation remains ambiguous in certain areas. Thus, material clarification is expected from the tax administration in the final version to be issued in the next few months.

In these circumstances, the importance of APAs is growing to reach a good degree of assurance, even though timing could become a material issue.

On the practical side, it would be helpful if the ITA aligned its internal procedures to the ever-changing economic environment, and released additional guidance regarding specific issues and business sectors consistent with the OECD Guidelines.

47 During the meeting for the public consultation mentioned at footnote 6, it was explained that new specific dispositions are expected with regard to VAT and customs aspects.
Chapter 14

JAPAN

Shigeki Minami

I  OVERVIEW

i  General

The principal Japanese transfer pricing legislation is Article 66-4 of the Special Taxation Measures Law (the Law) and Article 39-12 of the Enforcement Order thereof (the Order). For a taxpayer who files a consolidated tax return, Article 68-88 of the Law and Article 39-112 of the Order are applicable. While they are not legislation, the National Tax Agency of Japan (NTA) published detailed interpretations in respect of these statutory provisions in Chapter 12 of the Basic Circular of the Law (the Circular) and in the Commissioner’s Directive on the Operation of Transfer Pricing (the Directive), under which the transfer pricing legislation is enforced.

The Japanese transfer pricing rules only cover income tax on corporations (under the Corporation Tax Law), and do not cover individuals or trusts (with certain limited exceptions). The rules are applicable to transactions between a Japanese corporation (or a foreign corporation subject to the Japanese corporation income tax) and its ‘foreign-related corporation’ (as defined by the Law). A ‘foreign-related corporation’ is defined, in essence, as a foreign corporation, controlling, controlled by or under common control of a Japanese corporation (i.e., a parent–subsidiary or brother–sister relationship), as measured by 50 per cent or more direct or indirect ownership, or by effective control through officers, business dependency or finance.

ii  Conformity with OECD Guidelines

The Law and the Order spell out a set of transfer pricing methodologies that effectively follow the OECD Transfer Pricing Guidelines (OECD Guidelines). Specifically, the Japanese transfer pricing rules were overhauled in 2011 in response to the amendments to the OECD Guidelines in 2010, confirming the prevalence of the transactional net margin method (TNMM) as well as introducing the ‘most appropriate method’ rule and the ‘range’ concept. The 2013 amendment to the Order adopted the Berry ratio as another net profit indicator, in line with the OECD Guidelines. In 2016, in line with Action 13 of the BEPS project, the Japanese government introduced new legislation under which it adopted the three-tiered documentation approach, consisting of a master file, a country-by-country report (CbCR) and a local file.

1 Shigeki Minami is a partner at Nagashima Ohno & Tsunematsu.
2 The Japanese transfer pricing rules cover individuals who are trustees for a trust treated as a corporation, or non-resident individuals doing business in Japan through their permanent establishments in Japan.
iii Covered transactions

The Japanese transfer pricing rules cover ‘foreign-related transactions’ conducted between a Japanese corporation and its foreign-related corporation, which cover any types of transactions that include, among others, purchases or sales of inventory or other property, leases, provision of services, sales or licensing of intangible property, and borrowing or lending of money.

While the Japanese transfer pricing rules cover any income transactions, they are unlikely to be applied to capital contributions, although it is not theoretically denied. For example, when a Japanese parent company was deemed to have received shares in its Thai subsidiary in excess of the value of the new capital money that the parent contributed, the NTA invoked the rules for ‘gift’, not resorting to the Japanese transfer pricing rules, which was affirmed by the Tokyo High Court judgment, dated 24 March 2016.

II FILING REQUIREMENTS

In 2016, the new documentation rules introduced in line with Action 13 of the BEPS project adopted the contemporaneous documentation requirement, under which taxpayers need to prepare a local file by the filing date of a final corporation income tax return, which is within two months following a fiscal year end (or later if an extension is granted). The foregoing new documentation rules for local files are applicable for the fiscal years that begin on or after 1 April 2017.

The new legislation adopted the three-tiered documentation approach, under which a separate master file and local file as well as a CbCR are required. Any Japanese corporations and foreign corporations with permanent establishments in Japan that are a constituent entity of a multinational enterprise (MNE) group with total consolidated revenues of ¥100 billion or more in the previous fiscal year (specified MNE group) are subject to the foregoing documentation rules.

Such corporations must file a notification for their ultimate parent entity, a CbCR and a master file with the Japanese tax authority online (e-tax). A local file is mandated for transactions with a foreign-related corporation, where the sum of the payments and receipts is ¥5 billion or more; or the sum of the payments and receipts for intangible transactions is ¥300 million or more, in the previous fiscal year. Therefore, relevant companies must prepare a transfer pricing file every year (as long as the foregoing conditions are met) even if no circumstances change.

In a master file, a taxpayer is required to report the items as described in Annex I to Chapter 5 of the revised OECD Guidelines, which include a description of the MNE’s businesses, intangibles, inter-company financial activities, and financial and tax positions.

In a CbCR, a taxpayer is required to report the items as described in Annex III to Chapter 5 of the revised OECD Guidelines, which include an overview of income, taxes and business activities by tax jurisdiction, and a list of all the constituent entities of the MNE group per tax jurisdiction.

In a local file, a taxpayer is required to report the items as described in Annex II to Chapter 5 of the revised OECD Guidelines, which include a description of the local entity, description of foreign-related transactions (controlled transactions) and relevant financial information. The key component is the description of the taxpayer’s foreign-related transactions, in which functions regarding the material foreign-related transactions must be provided (such as procurement of manufacturing services, purchase of goods, provision of services, loans, financial and performance guarantees, licensing of intangibles, etc),
accompanied by a detailed comparability and functional analysis and an indication of the most appropriate transfer pricing method with regard to the transactions and the reasons for selecting the applicable method.

As for the acceptable language, a master file can be prepared either in English or Japanese, and a CbCR must be prepared in English, while a local file must be prepared in Japanese.

Although the Japanese government will provide the CbCRs to tax authorities in other jurisdictions in accordance with the conditions and limitations under the relevant tax treaties, it is not expected to publish CbCRs.

III PRESENTING THE CASE

i Pricing methods

The following methods are applicable to tangible property transactions, including inventory transactions:

a the comparable uncontrolled price (CUP) method;

b the resale price method;

c the cost-plus method;

d the transactional net margin method (TNMM);

e the quasi-CUP, quasi-resale price and quasi-cost-plus methods, and quasi-TNMM; and

f the profit split method.

Methods equivalent to those listed above are applicable to transactions other than tangible property transactions, namely, intangible property transactions, services transactions and loans or advances.

The most appropriate method rule, which is equivalent to the best method rule, has been employed. Transfer pricing rules identify the following factors as relevant in selecting the most appropriate method in line with the OECD Guidelines:

a the respective strengths and weaknesses of the transfer pricing methods codified in the rules;

b the appropriateness of each potential transfer pricing method considered in view of the nature of the controlled transaction at issue, determined in particular through a functional analysis;

c the availability of the information needed to apply each potential transfer pricing method; and

d the degree of comparability between the controlled transaction at issue and comparable transactions (including the reliability of the comparability adjustments).

In recent years, the TNMM has been the most prevalent method in practice and accounts for 56 per cent of the mutual agreement procedure (MAP) cases completed by the Japanese tax authority in 2016. For service transactions, the cost-plus method is often used if no significant intangible property is involved. For loans or advances, the quasi-CUP method is often applicable by referring to the terms and conditions of similar transactions under similar conditions. For transactions involving intangibles, see below.
ii Authority scrutiny and evidence gathering

The Japanese tax authority does not necessarily ask for discussions with witnesses within or outside the taxpayer group, including the taxpayer’s customers. However, the taxpayer definitely needs the assistance of experts or professionals within or outside the taxpayer group, as demonstration of an appropriate transfer pricing methodology involves highly sophisticated economic analysis and extremely technical legal arguments.

The Japanese tax authority does not use dawn raids for transfer pricing audits in general, as transfer pricing audits concern evaluation or judgement on pricing, not factual issues involving hiding or disguise.

Under the new documentation rules introduced in 2016, the Japanese tax authority is allowed to resort to ‘presumptive taxation’ and may inquire about and inspect third parties conducting similar businesses (‘secret comparables’), if a taxpayer fails to:

- for non-exempt transactions (see below), submit a ‘local file’ by the day designated by the tax examiner that comes within 45 days after the tax authority’s request, or to submit documents ‘important for calculating the arm’s-length price’ by the day designated by the tax examiner that comes within 60 days after the tax authority’s request; or
- for exempt transactions (see below), submit documents ‘important for calculating the arm’s-length price’ by the day designated by the tax examiner that comes within 60 days after the tax authority’s request.

For this purpose:

- non-exempt transactions (subject to the local file obligations) are the transactions with a certain foreign-related corporation, with whom:
  - the sum of payments and receipts is ¥5 billion or more; or
  - the sum of payments and receipts for intangible transactions is ¥300 million or more, in the previous fiscal year; and

- exempt transactions are the transactions with a certain foreign-related corporation, with whom:
  - the sum of payments and receipts is less than ¥5 billion; and
  - the sum of payments and receipts for intangible transactions is less than ¥300 million, in the previous fiscal year.

IV INTANGIBLE ASSETS

Under Japanese transfer pricing rules, for transactions involving intangibles, the following methodologies can be applied.

i Licensing of intangibles

**Quasi-CUP method**

For a licensing transaction, the quasi-CUP method is likely to be the most appropriate method as long as a comparable transaction can be identified. However, since each intangible asset has its own unique character and varies from others, it would be rare for it to be the most appropriate method, except where the internal comparable transactions are identified.
TNMM

In the context of licensing transactions, when only one party contributes to DEMPE (development, enhancement, maintenance, protection and exploitation of the intangible) of the subject intangible asset, and the other party’s functions are simple, such as only manufacture or sale, the TNMM is likely to be the most appropriate method. In such case, the party not involved with the intangible asset will be tested, and it is necessary to identify companies comparable to such tested party, whose operating profits relative to sales or full costs, or Berry ratio, will be the net profit indicator (benchmark) for the tested party.

Residual profit split method

When both parties subject to a transaction perform ‘unique functions’ by engaging in the ‘creation, maintenance or development’ of the intangible asset, the NTA has a tendency to apply the two-stage residual profit split method (RPSM), which is presumably the most appropriate method. The revised OECD Guidelines, published in July 2017, states, in Paragraph 6.12:

> The functional analysis should identify the relevant intangibles at issue, the manner in which they contribute to the creation of value in the transactions under review, the important functions performed and specific risks assumed in connection with the development, enhancement, maintenance, protection and exploitation of the intangibles and the manner in which they interact with other intangibles, with tangible assets and with business operations to create value.

The Japanese transfer pricing rules adopted similar rules before the revised OECD Guidelines. Specifically, Section 3-12 of the Directive indicates how an intangible asset is recognised in the context of the transfer pricing, saying as follows:

>(Contribution to Creation, Maintenance or Development of Intangible Asset)

> In respect of a transfer pricing examination regarding the licensing of an intangible asset, not only its legal ownership, but also the [respective] degree of contribution by the Japanese taxpayer and its Foreign Related Party to the creation, maintenance or development of the intangible asset (the “Intangible Creation”) needs to be taken into consideration.

> In assessing the degree of contribution to the Intangible Creation, functions respectively performed by the relevant Japanese taxpayer and its Foreign Related Party in the course of decision-making, provision of services, incurrence of expenses and management of risk for the Intangible Creation should all be taken into account. In the case of the Intangible Creation regarding a certain intangible asset that is likely to be developed to become a source of [excess] profit, the degree of contribution shall be assessed to be low when the relevant Japanese taxpayer or its Foreign Related Party only bears the expenses for the Intangible Creation.

For example, if a certain party has made a decision with substantial discretion in conducting the research and development (R&D) services, and takes risks associated with the R&D activities, such party will be found to have significantly contributed to an intangible asset. If both parties are found to be involved in the ‘creation, maintenance or development’ of the intangible asset, the RPSM is likely to be the most appropriate method. Under the two-stage RPSM, the combined profits from the subject transaction are identified, from which ‘routine profits’ are assigned to each party based on the benchmark analysis (using companies
comparable to each party). The ‘residual profits,’ which are produced by subtracting the foregoing routine profits from the combined profits, will be assigned to each of the relevant parties in proportion to the ‘degree of contribution’, which can be presumed based on the value of the intangible assets owned by the relevant parties, or the expenses paid for the development of the intangible assets. In the practice of the Japanese tax authority, however, the relevant expenses such as those for the R&D paid by respective parties are usually adopted as the parameters and the ‘value’ of the intangible asset is not used.

ii  **Sale of intangible asset**

For the sale of intangible assets, the Circular lists the quasi-CUP and quasi-cost-plus methods as candidate transfer pricing methods. However, it is extremely difficult and practically impossible to identify comparable transactions for the sale of intangible assets given the uniqueness inherent in each intangible asset. Therefore, if the arm’s-length price of an intangible asset is at issue during a tax audit, such audit tends to become more controversial than otherwise. Although the revised OECD Guidelines suggests viability of the discounted cash flow method, the Japanese tax authority has not affirmed its validity, presumably because the method depends on specific models and assumptions adopted by a taxpayer that are prone to be subjective, possibly even arbitrary. However, the discounted cash flow method may be accepted to calculate an arm’s-length price where no other appropriate method can be identified and the taxpayer can successfully convince the Japanese tax authority that the adopted parameters are appropriate in using the discounted cash flow method.

V  **SETTLEMENTS**

Under Japanese tax law, the prevailing view is that the Japanese tax authority is not supposed to enter into a settlement with taxpayers, not only for transfer pricing cases, but also for any tax disputes; this is based on the idea that tax law should be applied impartially, without the tax authority exercising any discretion. However, in practice, the tax authority may suggest during the tax audit that a taxpayer voluntarily correct the original tax return to the tax amount that the tax authority indicates. The taxpayer may argue against the position suggested by the tax authority, and the tax authority may withdraw its position in whole or in part. After discussions, if the taxpayer and the tax authority agree on a middle ground, and the taxpayer makes a corrective filing in accordance with their mutual agreement, it will effectively close the case. Although this is not a ‘settlement’ in a legal sense, the end result is similar.

Even if a settlement is reached for a certain fiscal year, it will not automatically be incorporated into an advance pricing agreement (APA). Therefore, if the settlement is acceptable, even if not desirable, to a taxpayer, an APA could be a recommended course of action to ensure that the tax authority will not take a more disadvantageous position to the taxpayer in the future.

VI  **INVESTIGATIONS**

The Japanese tax authority’s assessments based on the Japanese transfer pricing rules must be made within six years from the deadline of the filing of the relevant corporation income tax
Within such period, the tax authority may review a transfer pricing filing without any other time limitations. Generally, a transfer pricing audit takes a significant amount of time, and may take one year, or even two or three years in some cases.

When the Japanese tax authority makes an assessment by issuing a correction notice, the taxpayer has two options. The first is to seek administrative remedies, followed by judicial review (which can be initiated before the final resolution of the administrative remedies under certain conditions). The second is to seek competent authority relief from double taxation if a relevant tax treaty so provides.

Generally speaking, with respect to a transaction involving a country where competent authority relief is effective, taxpayers tend to seek it. The Japanese tax authority has received a number of requests for competent authority relief (including APAs) with OECD member countries. Particularly with Australia, Germany, Korea, the United Kingdom and the United States, most of the requests have been successfully resolved by agreements between both relevant governments. In addition, the Japanese government has had APAs with non-OECD member countries including China, Hong Kong, India, Indonesia, Singapore, Taiwan, Thailand, Malaysia and Vietnam; however, with respect to competent authority relief with non-OECD member countries, precedents are relatively few.

With respect to a transaction involving a country where competent authority relief is ineffective (even if a relevant treaty allows such relief) or not available in the first place, administrative remedies and judicial review will be the only practical option that the taxpayer may seek.

VII LITIGATION

i Procedure

In response to a transfer pricing assessment, when a taxpayer does not or is not able to seek competent authority relief, the taxpayer may resort to the administrative appeals process to dispute the assessment. The taxpayer is required to exhaust the administrative appeals process before seeking judicial review. In general, the administrative appeal consists of two steps: a request for re-examination, and an appeal to the National Tax Tribunal (the Tribunal). The taxpayer is able to choose to proceed with the entire process, namely, a request for re-examination, followed by an appeal to the Tribunal if the decision of the re-examination is unsatisfactory. Alternatively, the taxpayer is able to unconditionally skip a request for re-examination and file an appeal with the Tribunal directly. For a request for an initial administrative appeal, the filing period (either for a request for re-examination or for direct appeal with the Tribunal) is three months from the date of delivery of a correction notice.

The Tribunal operates under the authority of the NTA but is a quasi-judicial institution that is supposed to be independent from the enforcement branch of the NTA. In an effort to secure impartiality, approximately half of the judges of the Tribunal are hired temporarily from private practitioners for two- to three-year terms. While the Tribunal’s cases are mostly decided within a year, cases involving transfer pricing may take more than a year, given their technical nature and complexity.

ii Recent cases

During the 2000s, the Japanese tax authority tended to apply the RPSM to cases involving valuable intangibles, resulting in corrections being made for a huge amount of income. However, the courts have taken a stringent position in finding comparability between a tested
party and comparable companies for the purpose of calculating routine profits under the RPSM, which was shown in the Tokyo High Court judgment, dated 13 May 2015, where Honda Motor Company Limited, a major Japanese automobile manufacturer, obtained a cancellation of a correction of ¥25.4 billion in taxable income. In the judgment, the court held that the tax authority’s selection of companies comparable to the tested party (the taxpayer’s foreign subsidiary) was illegal, based on the finding that the tested party was doing business where the tax incentives had been offered – specifically, in the Free Economic Zone of Manaus in Brazil – whereas the alleged comparable companies identified by the Japanese tax authority had been located outside the zone. The judgment is significant since it indicated that market conditions (including governmental regulations and interventions) are material in a comparability analysis.

VIII SECONDARY ADJUSTMENT AND PENALTIES

If a cross-border payment of interest or royalties is recalculated and decreased as a result of a transfer pricing correction, the transfer pricing correction has no effect on the underlying substantive transactions. Therefore, for example, even if a royalty payment from a Japanese licensee to its foreign-related corporation as a licensor is decreased for Japanese transfer pricing purposes, it will not oblige the Japanese licensee to receive the difference back from its foreign-related licensor, and the Japanese licensee is not eligible for a refund of any part of the withholding tax that was paid based on the original royalty amount notwithstanding the decreased amount of the royalty for the transfer pricing purposes. In addition to this, a reduced rate under a relevant tax treaty may not be available with respect to the amount in excess of the arm’s-length price, which will result in additional withholding tax. However, if the Japanese licensee does choose to receive back the difference, under a certain clause in the Circular, provided that a certain report is filed with the relevant tax office, the amount that the Japanese licensee receives back will not be subject to the Japanese corporation income tax, while the analysis for the withholding tax set forth above will not be changed.

IX BROADER TAXATION ISSUES

i Diverted profits tax and other supplementary measures

There are no diverted profits taxes or similar taxes under Japanese law and no immediate proposals have been made for such taxes.

ii Double taxation

Japan has an APA programme, which may be effective depending upon the counter-party countries (see above). Not only unilateral but bilateral APAs are available, and in practice, multilateral APAs are rare.

In general, any transaction types or issues with foreign-related corporations can be covered by APAs. A taxpayer must submit to the relevant regional tax bureau of the NTA a proposed method to calculate the arm’s-length price and the relevant materials to support the proposed method, for review by the relevant section of the regional tax bureau. The taxpayer needs to pay no user fees for an APA application. In respect of a bilateral APA, the competent department of the NTA will also review the proposed method and then forward the same
to the counterparty of the tax treaty for consultation. The APA programme is independent from the Japanese tax authority’s enforcement function, but is not independent from the competent department staff that handle other double tax cases.

Roughly speaking, it often takes approximately two to three years to obtain a bilateral APA. According to the NTA, it took 29.1 months on average for a bilateral APA or MAP in 2016. In practice, APAs often cover five years. Rollback is also available. The key advantage of obtaining an APA with the tax authority is the avoidance of transfer pricing disputes in the future; the key disadvantages are that it is time-consuming and costly.

iii Consequential impact for other taxes
In practice, transfer pricing adjustments do not affect value added tax (‘consumption tax’ under Japanese tax law), or import or customs duties.

X OUTLOOK AND CONCLUSIONS
In 2015, there were 218 enforcements, corrections or amendments in respect of transfer pricing that were imposed or suggested by the Japanese tax authority, amounting to ¥13.7 billion, which represented a significant increase in number and considerable decline in monetary amount compared to 2005, where there were 119 enforcements, corrections or amendments, amounting to ¥83.6 billion, respectively. This shows that the investigations are now being directed to a wider range of companies, encompassing not only large companies but also small to medium-sized companies, while the amount involved in each case has become smaller, possibly due to the tax authority’s more prudent approach.

The Japanese tax authority tended to, in applying the two-stage RPSM to Japanese companies, assign considerably low operating profit margins to their foreign related-corporations on the grounds that they have only simple and limited functions, resulting in the assessment of a huge amount of income for the Japanese companies. This tendency received a significant blow after a series of cancellations ordered by the National Tax Tribunal and the courts. (See Honda Motors in Section VII.ii.) In recent years, the Japanese tax authority appears to have changed its strategy and adopted a relatively ‘soft’ approach, namely to incentivise taxpayers to comply with the transfer pricing rules; however, it remains to be seen if past aggressive enforcements will reemerge.

The BEPS could significantly change transfer pricing in Japan. Before the introduction of the CbCRs, the Japanese tax authority had no effective measures to obtain information regarding the taxpayer’s global tax position, which is necessary to assess the profit share per jurisdiction in respect of Japanese taxpayers. However, as the first CbCRs are due on or after 31 March 2018, depending on the taxpayer’s fiscal year, the Japanese tax authority is expected to be keen to examine the CbCRs to find potential imbalances of taxable income per jurisdiction and identify revenue losses due to inappropriate transfer pricing so that they may pursue transfer pricing audits more effectively.
I OVERVIEW

The Luxembourg tax system distinguishes between the taxation of individuals and companies. Resident individuals are subject to income tax, which is levied on eight categories of income:

- business income;
- agriculture and forestry income;
- income from independent professional services;
- employment income;
- pension and annuities income;
- investment income (i.e., interest and dividends);
- rental and royalty income; and
- miscellaneous income including capital gains.

Companies limited by share capital are subject to corporate income tax (CIT), which generally follows the computation rules of business income. Both income tax and CIT are governed by the Income Tax Law (ITL).\(^2\) In addition, business income is subject to municipal business tax (MBT), which is broadly levied on the same basis as the business income determined for income tax or CIT purposes. Companies are furthermore subject to a net worth tax (NWT). Withholding tax may be levied on dividends distributed by companies in cases where the participation exemption does not apply, as well as on directors’ fees (interest and royalties are not subject to any withholding taxes).

The Luxembourg transfer pricing legislation closely follows the OECD guidelines and is provided by Articles 56, 56 \textit{bis} and 164 of the ITL, as well as Paragraph 171 of the General Tax Law (GTL).\(^3\) Accordingly, the transfer pricing rules apply to business income subject to either income tax or CIT and to MBT. Transfer pricing adjustment may, however, also affect NWT and trigger dividend withholding tax (e.g., in the case of a requalification of a controlled transaction into hidden profit distribution – see below). Partnerships and trusts being as a rule tax-transparent entities (save for the purposes of MBT), transfer pricing issues are generally dealt with at the level of their partners or beneficiaries to the extent they are engaged in activities generating business profits. As a general principle, the determination of the business profits for income tax and CIT purposes is based on the commercial accounting

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1. Alain Goebel is a partner at Arendt & Medernach.
under Luxembourg Generally Agreed Accounting Principles and hence the accounting
treatment of a transaction may impact the tax and transfer pricing treatment thereof.
Non-arm’s length controlled transactions may also trigger corporate interest issues.

Article 56 ITL enshrines the arm’s-length principle into Luxembourg tax law,
following the wording of Article 9 of the OECD Model Tax Convention. Accordingly, if
(1) an enterprise participates directly or indirectly in the management, control or capital
of another enterprise, or (2) if the same persons participate directly or indirectly in the
management, control or capital of two enterprises, and in either case, the two enterprises
are, within their commercial or financial relations, bound by conditions agreed or imposed
that differ from those that would be made between independent enterprises, the profits
of these enterprises are determined and taxed on the basis of the conditions agreed upon
between independent enterprises.

Article 56 bis ITL provides further guidance as to the methodology regarding the
application of the arm’s-length principle, based on the conclusions of Actions 8–10 of the
OECD Base Erosion and Profit Shifting (BEPS) Report that revise Chapter I, Section D of
the OECD Transfer Pricing Guidelines (TPG).

Article 164(3) ITL requalifies any advantage that a shareholder, member or other
interested party receives directly or indirectly from a company or an association, which he or
she would normally not have received absent his or her quality, as a hidden profit distribution.

Finally, Paragraph 171 GTL requires that, upon request, taxpayers have to evidence the
accuracy of their tax return and provide clarifications, including the relevant documentation.
This includes transfer pricing documentation in case of transactions between associated
enterprises.

In addition, the administration for direct taxes has issued certain circular letters and
internal notes regarding transfer pricing:

a Circular Letter LIR No. 56/1 – 56 bis/1, dated 27 December 2016 relating to the
transfer pricing rules applicable to companies engaged in intra-group financing
transactions;
b Circular Letter LIR 164/1, dated 23 March 1998 relating to the interest rates on
shareholders’ corporate current accounts; and
c Internal Note LIR/NS-No. 164/1, dated 9 June 1993 relating to hidden profit
distributions within the context of shareholders’ corporate current accounts.

II FILING REQUIREMENTS

Paragraph 171 GTL requires that, upon request from the Luxembourg tax authorities,
taxpayers have to provide their transfer pricing documentation for controlled transactions.
Strictly speaking, there is no mandatory requirement to file the transfer pricing documentation
with the annual tax returns, but the tax authorities may, at any time, request the taxpayer to
disclose it. Hence, taxpayers are required to duly document compliance with the arm’s-length
principle of all intra-group transactions.

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5 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, dated
6 Administration des contributions directes.
The transfer pricing documentation must further be compliant with Article 56 bis ITL, which refers to the arm’s-length principle and the OECD TPG. The transfer pricing documentation must be updated if the factual or legal circumstances change. Where the arm’s-length pricing of a controlled transaction is secured by an advance pricing agreement (APA), the validity of the APA is limited to five years in accordance with Paragraph 29a GLT.

Note that Paragraph 171 GLT operates a reversal of the burden of proof whereby the taxpayers must prove that the pricing of their controlled transaction is at arm’s length. This is an exception to the general principle according to which the burden of proof regarding the facts that trigger a tax liability lies with the tax authorities while the proof of facts that releases the taxpayer from such tax liability or reduces said tax liability lies with the taxpayer.7

In addition, Luxembourg has implemented with effect from 1 January 2017 the conclusions of Action 13 of the OECD’s BEPS Action Plan regarding country-by-country reporting obligations. Accordingly, Luxembourg entities falling within the scope of the CbCR Law, dated 27 December 2016, will be required to communicate economic, financial and tax information for financial years as of 1 January 2016 in the form of a country-by-country report (CbCR) to the Luxembourg tax authorities, which will in turn exchange the information received with the other EU and non-EU jurisdictions concerned. If a Luxembourg resident reporting entity fails to file the CbCR, files it late or files false or incomplete information, or fails to inform the Luxembourg tax authorities that the ultimate parent refuses to provide key information for the purpose of the CbCR filing, it could be fined up to €250,000.

III PRESENTING THE CASE

i Pricing methods

Article 56 bis ITL follows the OECD TPG. Accordingly, it requires that an enterprise must, within the context of its transfer pricing documentation, determine a price that complies with the arm’s-length principle. The fact that a given transaction may not be observed between independent parties does not, however, necessarily mean that said transaction is not at arm’s length.

The determination of the arm’s-length price is based on the comparability analysis.8 A comparison has to be made between the conditions of a controlled transaction and those that would have been imposed to a comparable transaction between independent parties. In order for the comparison to be significant, the economically relevant characteristics of the considered transactions must be sufficiently comparable. Transactions are sufficiently comparable if there are no material differences between the compared transactions that could have a significant influence from the point of view of the methodology on the determination of the price or if reasonable reliable adjustments may be operated in order to eliminate the incidence on the determination of the price.

The methods retained for determination of the comparable price have to take into account the identified comparability factors and must be coherent with the nature of the transaction that has been accurately delineated. The price identified through the comparison

8 The same principles have been retained in particular in financing transactions within the scope of Circular Letter LIR No. 56/1 – 56 bis/1.
of the analysed transaction with transactions between independent enterprises represents the arm's-length price. The choice of the method of comparison must correspond to the method allowing for the best approximation of the arm's-length price.

If all or part of a transaction includes elements that in substance do not contain a commercial valid rationality and that have a negative impact on the determination of the arm's-length price, the transaction has to be ignored in whole or in part for the determination of the arm's-length price.

Article 56 bis ITL does not impose any specific transfer pricing method to be used. Based on the existing practice, the comparable uncontrolled price (CUP) method, the transactional profit split (TPS) method and transactional net margin (TNM) method seem to be the most frequently used methods in Luxembourg, although all methods provided for by the OECD TPG are acceptable. The use of a particular method primarily depends on the activity performed by the enterprise:

a the CUP method is mainly used for the determination of arm's-length pricing where sufficient comparables are available. Given the size of Luxembourg, it will be difficult to base a comparability analysis on mere domestic comparables. Therefore, pan-European comparables are generally accepted to the extent that the markets from which these comparables are derived are not completely different from the market conditions prevailing in Luxembourg;

b the TPS method is likely to be applied when a multinational entity’s business operations are highly integrated. Also, the TPS method is typically used for the pricing of the fees of the various service providers (managers, advisers, distributors, etc.) in the asset management industry;

c the TNM method, and in particular the net cost-plus method, is most often applied for manufacturing and certain intra-group services (e.g., human resources, IT, marketing, advertising, accounting); and

d the resale price method is usually deemed more useful for determining an arm's-length price for distribution or selling functions.

ii Authority scrutiny and evidence gathering

The Luxembourg tax authorities typically review the transfer pricing documentation within the course of the verification of the tax return, unless the documentation has been provided previously (e.g., in the case of an APA request). Since they follow the OECD TPG, they expect to see within the functional analysis information as to the organisation and structure of the multinational enterprise (MNE) group and how it operates, in particular how value is generated by such MNE group. Circular Letter LIR No. 56/1 – 56 bis/1 requires, for example, that an APA request must include, among others, a description of the group, the relations between the functions of the parties to the controlled transaction and the rest of the

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9 Pursuant to Paragraph 100a GTL the tax authorities may issue a provisional tax assessment on the basis only of a tax return and such assessment remains subject to a later verification within the five-year statute of limitation. Accordingly, the transfer pricing documentation may in certain cases only be reviewed by the tax authorities up to five years after the filing thereof.

10 In particular the requirements regarding the functional analysis provided for by Actions 8–10 of the BEPS (1.51).
group, as well as the value chain, the precise limits of the analysed transactions, an indication of any advance transfer pricing requests concluded with other states regarding the companies and transactions that are still in force at the time of the application.

Luxembourg has also implemented CbCR obligations (see Section II). CbCRs are, however, not publicly available.

In the event the taxpayer has not spontaneously provided the transfer pricing documentation (generally as an appendix to the annual tax return), the tax authorities can request the production thereof in accordance with Paragraph 171 GTL. Also, if they have reasonable doubts regarding the tax return, they must request the taxpayer to provide the necessary information to clarify the situation and in a second step to communicate relevant supporting documents. Once they have used all other means at their disposal to receive the necessary information from the taxpayer, they may request it from a third party. It should be noted that an international exchange of information upon demand may be requested by the tax authorities from other EU Member States, treaty countries and other OECD member countries. In the event the taxable income may still not be determined, the tax authorities may proceed to a lump-sum estimation thereof.

IV INTANGIBLE ASSETS

The Luxembourg tax authorities follow the TPG, which give a balanced definition of intangibles: an intangible is depicted in the final reports on Actions 8–10 of the BEPS Action Plan as ‘something which is not a physical asset or a financial asset, which is capable of being owned or controlled for use in commercial activities’. The accounting definition of intangibles is not always in line with the one used for transfer pricing purposes. Legal ownership, transferability or the availability of any protection are not decisive conditions to delineate intangibles. Indeed, the OECD lays emphasis on the effective control and management over the intangible.

From a Luxembourg standpoint, the practice shows that the arm’s-length character of the valuation of intangibles must be determined according to a technical approach in line with the OECD standards. To assess the value of an intangible, the most relevant transfer pricing methods to be used would be either the CUP or the TPS method. However, as transactions involving intangibles are usually very specific, the CUP method is not suitable in most cases. As a consequence, a comparability analysis must be supplemented with a case-by-case valuation of the intangible to support the arm’s-length character of the analysed transaction.

The OECD has incorporated in the TPG a definition of ‘unique and valuable’ intangibles to tackle situations where no comparables are available on the market. Following the OECD principles, the transfer pricing analysis involving intangibles should primarily rely on scientific valuation methods such as the techniques developed by corporate finance (discounted cash flow, dividend discount, super-profit or replacement costs methods). In addition, the OECD is now allowing the use of ex post data to assess the arm’s-length character of an ex ante pricing

11 Paragraph 206(2) GTL.
12 Paragraph 207 GTL.
13 Paragraph 209 GTL.
14 Paragraph 217 GTL.
15 See also Alain Goebel and Monique Adams, ‘The practical protection of taxpayers’ fundamental rights’, IFA Cahiers de droit fiscal international, Volume 100B.
arrangement in the context of hard-to-value intangibles in certain cases. The final reports on Actions 8–10 of the BEPS Action Plan also state that there is no automatic return on account for mere legal ownership of an intangible. To achieve entitlement to the returns from intangibles, an entity is required to perform directly or to control the performance of developments, enhancement, maintenance, protection and exploitation (DEMPE) functions and related risks regarding the intangibles. Therefore, the returns that an entity retains in an MNE group depend on the contributions it makes through DEMPE functions to the anticipated value of the intangible, relative to contributions made by other group members. The DEMPE approach has already been implemented in certain cases in Luxembourg (e.g., the steel industry) and has led to relevant value allocation between the parties. Such approach could be used more often in Luxembourg.

V SETTLEMENTS

Tax law is part of public policy and accordingly settlements on the application of tax law, including transfer pricing regulations, are prohibited. Should such a settlement nevertheless be reached, it would be void.

Settlements may, however, be reached in factual matters, even if they have an impact on taxation, as well as on penalties, late interest and other charges that do not constitute taxes. No public data on the occurrence and terms of such settlements is, however, available. The Luxembourg tax authorities are subject to very strict fiscal secrecy that prohibits them from disclosing any information regarding a taxpayer to third parties.

VI INVESTIGATIONS

The collection of income tax and CIT in Luxembourg is based on a reporting system, whereby the taxpayer completes a tax return which is reviewed by the tax authorities. The tax authorities have to investigate the factual and legal situation that is substantial for the determination of the tax and have a duty of an objective and impartial control in this regard.

In case of reasonable doubts as to the truth and completeness of the tax return – and hence of the transfer pricing documentation – the tax authorities are obliged to further investigate and verify the accuracy thereof, both in favour of and against the taxpayer. The fundamental principle of *audiatur et altera pars* has to be observed throughout the process: the tax authorities first have to invite the taxpayer in writing to complete the missing information and if this fails to be conclusive, they may summon him or her to their offices for a hearing. Finally, where they find deviations from the tax return, they have to notify the taxpayer of the points of deviation. The taxpayer must have sufficient time to review the deviations and to collect the necessary elements to submit his or her position before the administrative decision is taken. In the event the tax authorities do not observe the aforementioned principle, the tax assessment is voidable.

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16 Paragraph 166 GLT.
17 Paragraph 204 GLT.
18 Paragraph 205 GLT.
The tax authorities must also observe the principle of proportionality throughout the verification process:

\[ a \] they may only use means that are appropriate to achieve the relevant goal;

\[ b \] within the means at their disposal they have to select the one that least impairs the private interests; and

\[ c \] the gravity of the chosen measure has to be compared to the expected impact regarding public interest.

In case of a violation of the principle of proportionality, the administrative decision of the taxation office is voidable.

The tax assessment also has to observe several formal conditions;\(^{19}\) for example, it has to be made in writing,\(^ {20}\) contain the amount of taxes assessed and indicate how, when and where an appeal may be lodged. Once the tax assessment notice has been issued, the tax authorities may only amend it in limited cases (e.g., new facts have emerged that would change the taxation).\(^ {21}\) In the event the taxpayer objects to the tax assessment, he or she must lodge a written claim within three months following the notification thereof of the direct tax authorities.

The tax authorities may decide, in the event they have reasonable doubts on the accuracy of the tax return – and hence on the transfer pricing documentation – to proceed to an in-depth revision or tax audit in accordance with Paragraph 195 GTL. The tax audit may be ordered within the course of the verification of the tax return or at a later stage when the tax assessment notice has already been issued, subject to the applicable statute of limitation. The taxpayer and its employees have an obligation to cooperate and to provide the tax authorities with the necessary information.

Tax audits may only be performed within the statute of limitation. Regarding income tax and CIT, the statute of limitation is generally five years after the end of the year in the course of which the tax claim is established. It may, however, be extended to 10 years when no tax return has been filed or the tax return filed was incorrect or incomplete.

### VII LITIGATION

#### i Procedure

In Luxembourg, the litigation on income tax and CIT – and hence on transfer pricing issues – has been entrusted to the administrative courts. However, taxpayers who wish to contest their tax assessment must first lodge a complaint with the head of the administration for direct taxes, although the latter is not a judicial power. The seizure of the head of the administration for direct taxes is a mandatory but extrajudicial administrative act.

The procedure for seizing the head of the administration for direct taxes is not very formalistic. The taxpayer has to lodge his or her claim in writing within three months following the notification of the tax assessment notice. The taxpayer may act by him or herself and is not obliged to mandate a representative (e.g., lawyer, accountant or auditor). The head of the tax administration is then obliged to review the tax assessment from both a formal and factual perspective.

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19 Paragraph 211 GLT.
20 Paragraph 210b GLT.
21 Paragraph 222 GLT.
The decision of the head of the administration for direct taxes may be challenged before the administrative tribunal within three months as from its notification. In the event the head of the administration for direct taxes does not respond within six months of the filing of the claim, the taxpayer is allowed to directly seize the administrative tribunal. In such a case, no delay of foreclosure applies.

The administrative tribunal performs a material examination of the whole case, although it does not re-examine the global situation of the taxpayer. The procedure before the administrative tribunal is predominantly in writing, and the litigation procedure does not suspend the obligation to pay the tax claimed by the tax authorities. The state is represented by a governmental delegate and the taxpayer may appear in person, through a lawyer, a chartered accountant or an auditor.

The judgment of the administrative tribunal is subject to an appeal before the administrative court within 40 days as from the notification of the judgment. The administrative court re-examines the judgment of the administrative tribunal, taking into account both the factual and legal background. During the course of the procedure before the administrative court, the taxpayer has to be represented by a lawyer admitted before the courts of appeal. The administrative court is the highest and final judicial power in tax matters. It renders its decision in the last resort and no further revision is possible. Hence, from a timing perspective, a tax dispute in Luxembourg may usually be settled within 20 months as strict deadlines are followed.

Recent cases

Luxembourg courts have issued abundant case law in transfer pricing matters over the past decades. A considerable amount thereof regard adjustments on the basis of the recognition of hidden profit distributions (e.g., excessive interest payments between affiliated companies, advantages granted to shareholders, goods or services provided to affiliates at non-arm’s length prices, and the proof thereof).

Transfer pricing disputes tend, however, to become increasingly complex. A debatable decision was recently rendered in relation to a hybrid financing under the form of an interest-free loan granted by a Luxembourg parent company to its Italian subsidiary. The hybrid was considered from an Italian tax perspective as equity and the Luxembourg parent followed this treatment, while the tax authorities considered the absence of a remuneration as not compliant with the arm’s-length principle. The administrative court decided that the interest-free loan had to be considered as a debt instrument, as it was booked as such in the commercial accounts of the Italian subsidiary, and that hence the absence of a remuneration was indeed not arm’s-length compliant. The adjustment of the taxable profits of the company was thus confirmed, but the decision was based on the recognition of a hidden profit distribution to the Italian subsidiary. The position of the judges is questionable since it was not in line with the traditional application of the hidden distribution doctrine by scholars and case law, which only conceive a hidden profit distribution in cases where an undue advantage is granted to a shareholder or a shareholder-related beneficiary (as opposed to the granting of an undue advantage to a subsidiary, which may be constitutive of a hidden capital contribution).

22 See, e.g., administrative court, 26 March 2015, 34024C; administrative court, 19 January 2012, 28781C; administrative court 12 February 2009, 24642C.
23 See, e.g., administrative court, 1 February 2000, 11318C, administrative court 17 February 2011, 27172C.
24 Administrative court, 5 July 2015, 36888C.
VIII SECONDARY ADJUSTMENT AND PENALTIES

Luxembourg has not enacted any specific legislation or other regulations on secondary adjustments. However, depending on the case, the tax authorities may impose secondary adjustments in the form of hidden profit distributions or hidden capital contributions (see Section VII). Accordingly, any non-arm’s length advantage granted by a Luxembourg company to an affiliate may be requalified into a hidden profit distribution (in case of an affiliation through the shareholder) or hidden capital contribution (in case of an affiliation through a subsidiary).

Hidden profit distributions and contributions are non-deductible. Hidden distributions are further subject to a 15 per cent dividend withholding tax in the event the participation exemption does not apply. No further penalties are foreseen.

IX BROADER TAXATION ISSUES

i Diverted profits tax
Luxembourg has not enacted any diverted profit tax.

ii Double taxation
Luxembourg tax treaties generally follow Article 25 of the OECD Model Tax Convention that provides for a mutual agreement procedure. In such case, if none of the contracting states provide for unilateral relief, the latter shall endeavour to reach a mutual agreement, even though, practically speaking, there is no obligation to reach such an agreement.

In addition, for transactions between enterprises of different Member States of the European Union, the resolution of double taxation disputes resulting from transfer pricing adjustments can also be made through the EU Arbitration Convention (90/436). The EU Arbitration Convention provides for mandatory arbitration where Member States cannot reach mutual agreement on the elimination of double taxation. The competent authorities have to reach an agreement within two years from the date on which the file was submitted to one of the competent authorities. In Luxembourg, the Minister of Finance is the competent authority. In the event the Member States were not able to reach an agreement within this two-year period, the competent authorities shall set up an advisory commission whose opinion on the elimination of the double taxation ultimately binds the competent authorities.

Luxembourg has also signed the multilateral instrument (MLI) developed by the OECD under Action 15 of the BEPS Action Plan. Article 14 of the MLI introduces a mandatory mutual agreement procedure: a person who considers that the actions of one or both of the contracting states result in taxation not in accordance with the provisions of the covered treaty may present the case to the competent authority of either contracting state within three years. The competent authority must then resolve the case, either by itself or by mutual agreement with the competent authority of the other contracting state. Article 17 of the MLI further introduces a mandatory corresponding adjustment of tax charged on profits in one contracting state in case the other contracting state includes a portion of those taxable profits under applicable transfer pricing rules. An optional clause for mandatory binding arbitration is contained in the MLI, which will allow participating countries to limit the cases eligible for arbitration (based on reciprocal agreements).
iii Consequential impact

The Luxembourg tax authorities are divided into three administrations, each being responsible for a particular area of competence:

- the administration for direct taxes is mainly competent for CIT, MBT and NWT, as well as withholding taxes;
- the administration for registration duties and valued added tax (VAT)\(^{25}\) is mainly competent for VAT and registration duties; and
- the administration for customs and excise duties\(^{26}\) is mainly competent for customs and excise duties.

Since 2008, information that is relevant for the accurate assessment of taxes must be exchanged between the tax administrations. Accordingly, in the case of transfer pricing adjustments, the relevant tax administration could proceed to a corresponding adjustment in respect of the taxes or duties for which it is competent if such adjustment is not barred by the expiry of the statute of limitation.

X OUTLOOK AND CONCLUSIONS

The Luxembourg financial centre originally developed as a private banking centre and has grown to become a diversified hub for investment funds, banks, insurance and reinsurance companies, holding companies and family offices. The Luxembourg transfer pricing environment is hence largely focused on financial services.

Transfer pricing is, however, developing rapidly in Luxembourg and its latest amendments evidence the political attachment to a timely implementation of the OECD developments. Precise transfer pricing regulations were first introduced in Luxembourg in 2011 with respect to intra-group financing transactions. Since then, the legislation has been completed and rendered BEPS compliant. Transfer pricing now applies to all controlled transactions in all industries. In practice, the authors are most often solicited on controlled transactions in the asset management industry, although banking and insurance, as well as the manufacturing industries are increasingly active in establishing their transfer pricing documentation.

As the TPS method is very often used in determining the arm’s-length pricing in the asset management industry, and with Luxembourg being a hub for investment funds, the OECD developments in this respect are closely followed by local transfer pricing practitioners. Also, the practical impacts of the Actions of the OECD’s BEPS Action Plan may significantly change the Luxembourg transfer pricing environment in the future.

Given that Luxembourg has a transfer pricing legislation, the need to file for an APA in order to obtain certainty as to the tax treatment has mostly gone and consequently, the number of APA requests is expected to diminish over time. However, given the complexity of the rules and the lack of more precise guidance, it is equally expected that transfer pricing audits and disputes will increase.

\(^{25}\) Administration de l’enregistrement et des domaines.
\(^{26}\) Administration des douanes et accises.
Chapter 16

MEXICO

Oscar Campero P San Vicente and Alejandra Castillón Contreras

I OVERVIEW

Since 1997, Mexican tax authorities have recognised the arm’s-length principle for benchmarking related-party transactions, establishing for such purposes transfer pricing provisions.

Certain aspects regarding transfer pricing were introduced to the Mexican Income Tax Law (MITL) in 2001, 2002 and 2006, such as the transactional approach, recognition of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the OECD Guidelines) for transfer pricing interpretation purposes, as well as the hierarchy for the application of the methods.

Currently, the Mexican transfer pricing provisions contained in Article 76, Section XII of the MITL state that corporations that undertake transactions with related parties are required to determine their accumulated income and authorised deductions, taking into account the prices that would have been established with or between independent parties in comparable transactions (i.e., related-party transactions must comply with the arm’s-length principle).

Article 179 of the MITL sets out that two or more persons or entities are related parties when one of them participates directly or indirectly in the management, control or capital of the other, when a person or group of persons participates directly or indirectly in the management, control or capital of such people, or when there is a link between them in accordance with the customs legislation. In this sense, individuals may also be a related party to another person and therefore are subject to the Mexican transfer pricing provisions.

The MITL establishes that, for the interpretation of the Mexican transfer pricing provisions, the OECD Guidelines approved by the Council of the Organisation for Economic Co-operation and Development will be applicable as long as they are consistent with the provisions of the MITL and the treaties entered into by Mexico.

The Mexican transfer pricing provisions contained in the MITL do not specify the definition of the arm’s-length principle; however, the OECD Guidelines, as a source of interpretation for transfer pricing issues, state that the arm’s-length principle is reached if the conditions between related parties were made or imposed for their business or financial relations and do not differ from those that would have been used with or between independent parties.

Additionally, Article 179 of the MITL states that tax authorities may determine the accumulated income and authorised deductions of the taxpayers that have not been
determined in transactions carried out between related parties, taking into account the prices that would have been established with or between independent parties in comparable transactions. Moreover, if the tax authorities determine that a taxpayer did not undertake transactions with related parties at arm’s length, it is considered that the price or amount of the consideration that independent parties would have established is the median of the price, amount or margin range obtained from the application of any of the transfer pricing methods.

II FILING REQUIREMENTS

In general terms, the contemporaneous transfer pricing documentation for transactions carried out with Mexican and related foreign parties is not submitted to the tax authorities, unless it is formally required to do so in an audit process.

Notwithstanding, there is certain documentation that taxpayers must file before the Mexican tax authorities regarding transactions carried out between related parties; the principal filings that Mexican taxpayers must submit are described in this section.

When taxpayers undertake transactions with non-resident related parties, Article 76, Section IX of the MITL states that taxpayers must procure and maintain the supporting documentation that demonstrates that the amount of their accumulated income and authorised deductions derived from such transactions were made at arm’s length. Such evidentiary documentation shall contain the following:

a the name, domicile and tax residence of the related parties with which the transactions were undertaken, as well as the documentation showing the direct and indirect relation between the related parties;

b information regarding the functions or activities, assets and risks assumed by the taxpayer per type of transaction;

c information and documentation on the main transactions with related parties and the amounts thereof by each party in a relationship and per type of transaction; and

d the method applied in accordance with Article 180 of the MITL, including the information and documentation on comparable operations and enterprises, per type of transaction.

As can be seen from the aforementioned provision, taxpayers are not required to submit such documentation, but to procure and maintain it.

In practice, and derived from a statutory criterion issued by the tax authorities,² the requirement to procure and maintain supporting documentation that demonstrates that transactions carried out with related parties were made at arm’s length applies for both domestic and foreign transactions; that is, the evidentiary documentation must include all transactions undertaken between related parties.

Article 76-A of the MITL, which has been in force since fiscal year 2016, states that taxpayers who in the immediate previous year obtained operating revenues equal to or exceeding 708,898,920 Mexican pesos,³ as well as those who in such year had shares exchanged in the stock market, companies who applied for the optional tax regime for corporate groups, state companies of the federal public administration and foreign residents with permanent

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² Statutory criterion 00/2012/ISR.
³ Amount for tax year 2017, which will be updated for every tax year.
establishment in Mexico that undertook transactions with related parties, would be required to file no later than 31 December of the next year the following transfer pricing information in line with the OECD’s Base Erosion and Profit Shifting (BEPS) Action Plan 13:

a. the master file: information on the business multinational enterprise group, including an overview of the multinational enterprise group, overall transfer pricing policies, global allocation of revenue and economic activities;

b. the local file: information on related parties, including specific transfer pricing information on the group in Mexico; and

c. a country-by-country report on the business multinational enterprise group, which includes aggregate tax jurisdiction-wide information related to global allocation of revenue, taxes paid and indicators of the location of economic activities, among others.

Article 76-A of the MITL states that Mexican taxpayers that qualify as multinational controlling entities (the ultimate holding resident in Mexico) should not submit this report if the annual consolidated revenue of the multinational enterprise group in the immediate previous fiscal year is lower than 12 billion Mexican pesos.

Non-controlling Mexican taxpayers may still be required to file such return when appointed by the foreign parent company. In addition, the Mexican tax authorities could request other foreign tax authorities to file the country-by-country report through an information exchange mechanism.

Specific administrative rules for master and local files as well as the country-by-country report were published in April 2017.

In addition, Mexican taxpayers that undertake transactions with non-resident related parties are required to file Appendix 9 of the Multiple Information Statement (DIM), which requests information on the related party, percentage of profit or loss obtained by operation, rate or percentage agreed (interest, royalties, commissions, among others), income statement by operation, type of range used, interquartile range and SIC codes used. The transfer pricing analyses required on the aforementioned documentation must be performed for each type of transaction carried out by the taxpayer and must be submitted before the Mexican tax authorities on an annual basis.

### III PRESENTING THE CASE

Article 180 of the MITL establishes that, for the purposes of the transfer pricing provisions, the following methods should be applied:

a. comparable uncontrolled price method (CUP);

b. resale price method (RPM);

c. cost-plus method (CPLM);

d. profit split method (PSM);

e. residual profit split method (RPSM); and

f. transactional net margin method (TNMM).

As can be seen, the MITL establishes six transfer pricing methods, differentiating the PSM from the RPSM, which in the OECD Guidelines are considered as a single method.

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4 DIM is an annual filing for companies, regarding their main information for tax purposes.
Article 180 of the MITL also states that for the determination of prices for transactions carried out with related parties, taxpayers should consider the CUP as the first option and only use any of the other methods when it is proven that the CUP is not appropriate to determine that the transaction complies with the arm’s-length principle. Likewise, it has to be demonstrated that the method used is the most appropriate or the most reliable according to the available information, giving preference to the RPM and CPLM. These provisions are established in accordance with the OECD Guidelines.

In practice, the RPM is applied generally to distributing companies that do not apply complex productive processes to the products they distribute, because it compares the gross margins obtained for the distribution of products.

Likewise, the CPLM is mainly used to analyse manufacturing and rendering of services transactions since it compares the markup obtained over the cost of goods sold by independent parties in comparable transactions, in connection with the markup obtained over the cost of goods sold by a company.

The PSM and RPSM are usually applied when inter-company transactions are broadly related, and for this reason it is not possible to segregate financial information related to the operation. Additionally, the RSPM is applied to analyse transactions that involve non-routine intangible assets. The TNMM consists in identifying the transactions between related parties and determining the operating margin that comparable entities would have obtained in comparable independent transactions. This method takes into account transactional factors such as assets, sales, costs of goods sold, operating expenses and cash flows. The TNMM is mainly used to analyse transactions with a significant level of costs and expenses.

To determine the most appropriate transfer pricing method and the suitable profitability factor, the business approach of the transaction and its business cycle should be considered.

Article 179 of the MITL establishes that the operations or companies used in the application of a transfer pricing methodology should be comparable when there are no important differences between them that distort the price or amount of the consideration, or margin established. To determine such differences, it is necessary to take into account relevant elements that are required according to the method used, such as the characteristics of the operations, the functions or activities, including the assets used and risks assumed in the transactions of each of the related parties involved, as well as the contractual terms, economic circumstances and business strategies.

In general, the Mexican tax authorities consider public information when exercising their power of scrutiny over taxpayers’ transfer pricing methodologies; consequently, they can request key information on resident and non-resident companies, as well as the use of import summaries information.

In practice, taxpayers and the Mexican tax authorities consider it reasonable to use foreign information for comparable companies and comparable transactions purposes, given the lack of publicly available information regarding Mexican companies and transactions.

Derived from the above, in order to verify whether taxpayers fulfil their obligations, Mexican tax authorities perform an analysis that focuses on the functions performed, assets used and risks assumed on the transactions examined specifically.
IV  INTANGIBLE ASSETS

Article 179 of the MITL recognises that transactions between related parties that involve the exploitation or transfer of intangible assets should be determined at arm’s length, taking into consideration the type of intangible (patent, trademark, trade name or transfer of technology), as well as the duration and degree of protection of such intangible.

In accordance with the transfer pricing provisions, the RPSM should be used to analyse inter-company transactions that involve non-routine intangible assets, which in general terms consist in the determination of a minimum profit generated by each company involved in a transaction to determine the minimum profit that each party must generate by routine contributions. The excess profit of the routine profit is defined as the residual profit, which is attributable to intangible assets owned by one or more of the parties involved in the transaction. Such residual profit is split among the parties according to the relative value of the intangible property that each party involved contributed to or utilised in the transaction.

In practice, financial valuation methodologies are used to establish arm’s-length considerations for transactions carried out between related parties that involve intangible assets. It is important to point out that the application of financial valuation methods to determine market value of assets reflects the prices at which independent third parties would be willing to acquire such assets. In this sense, the price of an asset determined with a valuation methodology would be consistent with CUP application, and the value of an asset established with the mentioned methodologies would comply with the arm’s-length principle.

As discussed, the Mexican transfer pricing provisions included in the MITL regarding intangible assets are limited and do not provide broad guidelines for transactions between related parties involving such assets. However, and as previously mentioned, for Mexican tax purposes the OECD Guidelines are a source for interpretation regarding the transfer pricing issues that may arise.

In order to have a broader understanding of the intangible assets analysis, Mexican transfer pricing provisions regarding intangible assets should be complemented with Chapter VI of the OECD Guidelines, which was contemplated in Action 8 of the OECD’s BEPS Action Plan. However, queries arise regarding certain valuation in hard to value intangibles methodologies, which are mentioned in Action 8 of the OECD’s BEPS Action Plan (i.e., \textit{ex ante} and \textit{ex post} approaches).

The \textit{ex ante} approach relates to the relevance, enforceability and sustainability of a project to make an investment; on the other hand, the \textit{ex post} approach is given once the investment is concluded, the latter being given when there is no available information before the implementation of the project in question.

The Mexican tax authorities, when exercising their power of scrutiny on taxpayers when choosing CUP or RPSM to analyse transactions involving intangibles, usually focus on the differences between the projected income of taxpayers used in such methodology and their actual income.

V  SETTLEMENTS

In 2014, as part of the effort by the Mexican government to provide relief and support to taxpayers that must contend with a complex tax system that has excessive formal requirements that undergoes periodical amendments, the Federal Tax Code was amended introducing
a settlement procedure called ‘conclusive agreement’, which is filed before the Mexican taxpayers’ ombudsman (PRODECON), which acts as a mediator between the taxpayer and the tax authorities.

This procedure is intended to allow taxpayers to submit evidence before the tax authorities to clarify the alleged omissions identified during the audit procedure, before a tax deficiency is assessed, allowing both parties (taxpayer and tax authorities) to reach an agreement in which alleged omissions are clarified or the omitted tax paid. In such case the agreement is binding and could not be challenged by the parties.

In the event a petition of a conclusive agreement is filed, the audit procedure is suspended and in the event an agreement is not reached or only a partial agreement is signed, the audit procedure will continue from the stage at which it was suspended.

Additionally, during the audit process, it is possible to reach an agreement directly with the tax authorities by adjusting the considerations settled between related parties in accordance with the arm’s-length principle. Nevertheless, at this moment the conclusive agreement procedure is one of the most important mechanisms to reach an agreement between the Mexican tax authorities and taxpayers.

VI INVESTIGATIONS

Article 67 of the Federal Tax Code states that the power of the tax authority to determine tax omissions, as well as to impose penalties for violations of the tax provisions, is extinguished within five years from the date on which the annual return of the tax year assessed was filed or ought to have been filed. Thus, the time limit for the tax authorities to open a transfer pricing investigation is five years from the given fiscal year.

Typically, during a transfer pricing audit, the Mexican tax authorities have one year to carry out the review of the annual tax return in assessment and to request information from the taxpayer. Likewise, the tax authorities have two years to issue an official letter of observation or a final act with the results of the transfer pricing audit.

During a transfer pricing audit, the tax authorities may determine whether a transaction carried out by a taxpayer with related parties was made at arm’s length or not. As mentioned above, if the tax authorities determine that the transactions under consideration were not made at arm’s length, they would make a transfer pricing adjustment.

Once the official letter of observations or final act with the results of the transfer pricing audit is received, the taxpayer will have two months to appeal and present evidence or liquidate the tax assessment. In the event the taxpayer presents additional evidence or appeals, the tax authorities will have six months to determine the final tax regarding the transfer pricing adjustments.

In practice, the tax authorities review a series of economic indicators based on the taxpayer’s transactions with its related parties, such as the leverage level, to start an audit process.

Recently, the number of transfer pricing audits has increased due to the alignment of the Mexican transfer pricing provisions with the OECD’s BEPS Action Plan. The Mexican tax authorities have publicly announced that they are carrying out auditing programmes to review taxpayers that may be involved in aggressive tax planning strategies.

Various multinational enterprises have restructured their operations in Mexico under the supply chain concept, by establishing a contract manufacturer or a limited risk distributor,
or both, as well as the provision of various services, deriving from the transfer of profits to non-resident entities. These taxpayers may be audited by the Mexican tax authorities, seeking to change this structures to return the taxable profits back to Mexico.

Taxpayers that are licensees and pay royalties for the use of trademarks and other intangibles, which at the same time incur advertisement and promotion expenses, are also likely to be audited by the tax authorities, stating that such expenses must be absorbed by the licensor.

The Mexican tax authorities also focus on auditing pro rata expenses, verifying that such expenses’ deductions fulfil the requirements issued by the tax authorities, which in practice are very difficult for taxpayers to comply with. Additionally, the Mexican tax authorities are auditing certain restructures applied in previous years by the mining sector.

Currently, the Mexican tax authorities have adopted another mechanism to perform its verification attributions, issuing an invitation letter to taxpayers to encourage them to comply with its tax obligations, or to review some information or figure in which the authorities recognise inconsistencies. These invitation letters could derive from a tax self-assessment.

VII LITIGATION

i Procedure

There are two legal remedies by which taxpayers could challenge a tax-deficiency assessment. The first is by filing an administrative appeal before the tax authorities, and the second option is through an annulment complaint before the Federal Tax Court.

Administrative appeal

Ordinary procedure

Before going to court, the taxpayers could challenge a tax deficiency through an administrative appeal, which must be filed within a 30-business-day term following the date the tax assessment is notified to the taxpayers, in which it would be able to file additional evidence to demonstrate that such assessment is illegal.

After all the evidence is submitted, the tax authorities are compelled to issue a resolution within a three-month period.

One of the benefits of the administrative appeal is that according to the Federal Tax Code, taxpayers are not compelled to file any kind of security (such as bond deposit, administrative seizure, among others) to the tax authorities before such mean of defence is resolved.

5 The expenses incurred abroad on a pro rata basis by a Mexican taxpayer will not be considered deductible for income tax purposes. However, the consideration as deductible expenses incurred on a pro rata basis may not apply if certain requirements are met, such as the demonstration that the services that generated such expense have been effectively rendered, the price or consideration has been determined on an arm’s-length basis, there is a reasonable relationship between the expenses incurred, and the benefit obtained or expected to be obtained has been obtained, among others.
Substance procedure

In 2017, a new procedure was created in which taxpayers could challenge tax deficiencies that exceed approximately 5 million Mexican pesos through an optional procedure in which only substantial arguments could be made to question the legality of such deficiency, without taking into consideration any argument that question the fulfilment of procedure formalities.

According to the Federal Tax Code substantial arguments must be understood as those that referred to the taxpayers, activities subject of taxation, rates and payment period.

Such administrative appeal also must be filed within a 30-business-day term following the date the tax assessment is notified to the taxpayers, in which it would be able to file additional evidence in order to demonstrate that such assessment is illegal, and as in the ordinary procedure taxpayers are not compelled to file any kind of security.

In the event of obtaining an unfavourable resolution in any of the procedures, taxpayers may file an annulment complaint before the Federal Tax Court within a 30-business-day term following the date the resolution to the administrative appeal is notified.

Annulment complaint

Ordinary procedure

The annulment complaint must be filed before the Federal Tax Court within a 30-business-day term following the tax assessment or the resolutions to the administrative appeal being notified.

Against a favourable or unfavourable resolution to the taxpayer’s interest, the tax authorities or the taxpayer may, respectively, file an appeal or an amparo lawsuit, within a 15-business-day term following the date the decision is notified, which will be definitely decided by a collegiate tribunal.

When filing the annulment complaint, the taxpayer should file a security before the tax authorities in one of the forms established in the Federal Tax Code (bond, deposit, administrative seizure, payment, among others) within a 30-business-day term following the date the ruling letter was duly notified to the company, or within a 10-business-day term of the administrative appeal being resolved.

Substance procedure

In 2017, a new procedure was created in which taxpayers could challenge, through specialised judges, the tax deficiencies exceeding approximately 5 million Mexican pesos through an optional procedure in which only substantial arguments could be made to question the legality of such deficiency, without taking into consideration any argument that question the fulfilment of procedure formalities.

Such claim also must be filed within a 30-business-day term following the date the tax assessment is notified to the taxpayers, and an important benefit of this procedure is that, in contrast to the ordinary procedure, the taxpayers are not compelled to file any kind of security until a resolution is rendered.

Also against a favourable or unfavourable resolution to the taxpayer’s interest, the tax authorities or the taxpayer may, respectively, challenge such resolution through an appeal or an amparo lawsuit, within a 15-business-day term following the date the decision is notified, which will be solved by a collegiate tribunal.
Recent cases
There are some cases being discussed concerning transfer pricing disputes with regard to the following fees:

- research and development;
- cost sharing;
- services fees;
- information and technology;
- advertising and promotion; and
- travel and training expenses, all paid to related parties.

VIII SECONDARY ADJUSTMENT AND PENALTIES

In general, there are certain transactions whereby the taxable basis may be eroded between different jurisdictions among which transfer pricing adjustments are included. In this regard, it is important to enforce laws to implement transfer pricing adjustments for taxpayers to be certain of their transactions and for tax administrations to identify elusive practices. It is important to mention that such adjustments may lead to an increase in revenue, decrease in deductions or a decrease in revenue, and an increase in deductions for each of the entities involved in the underlying transactions.

The only provision related to transfer pricing adjustments included in the MITL is Article 184, which establishes that tax authorities of a country with which Mexico has a treaty to avoid double taxation may determine an adjustment to the prices or considerations of a taxpayer resident in such country; in this sense, the Mexican related party may perform the corresponding adjustment. That is, the MITL recognises the application of corresponding adjustments when the primary adjustment is determined by a competent authority of a country with which Mexico has entered into a tax treaty, and provided that the Mexican tax authorities accept such adjustment.

Certainly, this should not be understood as a Mexican taxpayer not being allowed to carry out a transfer pricing adjustment for Mexican tax purposes, but tax uncertainty exists when implementing such adjustments. To obtain tax certainty, taxpayers may request rulings from the Mexican tax authorities that provide legal certainty for diverse tax implications, and have even entered into mutual agreement procedures (MAPs) to obtain a higher level of security from a tax perspective.

Article 184 of the MITL establishes a mechanism by which a Mexican taxpayer can apply a corresponding adjustment derived from a primary adjustment, determined for a foreign-based related party that is resident in a country with which Mexico has entered into a tax treaty.

This mechanism consists of filing an amended tax return in Mexico to recognise the corresponding adjustment. Such an adjustment will only be recognised by the Mexican tax authorities to the extent that they fully agree with it. The aforesaid adjustment would not compute for tax return submission limitation purposes.

Derived from the above, the MITL recognises the application of corresponding adjustments, although at this stage it only recognises those derived from primary adjustments that have been carried out by the tax authorities in a country with which Mexico has a tax treaty. Such recognition may be obtained by means of an MAP involving the Mexican and foreign tax authorities. Therefore, in a non-tax treaty context this situation may lead to double taxation.
Recently, the Mexican Tax Authority issued specific rules with respect to primary and corresponding adjustments.

Current Mexican legislation does not include secondary adjustments, so in the event Mexican taxpayers need to apply these adjustments, there are no rules that give them certainty of their application.

**IX BROADER TAXATION ISSUES**

There are international mechanisms between jurisdictions for taxpayers to avoid double taxation; in addition to tax treaties between jurisdictions to avoid double taxation, the most used mechanism is the MAP, which allows designated representatives from the governments of the contracting states to interact with the intent to resolve international tax disputes.

Most MAP issues regarding transfer pricing in these cases have been issues of transfer pricing where associated companies of a multinational enterprise group incurred economic double taxation due to an adjustment to their income from intra-group transactions by one or more tax administrations.

Currently, to file an MAP application, Appendix 1-A of Fiscal Miscellaneous Resolution for 2018 establishes the requirements to be fulfilled to file a request for the initiation of an application procedure.

In this matter, Action 7 of the BEPS Action Plan states, among other measures, the inter-country agreement to adopt a series of minimum standards in tax treaties to avoid treaty shopping. The implementation of such standards will deny treaty benefits to certain commonly used holding structures.

Derived from Action 6 of the BEPS Action Plan, countries have agreed to include anti-abuse provisions in their tax treaties, including a minimum standard to provide a minimum level of protection against treaty shopping. The minimum standard requires countries to include a statement in the preamble of their tax treaties that they are not intended to be used to generate double non-taxation.

Often transfer pricing transactions may be treated as or mistaken for customs inquiries in Mexico. Transfer pricing provisions included in the MITL are considered only for the purpose of the Law – that is, transfer pricing provisions included therein apply only for income tax purposes.

The Mexican Customs Law (MCL) establishes that import and export taxes are computed on the customs value. The MCL establishes specific methods for determining the customs value in cases where a related-party transaction may have an impact on the customs value. In this sense, transfer pricing methods and customs methods, in general, are different, although in some cases are similar in their application. Therefore, in general terms, transfer pricing analysis or documentation is not valid for customs valuation purposes, and vice versa.

**X OUTLOOK AND CONCLUSIONS**

Mexican legislation follows the OECD Guidelines regarding transfer pricing issues. Adjustments have recently been made in order to adequately adopt the BEPS Action Plan.

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6 Treaty shopping involves strategies through which a person who is not a resident of a state attempts to obtain the benefits of a tax treaty concluded by that state.
Regarding dispute resolution mechanisms, the conclusive agreement has proven very effective in the audit process, since it is an alternative to mediation between the taxpayer and the tax authorities.

Currently, owing to the specialisation of the Mexican tax authorities in transfer pricing matters, a risk model is being implemented to address audit processes from a transactional and business perspective, focusing on the substance and not on the form and presentation as used to be the case in the past. This risk model includes further detail given the information filed by taxpayers through local file, master file and country-by-country report.

The number of transfer pricing audits has increased due to the mentioned alignment of the Mexican transfer pricing provisions with the OECD’s BEPS Action Plan. Additionally, the Mexican tax authorities have publicly announced that they are carrying out auditing programmes to review taxpayers that may be involved in aggressive tax planning strategies, and have shown particular interest in transfer pricing matters.
Chapter 17

NETHERLANDS

Bas de Mik and Maarten van der Weijden

I OVERVIEW

Prior to 2002, the application of the arm’s-length principle was based on case law. Effective 1 January 2002, however, the arm’s-length principle has been codified in the Dutch Corporate Income Tax Act 1969 (CIT). Article 8b CIT reads as follows:

1. Where an entity, directly or indirectly, participates in the management, control or the capital, of another entity and conditions are made or imposed between the two enterprises (transfer prices) which differ from conditions which would be made by independent parties, the profit of these entities will be determined as if those conditions applied.

2. The first paragraph applies similarly if the same person, directly or indirectly, participates in the management, control or capital, of one and another entity.

3. The entities referred to in the first and second paragraph must include information in their records which shows in which manner the transfer prices that are referred to in the relevant paragraph have been established and from which it can be derived whether the transfer prices established would have been agreed upon between independent entities dealing at arm’s length.

Article 8b CIT only applies to corporate taxpayers. However, the taxable income of individuals dealing with foreign or domestic related entities can also be adjusted based on the arm’s-length principle.

Article 8b CIT includes both vertical relationships (parent–subsidiary) and horizontal relationships (sister companies with a joint parent) between entities; both direct and indirect relationships are taken into account. Relationship thresholds have intentionally been omitted from the statute, and instead, an approach that looks at the substance of the relationship has been adopted. This is to avoid taxpayers having the ability to influence their tax position by planning around clearly defined statutory thresholds, and also ensures that entities that do not have a capital divided into shares, such as foreign trusts or Dutch foundations, are covered by the arm’s-length principle.

Taxpayers may apply for an advance determination of whether they are related for the purposes of Article 8b CIT.

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The application of Article 8b CIT is not limited to cross-border transactions. Article 8b CIT also applies to transactions between related entities in the Netherlands, and contains the requirement for taxpayers to document the arm's-length nature of the transfer prices used.

The Dutch government has on multiple occasions stated that, in its view, the OECD Transfer Pricing Guidelines (the OECD Guidelines) contain principles of Dutch law and are as such part of the Dutch legal framework. This view is not undisputed.

The Dutch Ministry of Finance has issued Decree 22 April 2018, No. 2018-6865 (the Dutch Transfer Pricing Decree). The Dutch Transfer Pricing Decree contains explanatory guidance in areas where the OECD Guidelines leave room for interpretation by individual countries or where the OECD Guidelines are unclear. The Dutch Transfer Pricing Decree has been amended to bring it in line with the revisions that the OECD Transfer Pricing Guidelines have undergone in connection with the outcome of the BEPS project.

Another decree issued by the Dutch Ministry of Finance, Decree IFZ2010/457M, contains guidance on the allocation of profits to permanent establishments. Next to these generic decrees, specific guidance has been issued in the area of group finance entities.

The Netherlands has a long tradition of cooperation between taxpayers and tax authorities to prevent conflicts in the tax area. There is a well-developed system for tax rulings, advance pricing agreements (APAs) and cooperative compliance agreements.

The rulings and APA practices have come under scrutiny of the European Commission, who claim that some of the agreements the Dutch tax authorities have entered into constitute state aid that is prohibited under EU law. In Starbucks, the Commission rendered a final decision that an APA entered into between the Dutch tax authorities and Starbucks represented state aid. Its decision has been appealed by the Dutch government and Starbucks before the European Court of Justice. In another case, IKEA, the Commission has rendered an opening decision concerning alleged state aid granted by the Netherlands.

Cooperative compliance agreements between the Dutch tax authorities and taxpayers are very common for large and medium-sized corporate taxpayers. Under the agreement taxpayers commit to notify tax authorities of issues that could give rise to disagreement on a current basis. The tax authorities commit to timely state their position with respect to these issues. The purpose of the agreement is to have fewer disputes in the assessment phase, thus assuring that the taxpayer's tax position is more certain on a current basis. One of the effects of these agreements is that taxpayers are less likely to take aggressive tax positions, or play the audit lottery. Another effect is that conflicts, including conflicts in the transfer pricing area, less frequently reach the stage where they are brought to court.

II FILING REQUIREMENTS

There are three levels of statutory documentation and filing requirements in the transfer pricing area.

i General transfer pricing documentation

Every taxpayer is required pursuant to Article 8b CIT to maintain transfer pricing documentation in its administration from which it can be derived whether transactions with related entities have been conducted under arm's-length conditions. In the context of an M&A transaction, the Dutch Transfer Pricing Decree states that the acquisition file of the buyer is part of the transfer pricing documentation.
There is no requirement to prepare a transfer pricing report. Taxpayers are free to substantiate their transfer pricing. The information should be available at the time of filing of the tax return and must be provided to the Dutch tax authorities upon request. If the transfer pricing relates to transactions between a Dutch taxpayer and an associated enterprise outside the Netherlands, the documentation may be retained outside the Netherlands. Notwithstanding this, the Dutch taxpayer must provide the requested information to the Dutch tax authorities upon request.

ii Medium-sized multinational groups

Entities that are part of a multinational group with a consolidated turnover in excess of €50 million are required to maintain in their administration a group file and a local file. The group file should contain a description of the nature of the activities of the group, the general transfer pricing policy of the group and a worldwide allocation of income and economic activities. The group file should enable the tax authorities to make a transfer pricing risk assessment. The local file should contain all information to assess whether the company has fulfilled its documentation requirements under Article 8b CIT. The local file and the group file should be available in either Dutch or English. The tax authorities may give additional guidance on the contents and format of the files. The files should be available at the latest at the time of filing of the tax return.

iii Large multinational groups

A Dutch resident ultimate parent of a multinational group with a total consolidated turnover exceeding €750 million is required to prepare a country-by-country report (CbCR). The CbCR should contain the following aggregate information for each jurisdiction in which the multinational group is active:

- the number of employees;
- the amount of the net turnover, including turnover in transactions with related parties;
- the amount of profit or loss before income tax;
- the amount of income tax accrued (current year), which is the current tax expense recognised on taxable profits or losses of the financial year by undertakings and branches resident for tax purposes in the relevant tax jurisdiction in the commercial accounts;
- the amount of income tax paid, which is the amount of income tax paid during the relevant financial year by undertakings and branches resident for tax purposes in the relevant tax jurisdiction;
- the capital of the companies in a particular jurisdiction;
- assets other than cash or cash equivalents; and
- the amount of accumulated earnings.

In addition, the CbCR should contain for each company in a jurisdiction an indication of the nature of the activities of that company; and needs to be filed with the Dutch tax authorities within 12 months of the balance sheet date.

Decree DB/2015/462M contains detailed regulations on the required content of the documentation and filing requirements for large and medium-sized multinational groups referred to above.

In addition to the above statutory requirements, a taxpayer and the tax authorities may agree as part of an APA that the taxpayer files a report annually that enables the tax authorities to review the taxpayer’s compliance with the APA.
In 2017, legislation became effective to enable the Dutch tax authorities to automatically exchange CbCRs received from multinational groups with other countries.

III PRESENTING THE CASE

i Pricing methods

The Dutch tax authorities apply the guidance of the OECD Guidelines on comparability factors. These factors include the characteristics of the property or services transferred; the functions performed by the parties (taking into account assets used and risks assumed); the contractual terms; the economic circumstances of the parties; and the business strategies pursued by the parties.

The Dutch tax authorities allow the use of both internal and external comparables. There is no specific guidance with respect to comparables. Due to the relatively small size of the Dutch economy, benchmarking analyses on the basis of international data are acceptable. Data from commercial databases made available by parties such as Bureau van Dijk, Bloomberg, Moody’s and Thomson Reuters are generally accepted.

The OECD Guidelines, in principle, look at transactions individually. Where there is a large number of comparable transactions, the Dutch tax authorities will apply aggregation of transactions and will expect that the taxpayer will demonstrate that its dealings are at arm’s length on an aggregate basis.

In cases where the arm’s-length transfer price is within a range, the Dutch tax authorities will take the position that the median should be taken as the basis for adjustment.

Taxpayers are, in principle, free to choose a transfer pricing method, provided that the method adopted leads to an arm’s-length outcome for the transaction in question. In certain situations, however, some methods will generate better results than others. Although taxpayers may be expected to base their choice of a transfer pricing method on the reliability of the method for the particular situation, they are definitely not expected to weigh up the advantages and disadvantages of all of the various methods and then explain why the method that was ultimately adopted generates the best results in the prevailing conditions (i.e., the best method rule). Certain situations are also suited for a combination of methods. At the same time, taxpayers are not obliged to use more than one method.

The only obligation resting on the taxpayer is to explain the decision to adopt the particular method that was adopted.

ii Authority scrutiny and evidence gathering

The Netherlands has implemented CbCRs and will actively exchange information with other countries. CbCR data is not public; however, certain members of the Dutch parliament have suggested that the government pursue changes in legislation that would include public disclosure of CbCRs.

The Dutch tax authorities have specialised regional teams and an expert national team for transfer pricing. These teams communicate with each other and (informally) ensure that there is consistency in the application of transfer pricing rules across the Dutch tax administration.

The Dutch tax authorities typically want to have a clear understanding of the business model of a multinational group and of the value drivers within the group. For this purpose, they may sometimes want to talk to in-house business people. There is debate as to whether
and to what extent a taxpayer is required to facilitate this. Only in exceptional circumstances, for instance when there is a suspicion of fraud, will they resort to fact finding through third parties. The Dutch tax authorities do not use secret comparables.

IV INTANGIBLE ASSETS

i Intangible assets

Dutch tax law does not provide for a definition of intangibles. The Dutch tax authorities will ordinarily take the legal arrangements on intangibles as the starting point for determining a company’s taxable profit from intangibles.

In the Dutch Transfer Pricing Decree, it is stated that the transfer of an intangible asset to a related enterprise that is not expected to add value because it lacks the required functionality (skills) is not at arm’s length. In this regard, the Dutch Transfer Pricing Decree takes into account the DEMPE principles introduced in the OECD BEPS project.

If the transaction as such is at arm’s length because the buyer also adds functionality, the terms and conditions of the transaction will be tested. In the Dutch Transfer Pricing Decree the Ministry of Finance commented on the transfer of intangibles. Sometimes intangible assets such as patents are transferred, and it is difficult to establish the value at the time of the transfer because insufficient information is available about the future benefits and risks associated with the intangible. The Dutch tax authorities then will apply the principles laid down in Paragraph 6.185 of the OECD Guidelines. If independent enterprises under similar conditions would have demanded a price adjustment clause, the Ministry of Finance takes the position that the Dutch tax authorities must be permitted to calculate the price using this type of clause as well (i.e., an arrangement whereby the consideration for the transfer is commensurate with the benefits that the intangible asset will generate in the future). An example would be a situation in which a new intangible asset has been developed that is sold to an associated enterprise at a time when there are very few guarantees as to its future success, for instance, because it has yet to generate any revenue and any estimates of future revenue are surrounded by major uncertainties.

With respect to hard-to-value intangibles, it is stated in the Dutch Transfer Pricing Decree that deviations of 20 per cent or more of the projections used to determine the value at the time of the transfer will be a reason for the tax authorities to use ex post data to test the reliability of the ex ante projections, in line with Paragraphs 6.186 to 6.195 of the OECD Guidelines. However, as a safe harbour, if such deviation does not occur until five years after the transfer, the intangible will not be treated as a hard-to-value intangible.

Further, in the Dutch Transfer Pricing Decree it is confirmed that, under certain conditions, the TNMM is an appropriate method to determine the residual profit attributable to the owner of an intangible, provided that all other functions have been properly rewarded.

ii Other topics

The Dutch Transfer Pricing Decree also addresses the following areas:

a intra-group services;
b shareholder costs;
c centralised purchasing;
d intra-group guarantees;
e internal reinsurance; and
f group finance.
Guidance in these areas follows the principles of the OECD Guidelines and the BEPS reports, but may have a higher level of detail.

V SETTLEMENTS

The Dutch tax authorities may agree to a settlement in transfer pricing disputes. A settlement is formalised in an agreement between the tax authorities and the taxpayer on the legal qualification of facts and circumstances of a case. Within certain limitations, the settlement may also cover penalties.

Settlements may be in the form of an APA. The tax authorities and a taxpayer then settle on the transfer pricing method to be used going forward. As part of the APA they can agree that the APA may have retroactive effect for all years that are still open for final assessment. In order to apply retroactively obviously facts and circumstances need to be comparable.

Alternatively, the Dutch tax authorities may settle tax disputes in audit without entering into an APA. A tax inspector would in such instance probably also discuss the proposed settlement with the specialists of the transfer pricing team that also is responsible for the APAs.

Settlements and APAs are not made public.

The Dutch tax authorities are not obliged to enter into a settlement agreement or an APA. They will not enter into an agreement or APA as a matter of principle if the agreement or APA is not in line with the good faith to be observed between treaty partners.

VI INVESTIGATIONS

A corporate tax return must be filed within five months of the close of the taxable year. Upon request of the taxpayer, the statute of limitations for filing a return may be extended.

Once the tax return has been filed, the audit process may start. Transfer pricing is part of the normal audit process. The inspector can raise a final assessment within three years following the close of the year, and the date is extended with extensions of the filing date that were granted to the taxpayer. A regular transfer pricing audit will normally have to take place within this three-year period. During the audit process, the tax authorities have broad authority to ask the taxpayer for information. In essence, everything that could be of relevance to determine the tax liability is subject to discovery. The tax authorities are not, however, allowed to embark on a ‘fishing expedition’. If a taxpayer does not cooperate with information requests, an ‘information decision’ can be issued. An information decision essentially puts the burden of proof that an assessment issued by the tax authorities is incorrect entirely on the taxpayer.

If the transfer pricing audit involves a complex case, the tax authorities may ask the taxpayer to agree to an extension of the statute of limitations for issuing the final assessment. There is no obligation for the taxpayer to grant this request. If the taxpayer is not willing to grant this extension, the tax authorities can issue an assessment including the adjustments that are in discussion. The discussion between the tax authorities and the taxpayer may then continue during the administrative appeals phase, although time limitations also exist during that phase.

After a final assessment has been issued, the tax inspector may issue a deficiency assessment. A deficiency assessment can be issued within five years following the close of the year plus the period for which extension for filing the return has been granted, provided
new information (a ‘new fact’) has come to light of which the tax inspector was not aware (and could not reasonably have been aware) at the time that the original final assessment was issued. The five-year period may be extended to 12 years if the taxpayer paid insufficient tax in respect of an asset held or profit that arose abroad. The tax inspector does not need to prove that a ‘new fact’ has come to light in the event the taxpayer has not acted in good faith and knows, or should have known, that the original final assessment was too low or that, erroneously, no assessment was issued at all. If the amount of tax due on the assessment is at least 30 per cent lower than the amount due based on tax law, the taxpayer is deemed to be aware of the incorrectness.

In the case of a deficiency assessment, the additional amount of corporate income tax due will be increased with interest and possibly penalties. No penalty is due if the fact that the amount of the original assessment was too low cannot be held against the taxpayer. The amount of a penalty depends on the amount of corporate income tax due and the degree of guilt or negligence of the taxpayer.

Taxpayers can lodge an administrative appeal against a final assessment or a deficiency assessment within six weeks after the date of the assessment with the relevant tax inspector. During the administrative appeal phase the taxpayer may be requested to provide additional information. The taxpayer has to be invited for a hearing. The taxpayer may avail him or herself of witnesses and specialists in the hearing process. The tax inspector who deals with the administrative appeal should be a different person from the tax inspector who raised the original assessment. The tax authorities must decide on the administrative appeal within six weeks after the final due date of the appeal (i.e., 12 weeks after the date of the assessment). This date can be extended by six weeks upon request of the authorities. In practice, extensions are often implicitly or explicitly given because of ongoing discussions between taxpayers and the tax authorities to resolve the case without having to go to court.

A decision on an administrative appeal is necessary to start litigation in court. If the statutory term for rendering a decision is exceeded, the taxpayer can file a court appeal on the basis that no decision has been rendered in the administrative appeal phase.

VII LITIGATION

i Procedure

The Dutch court system has three levels of judicial review: the district courts, the courts of appeal and the Supreme Court.

Taxpayers can lodge an appeal with the district court within six weeks after the date a decision is rendered in the administrative appeal. The district court must decide on the appeal within 16 weeks after the final due date of the appeal. This 16-week period can be extended by the court by 12 weeks. Further extension is also possible under certain conditions.

Both the taxpayer and the tax authorities can, within six weeks, lodge an appeal against the judgment of the district court with the court of appeal. The court of appeal should render its decision within 16 weeks after the final due date of the appeal. This date can also be extended by 12 weeks with the option of a further extension.

Against the decision on appeal by the court of appeal both the taxpayer and tax authorities can lodge an appeal within six weeks with the Supreme Court. The Supreme Court limits itself to a decision on legal matters. The facts as determined by the court of appeal are not subject to review by the Supreme Court.
There is no mandatory representation by lawyers in tax cases, except for pleadings before the Supreme Court. Taxpayers, or their officers or employees, may therefore present their cases before the district court and the court of appeal themselves.

Very few transfer pricing cases have entered the Dutch court system and even fewer have reached the Supreme Court. Within the climate of cooperative compliance parties tend to try to solve their disputes with the Dutch tax authorities outside formal proceedings. This may also be caused by the fact that many of the conflicts involve facts and circumstances instead of strictly legal issues.

Judges operating within the tax system are not specialised or trained in transfer pricing.

Recent cases

**HR:2016:2340 (14-10-2016)**

A loan was granted between two associated enterprises. The loan was granted without any pledges or other securities. The borrower defaulted and the question arose whether the loan was at arm’s length. With reference to its decision in BNB 2012/37, the Supreme Court referred the case to the court of appeal to assess whether the fact that the borrower provided business to the lender was a special circumstance that made the loan at arm’s length.

**HR:2016:1352 (08-07-2016)**

‘C’, a Dutch resident company, had granted a loan to ‘E’, a non-related entity. ‘C’ booked a loan loss provision against its taxable income. The provision was accepted in the assessment. A few years later, ‘D’, a related entity to ‘C’, acquired the shares in ‘E’. Subsequently, it issued a guarantee for all obligations of ‘E’. As a consequence, ‘C’ released its provision. Because it involved a guarantee by a related company, it classified the profit as a capital injection instead of an income item. The Supreme Court decided that it is not required that the guarantee is specifically directed towards ‘C’ to create a transaction between related entities. The case was referred to the court of appeal to decide. The court of appeal, weighing the evidence brought forward by the parties, decided that the guarantee in part was given because of shareholder relationships, and thus was not taxable, and in part for commercial reasons.

**HR:2015:3599 (18-12-2015)**

Company ‘A’ granted a loan to company ‘B’. The loan was granted in relation to a project in which both parties intended to become shareholder. The project was terminated and ‘A’ booked a loss on its loan. The fact that there was an intention for a joint venture did not make the companies related entities.

**Starbucks**

On 23 December 2015, the Netherlands filed an action of annulment (Case T-760/15) with the General Court of the EU, requesting the annulment of the European Commission’s final decision of 21 October 2015 that the Netherlands had granted state aid to Starbucks. In its decision of October 2015, the European Commission stated that the transfer pricing methodology agreed upon in the APA between the Netherlands and Starbucks led to economically non-justifiable results, providing Starbucks with a selective advantage.
‘B’, a Dutch resident company engaged in the sale and production of zinc products, entered into an agreement with a Swiss affiliate pursuant to which production planning, procurement of materials, logistics and sales were concentrated in Switzerland. ‘B’ received a remuneration of €28,351,364 as compensation and after that was remunerated on a cost-plus basis. The tax authorities increased the compensation to €184,627,000. The court of first instance denied the claim of the tax authorities with respect to the compensation, because the activities in respect of which the tax authorities claimed that compensation should be paid for had been transferred in earlier years. The court also approved the cost-plus 10 per cent remuneration. The tax authorities have lodged an appeal against the case.

VIII SECONDARY ADJUSTMENT AND PENALTIES

i Secondary adjustments

The Dutch tax authorities always require a transfer pricing adjustment to be processed by means of a secondary transaction. A secondary transaction may lead to a secondary adjustment, such as the attribution of interest to the current account or the levying of dividend withholding tax on a deemed distribution of income. Systems differ from one country to another, and this means that the foreign tax authority in question may not be prepared, for example, to credit Dutch dividend withholding tax on a deemed dividend against its own tax because it does not recognise the deemed dividend. The secondary adjustment, therefore, does not take place if the taxpayer is able to demonstrate that, in light of the difference between the tax systems used by the two states, the dividend withholding tax paid cannot be credited and there is no situation of abuse aimed at the avoidance of dividend withholding tax.

ii Interest and penalties

Late payment of tax will lead to interest being due on the unpaid balance. If the tax authorities adjust the transfer prices the interest will be 8 per cent per annum on the amount of tax that is due. The interest will be due on all unpaid tax six months after the close of the year.

Penalties of 50 per cent of the additional tax due may be imposed if the tax authorities demonstrate that the taxpayer intentionally misrepresented its taxable income. A rate of 25 per cent applies in case of negligence. In the parliamentary discussion of Article 8b CIT it was stated that penalties would only apply in the case of intentional misrepresentation. There was one district court case where an insurance company was fined for using conditions that were not at arm’s length in dealing with a reinsurance company in a tax haven. The Dutch Transfer Pricing Decree explicitly states that penalties may be imposed in cases involving transfer pricing adjustments.

There are light administrative penalties for not having available CbCRs; it may be expected that courts will shift the burden of proof (and will thereby construct negligence) in the event taxpayers do not have transfer pricing documentation required by Article 8b CIT available upon audit.
ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

IX  BROADER TAXATION ISSUES

i  Double taxation

The Dutch tax authorities actively promote the use of mutual agreement procedures (MAPs) and other instruments to resolve cases of double taxation. All of the treaties for the avoidance of double taxation that the Netherlands has entered into contain a clause that is comparable to Article 25 of the OECD Model Tax Convention. The Netherlands has issued detailed regulations on the way taxpayers should apply for the MAP process.

In addition, for Member States of the European Union, the Convention on the Elimination of Double Taxation in Connection with the Adjustment of Profits of Associated Enterprises (the Arbitration Convention (90/436/EEC)) has applied since 1 January 1995.

Some of the Dutch treaties for the avoidance of double taxation contain an arbitration clause, most notably the treaty with the United Kingdom. Meetings with the main trading partners (among others, Belgium, France, Germany, the United Kingdom and the United States) to solve outstanding tax issues take place on a regular basis. The Netherlands also advocates exchange of information and joint transfer pricing audits as methods to resolve double taxation issues.

ii  Consequential impact (VAT)

No specific rules for the value added tax (VAT) treatment of transfer pricing adjustments are implemented in the Dutch VAT legislation. This means that general principles of VAT should be applied. VAT is a tax on individual transactions and requires an actual payment for services. Where the transfer price adjustment consists of an adjustment in the taxable amount in conjunction with secondary adjustments, there is no payment for services. Additionally, if the transfer price adjustment involves the application of a profit level indicator, it is highly unlikely that there is an individual transaction that can be identified. Adjustments on CUPs in conjunction with actual flows of cash between related entities as a consequence may be taxable. There is no case law in this area and therefore some uncertainty.

Customs value is based on transaction value. It is common practice in the Netherlands to share transfer pricing reports to demonstrate that the transaction value has not been influenced by a relationship with a related entity and therefore can be applied as the value for customs purposes.

X  OUTLOOK AND CONCLUSIONS

Transfer pricing in the Netherlands is generally treated as a cooperative effort between taxpayers and the tax authorities. Most conflicts will thereby be solved in the assessment and internal appeal phase. APAs are an integral part of the tax system and applied very regularly.

The position that the EU has taken that (some of the) rulings issued by the Dutch tax authorities constituted state aid will have a major impact on the ruling practice. The Dutch tax authorities will be more reluctant to issue rulings in the area of transfer pricing and will probably also require more documentation to prove the arm's-length nature of dealings between related entities.

Since 2016, larger companies are required to prepare additional transfer pricing documentation as part of the CbCR initiative of the OECD and EU. A big unknown is what the tax authorities will do with transfer pricing details in reports that will be received as a consequence of this reporting.
I OVERVIEW

Polish transfer pricing regulations refer to and link directly to the OECD principles. Moreover, they are changing to be in line with current OECD standards: Poland has already incorporated country-by-country reporting rules (CbCR), a three-step approach to transfer pricing documentation (master file, a local file and CbCR) and guidelines on low value-adding services. Despite this, OECD standards are not formally implemented as a part of Polish domestic law. However, they are a source of interpretation in practice, not only for taxpayers or tax authorities, but also administrative courts.

Polish transfer pricing regulations apply to income taxes, both corporate income tax (CIT) and personal income tax (PIT), covering corporations (legal persons or units without legal personality) and individuals. As Polish law does not recognise trusts, there are no specifics applying to them. Further, there are also transfer pricing regulations implemented on the grounds of value added tax (VAT).

i CIT/PIT

Polish transfer pricing regulations provided for in the CIT\(^2\) and PIT\(^3\) Acts cover a wide definition of related parties. Accordingly, a relationship between parties occurs when:

\(a\) a domestic entity (i.e., a natural person, legal person or organisational unit without legal personality), having its place of residence, registered office or management board in Poland, participates directly or indirectly in managing an enterprise located abroad or in controlling the enterprise, or holds a share in the capital of the enterprise;

\(b\) a foreign entity (i.e., a natural person, legal person, or organisational unit without legal personality), having its place of residence, registered office or management board outside Poland, participates directly or indirectly in managing a domestic entity or in controlling it, or holds a share in the capital of the domestic entity;

\(c\) a natural person, legal person or organisational unit without legal personality, participates at the same time, directly or indirectly, in managing a domestic entity and a foreign entity or in controlling them, or holds a share in their capital;

\(d\) a domestic entity directly or indirectly participates in the management or control of another domestic entity, or holds shares in the capital of another domestic entity;

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\(^1\) Slawomir Łuczak is a partner and Magdalena Polak is an associate at Soltyński Kawecki & Szeląg – Kancelaria Radców Prawnych i Adwokatów Sp.k.


\(^3\) Act dated 26 July 1991.
a natural person, legal person, or organisational unit without legal personality, participates at the same time, directly or indirectly, in managing domestic entities or in controlling them, or holds a share in their capital; or

there are familial relationships (marriage, relationship or affinity to the second degree⁴), employment or property relationships between domestic entities or managerial, controlling or supervisory personnel of those entities, and if any person jointly performs managerial, controlling or supervisory functions in these companies.

The definition of ‘related parties’ includes both a direct or indirect qualified relationship between parties, which may be:

a a capital relationship, which is a situation where a given entity holds, whether directly or indirectly, a share of at least 25 per cent in the capital of another entity;

b a relationship resulting from participation in the management or control of a given entity;

c a property relationship (only in the case of domestic entities);

⁴ A second-degree relative is defined as a blood relative, which includes the individual’s grandparents, grandchildren, aunts, uncles, nephews, nieces or half-siblings.

d a relationship involving family ties (only in the case of domestic entities); or

e an employment relationship (only in the case of domestic entities).

Polish legislators have implemented a very wide definition of ‘transfer price’ since 1 January 2017. According to recent amendments, the transfer price is not only the price used in all transactions, but also other events reported in accounting books between related parties. This also includes a company deed of a company without legal personality, a joint venture agreement or another similar agreement. The definition of transfer price covers also making – whether directly or indirectly – payments of receivables to an entity having its place of residence, registered office or management board within a territory or country that applies harmful tax competition, where such payments arise out of transactions or other events, including a company deed of a company without legal personality, a joint venture agreement or another similar agreement. However, Polish legislators have not imposed transfer pricing obligations on all transactions and other events between related parties. The main criterion when identifying a taxpayer’s responsibilities is ‘a significant influence’ on the amount of related parties’ income (loss). This ‘significant influence’ also differs depending on the scale of the taxpayer’s business (met thresholds), that is, the amount of revenue or costs (within the meaning of accounting regulations) established from the maintained accounting records of taxpayer in the year preceding the given tax year.

The criteria regarding thresholds and significant influence amounts are presented in the table below:

<table>
<thead>
<tr>
<th>Exceeded threshold</th>
<th>Relations with entities in tax havens</th>
<th>Significant influence of transactions and other events</th>
</tr>
</thead>
<tbody>
<tr>
<td>€2 million to €20 million</td>
<td>€20,000</td>
<td>€50,000  + €5,000 per €1 million of revenue above the amount of €2 million</td>
</tr>
<tr>
<td>€20 million to €100 million</td>
<td>€20,000</td>
<td>€140,000  + €45,000 per €10 million of revenue above the amount of €20 million</td>
</tr>
<tr>
<td>€100 million</td>
<td>€20,000</td>
<td>€500,000</td>
</tr>
</tbody>
</table>

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Tax authorities may also request a taxpayer to prepare and present transfer pricing documentation covering transactions or other events whose value does not exceed the limits defined as ‘significantly influencing’. Such request may be filed only when it is likely that the value of the transaction or other event has been understated to avoid the obligation to prepare transfer pricing documentation. Tax authorities must then indicate the circumstances that justify their suspicions and demands.

Since 2018, regulations have been introduced that limit costs deductibility from certain services with related parties. According to those regulations, costs from the following are limited to 5 per cent of tax EBITDA:

- advisory services, market research, advertising, management and control, data processing, insurance, guarantee and surety services, and similar;
- all kinds of fees and charges for use or the right to use rights or values; and
- transfer of the risk of debtor’s insolvency in terms of debt receivables due to loans other than loans granted by banks and credit unions, including under derivatives agreements and similar.

Excluded from the above are services covered with advance pricing agreements (APAs), as well as costs of intangible services directly related to production of goods or provision of services. Limitations will apply to services in excess of 3 million zlotys.

**ii VAT**

A slightly different definition of related parties is provided for in the VAT Act. The qualified relationship exists when, among contracting parties or persons performing management, supervisory or control functions, there are links based on:

- family (which means marriage, consanguinity or relations to the second degree) or adoption;
- capital (which means holding a voting right that constitutes at least 5 per cent of all voting rights or being entitled to exercise said right directly or indirectly);
- property;
- employment; or
- where any of the aforementioned persons join management, supervisory or control functions performed for contracting parties.

Following the above, transfer pricing for VAT purposes is defined as: ‘remuneration for the supply of goods or services between a related customer and person accomplishing the supply of goods or supplier’. In this case, in contrast to the CIT/PIT regulations, VAT does not recognise any thresholds and amounts of significant influence.

**II FILING REQUIREMENTS**

Since 2017, a tripartite approach to transfer pricing documentation has been introduced in Poland. This means that, depending on a taxpayer’s situation, a taxpayer may be obliged to prepare transfer pricing documentation that meets the requirements of a local file, a master file or a CbCR. Besides documentation requirements, other tax obligations to fulfil exist,
depending on the taxpayer’s classification according to certain thresholds. They are calculated on the level of: €2 million, €10 million, €20 million and €750 million (revenues or costs calculated as indicated in Section I).

The documentation requirements and other obligations are presented in the table below:

<table>
<thead>
<tr>
<th>Threshold</th>
<th>Transfer pricing documentation</th>
<th>Other obligations</th>
</tr>
</thead>
</table>
| €2 million | The taxpayer is obliged to prepare a local file, which should include:  
- a description of qualified transactions or other events including: their type and subject, financial data, identification data of related parties and an indication of the method and manner for the calculation of the taxpayer’s income (loss);  
- a description of the taxpayer’s financial data, making it possible to compare the settlements of a transaction with the data derived from the approved financial statements;  
- information about the taxpayer including a description of: the organisational and management structure; the subject and scope of the business pursued; the economic strategy applied, including the assignment of economically significant functions, assets, or risks having an impact on the taxable person’s income (loss) made during a given fiscal year or the year preceding the given fiscal year between related parties; and the competitive environment;  
- documents including: contracts and memoranda concluded between related parties, etc.; and the company deed of a company without legal personality, joint venture agreement, or another similar agreement, documenting the principles governing the partners’ rights (parties to the agreement) to participate in profits and losses; and  
- arrangements pertaining to income tax made with the tax administrations of countries other than Poland, pertaining to transactions or other events including pricing arrangements. | The taxpayer is obliged to prepare transfer pricing documentation no later than the last day for filing an annual tax return (financial data should be prepared within the period of 10 days from the day of approving the financial statements).  
Within the same term, the taxpayer is obliged to file its declaration on the preparation of transfer pricing documentation to the pertinent tax office.  
On the request of the tax authority, the taxpayer is obliged to prepare and present transfer pricing documentation covering a transaction or other event which is below the ‘significant influence’ threshold. In such case, the obligation should be fulfilled within the period of 30 days from the delivery of the request. |
| €10 million | The taxpayer is obliged to prepare a local file (as mentioned above) and benchmarking study. | Besides the above, the taxpayer is obliged to submit a simplified report on the transactions or other events with related parties (CIT-TP form) along with the tax return. |
| €20 million | The taxpayer is obliged to prepare a master file. The master file, besides the requirements of the local file and benchmarking study, should also include information on the group of related parties that the taxpayer is a part of, that is:  
- an indication of the related party that prepared the information on the group, along with an indication of the date on which party files its tax return;  
- the organisational structure of the group;  
- a description of the transaction price policy the group applies;  
- a description of the subject and scope of business activities the group pursues;  
- a description of the significant intangible assets held, created, developed and used in the course of the group’s business;  
- a description of the financial condition of the entities comprising the group, along with their consolidated statements; and  
- a description of the arrangements pertaining to income tax made by the entities comprising the group with tax administrations of countries other than Poland, including unilateral prior pricing arrangements. | As above. |
| €750 million | Besides the obligation to prepare the master file, a taxpayer has to file the CbCR with its tax office. The CbCR includes information on: the amount of income generated and tax paid; locations in which the capital group pursued their activities; and the location of the activities of their subsidiaries and foreign establishments that form part of the capital group during a given fiscal year. | Besides the above, the taxpayer is obliged to file the CbCR with the tax office within the period of 12 months following the end of the taxpayer’s fiscal year. |
The transfer pricing documentation pertaining to transactions or other events carried over into the next fiscal year has to be periodically reviewed and updated at least once in every fiscal year, before the end of the period for the submission of the annual tax return. Further, taxpayers are obliged to provide benchmarking studies of transactions or other events, and should also update such studies at least once every three years, unless there is a change of economic conditions to the extent that has a significant impact on the analysis of comparative data which justifies conducting a review during the year in which such a change takes place.

III PRESENTING THE CASE

i Pricing methods

The conditions under which transactions or other events are performed between related parties should comply with the conditions agreed upon between independent entities, or conditions established by the party with an independent entity in comparable circumstances. Therefore, transfer pricing regulations\(^6\) indicate that all terms of transactions or other events between related parties should be presented in a comparability analysis (a benchmark or benchmarking study). It is an essential tool for both tax authorities (examining the terms of a transaction between related parties) and taxpayers (defending the method of transfer pricing applied). It also helps to evaluate whether the arm's-length principle is satisfied or not, as without it market prices would be hard to determine. It must be stated that transfer pricing regulations concerning the comparability analysis and its requirements bind only tax authorities, whose actions have to be evidenced and explicitly permitted by an act of law. Consequently, the comparability analysis presented by taxpayers may have a less restrictive form, as its main goal is to prove the given price is set at the market level. If the comparability analysis is effective in this matter, it cannot be questioned.

The analysis should take into account:

a the characteristics of goods, services or other benefits;

b the course of the transaction (parties' functions, engaged assets, human capital and incurred risks);

c the terms of the transaction;

d the economic conditions present at the time and place the transaction is executed; and

e an economic strategy – taking all the features of the analysis into consideration, its aim is to identify not only the conditions of the transaction that would be set by independent entities, but also the most appropriate pricing method.

\(^{6}\) The comparability analysis requirements were regulated specifically in the Regulation of the Minister of Finance of 10 September 2009 on the manner and procedure of determining legal persons' incomes by estimation and the method and procedure for eliminating the double taxation of legal persons re: adjustment of the profits of related parties, and the Regulation of the Minister of Finance of 10 September 2009 on the manner and procedure of determining natural persons' incomes by estimation and the method and procedure for eliminating the double taxation of natural persons re: adjustment of the profits of related parties.
Regarding pricing methods, transfer pricing regulations define five pricing methods that may be used by tax authorities to verify whether the conditions of the transaction between related parties are consistent with market conditions, which are:

- **a** the comparable uncontrolled price method – most often used in reference to typical products that can be publicly traded (i.e., by online exchange of agricultural products and goods);\(^7\)
- **b** the resale price method – most often used in the case of distributors, who are inclined to further market goods without improvements;\(^8\)
- **c** the reasonable margin method (cost plus) – most often used in the case of manufacturers or service providers selling goods or services in a standardised and routine manner;\(^9\)
- **d** the distribution of profits method – most often used in the case of distribution business transactions;\(^10\) or
- **e** the transactional net-margin method.

The comparable uncontrolled price method, the resale price method and the cost-plus method are indicated as basic models and are used initially. There is no hierarchy among them and they are treated as being equivalent to each other.\(^11\) Under previous transfer pricing regulations in force before 2013, the comparable uncontrolled price method had priority over others. However, this rule was repealed and the legislature underlined the freedom to select the transfer pricing method. When choosing the transfer pricing method, you should take into account which of the basic models appears to be the most effective. If none of them can be used, profit split methods may be applied.

### ii Authority scrutiny and evidence gathering

In January 2016, representatives of the Polish government signed the Multilateral Competent Authority Agreement concerning the automatic exchange of information contained in CbCR forms. In parallel, the specific provisions on CbCR were also applied from 1 January 2016, imposing a tax obligation to submit information about the group within a period of 12 months following the end of the taxpayer’s fiscal year. The requirements of content and structure of the CbCR were introduced in the Regulation of Minister of Development and Finance,\(^12\) which is consistent with the forms recommended by the OECD in BEPS Action 13 – 2015 Final Report. Moreover, the Act of 9 March 2017 on Tax Information Exchange with Other Countries introduced the exchange of tax information concerning, for example, the automatic exchange of information on advance pricing arrangements (APAs), tax rulings

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12 See; the Regulation of the Minister of Development and Finance on the detailed scope of data transferred information about a group of entities that will be passed in the CbCR dated 13 June 2017, in Polish: 'Rozporządzenie Ministra Rozwoju i Finansów w sprawie szczegółowego zakresu danych przekazywanych w informacji o grupie podmiotów oraz sposobu jej wypełniania'.

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and CbCRs. Thanks to those regulations, Polish tax authorities have gained new tools to gather information and evidence about taxpayers and their related entities. Consequently, one may predict that the international and global tax position standard and the profit share per jurisdiction assessment will be standard in the future.

IV  INTANGIBLE ASSETS

Polish transfer pricing regulations do not define intangible assets. However, the concept of intangible assets is raised on the occasion of the depreciation regulations under the CIT and PIT Acts and is defined as copyright or related property rights, licences and rights referred to in the Industrial Property Law and ‘know-how’. The definition of intangible assets should nevertheless be defined more widely for transfer pricing purposes because it covers not only transactions but also other events between related parties. When it comes to general approaches to dealing with intangible assets, transfer pricing regulations do not provide any specific regulations in this matter, and in particular do not impose an obligation on a taxpayer to show where the substance developing, supporting or exploiting the intangible asset is based to justify a higher than passive return. When it comes to pricing and cost distribution methods, the general rules described in Section III are applied. The only distinction for intangible assets provided in transfer pricing regulations concerns the examination and questioning of used prices and cost distribution between related parties from the tax authorities’ perspective.

With regard to the above, tax authorities examine intangible assets transactions or other events as to whether independent entities acting reasonably would have concluded the transaction or other event on the terms and conditions as agreed between the related parties. In cases where the reasonably expected benefits to the party are obviously lower than the expenses incurred in connection with this transaction or event, the party should indicate the rational reasons for this. When the party does not present a rationale, the tax authorities examine the correctness of the amount of incurred expenses, including also the costs conditioning the use of a given intangible asset.

In the case of a taxpayer’s participation in the costs jointly incurred by related parties to create an intangible asset, the amounts paid by the taxpayer can be regarded as compatible with the arm’s-length principle only when such terms and conditions could have been agreed between independent parties. In particular, conditions of the transaction or other event should be proportional to the expected benefits and burdens of the parties. Also, the benefits that were not expected (included) when determining those conditions should be proportionally distributed. Moreover, transfer pricing regulations order a party to accept lower cost values in the situation where the taxpayer had the opportunity to obtain comparable benefits under the agreement with a related party or from an independent entity, when in one of these cases lower costs would be incurred.

V  SETTLEMENTS

APAs were introduced into the Polish tax system from 1 January 2006 and are regulated in the Tax Ordinance Act. Polish APAs were not applied to be fully in line with OECD guidelines. In contrast to OECD solutions, Polish APAs cannot be treated as an agreement concluded between a taxpayer and tax authority. Procedurally, a solution implemented into the Polish tax system is a decision issued by the competent authority overseeing tax administration – the head of the National Fiscal Administration (NFA) – and for this reason, it constitutes a
unilateral and domineering act of an administrative case settlement. The APA decision may then declare: the comparability of material conditions determined between related parties with the conditions that would have been determined by independent entities, and the correctness of the used pricing method choice; or the comparability of material conditions determined in a cost distribution agreement concluded between related parties with the conditions that would have been determined by independent entities. For a taxpayer, APAs are a tool to reduce the risk of the tax authorities challenging pricing or cost distribution than a tool to jointly develop terms of pricing or cost split between related parties.

The procedure to issue an APA decision starts with a domestic entity’s request, indicating: the proposal of pricing or cost distribution methodology; reasoning for this method; and necessary materials and documents including a complex economic and financial analysis of the transaction and proposal regarding the decision’s validity period. The scope of the request cannot concern transactions completed before the date of the submission of the request or transactions started before such date that are already subject to tax audits before the tax authorities or administrative courts. Therefore, the APA decision mainly covers future transactions.

The Polish Tax Ordinance Act distinguishes three categories of APA decisions: one-sided, bilateral and multilateral. One-sided APA proceedings are carried out by the Polish tax authorities. The bilateral APA decision is in turn concluded between domestic and foreign entities and requires the approval from a tax authority of the given foreign country. If an arrangement concerns entities from more than one foreign country, the approval of each foreign tax authority is necessary to be able to conclude such multilateral APA decision. It must be emphasised that only APAs concerning pricing may be bilateral or multilateral, as the Tax Ordinance Act does not provide such possibility when it comes to cost split agreements.

The proceedings to issue the APA decision do not differ much from a typical tax audit: the applicant has to fulfil formal requirements, is entitled to submit additional clarifications and documents and even change the proposed pricing method (by the time the decision is issued) or withdraw the request. According to the Tax Ordinance Act, the APA proceedings should be completed without undue delay. The maximum limitation periods for case settlement are six months for a one-sided decision, a year for a bilateral decision, and 18 months for multilaterals. Yet, these terms are considered as procedural time limits and their expiry does not deprive the tax authority of the ability to issue a decision.

The Tax Ordinance Act imposes obligations on tax authorities to notify the applicant when the proposed pricing method is contrary to the conditions that would be agreed upon by independent entities. Such notification contains a factual and legal substantiation and gives the applicant the possibility to amend its proposal, submit additional clarifications or even withdraw the APA request within 30 days from being filed. Similarly, in the case of bilateral and multilateral APA decisions, when the tax authority competent for a foreign entity does not consent to the conclusion of an arrangement or if it may be reasonably expected that such consent will not be granted within six months from the day it is applied for, the tax authority has to notify the applicant about such fact. Consequently, within 30 days from the delivery of the notice, the applicant may: withdraw the application for the APA decision; change its application from bilateral to unilateral; or change its application from being multilateral to being bilateral.

The APA decision may be issued for no longer than five years, which may be renewed for subsequent periods, albeit no longer than five years, upon the request of a domestic entity filed no later than six months before the lapse of the previous period of validity. The renewal,
which is also proceeded in a form of the decision, is possible if the elements of the decision did not change in any significant manner. Such renewed APA decision enters into force as of the day following the day on which the validity period of the previous decision has elapsed.

The APA decision may be amended or declared as expired before the end of its validity period only in the case of a change of economic relations that results in the agreed terms of transaction being grossly inadequate. The procedure for this matter may be initiated by the party itself or ex officio. It must be stated that the term ‘change of economic relations’ was not explained in more detail. However, one may assume that the term should be interpreted as a situation significantly different and extraordinary from that in which the APA decision was issued (e.g., hyperinflation or a significant change in exchange rates).13 Amendments or the declaration of the expiry of the APA decision are in the form of a decision that enters in force from the day of its delivery to the party.

The APA decision may be also declared as expired ex officio by the NFA when the related parties do not apply the transaction price or cost distribution determination method or the conditions defined in the decision. Such declaration of the APA’s expiry is also in the form of a decision, which enters into force from the day it is delivered.

Regardless of the fact of having an APA decision, related entities are not exempt from the obligation to prepare transfer pricing documentation for the transaction. However, the formal requirements are limited. The transfer pricing documentation for a transaction confirmed with an APA decision must therefore consist of its financial data, description and the indication and explanation of pricing or cost distribution method used.

There is a lot of criticism regarding APAs functioning in Poland. First, they are considered as an inadequate yet expensive tool, taking into account statutory fees (up to 200,000 zlotys), but also all additional costs such as benchmarks, legal and advisory support costs. Second, the administrative procedure is also far from the flexible atmosphere of negotiations that entities commonly expect. Moreover, the length of the process, which in some cases may last as long as a year, does not meet the reality of a fast-changing business and economic world. Finally, the scant popularity of APAs (see the tables below)14 results also from the fact that Polish taxpayers are not willing to disclose all aspects of a planned transaction to tax authorities when they do not have to.

On 12 April 2018,15 the Ministry of Finance announced that it is working on regulations regarding simplified APA. The administrative procedure to gain simplified APA will be shorter (up to three months), simpler and cheaper. A ‘small’ APA is intended to cover low value-added services and simple trademark and know-how licences only. It will be valid for periods of less than three years.

Owing to the new APA regulations and the move towards limiting deductibility of costs from certain services with related parties (which limits do not bind transactions confirmed in APAs), taxpayers’ approach to APAs and their popularity may change.

15 See: www.blog.ey.pl/tpblog/uproszczona-apa-coraz-blizej.
VI INVESTIGATIONS

Tax authorities are entitled to investigate taxpayers to assess whether transactions or other events between related parties were performed in accordance with transfer pricing regulations. Therefore, the subject of the transfer pricing investigation usually concerns:

a) CIT or PIT grounds – whether the related parties have set the transaction’s conditions differently than independent entities would agree on; or

b) VAT grounds – whether the remuneration for goods or services set by related parties (a customer and a person supplying the goods or the supplier itself) was at the market-value level.

The transfer pricing investigation may then state that the pricing of the transaction or other event between related parties was in line with conditions that would be set by independent parties, or it may indicate some irregularities arising from the relationship between the parties. In the second case, the tax authorities have the right to determine the taxpayer’s taxable amount and tax due (see Section VIII).

The investigation may be initiated if the taxpayer’s tax liability expires. As a rule, the limitation period is five years beginning at the end of the calendar year in which the time limit to pay tax ended. That means that, owing to the effluxion of time, the tax liability expires by law and the tax authority cannot effectively demand payment of the due tax, as in fact it no longer exists. Nevertheless, the Polish tax system provides a catalogue of numerous circumstances that may suspend or interrupt the limitation period. The most common reasons to suspend the limitation period are: the application of an enforcement measure of which a taxpayer was notified; the commencement of proceedings in a case involving a fiscal crime or fiscal offence of which the taxpayer has been notified; or if a complaint against a decision concerning that liability is filed with an administrative court. Moreover, the limitation period is also interrupted with the taxpayer’s declaration of bankruptcy.
There are three types of tax investigation that may consider transactions or other events between related parties: a tax audit; tax proceedings; and a customs and fiscal audit. The choice of tax investigation depends mostly on whether a taxpayer to investigate has been chosen and what kind of tax authority is going to perform such investigation.

i  Tax audit

A tax audit starts with a notification being sent to the taxpayer that a tax audit is to be conducted. The tax audit is initiated no earlier than seven days and no later than 30 days from the delivery of such notice. In certain circumstances, a tax audit may be conducted without giving prior notification (e.g., a fiscal or commerce offence is committed).

The tax audit must be conducted within the period indicated in the authorisation (i.e., the document authorising the tax authority to initiate a tax audit), and during a single calendar year cannot exceed 28 business days. The limitation periods are established in the Business Freedom Act and depend on the taxpayer’s qualifications as a micro, small, medium-sized or large entrepreneur.

The tax audit ends with the delivery of the tax authority’s protocol. Such protocol consists of a description of the facts of the case and a legal assessment, but it does not constitute the taxpayer’s liability. If the tax audit indicates some irregularities, after the delivery of the protocol, the taxpayer may: agree with the tax authority and correct its tax settlements and tax return; or make reservations and clarifications to the protocol within 14 days after its delivery. The tax authority is then obliged to review them within the next 14 days. A tax audit that has ended with a dispute between the tax authority and the taxpayer usually continues in the form of tax proceedings.

ii  Tax proceedings

The main aim of tax proceedings is to settle the case by issuing a pertinent decision. To issue the pertinent decision, the tax authority will establish the case facts, collect evidence and make the most appropriate tax assessment. In most cases, tax proceedings are initiated by the tax authority when the tax audit reveals taxpayer irregularities. Although it is unusual, tax proceedings may be initiated upon a taxpayer’s application as well.

Tax proceedings should be settled without undue delay. When requiring evidentiary hearings, limits are longer and are set as a month, or in particularly complicated cases, two months from the day proceedings began. In practice, these limits are not kept and tax authorities extend them due to case complexity.

Tax proceedings are a two-instance procedure. The first ends with a decision which may be subject to the taxpayer’s appeal. The taxpayer’s appeal must be submitted within 14 days counting from the date of the delivery of the decision. In such case, the upper instance examines the whole case anew and settles the case with a further decision.

Appellate proceedings should be settled at the latest within two months from the submission to appeal, and in cases where a trial was conducted at the latest within three months. The above-mentioned time limits are often extended by tax authorities.

The decision of the upper instance is final and enforceable. However, such decision still may be challenged by lodging a complaint to the voivodeship administrative court (see Section VII).
iii Customs and fiscal audit

The customs and fiscal audit was introduced into the Polish tax system from 1 March 2017 and it replaced the fiscal audit procedure. Tax authorities that may initiate such investigation are customs and fiscal offices. The audit is initiated only ex officio on the basis of authorisation to carry it out. To resolve the matter that led to the authorisation being issued, the taxpayer may correct its tax returns within 14 days of receiving the authorisation. After that date, corrections made before the end of the customs and fiscal audit have no legal effect.

Customs and fiscal audit cases should be settled without undue delay, but not later than within three months of being started. Similarly to other investigation procedures, tax authorities may also in this case extend the period of the investigation.

The customs and fiscal audit ends with the delivery of the audit’s findings. Similarly to the tax audit, the taxpayer has the right to correct its tax settlements and tax returns within 14 days of the audit’s delivery. If irregularities were indicated during the audit and the taxpayer did not correct its tax settlements and tax returns, the audit investigation transforms into tax proceedings. Such tax proceedings are continued by customs and fiscal offices in line with the scheme described in Section VI.ii.

VII LITIGATION

i Procedure

Transfer pricing cases may be the subject of a dispute before administrative courts only when the taxpayer lodges a complaint against the tax authority’s decision. The complaint must fulfil formal requirements (e.g., be submitted within 30 days of the delivery of the decision via the tax authority that issued the decision). When a complaint is lodged, the administrative authority is under an obligation to turn it over to the court with the relevant files and to prepare a response within a period of 30 days from the date it is submitted. It must be emphasised that the complaint is not particularly formalised since it only has to meet the requirements of a letter in a court proceeding.

In examining the tax authority’s decision, the court’s main task is to check whether the decision was taken in accordance with the law, both in terms of substantive and procedural provisions. Although the court rules within the limits of the case, it is not bound by the claims or statements made in the complaint or the legal grounds raised by the party (i.e., a taxpayer or a tax authority). Consequently, the court independently assesses the correctness of the decision. What is important is that the procedure before the administrative courts does not provide extensive evidentiary proceedings. Although the regulations of the Law on proceedings before administrative courts16 allow evidence to be taken from documents, in practice courts reject parties’ applications to submit evidence.

The administrative courts may dismiss the complaint, overturn a decision fully or partially, or be confirmed fully or partially invalid.

The administrative court’s decision may be appealed to the Supreme Administrative Court, whose judgment is final. A cassation appeal is lodged via the court that issued the judgment, within 30 days from the date of judgment and its delivery of its justification. The cassation appeal may only be based on strictly defined grounds, namely the violation of substantial law – due to an erroneous interpretation or incorrect application of law, or

16 Act of 30 August 2002.
the breach of procedural regulations if said infringement could have seriously affected the outcome of a particular case. It is also more formalised than a complaint to the administrative court (e.g., the cassation appeal has to be prepared and submitted by professional proxy (advocate, attorney at law or tax adviser)).

As a rule, a case before the administrative court should be completed as soon as possible. However, the reality is slightly different as the waiting time for the first hearing can take up to 18 months. A taxpayer lodging a complaint at the voivodeship administrative court in Warsaw or Krakow will likely wait for approximately one year before the case is considered. A backlog of cases in the Supreme Administrative Court (as it is the only upper administrative court in Poland) causes long delays in obtaining a hearing date, up to 18 months.

ii Recent cases

As of 1 January 2017, transfer pricing regulations have significantly changed and consequently they will be applied to transactions or other events that occur or have occurred during the 2017 tax year. For this reason, new regulations haven’t been subject to juridical interpretation. Nevertheless, recent judgments may continue to be relevant.

The transfer pricing documentation obligation

Judgment of the Supreme Administrative Court, Ref. No. II FSK 4000/13, 8 March 2016

This case regarded the obligation to prepare transfer pricing documentation for transactions between related treasury companies. The transactions concerned shares and stocks contributions to the related company. The Supreme Administrative Court stated that the transfer pricing regulations and resulting taxpayer’s obligations also apply to transactions involving the transfer of goods, money and other things of value. Whether an economic operation triggers any income tax to be paid does not matter. Therefore, transfer pricing documentation is also required in the case of tax-neutral transactions.

Judgment of the Supreme Administrative Court, Ref. No. II FSK 2121/10, 27 April 2012

This case regarded the consequences of not fulfilling the taxpayer’s obligation to prepare transfer pricing documentation. The Supreme Administrative Court ruled that such infringement does not automatically exclude the taxpayer’s right to deduct expenses from an undocumented transaction. According to the judgment, only when the transaction price is contrary to its market value is it possible to use the exclusion from tax-deductible costs.

Transfer pricing estimation

Judgment of the Voivodeship Administrative Court in Białystok, Ref. No. I SA/Bk 978/16, 1 February 2017

The Court agreed with the tax authority on the correct application of the income estimation procedure due to the non-arm’s-length pricing of transaction. Against a taxpayer’s pricing weighed the following facts: sales of finished products were performed below the costs of their production (as a result of the increase in raw material prices), not even distribution of risks between the parties and payments in a 96-day payment period.

17 Slawomir Łuczak, Karolina Gotfryd, The Tax Disputes and Litigation Review, Fifth Edition (Law Business Research), Poland, Section III.
18 Ibidem.
Judgment of the Voivodeship Administrative Court in Warsaw, Ref. No. III SA/Wa 2017/14, 23 April 2015

This case concerned a taxpayer that provided subcontracting services on behalf of a related foreign company. The taxpayer also incurred licence fees under an agreement with that related foreign company in connection with subcontracted services. The licence fees were listed among deductible expenses. The tax authorities questioned the possibility to deduct those expenses and the court agreed with the tax authorities’ understanding. According to the judgment, the taxpayer did not bear any risks associated with the implementation of orders for its services. The licence fees also do not affect the number of received orders for a taxpayer’s services. In conclusion, the court stated that a taxpayer’s licence fees could not have been classified as tax-deductible expenses as there is no relation between the taxpayer’s income and expense. In addition, the court noted that the agreement introducing licence fees between the taxpayer and the related foreign company was concluded four years after the concerned period; therefore evidencing that the described activities were meant to be an income transfer from the taxpayer to a related entity. This judgment was an example of in-depth analysis of a transaction from the perspective of economic rationality and business, and this line of reasoning will probably be continued in future cases.

Judgment of the Supreme Administrative Court, Ref. No. II FSK 2364/11, 20 July 2013

This case regarded the possibility to estimate the taxpayer’s income resulting from transactions between related parties. According to the judgment, the mere existence of a capital relationship between the parties is not sufficient to estimate the amount of tax due from the taxpayer. It is important to examine whether, as a result of links between parties, there were established or imposed conditions that differed from those that would be made between independent entities. Moreover, tax authorities may estimate the income derived from a transaction with a related party only when the taxpayer does not claim income at all, or claims a lower than expected amount without such relationship between parties. Then, the taxpayer’s due income tax should be determined as if it were between independent parties.

Judgment of the Voivodeship Administrative Court in Wroclaw, Ref. No. I SA/Wr 1107/11, 24 November 2011

This case regarded the tax authorities’ contestation of a property’s selling price on which the construction of a shopping mall started. Tax authorities had estimated the market value of the transaction based on data from only one comparable transaction. The court stated that a single observation is not sufficient since it is hard to accept in advance that one transaction between independent entities reflects a typical example of such transactions and can form the basis to determine the market value of the sold property.

VIII SECONDARY ADJUSTMENT AND PENALTIES

i Tax penalties

Income corrections

When performing an investigation (see Section VI), tax authorities are entitled to examine whether related parties have set a transaction’s conditions differently from those that independent entities would agree upon. In particular, they identify comparable transactions or events and choose the best method to determine their market value. If tax authorities state
that the terms and conditions of transaction or other event between related parties differ from those between independent entities, they determine the taxpayer's income and the income tax due. Income tax at a rate of 19 per cent is charged on the difference between the income declared by the taxpayer and specified by the tax authorities.

50 per cent income tax rate

Tax authorities have the right to require the taxpayer to provide them with transfer pricing documentation. In this case, the taxpayer should present the transfer pricing documentation within seven days of delivery of the request. Where the taxpayer does not submit the transfer pricing documentation on time, the tax authorities can levy a sanction tax rate of 50 per cent. The conditions to impose such penalty are: the taxpayer failing to provide transfer pricing documentation, and tax authorities determining the taxpayer's income amount from the transfer pricing transaction or other event as higher (or taxpayer's loss amount lower) than the amount the taxpayer declared by itself.

It should be noted that the failure to file transfer pricing documentation does not automatically mean the application of the 50 per cent tax rate is possible. The sanction tax rate may be applied only when the transaction or other event between related parties was set contrary to its market value.

The sanction rate is applied in the form of a decision, which has a constitutive character. Therefore, as legal doctrine 19 indicates, it cannot be imposed on the taxpayer if the decision fixing the amount of the tax liability was delivered to the taxpayer after three years from the end of the calendar year in which the tax liability arose.

VAT obligations correction

The tax authorities are also entitled to question transactions between related parties if that relationship had an impact on the value of goods or services and remuneration for the transaction. In consequence, tax authorities have the right to determine the VAT taxable amount and VAT due taking into account the remuneration of goods or services that are not in line with their market value, for example, in situations:

a when the remuneration was lower than the market value and a customer of the goods or services did not enjoy a full right to reduce the input VAT;

b when remuneration was lower than the market value and a person supplying goods or services did not enjoy a full right to reduce the input tax amount, and a supply of goods or services was exempt from VAT; or

c when remuneration was higher than the market value and a person supplying goods or services did not enjoy a full right to reduce input VAT.

Having mentioned the above, the tax authorities have the right to increase or decrease the tax base for VAT purposes to the transaction’s market-value level.

Interest on tax arrears

As a consequence of redetermining the due VAT or CIT or PIT, the taxpayer has tax arrears. Further, the taxpayer also has to pay penalty interest. The interest rate for tax arrears incurred

19 Kosieradzki Tomasz, Piekarz Radosław, Ceny transferowe, Mechanizmy ustalania i zarządzanie ryzykiem, 'Rozdział 18. Sanкции w zakresie cen transferowych'.

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from 1 January 2017 is 8 per cent. It must also be underlined that the interest rate may be applied at a higher 12 per cent rate when VAT arrears have their source via understating a tax liability, or overstating a tax overpayment or a refund amount that was subsequently discovered by the tax authority during a tax investigation.

**Fiscal penal liability**

If a taxpayer fails to comply with tax obligations, it may result in fiscal penal liability. According to the Fiscal Penal Code, only individuals may bear fiscal penal liability even if a tax obligation is imposed on a legal entity. Therefore, the liability for fiscal offences rests with an individual who, under the provisions of law, a decision of the relevant authority, an agreement or actual execution, conducts the economic and, in particular, financial affairs of the legal person. Furthermore, a fiscal offence is committed only by an individual to whom guilt may be attributed in the course of an act; however, this does include the awareness of the misconduct along with acceptance thereof. From this perspective, the risk of fiscal penal liability rests in particular with the management board’s members and finance or tax director. Non-compliance with transfer pricing regulations may cover several criminal acts, for example, failure to disclose the object of taxation or tax base, tax fraud, obstruction of a tax audit or a customs and fiscal audit, and accounting procedure infringements.

Committing a fiscal criminal act may result in the imposition of a pecuniary fine or even imprisonment. In practice, imprisonment is rather theoretical and it refers to very serious economic crimes; however, criminal courts very often hand out pecuniary fines. The pecuniary fine may be up to 720 daily rates. In 2017, one rate may vary between 66.67 and 26,666.66 zlotys. Therefore, the potential maximum fine may be over 19 million zlotys (again, in practice, the criminal courts adjudicate much lower fines).

**IX BROADER TAXATION ISSUES**

i **Double taxation**

All double taxation treaties (DTTs) concluded by Poland provide the possibility to evoke the mutual agreements procedure (MAP). The MAP was implemented into Polish domestic law in the Minister of Finance’s Regulations.21

According to those rules, a person may present its case to the Minister of Finance to start the MAP under the Convention of 23 July 1990 on the elimination of double taxation in connection with the adjustment of profits of associated enterprises or on the basis of a DTT with Poland. The MAP procedure may be used when formal requirements are met and within the limit of a three-year term. This term is counted from the date of the delivery to the taxpayer or its related party of the tax audit protocol or tax decision that leads or may lead to double taxation. Polish regulations provide that the MAP is required to be finalised within two years. Moreover, there is also the possibility of a trilateral MAP. The MAP cannot be used as a premise to suspend an ongoing tax proceeding. However, when the MAP has been successfully finalised, it may constitute a premise to revision.

20 Act dated 10 September 1999.
21 Ibidem, 5.
II Consequential impact for other taxes

**VAT**

See Sections I.ii and VIII.i, ‘VAT obligations correction’.

**Import and customs duties**

The customs aspect of transfer pricing remains unnoticed – at least in Poland – both by doctrine and the customs and tax authorities. However, there are binding customs system regulations covering transfer pricing (e.g., the Union Customs Code, which defines the obligations and duties in this matter).

X OUTLOOK AND CONCLUSIONS

Since 2015, the main policy of the current Minister of Finance is to ‘seal the tax system’. New tools and tax obligations have been introduced to fulfil this goal. One such tool is the extension of transfer pricing obligations and their effective enforcement by tax authorities. The number of tax investigations in this matter has increased in recent years; for example, in 2016, a total of 376 investigations were performed.\(^22\) The investigations are not only performed more frequently but also are more likely to end with tax liabilities being imposed. We believe that this trend will continue over the following years, reaching the levels seen internationally.

\(^22\) [www.podatkiw biznesie.pl/tp-kontrole-us-cen-transferowych-w-2016-r.](www.podatkiw biznesie.pl/tp-kontrole-us-cen-transferowych-w-2016-r.)
I OVERVIEW

The Portuguese transfer pricing rules have been in force since 2002, through the publication of Decree 1446-C/2001 (Portaria). This decree, combined with Article 63 of the Corporate Income Tax Code, establishes the transfer pricing principles and rules for Portugal. Complementarily, Article 138 of the Corporate Income Tax Code, as well as Decree 620-A/2008 of 16 July 2008, determine the framework of application of advanced pricing agreements (APAs).

These rules are based on the OECD Transfer Pricing Guidelines, and Portaria states that ‘for its application, in cases of greater technical complexity, it is advisable to consult the OECD Transfer Pricing Guidelines’.

Portaria also states that these rules apply to all operations conducted between a corporate or individual taxpayer and any other entity with which the taxpayer has a special relationship, which seems to indicate that the rules apply to individuals, corporations and any other types of entities with whom the taxpayer has a special relationship. However, although those rules have specific corresponding provisions in the Corporate Income Tax Code, there is no reference at all to transfer pricing in the laws that govern taxation of individuals. This situation has triggered some as yet unresolved litigation between the Portuguese tax authorities and certain individuals regarding the use of transfer pricing rules to adjust individuals’ taxable income. Although we should wait for final judicial decisions regarding this issue, it is more likely than not that the Portuguese transfer pricing rules do cover transactions that involve individuals, but do not allow any adjustment on the taxable income of individuals, but only in the taxable income of corporations and other entities subject to corporate income tax.

Portuguese transfer pricing rules do not apply to equity operations, namely dividends, equity increases and decreases, etc.

Under the provisions of the Corporate Income Tax Code, two entities are considered to be related if one of them has the power to exercise significant influence (directly or indirectly) in the management decisions of the other, which is considered to be true in the following scenarios:

1. one entity or individual holds (directly or indirectly) at least 20 per cent of the share capital or voting rights of another entity;
2. both entities are at least 20 per cent owned (directly or indirectly) by the same legal entity or individual;

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1 Patrícia Matos is a partner and chartered accountant and Filipe de Moura is an associate partner at Deloitte & Associados, SROC, SA.
an entity and the members of its corporate bodies, or any administration, direction, management, or supervising boards;

d entities in which the majority of their corporate bodies are constituted by the same individuals;

e entities connected by a subordination agreement or any other agreement of a similar nature;

f holding companies as stated in the Portuguese Commercial Companies Code;

g entities whose legal relationship allows one of them to exercise influence in the other’s management decisions; and

h a resident entity – or a foreign company’s permanent establishment (PE) – and entities resident in jurisdictions listed as tax havens.

In addition, foreign entities and Portuguese PEs; Portuguese entities and correspondent foreign PEs; and Portuguese PEs and foreign PEs are also deemed to be related parties.

Portaria clarifies that the scope of ‘operations’ subject to the transfer pricing rules includes financial operations and any commercial transaction, including those involving fixed or intangible assets, or goods, rights or services, even if those were conducted within cost sharing or contribution agreements, service agreements or other types of agreements, or if those result from any alteration of business structures, especially whenever that alteration involves the transfer of intangible elements or a compensation for losses or for lost profits.

The Portuguese transfer pricing rules cover both domestic transactions as well as cross-border transactions, including those between a branch or a PE and its mother entity.

Portaria determines that ‘the arm’s-length principle is the guiding tenet of the transfer pricing regime’ in Portugal. Article 3 of Portaria states how the transfer pricing rules are applied to adjust taxable income:

a whenever the conditions of a transaction, conducted between a Portuguese taxpayer and a non-resident related party, differ from those that would have been agreed, contracted or performed between independent enterprises, then that Portuguese taxpayer needs to positively adjust its taxable income in its tax return by the amount of that deviation to ensure that the taxable income is no different than what it should have been in the absence of the special relationship; and

b whenever the conditions of a transaction, conducted between a Portuguese taxpayer and a resident related party, differ from those that would have been agreed, contracted or performed between independent enterprises, then the Portuguese tax authorities might carry out the adjustments required for the taxable income of that Portuguese taxpayer to be no different than what it should have been in the absence of the special relationship.

The wording of Article 3 of Portaria has two relevant specificities: that taxpayers can only perform self-initiated transfer pricing adjustments on their tax return in case of cross-border transactions and when those adjustments are positive; and that all other transfer pricing adjustments are the exclusive competence of the tax authorities and, as such, are dependent on the tax authorities’ assessment and decision.

Although the Portuguese transfer pricing rules are closely based on the OECD standards, in 2014 the Portuguese tax authorities launched some new rules regarding the tax deductibility of some types of costs, namely financial, that do define a threshold above which those costs will not be tax-deductible, even when they comply with the transfer pricing

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rules, which is a first deviation from the strict application of the arm’s-length principle in some specific fields in which the tax authorities have faced, through consistent litigation, difficulties in effectively applying the arm’s-length approach.

Accounting rules and treatment are generally the basis for the computation of the taxable income, although the Corporate Income Tax Code has several specific identification, recognition and deductibility rules that do differ from the accounting rules and require a specific reclassification or computation within the taxable income assessment.

II FILING REQUIREMENTS

Article 13 of Portaria sets documentation requirements, namely a yearly preparation of a transfer pricing file for any taxpayer that has recorded, in the previous tax exercise, a total revenue of at least €3 million. Although that transfer pricing file must be prepared each year (for those taxpayers that have reached the above-mentioned threshold), it is not required to be automatically delivered to the tax authorities. It would only need to be provided to the tax authorities upon specific request, usually within a 10-calendar-day delivery deadline. Article 63 of the Corporate Income Tax Code also provides that taxpayers need to maintain proper transfer pricing support documentation.

Portaria defines in some detail the structure that the yearly mandatory transfer pricing file needs to follow, including:

a) a description of the taxpayer and of the taxpayer’s activity;

b) a description of each related party, including the nature of the existing special relationship with each of these related parties, according to the special relationship criteria foreseen in Paragraph 4 of Article 63 of the Corporate Income Tax Code, as well as a description of the activity conducted by each of these related parties;

c) a description of each type of transaction conducted by the taxpayer with each of the related parties, including the conditions and transfer pricing policies applied within those transactions as well as the quantification of the amounts of those transactions, by type and by counterparty, for the last three exercises;

d) a functional, risk and asset analysis;

e) the selection process for the transfer pricing validation methodologies applied to assess whether the controlled transactions are compliant with the transfer pricing rules and the arm’s-length principle, indicating why the applied methods were selected and, whenever the prioritised methods defined in the Portuguese transfer pricing rules were not applied, the reasoning that led to another method being applied; and

f) the transfer pricing economic analysis conducted to assess the compliance with the transfer pricing rules of each group of controlled transactions.

No specific provisions are expressed in the legislation regarding a documentation structure of a master file and a local file. Nevertheless, the Portuguese transfer pricing documentation requirements already address the contents and information that the OECD recommends to include in the master file and the local file, and, in practice, the Portuguese tax authorities have been accepting documents with a master file or local file structure, if those do comply with the Portuguese documentation requirements (those do require some additional information compared to the OECD master file or local file approach).
There is another filing requirement within a general accounting and economic statistics return that needs to be submitted each year by all taxpayers, which includes specific tables about transfer pricing, including:

a an indication of whether a transfer pricing file has been prepared;
b a report on the amount (in euros) of the transactions conducted with domestic related parties (such report requires the disclosure of the amounts recorded with each one of those domestic related parties, indicating the fiscal number of each one of those specific domestic related parties) for certain predetermined types of transactions;
c a report on the amount (in euros) of transactions conducted with non-resident entities, for certain predetermined types of transactions (does not require either the disclosure of the number of transactions by each counterparty or the identification of those non-resident entities); and
d the transfer pricing methodologies used to assess compliance with the transfer pricing rules.

Following BEPS Action 13, the Portuguese Budget Law for 2016 introduced a new additional documentation requirement through Article 121-A of the Corporate Income Tax Code. This new provision implements the country-by-country (CbC) reporting obligation for fiscal years starting on or after 1 January 2016. This new rule follows OECD recommendations regarding the CbC reporting requirements. The Portuguese legislation allows a surrogate entity to be designated by the group, in the event a parent entity is not obliged to file a CbC report (CbCR), or where an automatic exchange of information process by the tax authorities of that jurisdiction with the Portuguese tax authorities is not in place. Nevertheless, such a reporting entity should be identified and communicated to the Portuguese tax authorities by the end of the relevant tax period.

The deadline for a CbCR submission to the tax authorities is one year after the end of the underlying tax exercise. That submission is performed electronically through a specific internet portal within the tax authorities’ internet site, and requires the submission of a .xml file following the OECD .xml CbCR format exactly. That specific internet portal in which the .xml file submission is processed requires also the complementary filling of some fields of additional information not requested by the OECD CbC guidelines, namely:

a an indication of whether the information reported in the CbCR is complete or incomplete; and
b in the case of an incomplete answer to the above, an indication of the motive of the incomplete submission, namely:
   • refusal by the final ultimate owner to provide information; and
   • another motive (which needs to be disclosed on the ‘other information’ field of the CbCR.

The CbC rules also imply the submission of additional information, also based on the OECD CbC guidelines, namely a communication of who will be the CbC reporting entity and in which jurisdiction that entity is located. The corresponding form also requires some information regarding that entity, namely its tax number and address, as well as the confirmation if that entity is a final ultimate owner or if it is submitting the CbCR as a surrogate entity. The deadline for that communication submission is the end of the fifth month after the closing of the accounts.
III PRESENTING THE CASE

i Pricing methods

Article 63 of the Corporate Income Tax Code defines the transfer pricing methods of analysis that are deemed acceptable in Portugal (again based on the OECD recommended methods), which are also defined in more detail in Articles 4 to 10 of Portaria. Article 4 of Portaria indicates the following allowed methods:

a the comparable uncontrolled price method (CUPM), the cost-plus method (CPM) and the resale minus method (RMM); and

b the profit split method (PSM), the transactional net margin method (TNMM) and any other method deemed as the most appropriate taking into consideration the facts and circumstances and the arm’s-length principle, whenever the methods foreseen in (a) are deemed non-applicable.

As a result of the wording of Article 4 of Portaria, transaction-based methods such as CUPM, CPM and RMM are deemed as being the common usual methods, while the remaining profit-based methods can only be applied whenever the taxpayer can demonstrate that the transaction-based methods were not applicable.

As a result, the method selection process described in the transfer pricing file of the taxpayer needs to address that inherent method hierarchy and, apart from explaining and supporting why the applied methods were deemed as being the most appropriate ones to test the controlled transactions under analysis, in the event profit-based methods were applied, it also needs to explain why transaction-based methods could not be applied or were not deemed as being the most appropriate testing method.

Portaria contains quite detailed considerations about comparability, whether in Paragraph 3 of Article 4 or in Article 5 (the title of this article is ‘Factors of comparability’), and those considerations follow closely the OECD Transfer Pricing Guidelines.

Usually, whenever the taxpayer (or its related-party counterparty) conducts similar transactions with independent parties, then the internal CUPM, through the use of internal comparable data, will be deemed the most appropriate method to test compliance with the transfer pricing rules.

The tax authorities do consider that internal comparable data may provide more reliable data to analyse the transaction or company under analysis than external comparable data. Taking this into consideration, internal comparable data are usually preferred over external data.

If no internal comparable data (or no good internal comparable data) is available, but that external comparable price data can be identified, and whenever those external comparable data can be deemed as sufficiently comparable, then this is usually considered as the second-best testing method.

The application of both internal and external CUPM is more demanding comparability-wise than the other indirect testing methods. As an example, loans are usually analysed through internal or external CUPM. In both cases, to ensure comparability with the operation under analysis, it is required that the comparable data has similar characteristics, namely that it is:

a contracted or issued within the same period;

b in the same currency;

c for a similar maturity;
d with similar collaterals and guarantees (subordinated, senior, secured, unsecured, convertible, non-convertible, etc.);

e with a similar reimbursement arrangement (bullet loan, zero coupon, periodical, etc.);

f with a similar interest rate type (fixed, floating, variable, etc.);

g issued or loaned to an entity bearing a similar credit risk;

h issued or loaned to an entity operating in similar industries; and

i issued or loaned to an entity located in the same region.

There have already been some court cases that have confirmed the importance of comparability within the application of the CUPM.

When the CUPM cannot be applied, one of the remaining indirect methods will be used, which will require the search of potentially comparable companies developing potentially comparable activities to the one being tested, within publicly available databases. Those methods are usually less demanding in terms of comparability, but those searches will nonetheless seek to obtain the most comparable data possible, namely through detailed industry and activity description searches, complemented with internet searches for more information about the potentially comparable companies. Apart from the comparability factors, those searches will seek to confirm whether those potentially comparable entities comply with the Portuguese independence rules (meaning that none of those entities can be directly or indirectly owned by a corporation by 20 per cent or more, and cannot own directly or indirectly any subsidiary by 20 per cent or more).

The PSM is a method rarely used to date, because taxpayers are usually reluctant to proactively share information about the profits earned by their non-resident related entities, although tax authorities have tried to enforce the use of this method in some cases, with limited success. A possible outcome of BEPS may be an increased use of PSM, although this is yet to be seen in practice.

ii Authority scrutiny and evidence gathering

The audit procedure usually begins with a notification sent by the tax authorities to the selected taxpayer, which sets out the nature and scope of the audit, as well as the rights and obligations of the taxpayer during the audit process. Nevertheless, we have observed an increasing tendency of the tax authorities to send initial informal requests for information prior to the sending of the notification and of the official audit procedure. In most cases, tax audits will be conducted through a series of requests for information or documents and access to accounting systems and books, and through several meetings and queries conducted with the accounting and financial interlocutors of the taxpayer. We have also observed an increasing tendency of the tax auditors to contact third parties (e.g., clients or providers) to gather evidence or to confirm statements made by the taxpayer.

When the tax authorities identify potential transfer pricing issues within transactions conducted with non-resident entities they seek to gather information about the global tax position in order to assess the profit share by jurisdiction. For that purpose, they usually send requests of cooperation to other tax jurisdictions for them to issue requests of information to the counterparties of the transaction located in those jurisdictions.

The implementation of CbC reporting (see Section II) will provide more information to the tax auditors to identify potential non-compliance of certain group transfer pricing policies.
IV INTANGIBLE ASSETS

The Portuguese transfer pricing rules do not include any specific consideration on intangibles, but, as mentioned earlier, they contain an explicit referral rule directly to the OECD Guidelines. As such, the guidance for how to identify and recognise transactions with intangibles for transfer pricing purposes are the OECD Guidelines. As a result, the changes originated through BEPS Actions 8–10 were assimilated by the Portuguese market players as a more recent and updated definition of the guidance on how to deal with intangibles for transfer pricing purposes, not requiring a specific legislative change (and no such legal change is foreseen or expected regarding intangible definitions).

Consequently, the recognition process has to be based on a detailed functional and risk analysis, which will identify the intangibles in the transactions under review, how they contribute to the creation of value and how they interact with other intangibles, with tangible assets and with business activities. The new OECD guidance clarifies that this functional analysis step will have to focus on DEMPE (development, enhancement, maintenance, protection, exploitation) functions and risks, seeking to identify which entity develops those functions, which entities assume the subsequent risks, which have control over risk (requiring ability and resources to perform that control) and which are funding the DEMPE functions or risks. It also highlights some specific functions deemed as particularly relevant for intangibles, namely design and control of research and marketing programmes, direction of and establishing priorities for creative undertakings, control over strategic decisions regarding intangible development programmes, management and control of budgets, important decisions regarding defence and protection of intangibles, and ongoing quality control over functions performed by independent or associated enterprises. Similarly, it also highlights some specific risks deemed as particularly relevant for intangibles, namely risk related to the development, obsolescence risk, infringement risk, product liability risk and exploitation risk.

Taking into consideration that tax treatment is a critical factor in any investment decisions, in 2014 the Portuguese government launched a tax reform aiming to achieve a more competitive tax framework to attract investment, and promote economic growth and employment. Intangibles was one of the areas in which tax treatment was significantly changed. More specifically, the 2014 tax reform launched a new regime for intangibles through Articles 45-A and 50-A of the Corporate Income Tax Code. Article 45 aimed at recognising tax effects for intangibles with an indefinite life, and as such, it introduced the recognition, as a tax-deductible expense, of a constant depreciation, within the 20 tax exercises following the recognition, of the acquisition cost of some specific intangible assets that have no limited lifetime, namely patents, brands, licences and permits, production processes, models or other assimilated rights. The same applies to goodwill generated by acquisitions of the shares of other entities or of other entities’ assets and liabilities.

Similarly, at the same time (2014), a patent box regime was also introduced which enabled that income deriving from the sale or the temporary licensing of the use of industrial property rights (i.e., patents and industrial drawings and models) was 50 per cent exempt from corporate tax taxation. In 2016, that regime was amended, following the BEPS Action 5 guidance, also introducing a limit on the tax deduction, as well as a 30 per cent uplift on the tax deduction of some eligible R&D expenses.

Tax authorities always fear that intangibles’ intra-group transactions might lack effective substance and that they might have been artificially structured only to benefit from tax incentives or to shift profits abroad. These concerns regarding substance were particularly addressed by BEPS Actions 8–10.
Despite the ‘substance over form’ concept being generally foreseen in the Portuguese rules, as stipulated in the General Taxation Law, the issues addressed under these BEPS Actions are not specifically embedded in the Portuguese transfer pricing rules. However, we do not anticipate that the Portuguese tax authorities will formally propose changes to the domestic transfer pricing framework. Hence, the OECD Guidelines are followed because Portugal is a Member State of the OECD and because the Portuguese transfer pricing rules include a specific referral to the OECD Transfer Pricing Guidelines.

Nevertheless, it is important to note that the Portuguese transfer pricing rules are not embedded within the anti-abuse rules in place within the Portuguese legal and tax framework. As the application of the substance over form concept often implies more than just a pricing adjustment, we have observed several court decisions that have ruled against the tax authorities’ attempt to recharacterise some transactions (due to the lack of substance) based on the transfer pricing rules, as the court considers that those attempts lack the substantiation and support required by the Portuguese anti-abuse rules, which are quite complex. As a result of that complexity, the Portuguese anti-abuse rules are not a path that is often followed by the Portuguese tax authorities, which, together with the fact the Portuguese transfer pricing rules are not embedded within that anti-abuse regime, limits the effectiveness of the substance over form concept in Portugal. It is still too early to conclude whether the new BEPS guidance can improve this paradigm.

Under this new guidance, a contractual arrangement and the subsequent expected return will only be accepted if each party that is supposed to bear a risk is deemed to be effectively controlling that risk, taking the decisions to take on, lay off or mitigate that risk, and to have the financial capacity to bear that risk. As a result, even more than before, the functional and risk analysis is a critical part of the transfer pricing analysis. The new guidance calls that analysis the ‘accurate delineation of a transaction’, meaning comparing what derives from a written contract with the actual behaviour of the parties.

The new guidance also states that the mere fact that a party is funding an activity or controlling the funding risks does not entitle that entity to the returns associated with the operational risks of that activity, unless it does exercise control over those risks as well. Control of funding risk is deemed to be about being able to evaluate an investment opportunity as an investor, meaning as a provider of funds, to take investment decisions and to set up mitigation procedures for funding risks. As a result, these functions and risks are deemed to be entitled to a remuneration aligned with what the market usually pays for similar financial functions, which is no more than a risk-adjusted financial return, and not the residual income deriving from operational risks or activities. The new guidance goes even further when stating that if the legal funding entity is not even managing and controlling the funding risks, namely due to lack of resources, but only providing the funds (meaning that some other entity is effectively managing and controlling that funding activity), then it will only be entitled to receive a risk-free rate of return.

Comparatively, control of operational risks implies being able to analyse the consequences of potential alternative operational decisions on the business being developed and on its subsequent returns, having the authority to take those operational decisions and to assess, decide and implement mitigation procedures for those operational risks. Operational risks are entitled to receive residual returns.

All of these characteristics imply specific resources and specific operational know-how, which cannot be found in pure funding structures. As such, decision-makers must be competent in the area of risk for which the decision is required, and they must be performing
the decision-making function in the location of the entity claiming to be controlling the risk and the associated return. As a result, mere minutes of board meetings performed outside of that location, or signature of documents executing the decisions are deemed to be insufficient to demonstrate decision-making (this has already been enforced by an existing rule in place in Portugal, namely through the concept of ‘effective management’).

Traditional ‘principal versus operational structures’, in which the operational structures were traditionally awarded a return based on a transactional net margin method or a comparable profit method and the funding principal would get the residual income, might be non-compliant with the new guidance whenever the principal is merely funding the activity and not managing and controlling the operational risks.

Whenever more than one entity controls the risks that drive the return, they will have to share the income based on their real contributions to the value creation.

The new guidance recognises that payment for use of an intangible should be made to the party having the legal rights to such intangible, which, at a first glance, could be seen as a step back in the substance over form paradigm. However, the new guidance also stipulates that, when another entity has developed or participated in the development of the DEMPE functions, provides funding or assumes risks, a separate transaction dealing with that contribution must be considered. That assertion implies that the income flow deriving from the use of an intangible will not be diverted from the legal owner, but that entity has a transfer pricing obligation to remunerate the other entities that are developing activities that the legal owner is not performing, which can mean that the legal owner may end up not registering any profit at all after appropriately compensating the other group members for their contributions.

The new guidelines also recognise that the legal owner does not need to perform all the DEMPE functions, as independent parties do sometimes subcontract others to develop parts of those functions, but, in that case it requires control to be effectively applied over those subcontracted activities and their performance, which requires determining the objectives of the outsourced activities, as well as capability to understand and assess the performance of the activity, to take decisions regarding selection, hiring, change and cancellation, as well as to effectively exercise those functions.

The new guidance also highlights some functions deemed to be particularly significant in an intangible value creation, which should drive relevant compensation, namely:

- design and control of research and marketing programmes;
- direction of and establishing priorities for creative undertakings and research;
- control over strategic decisions regarding intangible programmes;
- management and control of budgets;
- decisions regarding defence and protection of intangibles; and
- ongoing quality control over functions performed by other parties that may have a material impact on the value of the intangible.

The new guidance also lists some relevant risks deemed as important for transactions involving intangibles:

- risk related to the development of intangibles, namely that it may end up not being successful;
- risk that other technological advances might make the research obsolete;
- infringement risks;
- liability risks; and
viability and profitability risks associated with the returns to be generated by the future exploitation of the intangible being able to generate appropriate returns compared to the research and development costs.

The party actually controlling, managing and assuming the risks will be entitled, through a secondary transaction, to the potential gains and losses deriving from those risks. In contrast, a party that is not controlling, managing and assuming those relevant risks, nor developing the relevant functions listed above, will not be entitled to the gains or responsible for the losses.

V SETTLEMENTS

There were no formal settlement or negotiation procedures with the Portuguese tax authorities foreseen in the Portuguese General Tax Law before the introduction of APA procedures. Until then, the interaction between taxpayers and tax authorities consisted mostly of audits, investigations and litigation.

The only procedure that could be deemed as closer to a negotiation or settlement procedure is the taxable income revision procedure foreseen in Article 91 of the General Tax Law, which can only be initiated in the event the tax authorities do apply indirect methods to determine the taxable income of the taxpayer. In that procedure, both parties (taxpayer and tax authorities) will nominate experts who will analyse the case, and conduct working sessions and contradictory debates (which end up involving some kind of negotiation) in order to achieve a common technical understanding, which will be binding for the tax authorities (except in cases of tax crimes).

Although the law did not specifically entail a negotiation alternative (apart from APAs, which will be addressed below), there have been cases where, in view of the proposed adjustments, informal discussions with the tax authorities (at an administrative stage of the process or during the audits) were conducted, in order to assess the arm’s-length pricing of the controlled transaction under controversy.

In this regard, it should be noted that following this solution is dependent on a variety of issues, ranging from the specialisation of the tax authorities’ audit team involved in the process, and the availability of the latter for initiating such a negotiation, to the complexity of the analysis.

In situations where the tax authorities’ transfer pricing team is not involved or the taxpayer pursues a resolution of the controversy aimed at a full annulment of the proposed adjustment, this alternative is usually not successful.

The possibility to conclude unilateral and multilateral APAs was introduced in 2008 and the inherent legal dispositions were subsequently amended in 2014, essentially with the aim of promoting and facilitating unilateral agreements. As such, the APA alternative is the unique course of action in situations in which a taxpayer wishes to proactively seek a negotiated understanding for a complex transfer pricing issue. However, note that a rollback of the terms and conditions negotiated under the APA is not formally possible, according to Portuguese law, although the tax authorities have informally agreed in the retroactive application of some signed APAs. Therefore, any retroactive application of the APA is subject to acceptance by the tax authorities responsible for the negotiation.
VI INVESTIGATIONS

Portuguese tax laws do not include any specific process for handling formal inquiries into transfer pricing issues. Therefore Portuguese tax authorities should follow the general tax inspection procedures stated in the Portuguese Tax Procedure Code (CPPT), as well as apply the timelines and detailed requirements given by the Complementary Requirements Code for Tax Inspection Procedures (RCPIT).

Regarding the tax inspection procedure, Portuguese tax authorities may start this procedure for a four-year period after the end of the accounting period to which the tax assessment relates. However there are special rules applied if the tax return presents tax losses; in such cases, the forfeiture period shall be the same as the exercise of such right.

The tax inspection procedure follows strict formal requirements, is continual and must be concluded within six months (Paragraph 1 of Article 57 of the General Tax Law). However, under certain circumstances, this period may be extended twice for three months each.

The audit procedure is completed when the tax auditor considers that all the necessary information has been obtained to draw up a proposed tax audit report. This proposal is sent to the taxpayer, who has 10 days in which to dispute the preliminary conclusions of the proposal. After the 10-day period has elapsed, the tax auditor will issue a final audit report, which may give rise to an additional tax assessment.

Afterwards, the taxpayer is entitled to challenge the tax assessment, either by means of:

a) an administrative claim submitted to the tax authorities, 120 days after either the end of the period for voluntary payment of the tax amount legally notified to the taxpayer (usually, 30 days after notification for payment); or a notification of the remaining tax acts, even if such acts do not give rise to any liquidation; or

b) an administrative appeal, 30 days after the notification of the act to be appealed.

Finally, resolution of tax disputes is regulated by a complex set of legal rules that determine different types of actions and deadlines, among other things, depending on the type of dispute in question.

VII LITIGATION

i Procedure

Should the taxpayer decide to appeal to a court, the following deadlines apply:

a) for judicial courts, within three months after the end of the period for voluntary payment of the tax amount legally notified to the taxpayer (usually, 30 days after notification for payment), or notification of the remaining tax acts, even if such acts do not give rise to any liquidation; and

b) for the arbitration court (Article 10 of the Legal Regime of Tax Arbitration), within 90 days after any of the facts foreseen for the judicial courts mentioned above, or from the notice of the decision – as long as such acts can be subject to a separate claim – or from the end of the term for the decision of the administrative appeal; or within 30 days from the declaration of the illegality of acts determining the tax base when it does not give rise to the assessment of any tax.
A typical process in preparing for litigation is usually based on the following steps:

1. **a** a decision on which process type to follow (i.e., judicial or arbitration court). Most cases that can be appealed before a judicial court can also be appealed before the arbitration court. Access to the arbitration court is prevented in the following situations:
   - application of indirect methods in the administrative procedure;
   - value of the process is higher than €10 million;
   - if a court appeal needs to be preceded by a mandatory administrative process for claiming the legality of the adjustment and such administrative process was not used; and
   - certain situations where the discussion of the cause refers to customs, depending on the taxpayer’s view and strategy, as well as on previous decisions issued by both courts;

2. **b** thorough identification of all means of evidence that sustain the taxpayer’s position;

3. **c** identification of all possible lines of technical argumentation, including subsidiary requests; and

4. **d** preparation of the allegations in written form (typically, in an articulate form), indicating and providing all means of evidence needed.

As for the timelines, once again it depends on which litigation forum was used by the taxpayer: if the taxpayer has appealed to the judicial courts, a first instance decision is usually reached within three to five years after the submission of the process to the competent court. In situations where the taxpayer initiates the process in the arbitration court, a decision is usually reached within four to six months.

In Portugal, the initial courts are the only fact-finding forums. As such, all evidence needs to be produced in the court of first instance. For this purpose, all means of evidence are admissible (documents, witnesses, specialist technical reports, etc.), albeit the judge has some discretionary power to decide which means of evidence are useful for deciding the case.

As such, any further appeals cannot be based on the existence of additional evidence, or aimed at producing evidence on the case under analysis. Nonetheless, the applicant can appeal based on the fact that the first instance decision did not allow a certain mean of evidence necessary for the decision of the cause, or such decision did not consider certain statements, documents or other means of evidence that should have been considered in the decision.

For regular judicial process, decisions from the initial court can be appealed on the following terms:

1. **a** an appeal to the Central Administrative Court within 10 days after the final decision from the initial court, if the reasons for appealing include factual and legal grounds; or

2. **b** an appeal to the Supreme Administrative Court within 10 days after the final decision from the initial court, if the reasons for appealing include only legal grounds.

In any case, if the value of the case is lower than €5,000, no appeal can be brought.

As a rule, the process includes a notification of the intention to appeal (within the aforementioned 10 days), a notification by the court accepting the appeal, and the presentation of the grounds for appealing and conclusions, within 15 days after the notification by the court (for the applicant), and 15 days after the end of the deadline for the applicant to present the allegations, with respect to the defendant.

With respect to the likely timing for reaching a decision, it is somewhat difficult to estimate such deadline – in fact, it greatly depends on the complexity of the issue, as well as
the court that is going to decide the appeal. Nonetheless, this tends to be a rather lengthy process, with decisions from the superior courts being reached 10 or even 15 years after the appeal.

For arbitration processes, decisions cannot, as a rule, be appealed and gain res judicata force, although the following exceptions apply:

- An appeal to the Constitutional Court to require an assessment of a potential unconstitutionality;
- An appeal to the Supreme Administrative Court when the arbitration decision is in opposition with a decision issued either by the Central Administrative Court or the Supreme Administrative Court; or
- A challenge to the Central Administrative Court based on
  - the lack of specification of the factual and legal grounds that justify the arbitration decision;
  - opposition between the grounds and the decision;
  - a decision on undue matters or lack of decision on necessary matters; and
  - breach of the audi alteram partem and ‘equality of arms’ principles.

In practice, most arbitration decisions are final.

**VIII SECONDARY ADJUSTMENT AND PENALTIES**

Portuguese transfer pricing rules do not include any specific provisions for secondary adjustments and, in practice, we have not observed any attempt by the tax authorities to apply such adjustments.

Nevertheless, a case could be made that such adjustments could occur regarding customs, VAT or even stamp tax.

Regarding customs, for example, in the case of a transfer pricing post-year-end adjustment to the price paid for imported goods, the Portuguese customs rules establish that a post-importation change in the reported customs value due to such an adjustment always needs to be reported (even in situations where the duty rate is zero).

For this purpose, the following situations should be considered:

- The post-closing adjustment increases the price paid by the importer for the goods: in these situations, additional customs duties and related taxes or fee payments may be due, within three years from the date of the taxable event; or
- The post-closing adjustment decreases the price paid by the importer of the goods: should the transfer pricing adjustment decrease the price paid by the importer, a duty refund may be requested, within three years from the date of the taxable event, provided that the importer can provide proof to support the claim.

The administrative procedure for claiming a refund is the same as the one prescribed for other value-related corrections; however, the taxpayer should contact the customs authorities to seek guidance on how to proceed.

It should be noted that, although in theory an aggregate transfer pricing adjustment (i.e., an adjustment to the importer’s profitability under a profit-based pricing method) may be relevant for adjusting the value of imported goods, the fact is that those types of adjustments rarely allow for a correction to the value of the goods for customs purposes.
As such, it is recommended that, should customs be a concern for the taxpayer, a transaction-by-transaction transfer pricing adjustment be made, in order to be relevant for revising the customs duties already paid.

There is also a relevant interaction between the customs authorities and the VAT tax authorities whenever a customs value increase or decrease is reported. In fact, in situations where a customs value increase is reported to the customs authorities, such an adjustment will automatically result in the assessment of additional VAT, if applicable; and where a customs value decrease is reported, the taxpayer needs to file a request in order to obtain a refund of overpaid VAT.

Whenever a change to customs value occurs due to a post-year-end transfer pricing adjustment, the rules anticipate the application of penalties to the importer or taxpayer:

- penalties for inaccurate declaration ranging from €150 to €5,750 (per transaction);
- penalties for negligent or low-value activities ranging from €500 to €165,000 (per transaction);
- a fine of up to €180,000 or three years' imprisonment, for intentional acts; and
- penalties ranging from 30 per cent up to 100 per cent of the VAT or customs duties owed, with a maximum of €45,000 per transaction, plus 4 per cent interest per annum.

These penalties may be reduced when a voluntary disclosure is made.

Regarding VAT, in situations where a post-year-end adjustment occurs, and the taxpayer wishes to adjust the value of the goods or services considered for VAT purposes correspondingly, the corrective invoice that performs the adjustment needs to meet all the requirements of an original invoice, plus a reference to the original invoices to which the adjustment refers, and a reference to the elements of the original invoices that are subject to modification.

Only corrective invoices that comply with these requirements may be considered in adjusting any original invoices that have already been submitted in the periodic VAT return.

On the other hand, if the corrective invoice reduces the taxable value of the transaction, also causing a reduction in the VAT initially paid, the taxpayer may correct the initial VAT amount, up to the end of the period subsequent to the one in which the circumstances giving rise to the correction occurred. Note, however, that this is not a mandatory regularisation.

If the corrective invoice results in more taxable value for the transaction, thus more VAT than the amount initially deducted, such regularisation is mandatory and can be done, without incurring penalties, until the end of the period subsequent to the one to which the original invoice refers. If this correction is not made by the prescribed deadline, the correction is still mandatory but then should take place in a replacement of the periodic VAT return for the period when the correct transaction should have occurred.

Regarding penalties, specific transfer pricing penalties (from €500 to €10,000) apply for failure to present transfer pricing documentation within the time frame determined by the tax authorities. Should the taxpayer be subject to a transfer pricing adjustment, no specific transfer pricing penalties apply.

In addition, depending on the circumstances, general tax penalties of up to €150,000 apply for refusal to provide information, or for providing incorrect or incomplete information.
IX BROADER TAXATION ISSUES

Double taxation
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Double taxation treaties signed by Portugal do include the possibility for taxpayers to invoke a mutual agreement procedure (MAP).

Also, as Portugal is a member of the European Union, the taxpayer may, whenever there is a tax dispute involving another member of the EU, invoke the EU Arbitration Convention (EUAC).

As a practical disadvantage, the MAP is a long process and, ultimately, the tax authorities are not obliged to reach a decision on eliminating double taxation. Therefore, whenever possible (i.e., when the dispute involves another member of the EU), it is highly recommended that the taxpayer invokes the EUAC, as there is an obligation to reach a decision within two years after all relevant documentation is filed (in practice, we have had some cases where an agreement has been reached within three to five years).

There are also some cases where the Portuguese tax authorities have even reached a decision to eliminate double taxation with respect to years already closed for inspection, under the good-faith and collaboration principle.

X OUTLOOK AND CONCLUSIONS

Portugal adopted several of the OECD recommended BEPS initiatives prior to the publication of the BEPS reports, and is following through with the implementation, when required, of the remaining ones.

The Portuguese tax authorities have become increasingly active in transfer pricing issues, developing more audits and focusing more on complex issues, namely intangibles, financial operations, systematic loss makers, branches and equity allocation. We have also observed an increase in the number of APAs under negotiation.

It is still too early to judge the impact of the adoption of the BEPS initiatives. Surely, the tax authorities have expectations that these new rules will effectively tackle several of the usual tax-optimisation structures that were set up by multinational enterprises to achieve greater tax efficiency. The complexity and subjectivity of some of the recommended measures could make achievement of that objective difficult. It is likely that significant changes in the way multinational enterprises operate will occur and empty structures with no substance will probably disappear, but they will probably be replaced by other structures in which part of the relevant functions focused on by BEPS will be developed, as well as the relevant risks assumed. Those structures will still seek to take advantage of taxation differentials between jurisdictions, which are not expected to disappear, as tax authorities and governments will still compete to attract investment and employment, and, as a consequence, tax revenues, through differential and attractive tax measure packages.

BEPS measures, namely the greater consistency deriving from the new documentation requirements and the new guidance, will probably increase and accelerate the already current trend of greater centralisation and greater automatisation and IT integration regarding transfer pricing policies and documentation, as opposed to the multiplicity of local policies aimed at adapting global policies to address local specificities of local transfer pricing rules. The digital economy is expected to be particularly affected by BEPS, although the divergences between the United States, European Union and OECD regarding this issue may imply lengthy negotiations and require adaptations to the current proposed measures.
Chapter 20

SWITZERLAND

Jean-Blaise Eckert and Jenny Benoit-Gonin

I OVERVIEW

The Swiss Federal Constitution grants both federal government and the cantons the power to levy direct taxes. Federal income tax and corporate income tax is levied in accordance with the Federal Income Tax Act (FITA) of 14 December 1990; the cantons enact their own laws concerning cantonal income tax, wealth tax, corporate income tax and capital tax, but these laws must conform to the Federal Tax Harmonisation Act of 14 December 1990.

Taxes are levied by the Federal Tax Administration and the cantonal tax authorities. Switzerland relies heavily on the OECD Transfer Pricing Guidelines and is actively implementing the recommendations of the OECD’s Base Erosion and Profit Shifting (BEPS) project. The Federal Tax Administration has directed cantonal tax administrations to follow the OECD Guidelines for all questions related to transfer pricing.

Transfer price adjustment in Switzerland is based on the principle of the prohibition of harmful profit shifting between related parties. According to settled case law of the Swiss Federal Supreme Court, harmful profit shifting occurs when:

a a company provides consideration without corresponding counter payment;
b the consideration was provided to a shareholder or related party;
c the consideration would not have been granted to a third party; and
d the disproportion between the consideration and counter-payment would have been clear to the company.

If these conditions are met, the tax authorities will decide that harmful profit shifting has occurred; there is no need to prove that the parties sought to evade paying taxes.

Switzerland does not have a specific piece of legislation defining and addressing transfer pricing. However, certain Swiss federal and cantonal tax laws address related issues, such as the arm’s-length principle and hidden equity.

The legal basis for transfer price adjustment is contained in laws governing income tax and corporate income tax, withholding tax, stamp duty and value added tax (VAT).

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1 Jean-Blaise Eckert is a partner and Jenny Benoit-Gonin is an associate at Lenz & Staehelin.
3 ATF 115 Ib 274, consid. 9b.
4 E.g., Article 58 FITA and Article 24 the Federal Tax Harmonisation Act.
Only the VAT Act of 12 June 2009 defines the notion of closely related persons. Article 3, Letter (h) of the VAT Act defines closely related parties as:

- the owners of at least 20 per cent of the nominal or basic capital of a business or of an equivalent participation in a partnership, or persons associated with them; or
- foundations and associations where there exists a particularly close economic, contractual or personal relationship.

Pension schemes are not regarded as concerning closely related persons.

Article 58 FITA forbids the deduction of unjustified expenses, meaning that all dealings with shareholders and related parties must be conducted at arm’s length. The shareholder will also be subject to income tax on any constructive dividends.

Further, if the company is found to have distributed constructive dividends, these dividends will be subject to withholding tax of 35 per cent (in accordance with Article 4 Section 1, Letter (b) of the Withholding Tax Act of 13 October 1965). In the event of a hidden capital contribution, the capital contribution will be subject to stamp duty tax of 1 per cent (Article 5, Section 2, Letter (a) of the Stamp Tax Act of 27 June 1973).

The Federal Tax Administration also issues directives in the form of circulars and circular letters that provide guidance on transfer pricing and related topics. These cover safe harbour rules (thin-capitalisation and interest rates), service companies and restructurings.

II FILING REQUIREMENTS

There is no explicit list of documents concerning transfer pricing that must be included in the tax filing. However, tax authorities may dispute certain transfer prices, and the taxpayer must be able to provide commercial justification for all transfer prices.

Since 1 December 2017, Swiss tax law requires multinational companies to submit a country-by-country report that complies with the requirements of Annex III to Chapter V of the OECD Transfer Pricing Guidelines. These will not be published and there is no initiative from lawmakers suggesting future publication.

Tax returns must be filed in one of the official languages of Switzerland.

III PRESENTING THE CASE

i Pricing methods

Switzerland relies on the OECD Transfer Pricing Guidelines concerning pricing methods.

Taxpayers may select the appropriate OECD complaint pricing method to determine the arm’s-length price. These include traditional transaction methods, such as the comparable uncontrolled price method, the resale price method and the cost-plus method. Also acceptable are transaction profit methods, such as the transaction net margin method and profit split method. The global formulary apportionment method is not considered OECD-compliant.
The comparable uncontrolled price method is the preferred method and the transactional net margin method is the most common method.8

ii Authority scrutiny and evidence gathering
The cantonal tax authorities are responsible for assessing direct federal and cantonal taxes and the Federal Tax Administration plays a supervisory role. Further, tax authorities may audit taxpayers. Accordingly, taxpayers should retain all documents necessary to prove that transfer prices were made in accordance with the arm’s-length principle. The burden of proof rests on the taxpayer to prove that expenses were justified, and the tax authorities must offer proof for adjustments that increase the taxpayer’s taxable income. In recent years, there has been an increase in the number of audits performed by Swiss tax authorities.

Decisions may be challenged before cantonal courts (for decisions made by cantonal authorities) and the Swiss Federal Administrative Court (for decisions made by federal tax authorities). Decisions can be appealed to the Swiss Federal Supreme Court.

IV INTANGIBLE ASSETS
Swiss tax legislation does not contain specific provisions relating to transfer pricing of intangible assets or hard-to-value intangible assets. Switzerland follows the OECD Guidelines for transactions involving intangible assets.

V SETTLEMENTS
Advance tax rulings are common. Taxpayers may request advance rulings from the Swiss tax authorities to learn how they will be subject to Swiss tax law and how much they will own in Swiss taxes.

The system of advance rulings reduces the number of tax-related disputes that are litigated before the courts.

Advance pricing agreements (unilateral, bilateral and multilateral), mutual agreement procedures and international arbitration may be used in an international dispute.

VI INVESTIGATIONS
The Swiss tax authorities do not usually perform transfer pricing investigations. However, based on the ordinary taxation procedure, the assessment authorities shall review the taxpayer declaration and carry out the necessary investigations (Article 130, Paragraph 1 FITA).

In particular, the Swiss tax authorities are allowed to review information submitted by the taxpayer under its yearly tax return and request additional information. This is related to the Swiss tax authorities’ obligation to determine all the relevant facts to assess the taxation and to take into consideration only facts they consider as proven.

Swiss taxpayers submit tax returns on a self-assessment basis. In this respect, the Swiss tax authorities can also consider that the tax return is complete and that no further investigation is necessary. Investigations are, therefore, not automatic, including for transfer pricing issues.

Swiss tax authorities can open an investigation following submission of the tax return for the relevant tax period. The time limit for tax authorities to proceed with investigations depends on the tax concerned.

For corporate income tax, this right is generally limited to 10 years and can be extended by up to 15 years by the tax authorities after the close of the relevant tax period. Indeed, the 10-year statute of limitation can be interrupted by various official acts, such as an appeal, complaint or revision proceedings (Article 120, Paragraph 2 FITA). This includes any official communications from the tax authorities to the taxpayer that aims at interrupting the statute of limitation. In practice, a simple letter announcing the interruption is generally considered as sufficient, even in cases where a tax assessment is not yet issued.

For withholding tax, this right is generally limited to five years after the end of the calendar year in which the tax claim arose. Unlike corporate income tax, there is no absolute statute of limitation. As a result, the tax authorities can interrupt the five-year period by official communications without limitation, unless they act against the general principle of good faith.

Taxpayers can adjust their tax return, once submitted, as long as the tax authorities have not issued a final tax assessment. After receiving the final tax assessment, taxpayers can lodge a written protest against the assessment notice with the assessment authority within 30 days. If the protest is brought against a tax notice that sets forth extensive grounds, the protest may, with the consent of the appellant and the other petitioners, be referred directly as an appeal to the Cantonal Tax Appeals Commission (Article 132, Paragraph 2 FITA).

After receiving a written protest, tax authorities may proceed with new tax assessments and may adjust their first decision in favour or in disfavour of the taxpayer. Once the protestation decision (a second decision taken by the tax authorities after the first tax assessment) is notified to the taxpayer, the latter has 30 days to lodge an appeal against this decision to the Cantonal Tax Appeals Commission.

VII LITIGATION

i Procedure

From a procedural perspective, the general limitation period of 10 years after the close of the relevant tax period can be extended to 15 years for corporate income tax purposes, following an official act that interrupted the statute of limitation. For withholding tax purposes, the general limitation period of five years after the end of the calendar year in which the tax claim arose does not suffer any limitation if officially interrupted.

A final tax decision can also be revised in favour of the taxpayer, provided certain conditions are fulfilled (e.g., significant facts or decisive evidence is discovered (Article 147, Paragraph 1 FITA)). This procedure must, however, be filed either within 90 days after discovery of such grounds for revision or, at the latest, 10 years after notification of the final tax decision (Article 148 FITA).

Upon submission of their tax return, taxpayers can generally expect to receive a final tax decision from the tax authorities within one to two years. This timeline mostly depends on the tax authorities’ requests for information and the taxpayers’ cooperation with tax assessment
decisions. If the taxpayer does not agree to the specified taxation and lodges a written appeal with the tax authorities, this procedure can take up to an additional two years. A later appeal to the Cantonal Tax Appeals Commission is generally subject to the same waiting period.

As a result, after receipt of the first tax decision from the tax authorities, a procedural process with the Federal Supreme Court generally lasts from six to eight years.

The initial process before the tax authorities (submission of the tax return and written protest to the same tax authorities) generally allows taxpayers to disclose all relevant facts and evidence. Even once the procedure goes before the Cantonal Tax Appeals Commission, new evidence is still acceptable as the commission has powers to review all facts and the law (Article 142, Paragraph 4 FITA). Any other higher jurisdiction where an appeal is lodged (a superior cantonal court or the Federal Supreme Court) is, however, restricted in its power to review the facts.

ii Recent cases

Recent cases law involving transfer pricing issues are quite rare in Switzerland. As of tax year 2016, one main relevant judgment has been rendered by the Swiss Federal Supreme Court.

**Federal Supreme Court, 13 February 2017 (2C 411/2016).**

This decision was rendered based on international administrative assistance in tax matters, and discussed the concept of relevant information to be provided in view of transfer pricing issues. It has been confirmed that information on affiliated entities, in particular profits of each group entity, could be considered as relevant to review transfer of profits in a group structure and therefore, could be disclosed to another country.

VIII SECONDARY ADJUSTMENT AND PENALTIES

Provided a non-arm’s-length transaction is considered by the tax authorities, such as a hidden dividend distribution or interests received against a loan considered as insufficient, a Swiss withholding tax of 35 per cent may be levied. Secondary adjustments (e.g., transfer of an amount representing the adjustment to its foreign parent) are also subject to this 35 per cent withholding tax (or 54 per cent if not paid directly by the transaction’s beneficiary) provided is has not been agreed in a mutual agreement procedure.

A partial or full reimbursement of the withholding tax withheld may be claimed in accordance with double tax treaties and Swiss internal law. Late interest fees of 5 per cent may also be applicable without a possibility to claim full or partial reimbursement.

Under the ordinary tax procedure and provided a non-arm’s-length transaction is considered by the tax authorities, penalties do not generally apply in practice and late interests fees are privileged. However, penalties may occur, in particular where tax fraud is considered.

Penalties are generally assessed in view of the taxpayer’s fault. It can be challenged during the administrative or criminal procedure by giving relevant evidence or facts, or during later legal proceedings in front of the Swiss courts up to the Swiss Federal Supreme Court.
IX  BROADER TAXATION ISSUES

i  Diverted profits tax and other supplementary measures

Under Swiss tax law, there is no specific regulation about transfer pricing issues. Tax authorities should, however, follow OECD Transfer Pricing Guidelines as disclosed under Circular No. 4 of the Swiss Federal Tax Administration, dated 1997, revised in 2004. This Circular provides a general application of the arm’s-length principle to determinate taxable income of service companies. Those generally applicable principles have not been supplemented by any other regulations.

ii  Double taxation

Switzerland concluded double taxation treaties with numerous countries. If double taxation occurs with a country Switzerland signed a double taxation treaty with or if there is a risk of double taxation occurring, Swiss resident taxpayers, both individuals and corporations, can ask the Federal Department of Finance in Bern to initiate a mutual agreement procedure.

In accordance with the OECD Model Tax Convention on Income and Capital, taxpayers can initiate a mutual agreement procedure within three years of the first notification of the action resulting in double taxation. Most double taxation treaties concluded with Switzerland provide this three-year time limit, but each double taxation treaty must first be reviewed. An arbitration procedure is also available under a number of double taxation treaties concluded with Switzerland. In general and in contradiction with mutual agreement procedures, taxpayers can only file a request for arbitration with one of the competent authorities, for example, if an agreement has not been reached after two years (Article 25, Paragraph 5 OECD Model Tax Convention on Income and Capital).

To avoid double taxation, taxpayers can also request a ruling with the Swiss tax authorities before a transfer pricing transaction occurs. Swiss taxpayers generally choose this route; however, provided a foreign country decides to adjust a transfer pricing transaction, double taxation may still occur. In this respect, advance pricing agreements can also be chosen by Swiss taxpayers to confirm the tax treatment under the relevant double tax treaty, and obtain an agreement between Swiss tax authorities and foreign tax authorities.

iii  Consequential impact for other taxes

Even if transfer pricing adjustments are generally analysed from an income tax and withholding tax perspective, VAT consequences need to be considered. Under the Swiss Federal VAT Act, the arm’s-length principle also applies for transactions between parties considered as related. Consequently, an adjustment required by the tax authorities may have an impact on the tax levied. Penalties and interests may also apply if an adjustment is discovered during an audit.

X  OUTLOOK AND CONCLUSIONS

Switzerland does not have any specific transfer pricing legislation and there is currently no indication that it will in the near future; however, Swiss authorities, including both the administration and the courts, are increasingly influenced by OECD, which includes, as mentioned, the BEPS project. This means that any taxpayer active in Switzerland should remain extremely cautious when dealing with transfer pricing issues and should always take into account the OECD Transfer Pricing Guidelines.
I OVERVIEW

Parts 4 and 5 of the Taxation (International and Other Provisions) Act 2010 (TIOPA) contain the main United Kingdom transfer pricing legislation that applies for corporation tax and income tax purposes. These rules apply the arm’s-length principle and are intended to counter transactions where a potential tax loss or reduction in taxable profits is created as a result of non-arm’s-length pricing between related parties.

If certain conditions are met, the rules require that a person’s profits and losses are calculated for tax purposes by substituting an arm’s-length provision for an actual one. In broad terms, the conditions can be summarised as follows:

- an actual provision has been made or imposed between two persons by means of a transaction or series of transactions;
- one of these persons was directly or indirectly participating in the management, control or capital of the other, or the same person or persons were directly or indirectly participating in the management or control of the two parties to the provision;
- the actual provision differs from the arm’s-length provision that would have been made between independent enterprises; and
- the actual provision confers a potential UK tax advantage on one or both of the parties to it.

The main elements of these conditions are considered below.

i Meaning of ‘provision’

A ‘provision’ must be made or imposed for the UK rules to apply. While the term ‘provision’ is not defined in the legislation, Her Majesty’s Revenue and Customs (HMRC) guidance suggests that it embraces all the terms and conditions attaching to a transaction or series of transactions and should be given a wide meaning. The guidance also provides that the term is broadly equivalent to the phrase ‘conditions made or imposed’ in Article 9 of the OECD Model Tax Convention (the Model Convention) and so should be interpreted in line with the OECD Transfer Pricing Guidelines (the OECD Guidelines). The UK’s First-Tier Tribunal (FTT) recently concluded that a share issue could be treated as a ‘provision’ for transfer pricing purposes. This interpretation suggests that the term is not confined to commercial transactions between companies and that the transfer pricing legislation can also impact
shareholder transactions. However, the FTT declined to follow this decision in a subsequent case and held that the bonus issue of shares was not a transaction within the scope of the transfer pricing rules. This latter case is the subject of an appeal to the Upper Tribunal, which should hopefully resolve this uncertainty.

The rules operate in only one direction so that it is not possible to substitute an arm’s-length provision for the actual provision, where to do so would result in a reduction in taxable profits or an increase in allowable losses.

ii  Degree of relationship

The participation condition sets out the required degree of relationship between the parties and can be satisfied by way of direct or indirect control. In relation to a body corporate, ‘control’ means the power of a person to ensure that the affairs of the body corporate are conducted in accordance with the wishes of that person by means of holding shares, possessing voting power, or powers conferred by a document regulating the body corporate. In relation to a partnership, ‘control’ means the right to a share of more than half the assets, or of more than half the income, of the partnership.

‘Direct’ control is most commonly satisfied where a person has voting control over a body corporate. Certain additional rules apply, however, for the purposes of determining whether a person has ‘indirect’ control. Indirect control will arise in any of the following scenarios:

- where a person would have direct control if certain additional rights and powers were attributed to that person, including, by way of example, entitlements to rights and powers of connected persons, and future rights and powers;
- where a person is a 40 per cent participant in a joint venture and there is one other participant who holds at least 40 per cent of the venture; and
- where a person acts together with other persons in relation to a financing arrangement, and that person would have direct control if the rights and powers of those other persons were attributed to it.

iii  Scope

The UK rules apply where an actual provision has been made or imposed between two ‘persons’. There is no definition of ‘person’ in UK tax legislation but HMRC will apply the term to include bodies corporate, partnerships and individuals. The effect of the participation condition (see above), however, is that one of the parties to the actual provision must be a body corporate or a partnership.

Both cross-border transactions and domestic transactions fall within the scope of these rules.

Where an adjustment is required by the transfer pricing rules to increase the profits (or reduce the losses) of one party (the ‘advantaged party’), the connected UK party (the ‘disadvantaged party’) may, in turn, claim a compensating adjustment to their taxable profits. The rules also allow for a balancing payment to be made by the disadvantaged party to the advantaged party tax-free up to the amount of the compensating adjustment.

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3 Abbey National Treasury Services plc v. HM Revenue & Customs, TC/2012/02613.
5 Section 1124 of the Corporation Tax Act 2010.
6 Sections 157 to 163 of the TIOPA.
7 Section 196(2) of TIOPA.
Exemptions apply for small and medium-sized enterprises and dormant companies where certain conditions are met.

The UK transfer pricing rules do not apply to the calculation of a chargeable gain (or allowable loss) except to facilitate a claim for a compensating adjustment where there has been a transfer pricing adjustment. Notwithstanding this, a market value rule may be imposed on related-party transactions under the Taxation of Chargeable Gains Act 1992, which should, in the majority of cases, produce a similar result.

iv OECD principles

The UK rules contain an express provision that Part 4 of the TIOPA should be construed in a manner that best secures consistency with the arm’s-length principle in Article 9 of the Model Convention and the OECD Guidelines. The definition of the OECD Guidelines has been updated to include the Base Erosion and Profit Shifting (BEPS) Actions 8–10 Final Reports on Aligning Transfer Pricing Outcomes with Value Creation. While the strict statutory position is that these updates to the OECD Guidelines should apply only in relation to accounting periods beginning on or after 1 April 2016 for corporation tax purposes, HMRC generally views the updates as merely clarifications. Therefore, HMRC contends that applying a particular version of the OECD Guidelines to a transaction or provision that pre-dates that version coming into effect should not result in a different outcome.

II FILING REQUIREMENTS

There is no specific requirement under the UK rules to prepare a transfer pricing report. However, given transfer pricing forms part of the UK self-assessment system, a taxpayer must keep and retain appropriate records and documentation so that it can submit a correct and complete tax return.

HMRC guidance refers to four classes of records or evidence that it would need to consider in order to assess whether a taxpayer’s transfer pricing accords with the arm’s-length standard, as follows:

a primary accounting records;
b tax adjustment records;
c records of transactions with associated businesses; and
d evidence to demonstrate an arm’s-length result.

While HMRC would expect the first three categories to be prepared in advance of submitting a tax return for the relevant accounting period, evidence to demonstrate an arm’s-length result may be required only in response to an information request from HMRC as part of an inquiry into a taxpayer’s return. Of course, preparing contemporaneous transfer pricing documentation should assist in demonstrating that a taxpayer has taken reasonable care in determining its transfer pricing. Therefore, provided any transfer pricing report is credible, it should prove helpful in defending the imposition of any penalties should the taxpayer’s transfer pricing subsequently prove to have been incorrect.

8 HMRC International Manual (INTM480020).
9 Section 164 of TIOPA.
10 HMRC International Manual (INTM483030).
Recommendations about transfer pricing documentation can also be found in the OECD Guidelines. In addition, HMRC will also accept documents prepared in accordance with the EU’s Code of Conduct on transfer pricing documentation.11

III PRESENTING THE CASE

i Pricing methods

Since the UK’s domestic transfer pricing legislation must be construed in a manner consistent with the OECD Guidelines, any of the five transfer pricing methods provided for in the OECD Guidelines may be adopted in the UK, provided the relevant method establishes pricing that satisfies the arm’s-length standard.

It is also worth noting that the OECD Guidelines permit taxpayers to adopt ‘other methods’ outside of the five OECD-recognised methods where the latter are regarded as less appropriate or unworkable having regard to the particular facts and circumstances of the case. Under most of the methods, it is necessary to carry out a comparison of the controlled (i.e., related party) transaction against an uncontrolled (i.e., independent party) transaction.

Generally speaking, the nature of the controlled transaction in issue (having regard, in particular, to the functional analysis), the availability of information, the degree of comparability and the reliability of comparability adjustments are factors that influence the selection of the most appropriate method. HMRC endorses the OECD’s preference for traditional transaction methods over transaction profit methods where both can be applied in an equally reliable manner and, similarly, it is generally accepted that a comparable uncontrolled price (CUP) is the most effective way of assessing the arm’s-length price.

Comparability

HMRC emphasises the importance of carrying out a robust comparability analysis as this may have a considerable impact on the acceptable range of arm’s-length pricing. However, it is difficult for a CUP to be entirely robust given that access to information on a third party’s actual position is limited. A determination as to whether any given comparable is reliable must be made case by case having regard to the extent to which they satisfy the five comparability factors identified in the OECD Guidelines (i.e., the characteristics of the property or services transferred, the functions performed taking into account the assets used and risk assumed, the contractual terms, the economic circumstances of the parties and the business strategies pursued by the parties).

In practice, both quantitative and qualitative data will be used to include or exclude potential comparables. HMRC acknowledges that a small number of strong comparables is likely to give a more accurate result than a large number of weak comparables.

The feasibility of carrying out reasonably accurate comparability adjustments is equally important when performing a comparability analysis. Examples of comparability adjustments include adjustments for accounting consistency and adjustments for differences in functions, assets and risks. However, in line with the OECD Guidelines, the only adjustments that should be made are those for differences that will have a material effect on the comparison

11 HMRC International Manual (INTM483030).
and that are expected to improve comparability. If numerous or substantive adjustments to important comparability factors are required, this may be an indication that the comparability of the independent transaction is not, in fact, sufficiently reliable.

**Cost-plus**

The cost-plus method is typically applied in the UK for routine low-risk activity (e.g., administrative business support functions or services that a multinational group would be prepared to outsource). A key consideration in applying this method is to ensure that all relevant costs have been included in the tested party’s cost base.

**Profit split**

In contrast, the profit split method is often applied for highly integrated operations or where both parties make unique and valuable contributions (e.g., contribute unique intangibles) to the transaction. This method is more commonly applied where the level of integration or contribution made by the relevant parties is akin to a joint venture. A search for reliable comparables must have been suitably exhausted before availing of this method. Following a consultation over 2016 and 2017, the OECD is in the process of revising its guidance on the application of the profit split method, which is expected to be published later this year.

**Cost sharing**

The guidance contained in the OECD Guidelines on cost sharing arrangements applies in the UK. In applying this guidance, HMRC emphasises that there is no difference in the approach for analysing transfer pricing for cost sharing arrangements than for any other transactions and that parties performing activities under similar economic circumstances should receive the same expected return irrespective of whether those activities are performed within the framework of a cost sharing arrangement or not.

The BEPS Actions 8–10 Final Reports make clear that contributions made to such an arrangement should not be measured at cost where this is unlikely to provide a reliable basis for determining the value of the relative contributions of the participants. While cost share methods are acceptable in the UK, it is expected that arrangements of this kind will be less commonly used for IP in the future due to this general requirement to measure contributions at fair value (rather than cost).

### ii Authority scrutiny and evidence gathering

**Cross-checks**

While one particular method may be selected and applied for the purposes of determining the arm’s-length pricing of the transaction, HMRC also emphasises the importance of cross-checking this result against other methods and applying sense checks. In light of the increased public interest in the tax affairs of multinational companies, HMRC will be interested in how the ‘man on the street’ would perceive the result. While this is, of course, a valid consideration, it must be balanced with the need to arrive at a principled arm’s-length price having due regard to the established rules and OECD guidance. This can involve exercising judgement based on experience as to the reasonableness of the result from a business and economic perspective.

Another sense check that HMRC is keen to examine is the global tax position for multinational groups and the profit share in each jurisdiction. This enables it to form a view
on whether the UK is getting its ‘fair share’ of the profits. Major difficulties can arise in trying to value the rate of return on IP across a multinational group. In a financial services context, however, it is generally easier to value the return on capital employed.

Following the introduction of the diverted profits tax (DPT) legislation (see Section IX), HMRC now expects to be provided with information on a group’s full supply chain, and the profits earned in each entity. Details on the transactions between UK and non-UK affiliates are unlikely to be sufficient, so taxpayers should expect to be required to provide information on pricing or profit allocation between non-UK members of the group also.

**Country-by-country reporting**

Consistent with the outcome of the BEPS project, the UK has adopted country-by-country reporting (CbCR) rules with effect for accounting periods beginning on or after 1 January 2016. The rules require any UK headed multinational enterprises or, in certain circumstances, UK sub-groups of multinational enterprises with a consolidated group turnover of €750 million or more to file an annual report containing information about global activities, profits and taxes to HMRC. The Finance Act 2016 afforded Her Majesty’s Treasury the power to make regulations requiring CbCRs to be included in a group’s published tax strategy. The UK government has confirmed that it is keen to achieve an international consensus for such a public model before exercising its powers to make such regulations.

**Evidence gathering**

HMRC’s governance process plays a key role in shaping how transfer pricing investigations are conducted. For any settlement to be approved by HMRC’s governance process, the HMRC case team must conduct a comprehensive fact-finding exercise.

**Interviews**

In addition to carrying out a review of documentary evidence (including email reviews), witness interviews may also be needed. Interviews with key business personnel can serve as a useful tool to address any gaps in HMRC’s knowledge following a review of the documentary evidence, to verify HMRC’s analysis of the material functions and risks in the business, and to assess whether there is any divergence between the related parties’ conduct and the terms of the written contracts between them. In addition to speaking with the tax personnel in the business, HMRC is keen to meet with those working at the coalface to get a proper understanding of where they perceive the real value-generating activities of the business to be located.

Depending on the facts and circumstances of a particular inquiry, HMRC may request interviews with third parties outside the taxpayer group, including customers. To avoid any undue business disruption, it is generally accepted that HMRC should try, where possible and practical, to obtain information and documents from the taxpayer concerned before approaching third parties. That said, third-party witness interviews can enable HMRC to independently check information provided by a taxpayer and to gain a more holistic picture of the business concerned.

In the case of customers, HMRC will liaise in the first instance with the taxpayer concerned to coordinate the interviews. If the taxpayer or the third party refuses to comply with this informal request, HMRC may decide to issue a third-party information notice that would legally require the customer to give HMRC certain information or documents to help it check the relevant taxpayer’s position. Before making a decision, HMRC case teams are
advised to consider carefully whether they can be satisfied in any way other than by issuing a third-party information notice. In addition, the approval of the tribunal is required in order to issue such a third-party information notice. HMRC cannot, however, require the third party to produce a document that is not in its possession or power or that is subject to legal professional privilege.

**Information exchange powers**

If information essential to a transfer pricing inquiry is shown not to be within the power or possession of a UK business or its officers, HMRC may consider invoking formal information powers, such as the exchange of information facility with other tax authorities. However, HMRC is expected to exhaust all other sources before invoking such powers. HMRC may avail of these facilities pursuant to a double tax treaty that contains an exchange of information article, the Joint Council of Europe or OECD Convention on Mutual Administrative Assistance in Tax Matters, various EU directives and regulations (pending the UK’s formal exit from the EU) and exchange of information agreements where no double tax treaty is in force.

Exchange of information articles typically restrict HMRC in the specific uses to which it may put the exchanged information it receives and the onward disclosure of that information. The usual rule is that the information can be used only for the purposes of the assessment and enforcement of the taxes covered by the relevant treaty. While transfer pricing will fall within the scope of most double tax treaties, this may not be the case for diverted profits tax (DPT) since HMRC views DPT as a tax ‘in its own right’ and not as corporation tax. However, HMRC may be able to obtain information for the purposes of a DPT investigation under the Convention on Mutual Administrative Assistance in Tax Matters as this effectively applies to all taxes.

**IV INTANGIBLE ASSETS**

HMRC recognises that the use and transfer of intangible assets represent a material risk area for transfer pricing, particularly in the context of multinationals.

The BEPS Actions 8–10 Final Reports provide revised guidance specifically tailored to determining arm’s-length conditions for intangible asset transactions. The revised guidance provides a framework for determining which members of a multinational group should share in the economic returns generated by those intangibles based on the value they create through functions performed, assets used and risks assumed in their development, enhancement, maintenance, protection and exploitation (DEMPE).

Based on recent transfer pricing inquiries involving multinationals in the technology area, it is expected that HMRC will look to carry out a DEMPE analysis across the global value chain of these multinationals so as to ensure that the transfer pricing resolution accords with the guidance in the BEPS Actions 8–10 Final Reports.

The framework for analysing DEMPE associated risks builds upon existing OECD guidance, which requires one to take into account both the capability to perform relevant ‘day-to-day’ decision-making functions together with the actual performance of those functions. Legal ownership of intangibles alone does not determine entitlement to returns,

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12 HMRC International Manual (INTM156050).
so if a member of a multinational group contractually assumes a specific risk but neither exercises control over that risk nor has the financial capacity to assume the risk, the risk should be allocated to another multinational group member that satisfies those requirements. To justify a higher than passive return for a member of a multinational group, it would be necessary to evidence that the member in question has appropriately skilled and qualified employees and resources to manage the economically significant risks associated with the relevant DEMPE functions.

V INVESTIGATIONS

i Process

The way in which a transfer pricing inquiry is conducted will vary from case to case, although once an inquiry has been opened the process generally involves HMRC: making and agreeing an action plan and timeline with the taxpayer; carrying out a fact-finding exercise; assessing the evidence and engaging in technical discussions with the taxpayer; and resolving the inquiry.

A transfer pricing inquiry is undertaken by large business service or local compliance case teams headed by their respective customer compliance manager. A transfer pricing specialist is allocated to each inquiry. The customer compliance manager is responsible for HMRC’s relationship with the customer and for the planning and direction of the work of the case team.13

Due to the punitive rate of DPT and for the other reasons outlined in Section IX, DPT can represent a strong incentive for taxpayers to be open and cooperative with transfer pricing inquiries.

ii Time limits

In the majority of cases, HMRC may open an inquiry into a taxpayer’s return within 12 months from the date on which a tax return is filed. Once opened, there is no specified time limit for completing the inquiry, although HMRC’s ‘Review of Links with Large Business’ commits HMRC to resolving transfer pricing inquiries within 18 months for the large majority of cases, and 36 months for those that are particularly complex and high risk. In its guidance, HMRC comments that a transfer pricing inquiry should not be opened without the approval of the Transfer Pricing Panel or Transfer Pricing Board. The taxpayer may request HMRC (or the tax tribunal) to close an inquiry if there appears to be an unnecessary delay by HMRC in progressing the case.14

Where the 12-month period within which an inquiry must be opened has passed, HMRC has the power to raise a discovery assessment where there has been incomplete disclosure or careless or deliberate conduct by the taxpayer. The time limit for raising a discovery assessment is generally four years from the end of the relevant accounting period to which the assessment relates. This may be extended to six years where the assessment is made to recover an underpayment of tax due to carelessness by the taxpayer (or 20 years where the error in the taxpayer’s transfer pricing position was deliberate).

13 HMRC International Manual (INTM481080).
14 Section 33 of the Finance Act 1998.
To conclude a formal inquiry, HMRC must issue a closure notice either confirming that no amendment is required or requiring the taxpayer to amend their return. If a taxpayer fails to comply with the contents of the closure notice, HMRC may make a determination as to the amount of tax that it considers is payable by the company. Such a determination has effect for enforcement purposes as if it were a self-assessment by the taxpayer.

An appeal may be brought against any closure notice or assessment by giving notice in writing within 30 days after the notice or assessment was issued.

VI SETTLEMENTS

The settlement of a transfer pricing inquiry must be approved by the Transfer Pricing Panel or the Transfer Pricing Board, following the submission by the HMRC case team of a resolution report. However, if arrangements have been identified as meeting the conditions for a potential DPT charge, a newly formed Diverted Profits Board will consider both the transfer pricing and DPT issues in point. A resolution report will include a summary of the case, a recommendation by the customer compliance manager as to how the case should be settled and a statement about culpability. The statement about culpability is intended to assist the relevant panel or board in assessing whether penalties should be imposed. Therefore, while the relevant panel or board is charged with approving or rejecting the resolution paper, the customer compliance manager retains a degree of influence over the process.

The Transfer Pricing Board makes decisions on high-profile or contentious transfer pricing enquiries. It also makes recommendations to the Tax Disputes Resolution Board (TDRB) about transfer pricing risks that fall within the TDRB’s remit. In 2016–2017, it considered 32 cases (22 in 2015–2016). The Diverted Profits Board similarly makes recommendations to the TDRB on HMRC’s largest and most sensitive cases. Since DPT was introduced, the Diverted Profits Board have considered 11 proposals to resolve DPT issues.

This governance framework is intended to ensure consistency across taxpayers and provide assurance to taxpayers that HMRC treats taxpayers fairly and even-handedly, irrespective of the size or complexity of the taxpayer or its affairs.

The relevant panel or board will examine the recommendations made in the case team’s resolution report. If the settlement is authorised, HMRC will confirm the agreement and its terms in writing to the taxpayer and their advisers. The taxpayer is then afforded a 30-day ‘cooling-off period’ in which it may withdraw from the agreement before a closure notice or assessment is issued.

If the resolution report is not approved, the relevant panel or board will set out the reasons why and the basis upon which the case team should revisit the negotiation or proceed to litigation.

Where a settlement has resulted in an adjustment to a taxpayer’s returned profits, this may be relied upon to inform the future returning position provided there has been no material change in the circumstances of the business or in the market conditions in those circumstances.
future periods. In such cases, HMRC may provide comfort that the inquiry period will be regarded as ‘low risk’. However, HMRC emphasises in its guidance that it cannot provide any assurances that a future return will not be subject to a transfer pricing inquiry.21 Certainty in relation to future years can be obtained only through a formal advance pricing agreement (APA) process. Certainty will only be achieved, of course, if the critical assumptions arrived at in the APA process remain true. Negotiating these assumptions will often require significant work in any APA discussions.

In certain cases, HMRC will recommend an APA either following a transfer pricing inquiry or during the process. This has the obvious advantage of increasing certainty that the transfer pricing method agreed upon will not be challenged and enables a taxpayer to realise more long-term benefits from the cost, time and effort involved in resolving the inquiry itself.

Notwithstanding the fact that an APA may be in place or HMRC may have agreed to treat a particular period as ‘low risk’, it is still open to HMRC to raise a discovery assessment in circumstances where it believes there has been incomplete disclosure or careless or deliberate conduct by a taxpayer.

VII LITIGATION
i Procedure
If a transfer pricing inquiry cannot be resolved by agreement, the taxpayer may appeal any final decision by HMRC to the FTT. The time limit for taxpayers to make an appeal is generally 30 days from the date of such final decision.

Most appeals will, in the first instance, be considered by the FTT. Where an appeal turns on a particularly complex point of law, without any disputed facts, it may be heard by the Upper Tribunal at first instance, where the parties agree and with the consent of the chamber presidents. Decisions by the FTT may be appealed to the Upper Tribunal on a point of law where permission has been granted. The Upper Tribunal will be a Superior Court of Record, which means that its decisions create legally binding precedents.

As a public body, a taxpayer may seek judicial review of the decision of an HMRC officer if certain requirements are satisfied. A taxpayer may seek this avenue of redress if, for example, it believes an HMRC officer has failed to properly carry out his or her duties or misdirected the taxpayer and in consequence the taxpayer has suffered a disadvantage. The FTT cannot hear judicial review claims. In Glencore Energy UK Ltd v HMRC,22 the taxpayer received a DPT charging notice and sought judicial review of the notice, arguing that the statutory appeal process was ‘slow, inappropriate and ineffective’. Unsurprisingly, given the very high threshold required for a judicial review case to succeed, the High Court refused this application.

The process to prepare for a transfer pricing hearing is the same as for any other tax litigation. The timeline for any given tax trial will vary according to the complexity of the dispute in question.

A court decision may be appealed where permission has been granted. Appeals from the FTT must be applied for within 56 days of the tribunal decision. Appeals from the Upper Tribunal and the Court of Appeal must be applied for within one month and 28 days,

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21 HMRC International Manual (INTM483130).
respectively. Appeals against the decisions of lower tribunals or courts can generally be made only on a point of law. However, if a party believes that the findings of fact made by the lower court or tribunal are such that no judge properly could have come to that determination, an appeal may be permitted on such wider grounds.

**ii Recent cases**

Very few transfer pricing cases have been litigated in the UK.

_DSG Retail Ltd v. HMRC_23 is one of very few transfer pricing cases to have reached the tribunal. This case concerned a UK company that sold electrical goods by retail. It encouraged customers to purchase extended warranty agreements. The liability to customers under those warranty agreements was insured or reinsured by an associated Isle of Man company via a third-party insurer. The tribunal considered the extent to which transfer pricing rules apply to the indirect provision of a business facility between connected companies where there is no contractual relationship between those companies, and the appropriate transfer pricing methodology for an adjustment.

The tribunal held that the UK company had provided an indirect business facility to its Isle of Man subsidiary, by enabling the subsidiary to enter into commercially advantageous insurance contracts with a third-party insurer. The tribunal further held that, if the UK company and its Isle of Man subsidiary had been dealing at arm’s length, the subsidiary would have remunerated its parent for the provision of that business facility, thereby increasing the UK company’s taxable profits.

**VIII SECONDARY ADJUSTMENT AND PENALTIES**

**i Secondary adjustments**

The UK government launched a consultation in 2016 on whether a secondary adjustment rule should be introduced into the UK’s transfer pricing legislation and how that rule would be designed. The effect of the secondary adjustment rule (if introduced) would be to reverse the additional financial benefit arising from the non-arm’s length pricing of an underlying transaction that currently remains after the application of the UK’s transfer pricing rules. For example, if a UK company purchased products from a related overseas company at a price in excess of the arm’s-length pricing, the UK transfer pricing legislation would adjust the incorrect pricing by reducing the deduction in calculating the UK company’s taxable profits and the secondary adjustment would seek to remove the benefit obtained from the retention of that excess cash by the related overseas party. Responses to the consultation document have not been published to date.

**ii Penalties**

HMRC may impose penalties if an incorrect return is made and a taxpayer has been careless or negligent in establishing an arm’s-length basis for the return; or a taxpayer does not maintain adequate records. Penalties may also apply where a taxpayer fails to comply with information requests made by HMRC in the conduct of an inquiry.

Tax-geared penalties apply for inaccuracies in tax returns and documents submitted to HMRC. This means that they are calculated as a percentage of the tax that is due. The

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percentage to be applied will depend on a number of factors including, among others, whether the underlying behaviour that gave rise to the inaccuracy was careless, deliberate, or deliberate and concealed; whether the disclosure was prompted or unprompted; and the quality of disclosure.

Given that transfer pricing is more of an art than a science and to some extent what is an arm’s-length price is a matter of judgement, it can be difficult to determine what is meant by ‘careless’ or ‘negligent’ in a transfer pricing context. While each case must be judged on its own merits and facts, HMRC provides some examples in its guidance on how it interprets these concepts. For example, where HMRC is satisfied that the taxpayer has made an honest and reasonable attempt to comply with the arm’s-length principle, no penalty should apply.

IX  BROADER TAXATION ISSUES

i  Diverted profits tax and other supplementary measures

DPT was introduced from April 2015 to tax profits of multinational businesses that have been diverted from the UK tax net through contrived arrangements. It is intended to provide the transfer pricing legislation with a little more steel to support HMRC inquiries in high-risk transfer pricing areas (such as the digital economy and IT). The expectation is that this, in turn, will encourage better transfer pricing compliance, and greater transparency with HMRC in dealing with transfer pricing inquiries.

Broadly speaking, a DPT charge can arise in two scenarios: first, where a UK subsidiary or permanent establishment enters into arrangements with a related person where that person, the transaction or transactions lack economic substance, resulting in a reduction of the subsidiary’s or permanent establishment’s taxable profits; or second, where a person carries on an activity in the UK connected to the supply of goods, services or other property made by a non-UK resident company in the course of its trade in a way that avoids creating a UK permanent establishment. The amount of DPT payable is 25 per cent of the amount of ‘taxable diverted profits’.

In the majority of cases, any DPT charge can be franked by making appropriate transfer pricing adjustments. DPT can accelerate resolution of a transfer pricing inquiry for the following reasons: the DPT rate is considerably higher than the UK corporation tax rate; it is not possible to postpone any DPT payment once a charging notice has been issued; and DPT gives credit for transfer pricing adjustments only if they are made before DPT is assessed.

In 2016 and 2017, HMRC issued 16 DPT preliminary notices and 14 DPT charging notices. HMRC reported that the amount raised from the first issue of DPT charging notices during 2016 and 2017 was £138 million, comprising DPT receipts and additional corporation tax arising from behavioural change.24

ii  Double taxation

Most of the UK’s tax treaties have effective mutual agreement procedures (MAPs). These provisions typically permit HMRC to engage in the MAP but do not require the case in question to be resolved. Consequently, there is no guarantee of relief from double taxation.

under an MAP. That said, the UK is generally seen as having a good track record in obtaining relief from double taxation in cases involving transfer pricing adjustments. HMRC resolved 36 MAP cases in 2016 and 2017.\textsuperscript{25}

The EU Convention (90/463/EEC) on the elimination of double taxation in connection with the adjustment of profits of associated enterprises may provide an alternative to the MAP procedure where residents of EU Member States are potentially subject to double taxation. The MAP may be invoked under a treaty, under the EU Convention or under both simultaneously. While the UK will not cease to be a party to the EU Convention by virtue of Brexit, the territorial scope of the EU Convention is defined by reference to EU membership. Therefore, the UK will fall outside the territorial scope of the EU Convention following the UK’s formal exit from the EU. It is not yet clear what (if any) new or, indeed, transitional arrangements the UK or the EU 27 will seek to put in place post Brexit.

The MAP is not an alternative to the normal transfer pricing inquiry process. An inquiry will not be conducted as part of an MAP and, equally, an MAP will not suspend or replace an inquiry. A taxpayer cannot pursue domestic legal remedies and the MAP concurrently. If a case is accepted for the MAP while domestic legal remedies remain available, HMRC will generally require the taxpayer to agree to suspend these remedies or delay the MAP until these remedies are exhausted.\textsuperscript{26}

Part VI of the multilateral instrument that was adopted pursuant to Action 15 of the BEPS project enables countries to include mandatory binding arbitration (MBA) in their double tax treaties. MBA applies only between countries that expressly choose to apply it with respect to their double tax treaties. Twenty countries (including the UK) have committed to adopt and implement MBA in their bilateral tax treaties. These provisions will provide taxpayers with certainty that a case submitted to the MAP will be resolved.

HMRC is of the view that DPT is a separate, stand-alone charge on diverted profits and is not income tax, capital gains tax or corporation tax. Consequently, HMRC would not make it the subject of a bilateral APA or enter into MAP discussions concerning it. This is another reason why it is important to agree transfer pricing disputes before disputing DPT.

### iii Consequential impact for other taxes

#### VAT

Where a business records its transactions with related parties on arm’s-length terms, no transfer pricing issues should typically arise in respect of those transactions for VAT purposes. Further, HMRC is of the view that balancing payments do not in themselves create taxable supplies for VAT purposes. However, the existence of a transfer pricing adjustment or the payment or receipt of a balancing payment may indicate that the value of a previous VATable supply has been understated so that a VAT correction may be required.\textsuperscript{27}

Where the advantaged party and the disadvantaged party are within the same VAT group at the time of the original supply and subsequent adjustment, no VAT liability would normally arise.

\textsuperscript{25} Transfer Pricing and Diverted Profits Tax Statistics, to 2016/17.

\textsuperscript{26} HMRC Statement of Practice 1/2018.

\textsuperscript{27} HMRC VAT Valuation Manual (VATVAL 15700).
If a balancing payment is made conditional by one party in return for another VATable supply, it may, depending on the particular circumstances, be considered (in whole or in part) as non-monetary consideration so that an open market value direction under Schedule 6 of the Value Added Tax Act 1994 may be appropriate.

Import and customs duties

Similar issues arise in relation to the interaction of the transfer pricing rules with import and customs duties. Balancing payments may need to be considered in ascertaining whether there has been an under- or overvaluation of the import price of a particular transaction and, therefore, in determining whether an adjustment is needed.\(^28\)

X OUTLOOK AND CONCLUSIONS

Following the BEPS project, there is an increased focus on the functional analysis in applying the transfer pricing rules in the UK to ensure that transfer pricing outcomes are aligned with value creation.

Following the investigations by the House of Commons Public Accounts Committee into the tax affairs of multinational companies in late 2012 and the decisions of the European Commission in the more recent state aid investigations, the profile of transfer pricing has been raised in the media and has led to heightened public interest in the tax affairs of multinationals. While transfer pricing inquiries in the UK are being conducted by HMRC with increased vigour as a result, one tide that is yet to change is the widespread public criticism of multinational taxation. It is hoped that the implementation of the BEPS project will change public perception and make it easier for BEPS-compliant multinationals to convince their stakeholders and the court of public opinion that they pay their fair share of taxes in accordance with internationally agreed rules.

\(^{28}\) HMRC VAT Valuation Manual (VATVAL 15900).
I OVERVIEW

Transfer pricing generally

Given the historically high corporate tax rate in the United States, transfer pricing has been an area of particular concern to the Internal Revenue Service (IRS). Accordingly, the US has developed a comprehensive regulatory regime to ensure that related taxpayers engaging in cross-border transactions do so at arm's length.

Section 482 of the Internal Revenue Code (the Code or IRC) is the main statutory tool provided to the IRS to combat inappropriate transfer pricing. This statute gives the IRS broad authority to allocate gross income, deductions, credits and other allowances between two or more organisations, trades or businesses owned or controlled by the same interests whenever 'necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses'. The objective of Section 482 is to place ‘a controlled taxpayer on a tax parity with an uncontrolled taxpayer by determining the true taxable income of the controlled taxpayer’. True taxable income is determined by judging transactions between controlled taxpayers against comparable transactions between unrelated persons dealing at arm's length.

In the case of any transfer or licence of intangible property, Section 482 specifically provides that ‘the income with respect to such transfer or licence shall be commensurate with the income attributable to the intangible’.

Section 482 and its implied arm's-length standard was first codified in Section 482 of the Code in 1934. However, it was not until 1968 that the IRS promulgated regulations concerning specific methods for applying the arm's-length standard. These original methods – the comparable uncontrolled price (CUP) method, the resale price method, and the cost-plus method – have remained largely unchanged to the present day. As part of the Tax Reform Act

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1 Edward Froelich is of counsel and Jessica Stern is an associate at Morrison & Foerster LLP.
2 Profit shifting between multinational companies has cost the US government between US$77 billion and US$111 billion in corporate tax revenue between 1987 and 2012. Kimberly A Clausing, ‘The Effects of Profit Shifting on the Corporate Tax Base in the United States and Beyond’, 69 National Tax J. 905 (17 June 2016). Not all of this profit shifting arises from transfer pricing abuses, but a significant portion may. However, with the enactment of substantial corporate tax rate cuts and certain cross-border tax legislation effective 1 January 2018, there may be less incentive for multinational US companies to engage in transfer pricing as a tax avoidance vehicle.
3 IRC Section 482.
4 Treas. Reg. Section 1.482-1(a)(1).
5 Treas. Reg. Section 1.482-1(b)(1).
6 IRC Section 482.
of 1986, Congress amended Section 482 by adding the commensurate with income standard for the transfer of intangible property. At the same time, Congress directed the IRS to undertake a study of the operation of transfer pricing mechanisms, particularly with respect to the exploitation of intangible property, which resulted in the issuance of the Section 482 White Paper in 1988.\(^7\) The Section 482 White Paper led to a series of proposed regulations that were amended repeatedly before being issued in final form in 1994 through 1996. These regulations implemented the commensurate with income standard and introduced new procedural rules and pricing methods for intangible property. They also included new rules for cost-sharing arrangements. In 2009, the IRS proposed an entirely new set of regulations on cost-sharing arrangements, effective for transactions after 4 January 2009, which were adopted in final form in 2012.\(^8\)

**Statutory requirements of Section 482**

There are three prerequisites for a reallocation under Section 482. First, there must be ‘two or more organizations, trades, or businesses’. Second, these organizations must be ‘owned or controlled directly or indirectly by the same interests’. Finally, the IRS must have determined that reallocation is ‘necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses’.\(^9\) The regulations interpret these requirements in the broadest possible sense.

For the purpose of Section 482, an organisation is defined to include any corporation, partnership, trust, estate, association or sole proprietorship, regardless of where it is organised, operated or carries on its business.\(^10\) For these purposes, it is irrelevant whether the organisations are members of an affiliated group or whether that group files a return. In addition to these types of organisations, Section 482 also applies to any trade or business activity of any kind, regardless of the place of organisation or operation, the formalities of organisation or the type of ownership.\(^11\) In some instances, shareholders in a corporation they controlled have been found to be ‘organizations, trades, or businesses’ such that income of the corporation could be reallocated to them under Section 482.\(^12\)

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8 Treas. Reg. Section 1.482-7. Under the cost-sharing regulations previously in effect, intangible property acquired through a ‘qualified cost-sharing arrangement’ was not subject to the general rule of Section 482. Instead, the IRS was only permitted to make allocations so that each controlled participant’s share of costs of development equaled its share of the reasonably anticipated benefits of the development. Treas. Reg. Section 1.482-7A(a)(1). The prior regulations remain in effect for transactions occurring on or before 4 January 2009.
9 IRC Section 482.
10 Treas. Reg. Section 1.482-1(i)(1).
11 Treas. Reg. Section 1.482-1(i)(2).
12 See, e.g., Dolese v. Comm’r, 811 E2d 543 (10th Cir. 1987) (partnership distributions reallocated among partners, one of whom was the sole shareholder and an employee of the second partner); Rubin v. Comm’r, 460 E2d 1216 (2d Cir. 1972) (management services income paid by one corporation to another reallocated to a shareholder who performed the management services and controlled one of the corporations); Borge v. Comm’r, 405 E2d 673 (2d Cir. 1968), cert. denied, 395 US 933 (1969) (entertainment services performed for a controlled corporation, which subcontracted services to third parties, producing profits offset by losses from other activities reallocated to sole stockholder).
The requirements for ownership or control are similarly broad. Ownership may be direct or indirect. Control may be any kind of control, whether direct or indirect, legally enforceable or not. Control for the purpose of Section 482 also exists where two or more taxpayers are acting in concert or with a common goal or purpose.\textsuperscript{13} The regulations make it clear that the reality of the control is what is ‘decisive, not its form or the mode of its exercise’.\textsuperscript{14} An arbitrary shifting of income or deduction raises a presumption of control. This broad definition of control allows Section 482 to be applied to enterprises owned by different members of the same family or in different proportions by a group of persons.

The final requirement, namely that the IRS make a determination that the allocation is necessary to prevent tax evasion or to clearly reflect the income of any member of the controlled group, is practically meaningless as a prerequisite. If the IRS determines the transfer price adopted by the group is erroneous then, by definition, certain group members’ income is not clearly reflected. Allocations affecting taxable income can be made to income, deductions, credits and allowances. The courts have generally upheld a reallocation by the IRS unless the taxpayer is able to prove that the IRS abused its discretion by engaging in conduct that was arbitrary, capricious or unreasonable.\textsuperscript{15}

\section*{II \hspace{1em} FILING REQUIREMENTS}

Neither the Code nor the Treasury Regulations require a taxpayer to prepare documentation supporting its transfer price. Nevertheless, well-advised taxpayers will prepare a supporting analysis contemporaneously with the filing of the relevant income tax return. A complete set of transfer pricing documentation will typically insulate a taxpayer from the assertion of accuracy-related penalties by the IRS under Section 6662(e) of the Code. The Treasury Regulations provide specific descriptions for the principal documents that comprise adequate transfer pricing documentation:

\begin{enumerate}
\item an overview of the taxpayer’s business including an analysis of the legal and economic factors affecting its pricing;
\item a description and chart of the organisational structure covering all relevant related parties;
\item any documents explicitly required by regulations under Section 482 (for example, Treas. Reg. Section 1.482-7(k) requires that cost-sharing agreements between controlled parties be recorded in writing in a contemporaneous contract);
\item a description of the pricing method selected and reasons why the method was selected (i.e., a best-method analysis);\textsuperscript{16}
\item an explanation why alternative methods were not selected;
\item a description of the controlled transactions and any internal data used to analyse them;
\item a description of the comparables used, how comparability was evaluated and any adjustments that were made;
\item an explanation of the economic analysis and projections used to develop the pricing method;
\end{enumerate}

\textsuperscript{13} Treas. Reg. Section 1.482-1(i)(4).
\textsuperscript{14} Id.
\textsuperscript{16} In general, the best method is the method that provides the most reliable measure of an arm’s-length result.
a description or summary of any relevant data obtained after the close of the tax year but before filing the tax return; and

a general index of the principal and background documents and a description of the record-keeping system for such documents.

Controlled parties who enter into a CSA are obliged to update and maintain the CSA documentation.17

Where controlled parties enter into a CSA to determine their transfer pricing, each controlled participant in the agreement must file a statement with the IRS under Treas. Reg. Section 1.482-7(k)(4) (describing contents and time and manner of filing of the CSA statement). There is an annual requirement for each taxable year in which the CSA is effective for each controlled participant to file the original CSA statement with its US tax return and to provide updated information if any.18

A taxpayer must provide its transfer pricing documentation to the IRS within 30 days of the IRS’s formal request for such documentation during the audit. It is typical for the IRS to make this request with reference to Section 6662(e) (the relevant penalty provision) at the outset of the audit.

If a taxpayer has not prepared such documentation at the time of the return filing, there is no general requirement to prepare any such documentation during an IRS examination. However, during the examination the IRS will request support for the transfer pricing adopted by the taxpayer. If the taxpayer does not provide any support, the IRS will evaluate the appropriate transfer price based on its own economic analysis, and, if that analysis results in a price supporting a tax deficiency, the IRS will assert accuracy-related penalties under Section 6662(e).

III PRESENTING THE CASE

Pricing methods

Acceptable methods vary according to the nature of the transferred item (i.e., tangible or intangible property, or services). What is key is that the method ultimately employed by the taxpayer should be the result of a comparison between methods that determines the best method (known as ‘the best method rule’).19 In general, for tangible property, the CUP, resale price, cost-plus, comparable profits method (CPM), profit split and unspecified methods are all acceptable. For intangible property, the IRS accepts the comparable uncontrolled transaction (CUT), CPM, profit split and unspecified methods. With respect to services, the IRS accepts the services cost, comparable uncontrolled services price, gross services margin, cost of services plus, CPM, profit split and unspecified methods. For CSA buy-ins, technically called platform contribution transactions or PCTs, the IRS accepts the CUT, income, acquisition price, market capitalisation, residual profit split and unspecified methods. The IRS has shown a clear preference for the income method in determining an appropriate buy-in valuation.

17 Treas. Reg. Section 1.482-7(k)(2).
18 Treas. Reg. Section 1.482-7(k)(4)(iii)(B). If a controlled participant does not file a US income tax return that participant must ensure that the same information is attached to Schedule M of any Form 5471 ‘Information Return of a Foreign Owned Corporation’ or the equivalent foreign partnership form.
19 Treas. Reg. Section 1.482-1(c).
ii Authority scrutiny and evidence gathering

In scrutinising a taxpayer’s return position, the IRS may request to interview key personnel. The IRS has broad authority under Section 7602 of the Code to examine the books and records of the taxpayer and this can include interviews. Section 7603 empowers the IRS to issue an administrative summons to require a taxpayer to provide information and to submit to an interview; however, a taxpayer can oppose such a summons in court on various grounds such as privilege or administrative defects in the issuance of the summons. Further, the IRS is not limited to seeking information from the taxpayer. The IRS can and does seek relevant information from third parties such as accounting firms who may have advised the taxpayer, outside financial auditors, banks or other parties. Section 7609 of the Code authorises the IRS to issues summons to third parties. In no event is a taxpayer required to create new documentation as the authority of the IRS is limited to an examination of the books and records supporting the filing position.

Interviews are not a routine audit practice. For the most part, a taxpayer will satisfy the IRS information needs through a combination of documents and written responses to questions, called information document requests or IDRs. It can also be helpful to both the IRS examiner and the taxpayer for the taxpayer to make a presentation to the IRS regarding the transfer pricing transactions and supporting economic analysis. Such presentations can feature the key taxpayer personnel who took part in the implementation of the transactions.

Apart from information exchange agreements and treaty provisions, the IRS is generally limited in its authority to obtain information outside the jurisdiction of the United States. On 30 June 2016 the Treasury Department published final country-by-country reporting rules.20 The Treasury explained the reasons for adopting these rules in the preamble:

U.S. MNE groups will be subject to CbC filing obligations in other countries in which they do business if the United States does not implement CbC reporting. Thus, a decision by the Treasury Department and the IRS not to implement CbC reporting will result in no compliance cost savings to U.S. MNE groups. In fact, failure to adopt CbC reporting requirements in the United States may increase compliance costs because U.S. MNE groups may be subject to CbC filing obligations in multiple foreign tax jurisdictions.

In addition, CbC reports filed with the IRS and exchanged pursuant to a competent authority arrangement benefit from the confidentiality requirements, data safeguards, and appropriate use restrictions in the competent authority arrangement. If a foreign tax jurisdiction fails to meet the confidentiality requirements, data safeguards, and appropriate use restrictions set forth in the competent authority arrangement, the United States will pause exchanges of all reports with that tax jurisdiction. Moreover, if such tax jurisdiction has adopted CbC reporting rules that are consistent with the 2015 Final Report for Action 13 (Transfer Pricing Documentation and Country-by-Country Reporting) of the Organization for Economic Co-operation and Development (OECD) and Group of Twenty (G20) Base Erosion and Profit Shifting (BEPS) Project (Final BEPS Report), the tax jurisdiction will not be able to require any constituent entity of the U.S. MNE group in the tax jurisdiction to file a CbC report. The ability of the United States to pause exchange creates an additional incentive for foreign tax jurisdictions to uphold the confidentiality requirements, data safeguards, and appropriate use restrictions in the competent authority arrangement.

20 Treas. Reg. Section 1.6038-4.
The IRS and 32 foreign tax agencies have entered into competent authority agreements to exchange taxpayers’ global tax and profit reports with foreign jurisdictions. Nine more foreign agencies are in negotiations with the IRS to execute such agreements.

These bilateral agreements would allow US multinationals to file their global tax and profit reports with the IRS instead of with foreign jurisdictions.

IV INTANGIBLE ASSETS

The Treasury Regulations define the term ‘intangible’ to include all property that both has ‘substantial value independent of the services of any individual’ and fits within any of six classes:

- patents, inventions, formulae, processes, designs, patterns or know-how;
- copyrights and literary, musical or artistic compositions;
- trademarks, trade names or brand names;
- franchises, licences or contracts;
- methods, programmes, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists or technical data; and
- other similar items.

For the purpose of Section 482, an item is considered similar to those listed in paragraph (b), (a) to (e) of this section if it derives its value not from its physical attributes but from its intellectual content or other intangible properties.21

Section 482 provides special rules for controlled transfers of intangible property. A controlled transfer of an intangible may be either a sale or other transfer of ownership, or a licence. The IRS normally respects the form chosen by controlled taxpayers if it conforms to the economic substance of the transaction.22 However, even if the IRS respects the taxpayer’s chosen form, alternatives to that form may be considered in assessing whether the consideration is at arm’s length if persons dealing at arm’s length would use one or more of the alternatives.23 For example, in deciding whether a royalty is at arm’s length, the IRS may attempt to consider the profits that would have been realised by the licensor if, instead of licensing the intangible, it had itself carried on the controlled licensee’s activities (e.g., producing and selling goods under the licensed intangible).24 Additionally, because of the language in Section 482 requiring that in the case of any transfer or licence of intangible property, ‘the income with respect to such transfer or licence shall be commensurate with the income attributable to the intangible’, the transfer or licence should be periodically re-examined and potentially adjusted, even if the licence or other agreement provides for no such adjustment.25

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21 Treas. Reg. Section 1.482-4(b). The recent tax reform legislation changed the definition of intangible for purposes of Section 936 of the Code to include ‘goodwill, going concern, workforce in place, and any other item the value or potential value of which is not attributable to tangible property or the services of any individual’. This may have a significant impact on transfer pricing valuation should this definitional change be considered relevant for Section 482 purposes.


24 We discuss the Amazon case in which the realistic alternative approach was rejected where the taxpayer appropriately applied and followed the CSA regulations.

Controlled transfers of intangibles are generally tested under arm’s-length principles, similar to other types of controlled transactions. The arm’s-length standard for transfers of intangibles is not necessarily satisfied by a royalty rate equal to the prevailing rate within the same or similar industry or the rate under an uncontrolled transfer that is not comparable to the controlled transfer. There is one method that is unique to determining transfer pricing for licences and other transfers of intangible property – the CUT method. As in the case of the determination of tangible property transfer pricing, the CPM and profit split method may be used for intangible property transfers. Also, some other reasonable method may be devised for an intangible transfer if it can be shown to be the best method under the circumstances. Each of the first three methods must be considered in determining the best method under Section 482 and its regulations.

V SETTLEMENTS

Settlements of transfer pricing disputes with the IRS can be accomplished in several ways. The ordinary settlement method is through the IRS Office of Appeals. IRS Appeals is engaged only after the taxpayer and the IRS examiners cannot agree on an adjustment. Another avenue for settlement is after the taxpayer brings a dispute to federal court. Indeed one of the largest transfer pricing disputes in the IRS’s history was settled after extensive litigation in the US Tax Court. A third method of settlement is through the competent authority process. The competent authority process can be initiated during the examination phase or after an initial settlement conference with IRS Appeals.

Appeals is the official settlement arm of the IRS for disputes arising from audits. It is staffed by appeals officers located in 11 appeals offices throughout the country. The Chief of Appeals, located in the IRS National Office in Washington, DC, is the top IRS appeals executive, and is assisted by the Deputy Chief of Appeals in his or her duties. An appeals officer is charged with making an objective evaluation of the taxpayer’s case based on the hazards of litigation. Importantly, the Appeals Office is independent from the IRS

27 Treas. Reg. Section 1.482-4(a).
28 Id.
29 Treas. Reg. Section 1.482-4(d).
30 IRS examiners do not have authority to settle cases based on litigation hazards. However, if the examiners and the taxpayers can agree on a particular valuation, for example by agreeing to a discount rate, a transfer pricing dispute can be resolved at the examination level. Examiners will need to have a non-hazards basis on which to agree to such a resolution.
31 In 2006, the Internal Revenue Service settled its transfer pricing dispute with Glaxo SmithKline Holdings (Americas) Inc & Subsidiaries (GSK). At the time this case was being litigated in the US Tax Court it was the largest tax dispute on record. Under the settlement agreement, GSK paid the IRS approximately US$3.4 billion, and abandoned its claim to a refund of US$1.8 billion in overpaid income taxes. The Tax Court dispute involved intercompany transactions between GSK and certain of its foreign affiliates relating to various GSK ‘heritage’ pharmaceutical products. The IRS questioned the amount of US profits reported by GSK after making intercompany payments that took into account product intangibles developed by and trademarks owned by its UK parent, and other activities outside the US, and the value of GSK’s marketing and other contributions in the US.
32 For disputes with the IRS that have been filed in court, Appeals has no official settlement role (apart from Tax Court cases that have not previously been before Appeals, which are immediately referred to Appeals after the petition is filed in the Tax Court).
audit team that has proposed the adjustments. An appeals officer learns of the taxpayer’s position regarding the proposed adjustments primarily through the taxpayer’s protest letter. The protest letter is addressed to the IRS audit team supervisor. In some instances, a taxpayer may supplement its original transfer pricing analysis with an independent economist analysis and provide such analysis with its protest. The IRS audit team then forwards the protest letter to the appropriate appeals office, along with the audit team’s written rebuttal to the protest letter. It is possible that the IRS audit team, upon review of the protest letter, may change its legal analysis to respond to the taxpayer’s argument, or may in fact be persuaded to concede.

Appeals’ review is an informal consideration of the contrasting positions. There is no testimony or formal hearing process. Instead, the appeals officer will convene a series of meetings to assist the officer in evaluating the litigation risks for both sides. It is typical for Appeals to include transfer pricing experts on its team in dealing with these disputes. They may also consult with a staff economist. The first (pre-conference) meeting allows the IRS audit team to explain its position on the various adjustments that it proposes. IRS legal counsel is likely to assist in that presentation. Because an appeals officer may not have ex parte communications with the audit team, a taxpayer must be allowed to attend this meeting.

If, after settlement discussions, the taxpayer and the appeals officer agree on a resolution, Appeals will prepare an internal memorandum to record the analysis of the case, and for approval by his or her supervisor. The appeals officer will then prepare either a Form 870-AD or a closing agreement for the taxpayer that contractually binds the taxpayer and the IRS to the terms of the settlement. If no settlement is reached, the appeals officer will prepare either a statutory notice of deficiency, giving the taxpayer the opportunity to seek relief in the US Tax Court, or a Form 870, which obtains the taxpayer’s consent to the immediate assessment and collection of any tax due. Most taxpayers will elect to receive a statutory notice of deficiency. However, some may wish to pursue their case in court after payment of taxes, and so will request a Form 870, pay the tax due and begin proceedings for filing a tax refund action in federal district court or the US Court of Federal Claims.

VI INVESTIGATIONS

As with any IRS examination, the first step of an audit is the delivery of a notice of audit letter, sometimes called an appointment letter. This is a standardised letter that is sent to the taxpayer’s address on file and, along with identifying the year or years under audit, includes a request for certain general business information and proposes a time for a meeting. What precedes the selection of a taxpayer for audit is a process of risk analysis. The IRS reviews income tax returns and, through a combination of algorithms and review of disclosure forms, decides which taxpayers present the highest compliance risk. Schedule UTP (Uncertain Tax Position) is one such disclosure form. In that form, businesses having assets of US$10 million or more must identify return positions for which they either recorded a reserve on their financial statements or for which they did not record a reserve but expect to litigate. Transfer pricing positions can present uncertainty and will be reflected on a business’s Schedule UTP in that circumstance. Moreover, the IRS Large Business and International Operating Division or LBI has recently modified its audit methods to focus on high-risk areas. They have adopted what is called a ‘campaign method’, whereby specific issues are targeted in an integrated

33 Form 906, ‘Closing Agreement on Final Determination Covering Specific Matters’, will bind the IRS and the taxpayer except where there has been fraud, malfeasance or misrepresentation of material facts.
manner. Campaign issues typically are those that present a high risk of non-compliance in the viewpoint of the IRS. A number of campaign issues have been announced by the IRS. Although to date only one is specifically transfer pricing related (inbound distributor pricing), IRS officials have indicated that transfer pricing more broadly is an area of high concern.

Generally, the IRS must assess tax within three years from the time of filing of the return. The IRS can request the taxpayer to agree to extend the assessment period. This is usually in the taxpayer’s interest because otherwise the IRS will be forced to make a protective assessment, which will always be an inflated amount.

VII LITIGATION

i Procedure

If efforts to resolve an issue within the administrative apparatus of the IRS have failed, a taxpayer has the option to file suit in federal court. A taxpayer thus is able to have its ‘day in court’ on the tax issue that the IRS has raised. As a matter of jurisdiction, there are four potential judicial venues in which to raise a federal tax claim: the US Tax Court, the US Court of Federal Claims, a federal district court or a bankruptcy court.

With the exception of the Tax Court, the above-mentioned courts hear tax cases just as they hear any other dispute that comes before them. They follow the Federal Rules of Civil Procedure (or similar versions of those rules) and apply the Federal Rules of Evidence at trial. They allow for a full range of discovery of the IRS, dispositive motions, oral arguments, motions in limine and trial, as well as all post-trial procedures, including appeal rights to a federal appellate court, and thereafter the ability to petition the court of last resort, the US Supreme Court.34

The Tax Court is a court of singular subject-matter jurisdiction (i.e., federal tax deficiency cases), and has some different rules of litigation; however, for the most part it operates just as the other courts with respect to discovery, motions and litigation. For some taxpayers, the US Tax Court is not available simply because they are not seeking to avoid payment of tax asserted to be due, but to force the IRS to repay tax they believe is overpaid. Thus, the only courts available to these taxpayers are the ‘refund’ courts (i.e., federal district courts or the US Court of Federal Claims). However, taxpayers who face proposed tax assessments after audit can choose between the US Tax Court and the refund courts. There are several points to consider when deciding which judicial venue is the best to hear a taxpayer’s case:

a which forum has the most favourable precedent;
b what the comparative cost differences are, other than the fact that payment of taxes (and possibly interest and penalties) is required to obtain refund jurisdiction;
c which forum offers the best opportunity to settle early and favourably;
d where the taxpayer is most likely to prevail in trial; and
e where the taxpayer is most likely to prevail upon appeal, if necessary.

The specific circumstances of the case and issues involved will, of course, affect the answer to some of these questions. Thus, where the precedent gives a distinct advantage on the merits of the issues, this will improve the chances of settlement in that forum and the chances of

34 While there is a right to appeal to the federal appellate court, there is no right of appeal to the US Supreme Court for tax cases. The Supreme Court takes these cases at its sole discretion.
prevailing in litigation. The US Tax Court may have more or less favourable case law than the refund courts. On the other hand, the US Court of Federal Claims, a tribunal separate from the federal district courts, may have the most beneficial case law. A taxpayer should retain counsel to carefully analyse the applicable precedent in each forum, as this is one of the most important factors to consider in the choice of forum.

ii Recent cases

Several major companies are disputing proposed IRS adjustments, including Coca-Cola, Inc, which is disputing in the Tax Court a US$9 billion proposed transfer pricing adjustment, Amazon.com, Inc, Microsoft Corp, and The 3M Company. Recent trial court decisions include Amazon v. Commissioner, Medtronic v. Commissioner, and Wycoff v. Commissioner.

Amazon

Amazon’s dispute is indicative of current IRS enforcement practices in the transfer pricing area. Like many multinational companies, Amazon entered into cost-sharing agreements with its foreign subsidiaries. Pursuant to the applicable Treasury Regulations, those subsidiaries were required to make ‘buy-in’ payments to reflect the value of pre-existing intangibles provided by Amazon for the development of the operations of its foreign subsidiaries. Among other issues, the IRS in audit focused on the value of the buy-in payment. To that end, the IRS audit team engaged outside economists to analyse and opine on the value of the pre-existing intangibles. The economists issued a report that concluded that the value of the intangibles was more than 10 times higher than the value used to determine the buy-in payment. The economists used a specific valuation method, the discounted cash-flow method and collected three sets of data (future cash-flow estimates, cash-flow timing and a discount rate) in the application of that method. In its petition to the Tax Court, Amazon attacked the discounted cash-flow method and compared it to the method used by the IRS in Veritas Software v. Commissioner, in which the Tax Court found that the IRS’s determination was arbitrary, capricious and unreasonable. Amazon prevailed in the Tax Court. On 23 March 2017, in a reviewed decision of the Tax Court, Judge Lauber rejected the IRS’s US$3 billion proposed transfer pricing adjustment against the online retail giant. Because of the IRS’s unreasonable disregard of certain critical facts, the Tax Court determined that the IRS had abused its discretion and threw out the proposed deficiency. The Tax Court then considered Amazon’s specific transfer pricing determinations and agreed with some and disagreed with others and came to a final ruling largely upholding Amazon’s tax return position.

Medtronic

In June 2016, the US Tax Court decided not to completely side with either the IRS or Medtronic in Medtronic v. Commissioner, instead fashioning its own solution in the US$1.36 billion tax dispute. The court found that the IRS’s adjustments to Section 482 allocations were arbitrary and capricious. However, rather than accepting Medtronic’s proposed allocations, the court came up with its own solution. Medtronic, a Minnesota corporation, is a leading medical technology company, servicing clients around the world. Medtronic has an affiliate in Puerto Rico called MPROC that manufactures cardiac rhythm disease management and neurological devices and leads. In 2002, the IRS audited Medtronic. The Commissioner was
concerned that Medtronic was shifting too much money to its affiliate, MPROC. Medtronic, in turn, agreed to lower the amount being shifted to the Puerto Rican affiliate. The agreement specified that the royalty rates for MPROC would be 44 per cent for devices and 26 per cent for leads. This agreement was memorialised in a memorandum of understanding (MOU). The Commissioner reviewed Medtronic’s tax returns for 2003 and 2004 and agreed with how the MOU was being applied.

In 2007, the IRS again audited Medtronic and determined that Medtronic owed an additional US$84 million because of a revision under the MOU. In 2009, the Commissioner determined that MPROC’s royalty payments should be increased by another US$455 million. Medtronic appealed this and in 2010, it was sent back to the Commissioner for re-examination at his request. In December 2010, after consulting with an expert, the Commissioner issued Medtronic a notice of deficiency for approximately US$1 billion for 2005 and 2006. In July 2014, the Commissioner adjusted the deficiencies up to US$1.36 billion.

The Tax Court had to determine whether the IRS had abused its discretion in proposing the deficiency. In its analysis there were two main considerations: whether the Commissioner abandoned a prior position; and whether the Commissioner’s adjustments were unreasonable because they did not give enough credit to the work MPROC does. The court found that because the Commissioner was not bound by positions taken in a previous year, the Commissioner had not abandoned the position taken. However, the court sided with Medtronic in finding that the Commissioner’s allocations were arbitrary, capricious and unreasonable, because the expert report that the Commissioner relied on to determine the allocations did not give the appropriate weight to MPROC’s role in the production process. The IRS had determined that MPROC was merely a routine manufacturer and thus shifted 90 per cent of the income back to Medtronic. On the contrary, the court determined that MPROC had significant independent responsibility, particularly with regard to quality control. This was especially important considering that the products being manufactured were medical technologies used in life or death situations. Thus, concluded the Tax Court, MPROC was far from an average manufacturer and the profits should not be allocated to the US parent as asserted by the IRS.

**Wycoff**

In this case, the US Tax Court agreed with the IRS’s application of the CPM in finding that management fees paid by an S corporation to a related S corporation were not at arm’s length. The taxpayers, a married couple, owned two S corporations (Sirius Products, Inc and Restore 4, Inc) that sold household chemical products. The taxpayers also owned another S corporation, Albion Management, Inc., where they served as president and secretary, respectively. To reduce their corporate income tax liability, the taxpayers had Sirius and Restore pay significant management fees to Albion. The IRS disputed the arm’s-length nature of the fees as excessive, and denied them deductions of nearly $12.8 million as a result.

As with many transfer pricing cases, the Section 482 issue in this case largely came down to a battle of experts. The court found that the use by the IRS expert of the CPM was reasonable and produced the most reliable measure of an arm’s-length result under the facts and circumstances.
VIII SECONDARY ADJUSTMENT AND PENALTIES

As noted, the IRS is entitled to impose special transfer pricing penalties under Section 6662(e) of the Code. As with any other assertion of a tax liability, a taxpayer can seek IRS appeals’ review and settlement of any such penalty and can also dispute penalties in court.

IX BROADER TAXATION ISSUES

i Diverted profits tax and other supplementary measures

The United States does not impose a diverted profits tax (DPT). It is unclear whether payment of such tax could support a foreign tax credit against any US tax liability of any taxpayer subject to a DPT because creditable tax must be in the nature of an income tax in the foreign jurisdiction.

ii Double taxation

Taxpayers can request the assistance of the US competent authority when the taxpayer believes that the actions of the United States or a treaty country result or will result in taxation in violation of treaty provisions. The US competent authority can assist taxpayers under the mutual agreement procedure articles of US tax treaties through consultations with the applicable foreign competent authorities but may also unilaterally act. The grant of such authority by the mutual agreement procedure articles of US tax treaties is separate from and in addition to the authority under such articles for the US competent authority to consult generally with foreign competent authorities to resolve difficulties or doubts regarding treaty interpretation or application, irrespective of whether the consultation relates to a current matter involving a specific taxpayer.

There are two offices within the US competent authority: the Advance Pricing and Mutual Agreement or APMA programme office, and the Treaty Assistance and Interpretation Team (TAIT) office. APMA handles issues relating to the business profits and associated enterprises articles of US tax treaties and will handle double taxation issues that arise as a result of an allocation made by the IRS under Section 482 or by a foreign tax authority under its own version of Section 482. TAIT handles issues arising under other articles of US tax treaties.

iii Consequential impact for other taxes

The United States does not impose value added tax or goods and services tax.

Transfer pricing adjustments proposed by the IRS typically propose a decrease in the value of the imported goods (which would result in a refund of duties to the importer). This is the opposite of what the customs agency, US Customs and Border Protection (CPB), typically proposes (i.e., higher import prices and therefore duties). In general, CPB will accept adjustments resulting in a refund of duties to the importer if certain criteria are met, for example, that a written transfer pricing determination policy has been adopted prior to importation and the policy takes into account Section 482 of the Code. CPB also encourages importers to report adjustments using its reconciliation programme, which allows for initial pricing to be provided to CPB with the understanding that it may be subject to change.
X OUTLOOK AND CONCLUSIONS

Cross-border transactions in general will remain a high priority for scrutiny and tax enforcement in the United States. Transfer pricing is probably the highest-priority issue within this general category of transactions. The IRS has already identified one type of transfer pricing transaction (inbound distributors) as a formal campaign audit issue but has also indicated that transfer pricing generally is a top enforcement issue.36

Efforts by the Treasury and the IRS to curb what they perceive to be aggressive transfer pricing practices will continue to include guidance and audit and litigation. The latest priority guidance plan of the IRS, for example, continues to list guidance under Section 482 including with respect to the treatment and allocation of risk. Further, the US participation in the BEPS project will continue to form the landscape for transfer pricing.

As noted, significant tax-reform legislation was passed, effective on 1 January 2018. The legislation reduced the corporate tax rate from 35 per cent to 21 per cent. This reduction alone will cause many US multinationals to reassess their foreign structures and their transfer pricing arrangements. In addition to the rate reduction, the legislation introduced two new cross-border taxes: the base erosion and anti-abuse tax (BEAT) and the global intangible low-taxed income (GILTI) tax. Both were created to combat base erosion conduct of US multinationals. In light of these taxes, US taxpayers will reevaluate their foreign structures and intercompany agreements to minimise their exposure. Finally, a taxpayer-favourable tax change, the foreign-derived intangible income (FDII) provision encourages US taxpayers to keep IP in the US. FDII reduces the tax rate on export income involving IP owned by the US corporation.

36 As further evidence of this, on January 12, 2018, the Commissioner of the IRS Large Business and International Division (LB&I) issued memoranda with instructions on transfer pricing selection, including instructing examiners to suspend examination of new stock-based compensation issues in cost sharing arrangements and to obtain supervisory approval before changing taxpayers’ selection of best transfer pricing method. The IRS is clearly focused on ensuring appropriate cases are brought to court.

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I OVERVIEW

The Venezuelan Income Tax Law sets forth transfer pricing rules that require Venezuelan taxpayers to report related-party transactions on arm’s-length terms for income tax purposes. The Venezuelan transfer pricing rules are based on the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the OECD Guidelines), which are applicable on a supplementary basis provided that they are congruent with the Venezuelan Income Tax Law and international treaties signed by Venezuela. The OECD Guidelines are commonly applied in Venezuela and certain tax courts have used them as a source for interpreting the Venezuelan transfer pricing rules.

Venezuelan transfer pricing rules apply to transactions between Venezuelan taxpayers and related parties, and they cover both income and capital transactions. Following the OECD Model Tax Convention, the Venezuelan transfer pricing rules define related parties as any enterprise that participates directly or indirectly in the management, control or capital of another enterprise, or when the same persons participate directly or indirectly in the management, control or capital of both enterprises. In addition, companies incorporated in low-tax jurisdictions for Venezuelan tax purposes conducting transactions with Venezuelan taxpayers are presumed to be related parties.

The Venezuelan tax authorities may adjust the profits reported by Venezuelan taxpayers by imputing income or reducing or denying deductions if transactions have been entered into between related parties on non-arm’s-length terms. Transfer pricing adjustments only generate income tax consequences and do not have any other legal implications.

The accounting treatment given by a Venezuelan taxpayer to a related-party transaction does not affect the technical position taken by such taxpayer for Venezuelan income tax purposes or its risk of challenge if such transaction has been reported on arm’s-length terms for income tax purposes. However, the accounting treatment of a transaction can be used as an indication of the applicable tax treatment.

II FILING REQUIREMENTS

Venezuelan taxpayers must report transactions with related parties to the tax authorities through an information transfer pricing return, which must be filed annually within six months after the end of the fiscal year.
The reportable information about related-party transactions carried out during the fiscal year includes, among other items:

- the related parties involved;
- the type of transactions;
- the transaction amounts; and
- the transfer pricing method used to calculate the prices.

Additionally, Venezuelan taxpayers must maintain and make available to the tax authorities the transfer pricing documentation while the statute of limitations period has not lapsed. The information and documentation to be kept includes:

- an analysis of fixed assets and the commercial and financial risks related to the transactions, including documentation to support the acquisition and use of assets;
- an organisational and functional overview of the taxpayer;
- information regarding the foreign related parties, including the type of business, the main clients and shareholdings in group companies;
- an overview of the controlled transactions, including activities carried out, dates, prices and the relevant currency;
- information on the main activities carried out by each of the relevant group companies as well as data on any changes affecting the group, such as capital increases or mergers;
- agreements entered into between taxpayers and their foreign related parties;
- the method or methods used to set the transfer prices, indicating the criteria and objective elements considered to determine that the method used is the most adequate;
- information regarding the operations of uncontrolled comparable companies; and
- specific information as to whether foreign related parties are or were subject to a transfer pricing audit, or if they are involved in transfer pricing competent authority or other procedures.

### III PRESENTING THE CASE

#### i Pricing methods

The Venezuelan Income Tax Law sets forth that the following pricing methods are acceptable:

- the comparable uncontrolled price (CUP) method;
- the resale price method;
- the cost-plus method;
- the profit split method; and
- the transactional net margin method.

Venezuelan taxpayers must first consider the CUP method. If the Venezuelan taxpayers do not use the CUP method, they must select the method that is considered more appropriate to the characteristics of the transaction and the economic activity carried out. Venezuelan taxpayers must justify the selection of the method used, typically in the transfer pricing documentation that is kept in case of an audit.

The analysis for selecting the appropriate method is usually done following the OECD Transfer Pricing Guidelines. Therefore, the cost-plus method is generally acceptable in transactions involving the sale of semi-finished goods between related parties, joint facility agreements or long-term buy-and-supply arrangements, or the provision of services. The
profit split method, although it is rarely selected, it may be deemed appropriate if the Venezuelan taxpayer can prove that the transactions are very interrelated and that they cannot be evaluated on a separate basis.

In certain audits, the tax authorities have challenged the use of a pricing method other than the CUP method. In *Veneasistencia, CA v. República de Venezuela* (Venezuelan Supreme Court, 27 November 2012) the Venezuelan Supreme Court ruled that Venezuelan taxpayers have the right to use transfer pricing methods other than the CUP method if they reasonably justify the use of other methods. The tax authorities had imposed a penalty on the taxpayer for not using the CUP method. The taxpayer claimed that the penalty was not applicable since the CUP method was not appropriate for its related-party transactions and provided evidence consisting of its transfer pricing documentation, which reasonably supported the use of the transactional net margin method. The analysis of the taxpayer’s transfer pricing documentation was sufficient evidence for the Venezuelan Supreme Court to revoke the penalty.

### ii Authority scrutiny and evidence gathering

Under the Venezuelan Tax Code, the tax authorities have broad investigative powers for conducting tax audits. Venezuelan taxpayers are required to submit all the available documents and information requested by the tax authorities, but they are not required to submit documentation or produce witnesses outside the jurisdiction.

In general, Venezuelan taxpayers subject to transfer pricing audits are subject to close scrutiny of their related-party transactions, but such scrutiny is not focused on assessing their global tax position and then assessing profit share per jurisdiction. However, sometimes the tax authorities ask whether any of the affiliated companies has been subject to transfer pricing audits or assessments in other jurisdictions.

The tax authorities typically begin a transfer pricing audit by requesting the taxpayer to submit an extensive list of documents and information, which always includes the transfer pricing documentation to be kept pursuant to the Venezuelan Income Tax Law. The tax authorities do not usually talk to witnesses within the taxpayer group, but instead send written questionnaires that may contain questions directed to certain employees. In recent years, most transfer pricing audits have resulted in adjustments to the taxpayer’s taxable profits and most of such adjustments have been subject to administrative or judicial review pending final resolution.

Venezuela has not adopted country-by-country reporting rules.

### IV INTANGIBLE ASSETS

Venezuelan taxpayers typically use the transactional net margin method for establishing the pricing of intangible assets. Even though the CUP method must be considered first under the Venezuelan transfer pricing rules, and the profit split method is likely to be the most appropriate method for establishing the pricing of intangible assets, in practice it is difficult for Venezuelan taxpayers to find reliable information to apply such methods for pricing intangible assets.

When establishing the price for intangible assets, Venezuelan transfer pricing rules provide that certain characteristics of the transactions involved must be taken into account, including whether it is the licensing or the sale of intangible assets, the duration of the contracts, the degree of protection and the expected benefits for the use of property rights.
The Venezuelan transfer pricing rules do not expressly provide that it is necessary to prove where the substance developing, supporting or exploiting the intangible asset is based in order to justify a higher than passive return; however, and not exempt from discussion, the tax authorities could try to raise those issues during an audit based on the OECD Guidelines.

The development, enhancement, maintenance, protection and exploitation (DEMPE) functions relating to intangible assets are not applied in practice yet. In this regard, Venezuelan authorities have not published their intention to implement standards provided by the BEPS Action Plan on transfer pricing matters.

V SETTLEMENTS

The tax authorities must conduct an audit to make an adjustment to the profits of a Venezuelan taxpayer based on the transfer pricing rules. If, resulting from an audit, the tax authorities make a transfer pricing adjustment and claim the underpayment of taxes through an assessment, there is no legal possibility of negotiating a settlement at the administrative level other than the option for the taxpayer of totally or partially accepting the adjustment and thus obtaining a reduced penalty, which is calculated on a percentage of the taxes underpaid and following the rules of the Venezuelan Tax Code. If the Venezuelan taxpayer does not accept the adjustment, the taxpayer has the right to subject the adjustment to administrative or judicial review.

At the request of the Venezuelan taxpayer, a judicial procedure arising from a transfer pricing dispute may be finalised through a settlement. The settlement must be filed before the tax court for its approval. The settlement is mandatory for the parties to the procedure and cannot be appealed. A settlement of such nature cannot be relied on to inform the returning position for future years.

The tax court must notify a proposed settlement to the tax authorities. Subsequently, the judicial procedure is suspended while the parties discuss the terms of the settlement. The tax authorities may agree to or reject the settlement, and must ask the non-binding opinion of the Attorney General’s Office.

If the tax authorities agree on the settlement’s terms and conditions, it must draft the settlement agreement and notify the taxpayer. The taxpayer can accept or reject the agreement drafted by the tax authorities. If the taxpayer rejects the settlement draft, the tax court resumes the judicial procedure.

In practice, the tax authorities are generally not open to settling transfer pricing disputes.

VI INVESTIGATIONS

The tax authorities must begin transfer pricing investigations with a formal notification to the taxpayer indicating the scope of the audit, including the taxes and the fiscal years subject to investigation. Under the statute of limitations rules set forth in the Venezuelan Tax Code, the tax authorities have six years after the closing of a fiscal year to audit that fiscal year. The six-year limit applies to the extent that the taxpayer filed the applicable tax returns. If the taxpayer failed to file the applicable tax returns, the period is extended to 10 years.

After a transfer pricing audit has commenced, the tax authorities are limited by the general statute of limitations period to close the audit. Typically, the investigation period in a transfer pricing audit before the tax authorities issue an assessment ranges from six months to two years. The assessments must be based on factual findings and Venezuelan law. Once the
tax authorities issue an assessment and make a transfer pricing adjustment the taxpayer has 15 business days to decide whether it accepts the assessment. If the taxpayer decides to challenge the assessment, the taxpayer has five months to file a defence brief and submit evidence to rebut the tax authorities’ position.

The tax authorities have one year to issue a final decision regarding the taxpayer’s defence brief, and if the tax authorities do not decide within the one-year period the administrative procedure is deemed void. The tax authorities may accept the taxpayer’s arguments contained in the defence brief and modify or completely annul the adjustment, or they can also dismiss the defence brief with appropriate legal and technical arguments. If the tax authorities uphold the assessment, the taxpayers have 25 business days to:

a accept the decision and pay the assessment, applicable penalties and interest;
b file an administrative appeal before a higher office within the tax authorities; or
c directly file a judicial appeal before the tax courts.

VII LITIGATION

i Procedure
Venezuelan taxpayers can appeal transfer pricing adjustments before the Venezuelan tax courts, which are the competent first instance courts for tax and customs disputes. The competent court for second instance in tax and customs disputes is the Political-Administrative Chamber of the Venezuelan Supreme Court.

Since the judicial tax appeal must be filed within 25 business days after the tax authorities have upheld the assessment, the timeline for preparing for a judicial transfer pricing dispute is short. The judicial process begins with the Venezuelan taxpayer filing a written appeal with all of the legal and technical arguments supporting its position, which generally has been discussed at the administrative level. After the written appeal is filed, the tax court must notify the tax authorities and other relevant authorities such as the Attorney General’s Office.

After all the relevant parties to the judicial process have been notified, the tax court must decide on the admission of the appeal. The admission of the appeal is followed by the evidence phase, in which the taxpayer and the tax authorities have the right to submit all the relevant evidence to the tax court. The evidence phase has strict timelines set forth in the Venezuelan Tax Code. It is common for Venezuelan taxpayers to bring expert witnesses to appeals relating to transfer pricing matters to support their tax positions.

Following the evidence phase, the taxpayer and the tax authorities must submit a conclusions brief, and subsequently they can submit a written rebuttal of the other party’s conclusions brief. Finally, the tax court has 60 days to issue its ruling. In practice, however, tax courts take between six months and three years to issue their rulings on tax matters.

The rulings issued by tax courts may be appealed before the Political-Administrative Chamber of the Venezuelan Supreme Court, which usually takes from one to three years to issue its final decision on tax matters. The second instance procedure is not a fact-finding forum, but the Venezuelan Supreme Court may overturn or uphold the tax court’s ruling based on the evidence present in the judicial file.
ii Recent cases

In recent years there has been an increase in disputes over transfer pricing adjustments. Several disputes involve challenges to:

\( a \) selection of comparable companies or transactions;
\( b \) costs segmentation; or
\( c \) adjustments to interest expenses or income.

The most important transfer pricing disputes are pending a final judicial decision. However, there are some judicial precedents available.

In *Coca-Cola Femsa de Venezuela SA v. Bolivarian Republic of Venezuela* (7th Tax Court of Caracas, 14 August 2017) the tax court annulled two transfer pricing assessments issued by the Venezuelan tax authorities in connection with deductions taken for the purchase of raw materials, fixed assets and the payment of interest to related parties. The tax authorities examined the application of the transactional net margin method (TNMM) and the comparable uncontrolled price method made by Coca-Cola Femsa to determine its transfer prices, concluding that certain transactions were not at arm’s-length terms. Coca-Cola Femsa appealed the assessments and the Tax Court granted all of Coca-Cola Femsa’s claims, ruling the following:

\( a \) Application of the OECD Guidelines is mandatory: the court ruled that the OECD Guidelines were an integral part of the Venezuelan legal system, except for when it contradicts international treaties signed by Venezuela, and the Income Tax Law, which, in turn, has mandatory rules that must be applied and followed on matters not expressly regulated within the Income Tax Law.

\( b \) The principle of annuity for Venezuelan income tax does not apply when comparing related transactions: when comparing transactions between related parties, it is more accurate to use the effective annual interest rate than the nominal interest rate. For this reason, the court ruled that Coca-Cola Femsa correctly considered all the years implicated in the loan agreement with a related party to determine the effective annual interest rate.

\( c \) The OECD Guidelines do not prohibit using comparable enterprises with losses: it was concluded that, after analysing the OECD Guidelines, there is no prohibition against using comparables with financial losses, given that a comparable enterprise can realise genuine losses.

\( d \) It is possible to compare enterprises that commercialise different products: the search for identical products is unnecessary and there is no justification for excluding the comparison of companies with different products. The Tax Court indicated that under the OECD Guidelines and when applying the transactional net margin method, the relevant aspects of the comparable enterprises are:

- the economic sector in which they operate;
- their competitiveness;
- their production capacity;
- the possibility to enter the market;
- management efficiency;
- individual strategy;
- assumed risks;
- variations in the companies’ cost structure; and
- their degree of experience in their field.
Multi-year data can be applied to obtain a complete understanding of facts and circumstances surrounding a controlled transaction in a volatile environment: this conclusion was based on the OECD Guidelines Paragraph 3.44 and acknowledged that the volatile economic environment in Venezuela – as evidenced by data of the Venezuelan Central Bank – had affected the financial results of Venezuelan companies during the years concerned with the tax assessments; therefore, Coca-Cola Femsa correctly adjusted some data when determining if its prices were at arm’s length.

Profit margin may be adjusted to median point of arm’s-length range if the principles of reasonableness and proportionality are met: the Tax Court established that adjusting the profit margin to the median point of the arm’s-length range, as performed by the tax authorities in the assessments made to Coca-Cola Femsa, is not a mandatory adjustment under the Income Tax Law and the OECD Guidelines. However, the Tax Court indicated that, if this adjustment is made, it needs to be sufficiently justified by the tax authorities and meet the principles of reasonableness and proportionality.

The decision by the Tax Court to annul the assessments can be appealed by the tax authorities before the Venezuelan Supreme Tribunal of Justice, which is the court of last resort.

In *Brightstar de Venezuela v. Bolivarian Republic of Venezuela* (5th Tax Court of Caracas 23 February 2017) the tax court annulled a transfer pricing adjustment, holding that the tax authorities did not follow the 2010 OECD Guidelines, which required taking into account the segmented financial information of the audited transaction under the transactional net margin method.

In *Sodexho Pass Venezuela v. República Bolivariana de Venezuela* (8th Tax Court of Caracas, 15 December 2016) the claimant (Sodexho Pass Venezuela) appealed an adjustment to its taxable profits made under the Venezuelan transfer pricing rules. The tax authorities claimed that the interest rate charged by Sodexho Pass Venezuela (LIBOR rate) on a loan made to a related party outside Venezuela (a company of the Sodexo Group) was not on arm’s-length terms. The tax authorities based their position claiming that when applying the comparable uncontrolled price method and comparing its related-party transaction with an uncontrolled transaction, Sodexho Pass Venezuela should have used an active rate such as the prime rate. In this case, the tax court ruled that Sodexho Pass Venezuela correctly applied the uncontrolled price method when comparing uncontrolled transactions and determining that the LIBOR interest rate charged to its related party (LIBOR) was within arm’s-length terms and therefore annulled the transfer pricing adjustment. This case will be decided by the Venezuelan Supreme Court as the tax authorities appealed the ruling.

In *Chevron v. República de Venezuela* (9th Tax Court of Caracas, 30 September 2014) the tax court upheld a transfer pricing adjustment to the profits of the taxpayer (Chevron). The tax authorities claimed that the interest paid by the taxpayer to a related party was not on arm’s-length terms. The taxpayer argued that the interest rate paid was on arm’s-length terms, and an expert witness was deposed during the process to prove its argument. However, the tax court ruled that the adequate mean of evidence to prove that the interest rate was at arm’s length should have been an expert report and not a simple expert witness. Therefore, based on the alleged lack of evidence the tax court upheld the transfer pricing adjustment.
VIII SECONDARY ADJUSTMENT AND PENALTIES

The tax authorities are not entitled to impose secondary adjustments. If the tax authorities have conducted a transfer pricing audit and issued an assessment that has either been accepted by the taxpayer, upheld or revoked by the tax authorities or a tax court, the tax authorities are not allowed under the Venezuelan Tax Code to investigate the same tax, transactions and fiscal years that were subject to the assessment.

Under the Venezuelan Tax Code, the penalties for underpayment of taxes resulting from transfer pricing adjustments are the same as those applicable to the underpayment of taxes resulting from other types of assessment. The penalty for underpayment varies depending on whether the taxpayer has accepted the assessment at an early stage of the audit procedure. If a taxpayer accepts and pays the assessment within 15 days after the assessment has been issued, the penalty for underpayment is 30 per cent of the amount of the taxes underpaid. If the taxpayer has not accepted the assessment and the tax authorities have upheld the assessment, the penalty for underpayment ranges between 100 per cent and 300 per cent of the amount of the underpayment. Under the general principles set forth in the Venezuelan Criminal Code, penalties that range between two limits are normally applied at its average (resulting from adding the two penalties and dividing them into two), also taking into account the merits of the circumstances. In practice, the tax authorities usually impose the penalty for underpayment at its average of 200 per cent, even when the underpayment is derived from a transfer pricing adjustment.

Taxpayers have the right to challenge penalties by filing an administrative or judicial appeal. If the taxpayer challenges a transfer pricing adjustment claiming that there is no underpayment, the penalties are also under the scope of the challenge. A taxpayer can also only challenge the imposition of an underpayment penalty derived from a transfer pricing adjustment, but the available case law shows that tax courts rarely revoke the imposition of an underpayment penalty if the underpayment has been upheld or is not subject to appeal. Pursuant to the Venezuelan Tax Code, a penalty may be eliminated if the taxpayer proves that the infraction (underpayment) was derived from either a fortuitous event, force majeure, or a mistake of fact or law. Taking into account the complexity of transfer pricing rules, taxpayers often challenge the imposition of penalties derived from transfer pricing adjustments arguing a mistake of law, but most of such appeals filed are still pending a decision.

IX BROADER TAXATION ISSUES

i Diverted profits tax and other supplementary measures

To supplement transfer pricing rules, in 2007 Venezuela enacted thin capitalisation rules that limit the deduction of interest paid to related parties if a 1:1 debt-to-equity ratio is exceeded. The debt-to-equity ratio and the related-party interest deduction allowed are calculated using the method provided in the Venezuelan Income Tax Law. Additionally, the Venezuelan thin capitalisation rules provide that debts between related parties that are not on arm’s-length terms must be recharacterised as equity and, therefore, interests paid on such debts are not deductible for tax purposes.

Venezuela has no diverted profits tax.
Double taxation

Under the Venezuelan Income Tax Law, taxpayers may credit taxes paid outside Venezuela against their foreign source income. In addition, Venezuela has a wide network of treaties for the avoidance of double taxation: 32 treaties are currently in force. The treaties signed by Venezuela are mainly based on the OECD Model Tax Convention on Income and on Capital, and some of them include clauses based on the UN Model Double Taxation Convention.

All of the tax treaties signed by Venezuela contain a mutual agreement procedure (MAP) clause. Eight of the 32 treaties have different MAP clauses from Article 25 of the OECD Model Tax Convention on Income and on Capital (Barbados, Belgium, Brazil, Canada, France, Germany, the Netherlands and the United States).

These changes mainly consist of:

- the number of years within which the case must be presented to the competent authority, after the first notification of the action resulting in taxation not in accordance with the provisions of the OECD Model Tax Convention on Income and on Capital;
- a list of agreements or measures that states can settle under an MAP; and
- application of the time limits imposed by domestic law to adopt the measures agreed by the MAP.

Only the treaty with Canada contains an arbitration clause, although the treaty to avoid double taxation with the Netherlands provides the right to recourse to ‘mechanisms established by international law’.

Consequential impact for other taxes

Under Venezuelan laws transfer pricing adjustments only have effects for income tax purposes. If the tax authorities have made a transfer pricing adjustment to the taxable profits of a taxpayer, it could be the case that the tax authorities later begin an audit on VAT or import and custom duties matters to determine whether there has been an underpayment of such taxes or duties, but such audits cannot be based on the transfer pricing rules or the transfer pricing adjustment.

OUTLOOK AND CONCLUSIONS

The transfer pricing area experienced significant activity in Venezuela after the country adapted its transfer pricing rules to the OECD standards in 2001. However, recent changes in domestic tax laws have been focused on raising tax revenue through other measures, and the transfer pricing rules have not been further developed. Currently, the tax authorities have been active in conducting transfer pricing audits and the tax courts have begun to rule on certain transfer pricing disputes, but most cases are still pending resolution.

Venezuelan authorities have not published their aim to implement standards provided by the BEPS Action Plan on transfer pricing matters, but it is possible that they will be incorporated in the future under the current transfer pricing rules, which must be revised to adapt them to the new standards for the application of the arm’s-length principle.
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Dr Lars Haverkamp is a senior associate at the Düsseldorf office of Baker McKenzie. He specialises in reorganisation and supply chain transformation for multinational company groups, and has particular expertise in the taxation of permanent establishments. His practice focuses on defending transfer price regimes in tax audits and court proceedings and in mutual agreement and arbitration procedures, advance pricing agreements and tax rulings.

Lars is admitted to the German bar. Following his law studies at the University of Münster, Germany, he earned a master of laws degree from the University of Canterbury in Christchurch, New Zealand before completing his doctorate in tax law at the University of Mainz, Germany. Further to his work experience in the United States, he spent several months at a prestigious law firm in Shanghai, China. Lars frequently publishes papers on transfer pricing and international tax matters, referenced both in State Tax Court and Federal Tax Court decisions.

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Romi Irawan is a partner of transfer pricing services at DDTC. He is an experienced practitioner in transfer pricing controversies. He has vast experience in handling transfer pricing issues for clients involved in crude palm oil, automotive, pulp and chemical industries.

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He is a regular speaker in various seminars and trainings organised by DDTC, covering topics in transfer pricing. He is frequently involved as a trainer and speaker in several forum and group discussions held by private institutions and government agencies.

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Orlaith joined Slaughter and May in 2016. Her practice covers all direct taxes, stamp duties and value-added tax, with a strong focus on corporation tax. She has experience of corporate transactions, including, in particular, mergers and acquisitions (public, private, domestic and cross-border) and group reconstructions. Orlaith also has experience of advising on transfer pricing and diverted profits tax disputes with HMRC.

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Jonathan Lafrance is an associate in Norton Rose Fulbright’s Montreal office. His practice focuses on litigation and resolving Canadian tax disputes. Jonathan has appeared before the Tax Court of Canada, the Federal Court, the Federal Court of Appeal and the Supreme Court of Canada. His areas of practice are income tax, indirect taxes, collection measures, access to information, judicial review of ministerial decisions and rectifications. He also provides assistance to taxpayers before the tax authorities at the audit level and through the voluntary disclosure programme.

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Patrícia Matos is a transfer pricing partner in Deloitte’s Portugal and Angola offices and has more than 18 years of experience as a tax and transfer pricing specialist in international projects, including the coordination of tax and transfer pricing planning, due diligence and tax and transfer pricing compliance for Portuguese and Angolan-based multinational companies.

Her contribution to the transfer pricing and tax fields in Portugal has been acknowledged by several awards across many years.

She graduated in economics from ISCTE, Lisbon, Portugal.

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Costas Michail graduated from the University of Hull after having completed his studies in law. He joined PwC Cyprus in 2006 and worked there until December 2016, when he then joined Scordis, Papapetrou & Co. He is a fellow member of the Association of Chartered and Certified Accountants, a member of the Institute of Certified Public Accountants in Cyprus and an international tax affiliate of the Chartered Institute of Taxation. He also obtained his transfer pricing certificate from Charted Institute of Taxation. He specialises in domestic and international tax planning for companies active in Cyprus, as well as for multinational companies active in financial services, real estate and retail trade.

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Nagashima Ohno & Tsunematsu
Shigeki Minami is a lawyer licensed in Japan and a partner at Nagashima Ohno & Tsunematsu, Tokyo. His practice focuses on tax law matters, including transfer pricing, international reorganisations, anti-tax haven (CFC) rules, withholding tax issues, and other international and corporate tax issues, and, with respect to such matters, he has acted as counsel in various tax disputes on behalf of major Japanese and foreign companies. His recent achievements include the successful representation of a Japanese multinational company in a transfer pricing dispute before the National Tax Tribunal, which resulted in the cancellation of an assessment of more than US$100 million, and the successful representation of a US-based multinational company in a tax dispute involving an international reorganisation before the Japanese court, which resulted in the cancellation of an assessment of more than US$1 billion.

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Filipe de Moura is a transfer pricing associate partner in Deloitte’s Portugal and Angola offices and has more than 21 years of experience within Deloitte, 12 of which as a tax and transfer pricing specialist in international projects, including the negotiation of advanced pricing agreements and the coordination of tax and transfer pricing planning, due diligence, litigation, and other tax and transfer pricing projects for Portuguese and Angolan-based multinational companies.
He graduated in economics and management in 1994 from the Institut Supérieur du Commerce de Paris. He also completed a master’s degree in audit and management control at the Institut Supérieur du Commerce Paris in 1995 and an MBA at IEDE in 1999. He has also received several awards acknowledging him as one of the leading transfer pricing advisers in Portugal.

**STANISLAV NEKRASOV**

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Stanislav Nekrasov is an associate at bpv Hügel (attorneys-at-law). After graduating from the University of Vienna, he worked as research and teaching assistant for the tax department of the University of Vienna while completing his PhD studies. His thesis in the field of international tax law was honoured with the Wolfgang Gassner Science Prize of the IFA Austria. Stanislav’s practice focuses on reorganisation, international and corporate tax law, transfer taxes, tax controversy and fiscal criminal tax law. He is also the author of various articles relating to his practice areas.

**CATHERINE O’MEARA**

*Matheson*

Catherine is a partner in the tax department at Matheson. Catherine has over 10 years’ experience advising multinational corporations doing business in Ireland on Irish corporate tax.

Catherine has a particular interest in transfer pricing, competent authority matters and business restructurings, and also has extensive experience in structuring inward investment projects, mergers and acquisitions and corporate reorganisations. Catherine’s clients include many of the leading multinational corporations established in Ireland, primarily in the pharmaceutical, healthcare, ICT and consumer brand sector.

Catherine speaks regularly on international tax matters and has published articles in leading tax journals. Catherine is currently chair of the International Fiscal Association Irish Branch. Catherine is a Chartered Tax Advisor and a member of the Law Society of Ireland.

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Magdalena Polak graduated with a law degree from the Cardinal Stefan Wyszyński University in Warsaw, specialising in the Business Law Programme. She is a third year advocate trainee at the Warsaw Bar of Advocates and joined SK&S in 2015, having previously gained experience in the tax team at PwC Poland. She is a member of the International Fiscal Association, International Fiscal Association YIN and board member of Social & Cultural Association of Yemeni in Poland.

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DOMINIC ROBERTSON  
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Dominic joined Slaughter and May in 2004, and became a tax partner in 2014. Dominic advises a wide range of clients on all areas of UK corporate tax law. His practice covers advice on structuring and other tax aspects of M&A and other corporate finance transactions; tax enquiries and disputes, including transfer pricing/DPT disputes and EU tax state aid investigations; and stand-alone tax advisory work, including group reorganisations, CFCs, and the tax treatment of IP. He is co-head of the firm’s tax disputes practice.

Dominic is listed as a leading individual for corporate tax in *Chambers UK* and is also listed in the ITR’s *Tax Controversy Leaders Guide*. Dominic has previously been named by the *Tax Journal* as one of their ‘40 under 40’ leading young UK tax professionals.

HUMBERTO ROMERO-MUCI  
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Humberto received his law degree *summa cum laude* from Universidad Católica Andrés Bello (UCAB) (1985). He also obtained a master of laws (LLM) and specialisation and diploma on international taxation from Harvard Law School (1986), as well as a doctor of laws (PhD) from Universidad Central de Venezuela (UCV) (2003). Humberto is a fellow of the National Academy of Political and Social Sciences, Seat No. 14 (2005). He is also chair professor and head of the finance law professorship in the faculty of law at UCAB, and is a professor on the PhD courses at the UCV.

Humberto has represented clients in important tax and transfer pricing disputes, including Coca-Cola Femsa, Brightstar Corporation and Sodexo. Humberto provides tax and legal advice to several multinational companies on corporate tax issues, such as Weatherford International, Zurich Insurance, FerroGlobe and Procter & Gamble, among others. Humberto has published more than 60 articles in law reviews in Venezuela and abroad, and more than 12 books on tax and accounting matters.

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Ramon Tomazeza Santos is a PHD candidate at the University of São Paulo. He has an LLM in international taxation from the Vienna University of Economics and Business and an LLM in tax law from the University of São Paulo. He is a member of the Brazilian Institute of Tax Law and a visiting professor on various postgraduate courses in Brazil.

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Dr Stephan Schnorberger is a tax partner and principal economist with the Düsseldorf office of Baker McKenzie. He works for international businesses to facilitate cross-border activities in today’s tax environment and to advocate and defend the rule of law in transfer price controversies. Stephan also supports businesses by economic analysis and advocacy in competition matters such as business combinations, cartel damage cases and questions of abuse market power. For many years, Stephan has been recognised as one of the top advisers in Euromoney Expert Guides’ ‘The Best of the Best’ Global Tax Advisors and Global Transfer Pricing Advisors.

His practice focuses on transfer pricing, business restructuring, supply chain modelling, international tax planning, high-value audit defences, complex tax litigation and competition and regulatory economics. As a certified tax adviser, Dr Schnorberger is admitted to the German tax bar. He holds a German doctoral and a master’s degree in business administration as well as a US master’s degree in economics. Stephan is a member of the Association of German Certified Tax Advisors and a member of the International Fiscal Association.

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Untoro Sejati is a senior manager of transfer pricing services at DDTC. He has been involved in handling transfer pricing controversies, as well as design, review, implementation and documentation of transfer pricing policies with emphasis on accounting analysis.

He received his bachelor’s degree in accounting from the University of Indonesia. He received his master’s degree of law in international taxation (LLM Int Tax) at Vienna
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Untoro Sejati has passed one out of three examination papers for advance diploma in international taxation from the Chartered Institute of Taxation – UK and therefore has been awarded a certificate in principles of corporate and international taxation (transfer pricing). He is a certified public accountant (CPA).

He is also frequently involved as a trainer or speaker in several tax trainings or seminars, held by DDTC, private institutions and government agencies.

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Heleen Van Baelen has been a manager at the boutique transfer pricing firm T/A Economics since 2018, serving clients as a transfer pricing and valuation manager. Before joining T/A economics, Heleen worked in the transfer pricing team of a Big Four company.

Heleen assists and manages multiple transfer pricing projects for large and smaller multinational entities providing tax, transfer pricing and valuation services. Further, she is also involved in global transfer pricing design and overall alignment, conversion of business operations and overall transfer pricing documentation. In addition, Heleen assists in the negotiation of APAs and rulings and is involved in assisting companies during transfer pricing audits.

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Appendix 2

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