The Transfer Pricing Law Review

Editors
Steve Edge and Dominic Robertson

The Law Reviews

THE TRANSFER PRICING REVIEW

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THE TRANSFER PRICING LAW REVIEW

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PREFACE

It has been a great honour – and an even greater education – to be asked to edit the inaugural edition of *The Transfer Pricing Law Review*.

Since the financial crisis in 2008, there has been continuous public attention on multinationals' tax position – which, for the most part, turns on their transfer pricing policy, and whether this properly aligns the taxable profits in each country with the value-generating activities taking place there. In the past couple of years, that public and political pressure has begun to turn into concrete action: for example, through the BEPS reforms on country-by-country reporting and transfer pricing; the European Commission's state aid investigations into Apple, Starbucks and others, which almost all relate to transfer pricing matters; and, as several chapters in this review make clear, increased audit scrutiny at the national level. It seems clear that transfer pricing issues will be filling tax professionals' working lives for several years at least.

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 through 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).

This review contains contributions from 17 countries, covering a broad spread both geographically and economically. We are very grateful to the authors of the country chapters for lending their time and expertise to this project.

Four key themes that emerge from the country chapters are:

a More disputes: unsurprisingly, many countries (including Mexico and Poland) report an increase in transfer pricing disputes, particularly around profit allocation in a multinational supply chain.

b Profit splits: several countries (including Israel, Mexico and the UK) are seeing tax authorities push for a greater use of profit splits, particularly for high value-added activities where it may be difficult to find a precise comparable. (How you identify an appropriate share of profits for each different country is, of course, a separate challenge here.)

c TP compliance tools: many of the reporting countries have adopted rules that are designed to encourage greater transfer pricing compliance. Country-by-country reporting, which has been very widely adopted, is the prime example of this, but other instances include automatic transfer pricing penalties in Canada and Russia, and the diverted profits taxes adopted in Australia and the UK.

d Varied transfer pricing approaches: it is striking that different countries continue to apply transfer pricing in rather different ways. At one end of the spectrum, Brazil has rejected the OECD arm's-length principle entirely, arguing that imposing fixed ratios and limits is more effective. Even within the large majority of reporting countries that apply the OECD principles, however, there are differences in approach which could lead to diverging outcomes in practice. For example, Germany's transfer pricing rules apply a 'prudent and diligent managing director' test on top of the normal arm's-length principle (which has perhaps inspired the 'prudent economic operator' concept developed by the European Commission in their tax state aid investigations); and the Luxembourg chapter discusses a recent case in which an interest-free loan from Luxembourg to Italy resulted in taxable interest income in Luxembourg, with no corresponding deductions in Italy. These variations, of course, increase the risk of double taxation of the same profits – and it is thus important (if perhaps optimistic) that countries adopt the BEPS Action 14 recommendations on tax dispute resolution mechanisms with the same enthusiasm they have often shown for the tax-raising recommendations.

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
London
June 2017

Chapter 1

AUSTRIA

Niklas J R M Schmidt and Eva Stadler[1]

I OVERVIEW

In Austria, there is no single comprehensive statute on transfer pricing. Rather, there exist a number of separate legal provisions and instruments that are relevant for transfer pricing, namely:

a Section 6(6) of the Income Tax Act, dealing with the realisation of profits in cases where assets are transferred from Austria to foreign permanent establishments or where Austrian permanent establishments are transferred abroad;

b Section 8(1) to (3) of the Corporate Income Tax Act, dealing with the allocation of profits in transactions between a company and its shareholder;

c Section 2(1) of the Income Tax Act, which is considered as the basis for attribution of income to taxpayers;

d Section 4(4) of the Income Tax Act, dealing with the deduction of business expenses by taxpayers;

e Sections 21 to 24 of the Federal Fiscal Procedures Act, dealing with substance over form, abuse of law, sham transactions and beneficial ownership;

f Section 124 et seq. of the Federal Fiscal Procedures Act, dealing with the requirement of taxpayers to keep books and other records;

g the Transfer Pricing Documentation Act, dealing with documentation requirements; and

h an implementing ordinance issued on the basis of the Transfer Pricing Documentation Act.

In addition to statutory law, case law has to be taken into account; in the area of transfer pricing, decisions by the Federal Tax Court and the Supreme Administrative Court are of particular relevance.

Moreover, other important sources of transfer pricing law are the guidance notes issued by the Ministry of Finance from time to time, which are binding for the tax authorities, but not for taxpayers. Most notable are the Transfer Pricing Guidelines 2010, which deal with multinational group structures, permanent establishments, documentation obligations, transfer pricing audits and tax planning by use of intermediate companies.[2] The Income Tax Guidelines 2000 contain guidance on the recognition of agreements between related

1 Niklas J R M Schmidt is a partner and Eva Stadler is a senior associate at Wolf Theiss Attorneys at Law.

2 Ministry of Finance, 28 October 2010, BMF-010221/2522-IV/4/2010.

parties.[3] The Ministry of Finance has also issued a decree on mutual assistance procedures and arbitration proceedings pursuant to double taxation treaties and the EU Arbitration Convention,[4] which deals with various procedural topics.[5] Finally, there are numerous published no-name rulings issued by the Ministry of Finance in international tax matters and specifically regarding transfer pricing.

The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, notwithstanding their being a mere recommendation of an international organisation, are seen by the tax authorities as a significant means of interpreting double taxation treaties.[6]

As a general rule and as a result of the substance over form approach, agreements between related parties are only recognised for tax purposes if (1) they have been concluded in writing; (2) their content is clear and unambiguous; and (3) they are concluded in line with the arm's-length principle, meaning on terms that unrelated parties would have agreed upon.[7]

II DOCUMENTATION AND FILING REQUIREMENTS

Until recently Austria did not have any statutory transfer pricing related documentation and filing requirements. Nevertheless, the Austrian tax authorities have for many years required that taxpayers set up transfer pricing documentation based on the OECD Transfer Pricing Guidelines. In particular, taxpayers are obliged to carry out a function and risk analysis regarding transactions with related parties. In this context, information regarding (1) the main assets employed; (2) the contractual conditions agreed upon; (3) the taxpayer's business strategy; (4) the market and competitive conditions insofar as they are relevant for the pricing; and (5) the position of the taxpayer in its group of companies, has to be documented.[8]

This lack of statutory rules partly ended in 2016, when the Transfer Pricing Documentation Act was enacted. It contains the obligation for taxpayers to, under certain circumstances, prepare and file (1) country-by-country reports; (2) master files; and (3) local files. All of these documents may be prepared in German or English.

Multinational enterprise (MNE) groups with consolidated group revenues of at least €750 million in the preceding fiscal year are required to prepare a country-by-country report.[9] Such document consists of three parts: (1) an overview of allocation of income, taxes and business activities by tax jurisdiction; (2) a list of all the constituent entities of the MNE group included in each aggregation per tax jurisdiction; and (3) additional information, if relevant.[10] In general, the country-by-country report has to be filed by the ultimate parent

3 Ministry of Finance, 22 March 2005, 06 0104/9-IV/6/00 as amended by Ministry of Finance, 25 August 2015, BMF-010203/0233-VI/6/2015, paragraph 1127 et seq.

4 Convention 90/436/EEC on the Elimination of Double Taxation in Connection with the Adjustment of Profits of Associated Enterprises, as amended.

5 Ministry of Finance, 31 March 2015, BMF-010221/0172-VI/8/2015.

6 Transfer Pricing Guidelines, paragraph 18.

7 Income Tax Guidelines, paragraph 1130 et seq. with references to case law by the Supreme Administrative Court. Examples of when individuals and entities qualify as related parties are stated in paragraph 1129 of the Income Tax Guidelines.

8 Transfer Pricing Guidelines, paragraph 310.

9 Transfer Pricing Documentation Act, Section 3(1).

10 Transfer Pricing Documentation Act, Schedules 1 to 3.

entity of the MNE group, if it is tax-resident in Austria, until at the latest 12 months after the end of the fiscal year.[11] Within 15 months of the end of the fiscal year, Austria will automatically exchange the country-by-country reports with the other EU Member States (or with the signatories of the OECD's Multilateral Competent Authority Agreement on the Exchange of Country-by-Country Reports).[12]

Separate business units of MNE groups are required to prepare transfer pricing documentation in the form of a master file and a local file, if such separate business units are tax-resident in Austria and had revenues of at least €50 million in the two preceding fiscal years.[13] The master file, on the one hand, has to contain (1) an overview of the MNE group's organisational structure; (2) a description of the MNE group's business(es); (3) documentation on the MNE group's intangibles; (4) documentation on the MNE group's intercompany financial transactions; and (5) documentation on the MNE group's financial and tax position.[14] The local file, on the other hand, must include (1) a description of the local separate business unit; (2) documentation of significant intercompany transactions; and (3) financial information.[15] Both the master file and the local file have to be transmitted to the competent tax office within 30 days of filing the corporate income tax returns.[16]

III TRANSFER PRICING METHODS

i General

In the following, a high-level overview will be given regarding the treatment of certain transactions as prescribed by the Ministry of Finance's Transfer Pricing Guidelines. As a general rule, the method that will most reliably lead to the determination of an arm's-length price shall be used. In the case of equal reliability, traditional transaction methods (the comparable uncontrolled price method, resale price method and cost plus method) are generally given priority over transactional profit methods (the transactional profit split method and transactional net margin method).[17]

ii Goods

In the case of manufacturing companies qualifying as contract manufacturers, generally the cost plus method is to be applied, while in case of distribution companies generally the resale price method is more appropriate.[18]

iii Services

Expenses incurred in connection with intra-group services are generally tax-deductible to the extent that they are in line with the arm's-length principle. Headquarter services should preferably be charged based on the direct allocation of costs, especially if such services are also rendered in relation to third parties. If this is not possible, generally a group allocation

11 Transfer Pricing Documentation Act, Sections 4(1) and 8(1).
12 Transfer Pricing Documentation Act, Section 11(1).
13 Transfer Pricing Documentation Act, Section 3(2).
14 Transfer Pricing Documentation Act, Section 6.
15 Transfer Pricing Documentation Act, Section 7.
16 Transfer Pricing Documentation Act, Section 8(2).
17 Transfer Pricing Guidelines, paragraph 43.
18 Transfer Pricing Guidelines, paragraphs 70 and 72.

method may be used, in which case a mark-up for profits must be applied.[19] For lack of comparable transactions, the cost plus method should be utilised.[20] Mark-ups should be determined on a case-by-case basis. Routine services should be marked up by between 5 per cent and 15 per cent; a mark-up of more than 5 per cent should be applied for the charging of high-quality services.[21]

While arm's-length management fees are generally tax-deductible, a parent company may not charge the costs of so-called shareholder activities to subsidiaries. These generally include: (1) costs of the management board, the supervisory board, and the shareholders meetings; (2) costs relating to the legal organisation of the group as a whole; (3) costs regarding group management, corporate policy, financial planning and reorganisation; (4) costs in connection with the acquisition and holding of shares in subsidiaries; (5) costs for services imposed on subsidiaries that they are not in need of; and (6) costs for the right to use the name of the group and to benefit from its higher creditworthiness.[22]

iv Financial services

In the case of intra-group financing, in order to determine an appropriate interest rate, the application of the comparable uncontrolled price method is preferable over other transfer pricing methods if comparable third-party transactions exist on the money and capital markets. The tax authorities understand that comparing intra-group financing transactions with third-party commercial banking transactions might sometimes lead to inappropriate results, as commercial banks aim to make a profit, while in a group the allocation of liquidity to different group companies according to their needs is more relevant. Thus, when assessing arm's-length interest rates, the upper limit is the interest rate offered by independent commercial banks to third-party borrowers. However, the interest rate that an intra-group lender could get when depositing cash with a commercial bank is also relevant. Further, in order to determine an arm's-length interest rate, factors such as currency, term, creditworthiness, currency risks and third-party refinancing costs should also be taken into account.[23]

As regards intra-group financing, thin capitalisation considerations are also important. While there are no Austrian statutory thin-capitalisation rules, the Supreme Administrative Court has established broad and rather liberal guidelines used to determine whether the equity funding in a specific case is adequate. In practice, debt-to-equity ratios of 3:1 to 4:1 are not uncommon. In the event the equity is inadequate, part of the indebtedness to shareholders may be regarded as shareholders' equity.

In the case of non-recourse factoring the purchaser of receivables should be remunerated for taking over the risk of default.[24]

As regards cash pooling arrangements, all involved group companies must benefit from such arrangements. Services rendered by a cash management provider should generally be remunerated in line with the cost plus method.[25]

19 Transfer Pricing Guidelines, paragraphs 75 and 81.
20 Transfer Pricing Guidelines, paragraph 76.
21 Transfer Pricing Guidelines, paragraph 77 et seq.
22 Transfer Pricing Guidelines, paragraph 84 et seq.
23 Transfer Pricing Guidelines, paragraph 87 et seq.
24 Transfer Pricing Guidelines, paragraph 99.
25 Transfer Pricing Guidelines, paragraph 101.

v Intangible property

The Transfer Pricing Guidelines do not define the term 'intangible property', but in connection with royalties cover payments for industrial property rights and other rights enhancing business activity, such as distribution rights. As regards the appropriate transfer pricing methods, reference is made to the OECD Transfer Pricing Guidelines.[26] Explicit guidance is only given on the provision of know-how, where intangible property is bundled with services: for that part of the compensation relating to services, the arm's-length price is generally to be determined by using the cost plus method, and any excess payments are generally to be seen as a royalty.[27] Regarding the determination of upper and lower limits for arm's-length royalty payments, on the one hand the licensee's additional yield due to the licence may be seen as an upper limit, while the total costs of the licensor may be considered as a lower limit.[28]

vi Cost contribution arrangements

In the case of cost contribution arrangements, costs should be allocated among participants on the basis of the benefits expected by each participant, with adaptations for the future being necessary in the event the actual benefits differ considerably from the expected benefits.[29]

vii Business restructurings

If tangible or intangible assets are transferred from one group company to another as a result of a business restructuring, or a group company is deprived of profit potential, adequate remuneration has to be provided.[30] While the tax authorities acknowledge that many types of business restructurings take place for genuine business reasons, in the case of business restructurings that lead to a significant decrease in profits of Austrian group companies, tax audits as to whether arm's-length principles were complied with may be expected.[31] Generally, the fact that limited intra-group contracts are not prolonged or are terminated is, on its own, not reason enough not to pay a remuneration.[32]

viii Permanent establishments

Regarding permanent establishments by virtue of a fixed place of business, these must carry out operational activities; however, this does not mean that such activities have to be carried out by humans, so that self-service petrol stations, tanning beds, snack machines and satellite dishes may also constitute permanent establishments.[33] While the relevant time period for permanent establishments is generally six months, under certain circumstances recurring use of facilities for periods of less than six months can lead to the existence of a permanent establishment.[34]

26 Transfer Pricing Guidelines, paragraph 102.
27 Transfer Pricing Guidelines, paragraph 103.
28 Transfer Pricing Guidelines, paragraph 108.
29 Transfer Pricing Guidelines, paragraphs 121 and 123.
30 Transfer Pricing Guidelines, paragraph 136.
31 Transfer Pricing Guidelines, paragraph 132.
32 Transfer Pricing Guidelines, paragraph 135.
33 Transfer Pricing Guidelines, paragraph 164 et seq.
34 Transfer Pricing Guidelines, paragraph 168.

Regarding permanent establishments by virtue of a dependent agent, the Transfer Pricing Guidelines state that an agent is not required to conclude contracts in the name of the principal; rather, concluding contracts in its own name is sufficient in the event the principal is contractually obliged to fulfil these.[35]

Regarding the attribution of profits to permanent establishments, Austria has implemented the Authorised OECD Approach; however, only insofar as it does not contradict the 2008 version of the OECD commentary to Article 7. This is due to the fact that the new Article 7 is generally not yet included in Austria's double taxation treaties.[36] As a result, (deemed) payments under loan, rental or licence agreements between the head office and a permanent establishment are currently not recognised for Austrian tax purposes.[37]

IV TRANSFER PRICING RULINGS

In Austria, three different types of rulings exist that may be used in transfer pricing matters.

First there is something like an informal tax ruling, which is a statement provided in writing by a tax authority upon a taxpayer's request as to the tax implications of a particular situation described by the taxpayer. Such rulings have no legally binding effect. Nevertheless, the taxpayer may still under certain circumstances be protected by the general principle of equity and good faith. This is an unwritten maxim applicable to all persons in a legal relationship, meaning that every person is obliged to adhere to his or her own words and actions and shall not without cause act in contradiction to what he or she has announced beforehand and upon which others have relied. Such principle applies if (1) the tax ruling has been rendered by the competent tax authority; (2) the tax ruling is not patently incorrect; (3) the incorrectness of the tax ruling was not easily noticeable for the party; (4) relying upon the correctness of the given tax ruling, the party has made dispositions or transactions that it would not otherwise have made or would have made differently if it had known about the incorrectness of the tax ruling; and (5) taxation contrary to the tax ruling would result in damage for the party. Informal rulings are not published and do not involve any administrative costs.[38]

Secondly, there are legally binding formal tax rulings, which can be applied for, *inter alia*, in transfer pricing matters. They are issued upon an applicant's written request, which must contain (1) a comprehensive and consistent description of the envisaged transaction; (2) an explanation of the applicant's vested interest in receiving the ruling; (3) an explanation of the legal issues at hand; (4) specific legal questions; and (5) a comprehensive analysis of the legal issues raised. In contrast to the informal ruling mentioned above, the competent tax office must issue a formal tax ruling. Such ruling must contain (1) the facts and statutory provisions on which it is based; (2) a legal assessment of the facts; and (3) the time frame during which it is valid. In addition, the applicant may be required to report on whether the facts of the case have been implemented as planned. Obtaining such formal ruling (irrespective of whether the result is in line with the applicant's view or not) involves administrative costs amounting to €1,500 to €20,000, depending on the applicant's turnover.[39]

35 Transfer Pricing Guidelines, paragraph 175.

36 Transfer Pricing Guidelines, paragraph 181.

37 Transfer Pricing Guidelines, paragraph 180.

38 Cf. Ministry of Finance, 6 April 2006, BMF-010103/0023-VI/2006.

39 Federal Fiscal Procedures Act, Section 118.

While both types of rulings outlined above are unilateral measures aiming at increasing planning certainty for taxpayers, they do not protect taxpayers from foreign tax authorities assessing the same facts differently for transfer pricing purposes. Pursuant to the tax treaty provisions corresponding to Article 25 of the OECD Model Convention, the Austrian tax authorities may conclude advance pricing agreements (APAs) with the tax authorities of other states. However, APAs have hardly any practical relevance in Austria.[40]

V INVESTIGATIONS

Corporate income tax is assessed by the local tax office based on the tax returns filed annually by taxpayers. Such assessment notices become binding after a period of one month following notification to the taxpayer[41] and can only be amended by the authorities under specific circumstances (e.g., if new facts have surfaced which, if they had been known earlier by the tax authorities, would have led to a different tax assessment).[42] The statute of limitations is normally five years.[43]

Taxpayers are regularly audited by the tax office, with transfer pricing aspects usually being an important part of tax audits of international groups of companies. Generally, and also outside the scope of a formal tax audit, the tax authorities may interview both the taxpayer as well as any other person who may be in a position to give information on tax-relevant aspects, such as the directors of a company or its employees; may ask to be shown written documentation, including transfer pricing documentation; and may enter the premises of a company (without, however, having the right to search them).[44] A formal tax audit generally encompasses the last three tax years for which tax returns have been filed or which have been assessed.[45] The taxpayer generally has to be informed of a tax audit at the latest one week before its start, unless such information would jeopardise the purpose of the audit.[46] While the burden of proof is on the tax authorities, the taxpayer has a duty to cooperate with the tax authorities as far as this is reasonable; in international tax matters a heightened duty to cooperate is assumed.[47] At the end of the tax audit, the auditor generally has to present and discuss his or her findings with the taxpayer and its tax representative, thereby giving the taxpayer the possibility to be heard.[48] The auditor's final report on the audit, a copy of which has to be provided to the taxpayer,[49] is the basis for adjusted assessment notices, if any.

40 Cf. Schmidt/Stadler, Austria, in *Income Tax Treaties: Competent Authority Functions and Procedures of Selected Countries (A-C)*, Bloomberg BNA Foreign Income Portfolios, Portfolio 6885 (2016), A-61.
41 Federal Fiscal Procedures Act, Section 245(1).
42 Federal Fiscal Procedures Act, Section 303 et seq.
43 Federal Fiscal Procedures Act, Section 207(2).
44 Federal Fiscal Procedures Act, Section 143 et seq.
45 Ministry of Finance, 31 March 2014, BMF-280000/0061-IV/2/2014, paragraph 8.4.
46 Federal Fiscal Procedures Act, Section 148(5).
47 Cf. Ritz, *Bundesabgabenordnung*[5] (2014) Section 115 paragraph 6 et seq.
48 Federal Fiscal Procedures Act, Section 149.
49 Federal Fiscal Procedures Act, Section 150.

VI LITIGATION

If a taxpayer is not satisfied with an adjusted assessment notice issued after completion of a tax audit, an appeal may be filed with the Federal Tax Court within one month.[50] The Federal Tax Court generally has to take into account new facts presented by the taxpayer.[51] Decisions of the Federal Tax Court may in turn be challenged before the Supreme Administrative Court and, in special cases, the Constitutional Court.

VII SECONDARY ADJUSTMENTS

Transfer pricing audits effected by foreign tax authorities and resulting in primary adjustments usually lead to secondary adjustments in Austria. In the event the result of the foreign audit is that the foreign taxable profit was too low, while the Austrian taxable profit was too high, the tax authorities can effect such secondary adjustment directly on the basis of the respective double taxation treaty, without the need to apply domestic Austrian law. This is due to the fact that, while double taxation treaties do not have priority over Austrian domestic law *per se*, they usually have priority due to being *leges speciales*.[52] The competent tax authority will effect a downward secondary adjustment if the taxpayer furnishes proof of the correctness of the foreign primary adjustment by submitting documentation in this respect.[53]

In the case of a foreign downward adjustment, however, the double taxation treaty does not prevent Austria from effecting an upward adjustment, but does not oblige Austria to do so either. Consequently, the legal basis for such upward adjustment is Section 6(6) of the Income Tax Act, thus an Austrian domestic provision.[54]

If a foreign primary adjustment leads to a change of the tax base for value added tax purposes, pursuant to statutory law a value added tax adjustment has to be effected.[55] However, pursuant to the Ministry of Finance such value added tax adjustment is not necessary in cases that do not negatively affect the tax revenue, such as tax-exempt exports or situations where a rise in the tax base for value added tax purposes of one entrepreneur would lead to a corresponding claim for input tax of another entrepreneur.[56]

VIII PENALTIES

If a transfer pricing audit leads to an upward adjustment of the corporate income tax base, then normally late payment interest falls due at a rate of 2 per cent above the base rate. Such interest is calculated on the balance between the corporate income tax previously payable and the corporate income tax payable as a result of the tax audit. Late payment interest is charged as of 1 October of the calendar year following the audited year and is payable until the day of notification of the adjusted corporate income tax assessment notice, but at most for a period of 48 months.[57]

50 Federal Fiscal Procedures Act, Section 245(1).
51 Federal Fiscal Procedures Act, Section 270.
52 Transfer Pricing Guidelines, paragraph 12.
53 Transfer Pricing Guidelines, paragraph 324.
54 Transfer Pricing Guidelines, paragraph 13 et seq.
55 Value Added Tax Act, Section 16.
56 Transfer Pricing Guidelines, paragraph 338 et seq.
57 Federal Fiscal Procedures Act, Section 205.

Apart from interest, penalties under the Fiscal Criminal Act may be imposed in cases of gross negligence or wilful tax evasion; such penalties may include monetary fines and imprisonment.

IX MUTUAL AGREEMENT PROCEDURES AND ARBITRATION

All double taxation treaties concluded by Austria contain a clause on the mutual agreement procedure (MAP), mostly corresponding to Article 25 of the OECD Model Convention. Normally, a taxpayer must present its case to the competent authority within three years from the first notification of the action resulting in taxation that is not in accordance with the applicable income tax treaty. Pursuant to the Ministry of Finance this is the point in time when the taxpayer becomes aware that an adjustment of profits is considered by one of the contracting states.[58] In case of related parties, the MAP generally has to be initiated in the state of residence of the parent company.[59] A MAP can also be initiated if an appeal is pending or the appeals procedure has not yet ended.[60] Mutual agreements achieved by the Austrian authorities with the competent authorities of the other treaty state can, according to most double taxation treaties concluded since the 1980s, be implemented notwithstanding the Austrian statute of limitation provisions. In the event a double taxation treaty does not contain such wording, the implementation of a mutual agreement is only possible within the long statute of limitations period of 10 years.[61] While the taxpayer has no legal claim for a certain result under a MAP, an assessment notice based thereon can be challenged by the taxpayer. There are several procedural rules contained in the Federal Fiscal Procedures Act under which a mutual agreement can be implemented.[62]

The income tax treaties concluded by Austria with Armenia, Azerbaijan, Bahrain, Bosnia and Herzegovina, Germany, Macedonia, Mongolia, San Marino and Switzerland contain arbitration provisions. Further, Austria is a party to the EU Arbitration Convention.

X OUTLOOK AND CONCLUSIONS

It can be expected that the area of transfer pricing will become ever more important in the future, in particular against the background of the OECD's BEPS project, which inevitably will lead to a rise in transfer pricing conflicts between jurisdictions.

58 Transfer Pricing Guidelines, paragraph 351.

59 Transfer Pricing Guidelines, paragraph 352, Ministry of Finance, 31 March 2015, BMF-010221/0172-VI/8/2015, paragraph B.2.1.1.

60 Ministry of Finance, 31 March 2015, BMF-010221/0172-VI/8/2015, paragraph B.2.1.1.

61 Cf. Schmidt/Stadler, Austria, in *Income Tax Treaties: Competent Authority Functions and Procedures of Selected Countries (A-C)*, Bloomberg BNA Foreign Income Portfolios, Portfolio 6885 (2016), A-56.

62 Ministry of Finance, 31 March 2015, BMF-010221/0172-VI/8/2015, paragraph B.6.4.

Chapter 2

BELGIUM

Géry Bombeke and Julie Permeke[1]

I OVERVIEW

Belgium's approach to transfer pricing issues is consistent with the OECD Guidelines and the administrative guidance[2] relating to transfer pricing explicitly refers to these Guidelines. Belgium thus generally applies the arm's-length standard both under domestic and treaty tax law.

In 2004, the arm's-length principle was introduced into Belgian tax law by means of Article 185(2) of the Belgian Income Tax Code (ITC). This article is equivalent in content to Article 9(1) and (2) of the OECD Model Tax Convention. It provides for the possibility to make positive adjustments (i.e., increases) of the taxable base of Belgian corporate taxpayers involved in transactions at non-arm's length conditions (Article 185(2) Section 1, a) ITC). Article 185(2) ITC also provides for the possibility of negative adjustments (i.e., decreases) or correlative adjustments of the taxable bases of Belgian corporate taxpayers that benefited from non-arm's length transactions (Article 185(2) Section 1, b) ITC). Such downwards adjustment is subject to the application of the EU Arbitration Convention or a double tax treaty or the obtaining of an advance decision ('ruling') from the Belgian Office for Advance Decisions (informally called the Ruling Commission).

According to the applicable administrative guidelines,[3] Article 185(2) ITC applies to transactions between: (1) a Belgian company and a foreign company of the same multinational enterprise (MNE); (2) a Belgian permanent establishment (PE) and a foreign PE of another company of the same MNE; (3) a Belgian company and a foreign PE of another Belgian company of the same MNE; (4) a Belgian PE and its foreign head office; and (5) a Belgian PE and a foreign PE of the same company. Transactions not covered by Article 185(2) ITC (e.g., domestic controlled transactions, transactions between a Belgian head office and its foreign PE, cross-border transactions between a company and an individual, transactions between

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2 The Belgian tax authorities have published several administrative circulars with guidelines on transfer pricing:
- *a* a circular of 28 June 1999 regarding transfer pricing audits and commentaries on the 1995 OECD Transfer Pricing Guidelines (the 1999 TP Circular);
- *b* a circular of 7 July 2000 (amended in 2003) regarding the EU Arbitration Convention;
- *c* a circular of 4 July 2006 on the interpretation of Article 185(2) ITC (the Article 185(2) Circular);
- *d* a circular of 4 July 2006 on the formation of a transfer pricing audit team; and
- *e* a circular of 14 November 2006 on transfer pricing audits, transfer pricing documentation and the transfer pricing code of conduct (the November 2006 TP Circular).

3 The Article 185(2) Circular.

individuals and transactions between non-associated companies) may nevertheless fall within the scope of other transfer pricing provisions laid down in Belgian domestic tax law or in double tax treaties concluded by Belgium (see further below).

To be considered a member of the same MNE for the purpose of Article 185(2) ITC, the relevant taxpayers must be associated. A company is considered to be associated with another company if: (1) it controls such other company; (2) it is controlled by such other company; (3) it is part of the same consortium; or (4) the other company is, to the knowledge of the company's directors, controlled by a company mentioned under (1), (2) or (3). 'Control' should be interpreted as the legal or *de facto* power to exercise a decisive influence on the appointment of the majority of the company's directors or managers, or on their management.

Aside from Article 185(2), the ITC contains a number of other provisions that are relevant from a transfer pricing perspective, the most important of which are Article 26 ITC and Article 79 *juncto* 207 ITC. These provisions are based on the Belgian variant of the arm's-length principle – the concept of 'abnormal or gratuitous advantages'. While Article 26 ITC can result in a tax adjustment if a Belgian taxpayer has granted an abnormal or gratuitous advantage to a foreign company or individual, Article 79 *juncto* 207 ITC denies the offset of certain tax deductions (such as tax losses carried forward) against any abnormal or gratuitous advantages received by a Belgian company from a related party. Based on the Belgian tax authorities' interpretation of the latter provisions (which was recently confirmed by case law (see Section VII.ii, *infra*)), a Belgian corporate taxpayer's tax base can as such not be lower than the amount of any abnormal or gratuitous advantage received even if the taxpayer is in a loss (carried forward) position.

Furthermore, Belgian tax law contains certain specific transfer pricing-related anti-abuse provisions that target the tax deductibility of non-arm's length payments (Article 54 ITC regarding payments to tax havens and Article 55 ITC regarding interest payments) as well as a general thin capitalisation rule (Article 198, 11° ITC).

II FILING REQUIREMENTS

For financial years starting before 1 January 2016, no statutory requirement exists in Belgium to prepare advance or contemporaneous transfer pricing documentation. However, following the 1999 TP Circular, it is clearly recommended that Belgian taxpayers prepare the necessary documentation in order to demonstrate that their transfer pricing policy complies with the arm's-length principle. It is recommended that such documentation includes the following:

a a description of the activities of the group (including market position, economic circumstances, business strategies, etc.), the identification and characterisation of intercompany transactions, and the contractual relationships among affiliates; and

b a functional analysis (including an overview of the relevant functions, risks and intangibles), a justification of the transfer pricing methods used and an economic analysis.

In the November 2006 TP Circular, the Belgian tax authorities have listed further documentation that is recommended to be prepared by Belgian taxpayers. Given the absence of any legal requirement for transfer pricing documentation with respect to financial years starting before 1 January 2016, there is no deadline for its preparation. It is, however, recommended that each transaction is documented at the time it is executed or by the time the tax return over the relevant period is filed, as a Belgian taxpayer must, under general tax rules, provide the Belgian tax authorities with all relevant information to determine its taxable income and is required to respond to all questionnaires from the tax authorities within one month.

For financial years starting on or after 1 January 2016, Belgium introduced OECD BEPS Action 13-compliant transfer pricing documentation requirements through the Program Law of 1 July 2016.

Based on this Program Law, qualifying Belgian corporate taxpayers are required to follow the three-tiered approach introduced by the OECD and file: (1) a master file; (2) a local file; and (3) a country-by-country (CbC) report. These filings must be made through specific forms, which were laid down in a Royal Decree of 2 December 2016.

i Master file

Belgian group entities (including Belgian PEs) of multinational groups must file a master file with the Belgian tax administration within 12 months after the relevant financial year (reporting period). In this file, information must be given on several items, such as the organisational structure, a description of the business, intangibles of the multinational enterprise, intercompany financial activities and the multinational enterprise's financial and tax positions.

Belgian companies not exceeding any of the following criteria on a stand-alone basis are exempt from the obligation to file a master file: (1) operating and financial income, non-recurrent income excluded, of €50 million; (2) a balance sheet total of €1 billion; and (3) an annual average personnel number of 100 full-time equivalents.

ii Local file

The same Belgian group entities must attach a local file to their annual corporate income tax return (filing deadline is in principle between six and nine months after financial year-end).

The local file must be filed through a specific pre-set form, which requires information on the local entity and a detailed information sheet regarding the transactions between the local entity and the foreign entities of the multinational group.

The detailed information sheet must only be filed for business divisions of Belgian group entities of which the total cross-border intercompany transactions exceed €1 million. Contrary to the general information sheet, the detailed information sheets only need to be filed for reporting periods starting on or after 1 January 2017.

iii CbC report

Each Belgian group entity that is the ultimate parent entity of a multinational group must file a CbC report with the Belgian tax administration within 12 months after the relevant financial year (reporting period).

This is also the case for Belgian group entities that are not the ultimate parent entity of a multinational group if: (1) the ultimate parent entity is not required to file a CbC report in its tax residence country; (2) the jurisdiction of the ultimate parent company has, at the latest 12 months after the reporting period, no qualifying exchange of information agreement with Belgium; or (3) the jurisdiction of the ultimate parent entity is systematically failing to exchange CbC reports and the Belgian tax administration has informed the Belgian group entity thereof.

The obligation for a Belgian group entity (not being the ultimate parent company) to file a CbC report with the Belgian tax administration does not apply if: (1) the multinational group has more than one group entity with tax residency in the European Union and has appointed one of these group entities to fulfil the above filing requirement in its local jurisdiction; or (2) the multinational group has appointed a surrogate parent entity to file the CbC report in its jurisdiction, provided that such filing is required by that jurisdiction and certain other conditions are met.

Belgian group entities are required to inform the Belgian tax authorities as to which group entity will file the CbC report. This must be done by the last day of the reporting period. The deadline for the first CbC report was extended until 30 September 2017.

The CbC reporting requirement does not apply to multinational groups with a consolidated annual gross group revenue of less than €750 million.

The information to be disclosed in the CbC report under Belgian legislation is in line with what is prescribed by the OECD.

In the transition period where certain (OECD member) countries have not yet introduced formal CbC reporting requirements, Belgium is prepared to accept voluntary CbC reporting in these countries provided that a qualifying exchange of information agreement is in place within 12 months after the reporting period.

For non-compliance with the new transfer pricing reporting requirements, penalties of €1,250 to €25,000 can be imposed as of the second violation.

As a final note, under Belgian accounting law, companies are required to provide in the notes to their statutory annual accounts certain transfer pricing related information, such as: (1) information regarding certain relevant off-balance sheet arrangements; and (2) material transactions with associated parties that cannot be considered at arm's length. Belgian tax law also provides for certain reporting requirements with respect to payments to tax haven companies.

III PRESENTING THE CASE

i Pricing methods

Taxpayers should use the transfer pricing method that is the most appropriate in a given case, and they should be able to support their choice for that method. There is no best method rule and taxpayers are, as such, not required to apply more than one method. All methods described in the OECD Transfer Pricing Guidelines are accepted for Belgian tax purposes. While conceptually the Belgian tax authorities prefer transactional methods, all OECD methods are accepted in Belgium (i.e., the comparable uncontrolled price (CUP), resale price, cost plus, profit split and transactional net margin methods).

Historically, a lot of weight was placed on the CUP method and the use of comparables. Advance pricing agreement (APA) practice shows, however, that the use of the transactional net margin method and other profit-based methods has currently become the rule rather than the exception. In the future, it is, in line with OECD developments, expected that the profit-split method will gain in importance.

ii Authority scrutiny and evidence gathering

In principle, the Belgian tax authorities bear the burden of proof when challenging the at-arm's length character of a transaction, although in practice this is somewhat shifted to the taxpayer. The tax authorities ask taxpayers to demonstrate that the transfer pricing methodology adopted is at arm's length. In this respect, Belgian tax law allows all means of evidence except for the oath (i.e., documents, testimonies, presumptions, etc.). The 1999 TP Circular states that evidence of non-arm's length situations will predominantly follow from presumptions made on the basis of factual evidence.

The Belgian tax administration will typically obtain the necessary information through addressing a request for information or questionnaire to the Belgian taxpayer or by means of an announced tax audit or an unannounced tax dawn raid at the premises of the Belgian taxpayer (including interviews of people present at the premises). It should be noted that the Belgian tax authorities also have the right to obtain information and documentation from third parties (e.g., a customer) established in Belgium. Every taxpayer who resides in Belgium is required to supply information and documentation requested by the tax authorities to determine the amount of income that may be taxed under Belgian tax law. This may include information with respect to their transactions with other taxpayers, which may be used by the tax authorities for the taxation of such third parties. Information provided by the tax authorities of a foreign state, pursuant to its domestic law or to any treaty to which such foreign state is a party or to EU law, can be used by the Belgian tax authorities to assess Belgian taxes as well. If the Belgian tax authorities wish to obtain information from a foreign entity (without a Belgian tax presence), they should direct the request to the foreign tax authorities using the appropriate legal procedures (e.g., in double tax treaties, the Mutual Assistance Convention, European directives).

IV INTANGIBLE ASSETS

Under Belgian statutory law, no specific rules exist regarding transfer pricing for intangible assets. Following the BEPS project, it can be expected that the Belgian tax authorities will follow and apply the DEMPE principles and that legal arrangements will experience increased scrutiny if not in line with the functionalities.

V SETTLEMENTS

Most transfer pricing audits are concluded with a settlement between taxpayer and the tax authorities on the items audited. Settlement discussions typically take place at the end of a transfer pricing audit, which normally takes between nine and 18 months, and on the basis of the issues retained by the tax authorities.

Upfront comfort on transfer pricing issues can be obtained through an APA. The Belgian Ruling Commission, being a separate service within the Belgian tax administration, provides unilateral APAs. Bilateral and multilateral APAs have to be applied for with the Department of International Relations of the Federal Service Finance. APAs are provided on an individual and case-specific basis.

A lot of transfer pricing rulings have been issued by the Ruling Commission over the past years on different types of transfer pricing issues: cost plus rulings for intra-group support services and toll manufacturing services, rulings determining what an appropriate margin is for full-fledged distributors or limited-risk distributors, etc.

An APA or transfer pricing ruling must relate to an actual and fully disclosed transaction or situation that has not yet produced any effects from a tax perspective (i.e., in general for as long as the tax return for the relevant financial year is not yet filed, which is normally six to nine months after the financial year-end). Applications for theoretical or hypothetical cases are not permitted. Additionally, no ruling is possible with respect to operations that have no economic substance in Belgium or transactions with tax havens. Finally, an APA or transfer pricing ruling cannot be obtained with respect to transactions that are subject of a pending tax dispute.

The request for an APA must be filed in writing with the Ruling Commission (or the Department of International Relations of the Federal Service Finance for bilateral and multilateral APAs) by or on behalf of a Belgian taxpayer. Anonymous filing is not possible. Until the APA is granted, all new information relating to the transaction must be added to the APA request. A copy of all APAs concerning the same transactions that have been requested and obtained from tax authorities of EU Member States or states with which Belgium has a double tax treaty on the same subject must be added to the ruling request. No fee is charged for the request or grant of an APA.

The APA procedure is as follows:

a Usually, a pre-filing meeting is organised to discuss the transaction (possible on a no-names basis). Such pre-filing meeting is preceded by a written pre-filing meeting request in which the transactions and the transfer pricing matters are described. Pre-filing meetings are often conducted using a slide presentation.

b A formal ruling request is filed.

c Within five working days, the receipt of the APA request is acknowledged and the names and contact details of the officials responsible for the APA request are communicated.

d A first internal meeting is organised to see whether the request contains all necessary information and what time frame is required to take the decision.

e Following the first meeting, the Ruling Commission further examines the APA request and may ask for additional information.

f There is no formal time limit for granting the APA but it generally takes about six months or more (four months for less complex APA requests).

Taxpayers are expected to provide the Ruling Commission with the identity of all parties involved, a detailed description of the applicant's business activities, a complete and accurate description of the relevant transaction, a fully detailed functional and risk analysis, a benchmarking study to support the arm's-length nature of the transfer prices, and the legal basis on which the ruling should be granted.

An APA binds the Belgian tax administration and can be relied upon by the Belgian taxpayer for the period as determined in the APA. Typically, this term is five years. APAs are renewable if the facts and circumstances on the basis of which the APA was granted remain unchanged. However, an APA will not be binding if, among others, the description of the envisaged transaction was incomplete or incorrect, essential elements of the transaction were not carried out in the way in which they were presented in the APA request, or the terms and conditions of the APA were not respected. The taxpayer is not bound by an APA and there is no obligation on its part to implement the envisaged transaction or operation on which an APA was obtained.

VI INVESTIGATIONS

A dedicated transfer pricing audit team exists within the Belgian tax administration. This team specialises in carrying out transfer pricing audits and assists on transfer pricing matters identified in tax audits carried out by local tax inspectors.

As of 2013, the audit activity of this transfer pricing unit significantly increased as the team was significantly expanded. Since then, the transfer pricing unit launches about 300 transfer pricing audits at the beginning of each calendar year.

The 1999 TP Circular hints towards an in-depth transfer pricing audit when one or more of the following risk indicators are present:

a the company provides vague, unsuitable or insufficient information concerning its transfer pricing;

b certain financial ratios derived from the company's accounts differ substantially from those customary in the company's sector; and

c the company enters into transactions with companies located in low-tax jurisdictions or companies with substantial and/or recurrent losses.

The 2006 TP Circular has further complemented the 1999 TP Circular and provides for an additional and non-exclusive list of circumstances that can give rise to a transfer pricing audit:

a the use of tax havens when little or no economic value is added (e.g., re-invoicing activities) and (in)direct payments to entities in tax havens (commissions, royalties, management fees, etc.);

b the use of back-to-back structures to conceal the true nature of the transaction;

c complex arrangements and circular structures that add little or no economic value;

d Belgian group entities incurring structural losses;

e company restructurings and delocalisation of entities, particularly with respect to the valuation and compensation of intellectual property (IP) such as patents, know-how and goodwill, as well as with respect to the legal and economic ownership of the IP; and

f invoices for the provision of intercompany services (management fees) at year-end.

The general statute of limitations rules apply to transfer pricing matters. In general, the Belgian tax authorities can open an investigation and make additional assessments during a period of three years following the closing of the financial year. In case of fraud, the limitation period of three years is extended by an additional four years (i.e., seven years in total), provided that the tax authorities can establish serious indications of fraud and the taxpayer is informed thereof in advance. In specific cases, the tax authorities are authorised to issue an assessment even after the expiry of the above-mentioned three- or seven-year statute of limitations periods.

A transfer pricing audit typically starts with a standard written request for information. In principle, the taxpayer is required to provide the requested information within one month. Failure to provide the requested information in time may result in an *ex officio* assessment. In practice, tax inspectors will often extend this deadline upon request by the taxpayer, provided that a longer period is required to gather all requested information (e.g., because information needs to be obtained from foreign group companies). The November 2006 TP Circular acknowledges this and instructs tax inspectors to show the necessary flexibility when receiving a reasonable request to extend the deadline for answering the request for information.

The November 2006 TP Circular encourages tax inspectors to hold a pre-audit meeting with the taxpayer concerned to discuss: (1) the scope of the transfer pricing audit; (2) the transfer pricing policy of the group; and (3) the level of transfer pricing information readily available. This is aimed at avoiding unnecessary or irrelevant requests for information and minimising the cost for the taxpayer concerned. Most taxpayers request a pre-audit meeting upon receipt of a request for information.

Upon completion of a transfer pricing audit, the tax inspector may propose an amendment of the corporate income tax base in a notice of amendment. This notice must set out the reasons for the proposed amendment. The taxpayer has one month to oppose such an adjustment. Subsequently, the tax inspector will issue a tax assessment in which the taxpayer's arguments may or may not be taken into account. The taxpayer has six months to appeal the tax assessment before the regional Tax Director. The decision of the Tax Director may further be appealed before Belgian courts (see Section VII, *infra*).

Currently, the Belgian tax authorities appear to focus on the transfer pricing of IP-related transactions (e.g., payment of royalties) and intercompany fee structures, financial transactions (including thin-cap), business restructurings and the value added by the different parties to an intercompany transaction.

VII LITIGATION

i Procedure

The taxpayer has six months to appeal against a tax assessment before the regional Tax Director. In the context of a tax complaint, the tax authorities may demand all information they deem useful, including information from third parties such as suppliers, clients and banks. The taxpayer or his or her representatives may make oral or written submissions so long as no decision is taken. The Tax Director may confirm the assessment as issued, vary the assessment by issuing a revised reassessment, or vacate the assessment; he or she may not increase the assessment.

In the event the tax complaint does not result in an acceptable resolution, the taxpayer may appeal to the competent Belgian Court of First Instance. The appeal must be filed with the court within three months after the dispatch of the decision of the regional Tax Director.

It is possible in the writ of appeals to invoke new legal or factual arguments that have not yet been invoked in the tax complaint. The writ of appeals should contain a summary of the arguments, which can be further developed in briefs of arguments later on in the procedure. Once the taxpayer and the tax authorities have exchanged their briefs of arguments, a hearing is fixed before the court at which the parties plead the case.

The decision of the Court of First Instance may be appealed by the taxpayer or the tax authorities to the competent Belgian Court of Appeals within one month following the notification by bailiff of the decision of the Court of First Instance. The decision of the Court of Appeals may be appealed to the Supreme Court by the taxpayer or the tax authorities within three months following the notification by bailiff of the decision of the Court of Appeals. The Supreme Court will only review questions of law. If the decision of the Court of Appeals is reversed by the Supreme Court, the case will be handed over to another Court of Appeals for final determination.

ii Recent cases

With respect to the application of Article 79 *juncto* Article 207, Section 2 ITC, the Supreme Court has recently quashed the decision of the Court of Appeals of Antwerp of 6 November 2012, in which it was decided that Article 79 *juncto* Article 207, Section 2 ITC cannot give rise to a minimal taxable base (i.e., the abnormal or gratuitous advantage received) in the event the taxpayer is in a loss-making position.[4] Following the decision of the Supreme Court, however, an abnormal or gratuitous advantage received by a (corporate) taxpayer is always subject to corporate income tax irrespective of the actual result of that taxpayer. This means that Article 79 *juncto* 207, Section 2 ITC applies if the taxable income of the taxpayer is lower than the abnormal or gratuitous advantage received, in which case the taxable base is increased to the amount of such advantage (thereby constituting a minimal tax base). The Court of Appeals of Brussels has been appointed by the Supreme Court to decide on the merits of the case.

VIII SECONDARY ADJUSTMENT AND PENALTIES

Belgium does not apply a system of secondary adjustments. Transfer pricing adjustments may be made for tax purposes only, without any accounting impact for the companies concerned.

Belgian tax law does not provide for specific transfer pricing-related penalties. For an incorrect tax return, the tax due on the non-reported income may be increased by a penalty ranging between 10 per cent and 200 per cent of the additional amount of tax due, depending on the nature and seriousness of the infringement committed by the taxpayer. Additionally, administrative and criminal fines may become applicable.

In practice, the Belgian tax authorities often waive the 10 per cent penalty upon transfer pricing adjustments. As the penalties depend on the type of infringement and on the company's possible negligence, they can be avoided or minimised if the taxpayer can demonstrate its good faith and intent to establish transfer prices in accordance with the arm's-length principle (e.g., through its documentation effort).

If the penalty is maintained by the tax authorities (after the appeal before the regional Tax Director; see Section VII, *supra*), the taxpayer could request the competent Court of First Instance to mitigate the penalty applied.

IX BROADER TAXATION ISSUES

i Diverted profits tax

There is no diverted profits tax regime in Belgium. The Belgian tax authorities do, however, have an increased focus with respect to substance.

ii Double taxation

As mentioned above, Article 185(2) ITC allows for downward corresponding adjustments similar to what is provided for in Article 9(2) of the OECD Model Tax Convention (see Section I, *supra*).

Furthermore, most of the tax treaties concluded by Belgium provide for a mutual agreement procedure (MAP). The Belgian tax authorities adhere to the principle that an upward transfer pricing adjustment in one contracting state should result in a corresponding downwards transfer pricing adjustment in the other contracting state. However, the MAP in most of Belgium's double tax treaties does not impose an obligation to eliminate double taxation. The only requirement is for competent authorities to endeavour in good faith to reach an agreement. Furthermore, as generally no deadlines are imposed, this procedure can

4 Supreme Court 10 March 2016, F.14.0082.

last many years before actual remedy is obtained. Belgium's model tax convention nevertheless contains a compulsory arbitration clause. Such a clause was inserted in the 2006 Belgium–US double tax treaty.

Finally, in certain cases, double taxation can be alleviated on the basis of the European Arbitration Convention, which installs a procedure on the basis of which EU Member States are required to eliminate double taxation on the basis of mutual agreement. In a circular of 2000 (amended in 2003), the Belgian tax authorities have provided guidance on the application of the EU Arbitration Convention.[5]

iii Consequential impact

The transfer pricing measures and adjustments discussed above only apply with respect to Belgian income tax. A transfer pricing adjustment may, however, also impact the taxable base for Belgian VAT or customs duties. The Belgian VAT Code and the Belgian Customs Code contain proper rules in order to determine the arm's-length value of the goods supplied or imported, and the application of such rules might not always lead to the exact same market value or pricing as for transfer pricing purposes.

Finally, it should also be noted that the Belgian income tax authorities, VAT authorities and customs authorities can exchange information among each other with respect to the valuation of goods and services supplied.

X OUTLOOK AND CONCLUSIONS

Following the introduction of the mandatory transfer pricing documentation requirements, Belgium has shifted from a country without formal documentation requirements to one with mandatory filing of master file, local file and CbC reports. We expect that this will further increase the focus of the Belgian tax authorities on transfer pricing-related matters (through, for example, data mining procedures).

Apart from this concrete change in compliance requirements, we are seeing an increased focus on value chain analyses and substance requirements. Legal arrangements experience increased scrutiny if not in line with the functionalities (e.g., DEMPE).

In the future, we expect more focus on the use of profit split methods with the impact of the position of the European Commission towards transfer pricing and the focus on the CUP method (as reflected in numerous state aid decisions) still being unclear.

5 Circular of 7 July 2000 (amended by the Circular of 25 March 2003).

Chapter 3

BRAZIL

João Francisco Bianco and Ramon Tomazela Santos[1]

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. In order 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 basically 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 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).

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

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 of kin up through 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 sale of the same product or the provision of the same service in the Brazilian market. The comparison must take place within 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, 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:

Method	Definition
Compared independent prices (PIC)	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.
Cost plus profit (CPL)	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.
Resale price less profit (PRL)	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.
Quotation price on imports (PCI)	The daily average values of the quotation of commodities subject to public prices on internationally recognised commodities exchanges and futures.

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:

Method	Definition
Export sales price (PVEx)	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.
Production or acquisition cost plus taxes and profit (CAP)	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.
Wholesale price in the destination country, less profit (PVA)	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.
Retail price in the destination country, less profit (PVV)	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.
Quotation price on exports (PECEX)	The daily average values of the quotation of commodities subject to public prices on internationally recognised commodities exchanges and futures.

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 the 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:

a market rates of sovereign securities issued by the Federative Republic of Brazil on the foreign market in US dollars, in the event of transactions at pre-fixed US dollar rates;
b market rates of sovereign securities issued by the Federative Republic of Brazil on the foreign market in Brazilian reais, in the event of transactions abroad at pre-fixed rates; and
c 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. It is important to mention that 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 administrations 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. Anyway, it is important to point out that 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, *supra*, 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 and knowledge, 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, *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, in order 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 (1) pay the tax debt upheld by the DRJ; or (2) 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 (*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.

ii 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 (decision No. 9101-002.315, of 3 May 2016; decision No. 9101-002.524, of 12 December 2016; decision No. 9101-002.175, of 19 January 2016). This matter is now under discussion before the judicial courts (e.g., writs of mandamus No. 1007189-70.2016.4.01.3400; No. 1005300-81.2016.4.01.3400; No. 0013044-60.2015.4.03.6105, among others).

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 (decision No. 9101-002.313, of 3 May 2016; decision No. 9101-002.174, of 19 January 2016).

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 (decision No. 9101-002.317, of 3 May 2016; decision 9101-002.512, of 12 December 2016; decision No. 9101-002.446, of 21 September 2016).

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 (decision No. 1301-002.185, of 25 January 2017).

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.

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 Administration is 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 mark-up 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, in order 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 such 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 standpoint, 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 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.

iii Consequential impact

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 be appraised in different ways, thus producing inconsistent outcomes.

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 operationalise the transfer pricing control, facilitating its practical application by both the Tax Administration 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 the competitiveness of Brazilian companies.

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 mark-up 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 that is 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.

Chapter 4

CANADA

Dominic C Belley and Jonathan Lafrance[1]

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[2] 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)[3] when Parliament enacted Section 247 of the ITA,[4] which is found in Part XVI.1 of the Act.

Canada's transfer pricing[5] 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,[6] to determine, modify and even re-characterise 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: (1) the Minister's power to impose adjustments to the quantum or recharaterise the nature of transfer prices, (2) automatic and independent penalty regime where the transfer pricing adjustments are above a certain statutory threshold, and (3) 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[7] and partnerships.[8] 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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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[9] 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).[10] 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.[11] 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.

In order 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, *infra*.

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 not 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-14[17] 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

12 *GlaxoSmithKline Inc.*, [2012] 3 SCR 3, 2012 SCC 52 (*GlaxoSmithKline Inc.*).

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.

14 *GlaxoSmithKline Inc.*, at paragraph 20.

15 *GlaxoSmithKline Inc.*, 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[18] and 'tax consequences flow from the legal relationships or transactions established by taxpayers'.[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 re-characterisation. 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.[20] However, when non-arm's length parties enter into a transaction primarily to obtain a tax benefit[21] and the terms and conditions of the transactions do not reflect arm's-length transactions, the CRA is allowed to re-characterise the transactions to terms that would have otherwise been made between arm's-length parties.[22]

All Canadian judicial cases that dealt with transfer pricing rules[23] involved the adjustment of terms and conditions as opposed to re-characterisation of transactions. According to the OECD Guidelines and pursuant to the CRA's administrative position,[24] the re-characterisation 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 re-characterisation of transactions by the CRA.

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'.

18 *Shell Canada Ltd. v. Canada*, [1999] 3 SCR 622, at paragraphs 39–40 and *Singleton v. Canada*, [2001] 2 SCR 1046, 2001 SCC 61, at paragraph 27, and *Quebec (Agence du revenu) v. Services Environnementaux AES inc.*, [2013] 3 SCR 838, 2013 SCC 65 at paragraph 45.

19 *Jean Coutu Group (PJC) Inc. v. Canada (Attorney General)*, 2016 SCC 55, at paragraph 41.

20 Pursuant to paragraph 247(2)(a) and (c).

21 The term 'tax benefit' is defined in subsection 245(1). Section 245 provides for the general anti-avoidance rule (GAAR).

22 Pursuant to paragraph 247(2)(b) and (d).

23 Whether with respect to former subsection 69(2) or Section 247.

24 Information Circular IC87-2R, International Transfer Pricing, at paragraph 44 [IC-87R2]. See also OECD Transfer Pricing Guidelines, Guideline 1.37.

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:

a the property or services to which the transaction relates;

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

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

e the 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 the 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]

25 Transfer Pricing Memorandum TPM-09, Reasonable efforts under Section 247 of the Income Tax Act.

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 functions'[33] 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

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.
34 Donald G H Bowman, *The Settlement of Tax Disputes in Canada*, at p. 1.

years.[35] By entering into an APA, taxpayers are provided with some degree of certainty on their transfer prices. Canadian taxpayers may seek unilateral or multilateral APAs.[36] 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,[37] 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.[38]

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. Furthermore, 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).[39] 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,[40] 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.

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35 Information Circular IC94-4R, International Transfer Pricing: Advance Pricing Arrangements, at paragraph 55 [IC94-4R].

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: prefiling 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.

39 Transfer Pricing Memorandum TMP-11, Advance Pricing Arrangement (APA) Rollback.

40 When an 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.

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 stand up under cross-examination in the heat of trial'.[41] 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[42] after the date of the written settlement offer.[43]

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.[44]

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 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[45] 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,

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).

44 Canadian Tax Foundation, Daniel Sandler and Colin Campbell, 'Catch-22: A Principled Basis for the Settlement of Tax Appeals', *Canadian Tax Journal* (2009) Vol. 57, No. 4, 762–86.

45 The misrepresentation must take place when filing the return, not at another time. See *Vachon v. The Queen*, 2014 FCA 224.

which must be proved on the balance of probabilities. Furthermore, the limitation period provided for in tax treaties does not apply to Part XIII reassessments issued for transfer pricing adjustments.[46]

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.

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 reliefs 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.[47]

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 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.

Canada v. GlaxoSmithKline Inc., [2012] 3 SCR 3, 2012 SCC 52

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

46 *McKesson Canada Corporation v. The Queen*, 2013 TCC 404, starting at paragraph 378.

47 *Hickman Motors Ltd. v. Canada*, [1997] 2 SCR 336.

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.* (*GE*) case is of some importance because of the comments on the weight of expert evidence and opinions in transfer pricing matters. In *GE*, 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.[48] 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.[49]

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.

48 *General Electric Capital Canada Inc. v. The Queen*, 2009 TCC 563.

49 Ibid., paragraph 226.

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.[50]

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

The *Alberta Printed Circuits Ltd.* (*APC*) decision was rendered before the *GlaxoSmithKline Inc.* case. 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.[51] 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 the *Marzen Artistic Aluminium Ltd.* case, 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 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

50 Files A-48-14 and A-49-14.

51 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.

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.[52]

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,[53] a deemed dividend of payment may be triggered by the application paragraph 214(3)(a)[54] 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.[55]

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 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

52 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.

53 Subsection 247(15).

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

55 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.

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.[56]

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.[57]

IX BROADER TAXATION ISSUES

i Diverted profits tax

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,[58] and specific rules for non-resident trusts,[59] back-to-back loans[60] and unreasonable deductions[61] (whether or not with an arm's-length party).

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.[62] 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.

56 For example, if there are losses, deductions or credits to offset the additional taxes otherwise payable.
57 Transfer Pricing Memorandum TPM-13, Referrals to the Transfer Pricing Review Committee.
58 For example, foreign accrued property income (FAPI) and surplus rules found in Section 95.
59 Section 94.
60 Section 17.
61 Section 67.
62 Details with respect to applications are set out in Information Circular IC-71-17R5.

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 impacts

Transfer pricing adjustments may have an impact on goods and services tax (GST)[63] 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 unremitted 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.[64] 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.[65]

X OUTLOOK AND CONCLUSIONS

Canadian transfer pricing is fundamentally composed of three integrated components: the determination or re-characterisation 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,[66] 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

63 And its provincial equivalents, the harmonised sales tax and the Quebec sales tax.

64 Canada Border Services Agency, Memorandum D13-4-5, Transaction Value Method for Related Persons.

65 Under the Customs Act (R.S.C., 1985, c. 1 (2nd Supp.)).

66 *Guindon v. Canada*, [2015] 3 SCR 3, 2015 SCC 41, at paragraph 1.

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[1]

I OVERVIEW

Cyprus, as an internationally recognised business centre, is largely an Organisation for Economic Co-operation and Development (OECD) compliant jurisdiction, as recognised in the latest OECD progress report,[2] and as such follows many of the OECD's principles and practices, including the (broadly accepted) international principle of 'separate legal entity' (see the OECD definition of the international arm's-length principle).[3]

Cyprus generally applies the above-mentioned international arm's-length principle, which essentially sets out conditions for 'controlled transactions' to regulate instances of 'transfer pricing' and to promote the principle that a 'controlled transaction' should reflect fair market conditions.

The OECD has over the years produced several reports and Transfer Pricing Guidelines[4] containing methodology that applies to controlled transactions purporting to assess whether the transfer price falls within a determined arm's-length range, the most recent of which comprises the approval of the Final Report on BEPS Actions 8-10,[5] which largely revises the previous Transfer Pricing Guidelines in a bid to align the transfer price in a controlled transaction with the value creation.

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[6] 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.

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2 Cyprus was largely compliant in the Phase 2 progress report of the Global Forum on Transparency.

3 OECD Model Tax Convention, Article 9.

4 Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (1995–2016).

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 […]

7 See footnotes 3 and 4.

8 Article 33, Income Tax Law of 2002, 188(I)/2002, as amended, CTR Publications Ltd.

9 Article 2, The Income Tax law of 2002, 118(I)/2002, as amended, CTR Publications Ltd.

Additionally, the Income Tax Law and relevant regulations also explicitly stipulate that certain 'transactions' should abide by 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.'[10]

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 immoveable property located in Cyprus.

However, Cyprus has yet to issue detailed transfer pricing guidelines for determining the 'transfer price', although in practice the OECD Transfer Pricing Guidelines may be used (1) to support the set 'transfer price' in 'controlled transactions', amid tax examinations; or (2) to potentially initiate a conventional advance ruling application (although a sophisticated advance pricing arrangement does not exist).

Briefly touching on empirical tax audit cases involving conditions underlying 'controlled transactions' that are deviating from fair market terms, the authorities do not hesitate in applying compensating adjustments, resulting in a respective change to selected tax computations, 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 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 transfer pricing regulations or guidance on the application and documentation of the methods used to determine a 'transfer price' on controlled transactions. The guidance is expected to be aligned with OECD BEPS Actions 8-10 (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.

II FILING REQUIREMENTS

At present, not least due 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

10 Article 9B, Income Tax Law of 2002, 118(I)/2002, as amended, CTR Publications Ltd.

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[11]).

However, the general rule applies, namely that taxpayer has a general obligation under the law[12] 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 years[13] (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 the purpose of 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 guidance notes are issued, taxpayers should expect that the traditional transaction methods[14] would generally apply to transfer pricing cases. Such methodology consists of (1) the comparable uncontrolled price method using comparables or near comparables; (2) the resale price method; and (3) 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 'arms-length' transactions suggests the following approach or methodology depending on the subject matter of the transaction:

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

11 Decree on Country-by-Country Reporting, 401/2016.

12 Article 30, Assessment and Collection of Taxes Law of 1978, 4/78, as amended.

13 Article 30(3), Assessment and Collection Law.

14 OECD Transfer Pricing Guidelines 2016, Part II: Traditional transaction methods.

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.

Buying or selling of goods or services:

The use, mainly, of a cost plus or similar method[15] by which one applies a reasonable (nearing arm's length) gross profit (GP) margin.

If the transaction involves finished or semi-finished products and the potential business function is to mainly store, promote and then supply the product (and incur the operating expenses and risks connected to these functions) the common approach is to apply a reasonable GP margin that reflects the average GP margin used in the industry or a GP margin of nearing comparables.

Alternatively, if the transaction involves services, then the common approach is the 'cost plus' methodology. 'Cost plus' comparables are generally acceptable in these types of transactions, and taxpayers generally use average GP 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[16] or capital gain on sale of corporate titles[17])

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

In this respect, it is advisable that such transactions be underpinned by commercial and business rationale and that (1) they conform with the reasonable pricing test (even if this does not amount to the precise fair market value which is generally accepted by the authorities) and (2) are coupled with a request for a relevant tax ruling.

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. However, 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).

15 OECD Transfer Pricing Guidelines 2016, Part II: Traditional transaction methods.

16 Article 3, Special Contribution for the Defence of the Republic Law of 2002, 117(I)/02, as amended (easily met participation exemption) and Article 8(20), Income Tax Law of 2002, 118(I)/2002, as amended.

17 Article 8(22), Income Tax Law of 2002, 118(I)/2002, as amended.

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 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 the taxpayers in controlled transactions. In fact, the authorities have issued a recent circular[18] stating that for the determination of 'embedded income'[19] 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, *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 *ex post* nature (applying on historic transactions) and not *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.

At the same time, 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.

Currently, the authorities[20] will abide by their rulings if the circumstances and parameters on which the conventional ruling is based remain substantially the same.

18 Circular issued by the Authorities, 2017/4.

19 Article 9(1)(e), Income Tax Law of 2002, 118(I)/2002, as amended.

20 TD Circular 2015/13.

VI INVESTIGATIONS

The law generally grants the right to the authorities to assess a taxpayer's tax return after the respective submission deadline[21] and issue notice of assessment to the taxpayer depicting the authorities' agreement or disagreement with the tax return submitted.[22]

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.[23]

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 authorities on issuing assessment potentially challenge the underlying terms of a 'controlled transaction'; the taxpayer should be in a position 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.

On a final note, 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).

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[24] or Court[25] 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).

21 Article 13(1), Assessment and Collection of Taxes Law of 1978, 4/78, as amended.

22 Article 19, Assessment and Collection of Taxes Law of 1978, 4/78, as amended.

23 Article 20(3), Assessment and Collection of Taxes Law of 1978, 4/78, as amended.

24 Article 20A, Assessment and Collection of Taxes Law of 1978, 4/78, as amended.

25 Article 21, Assessment and Collection of Taxes Law of 1978, 4/78, as amended.

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 […]*[26]

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 (1) deemed dividend distribution (if it involves Cyprus tax-resident and domiciled physical persons); (2) 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 (3) 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 ultimately be subject to taxation, especially if it lacks commercial or business rationale.

26 *Costas M. Pikis v. The Republic* (1965) 3 C.L.R. 131, at 149.

IX BROADER TAXATION ISSUES

i Diverted profits tax

The Cyprus 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 […]*[27]

> *[…] 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 […]*[28]

ii Double taxation

Cyprus has a very wide 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 Convention[29] (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 in order for the compensating adjustment to apply and therefore eliminate or mitigate possibility of double taxation.

Currently there is limited practical experience for invoking a MAP for the purpose of transfer pricing.

In addition, the law[30] 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

27 Article 33, Assessment and Collection of Taxes Law of 1978, 4/78, as amended, CTR Publications Ltd.
28 Article 9(4), Capital Gains Tax Law, CTR Publications Ltd.
29 Κ.Δ.Π.161/2016.
30 Article 33(5), Article 9(1)(e), Income Tax Law of 2002, 118(I)/2002, as amended.

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 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 documentations to be in place and certain methodology to apply with regard to 'controlled transactions'.

Chapter 6

GERMANY

Stephan Schnorberger and Lars H Haverkamp[1]

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 a large body of 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 UK tax jargon). 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 intercompany 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 intercompany 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.

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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 capital 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 (Gewinnabgrenzungsaufzeichnungsverordnung (GAufzV)). The statute provides that taxpayers are required to prepare documentation on cross-border transactions with related parties. The documentation requirement also covers head office–PE dealings and the allocation of assets between head office and PE. The GAufzV will be updated in the course of 2017. The Federal Ministry of Finance published a first draft on 21 February 2017. The draft reflects the new transfer pricing documentation requirements stipulated in Section 90(3) of the General Tax Act (GTA). The draft is intended to provide further legal certainty and clarifications on the content and preparation of master file and local file documentation reports under German domestic tax law. It can be expected that the Administrative Principles – Procedure (Verwaltungsgrundsätze-Verfahren) will also be amended accordingly. According to the draft – and in line with the OECD approach – more emphasis is put on value chain analyses, also reflecting an economic nexus approach. It is intended that the new GAufzV will already be applicable as of fiscal year 2017.

According to Section 6(2) GAufzV, enterprises with intercompany provisions of goods of no more than €5 million (paid or received) per annum or intercompany provisions of services of no more than €500,000 per annum (paid or received) are exempt from the documentation requirement.

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, 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 affect prices or margins significantly.

By way of exception, 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 intercompany agreements and the conclusion of cost allocation agreements.

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. But, 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).

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.

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 so-called 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 a very high level of 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, if they improve comparability. Also, 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 on a case-by-case basis, taking into account all applicable facts and circumstances.

Although disputed in lower tax courts (Local Tax Court Muenster, 14 February 2014, 4 K 1053/11 E.), the 'Knoppe formula' is a common tool 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 to 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. Transfer price auditors of the Federal Central Tax Office typically 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; and
g remuneration in line with DEMPE functions, arm's-length intangibles remuneration and the economic nexus approach.

IV INTANGIBLE ASSETS

In line with OECD BEPS Action Item 5, the Federal Ministry of Finance published a draft bill in 2016 on the limitation of the deduction of royalties. The bill is intended to focus on foreign IP boxes incompatible with the OECD nexus approach, and to make their use unattractive. The draft bill provides for a limitation of the deductibility of royalties paid between related entities. According to the draft bill, the limitation of royalty deduction applies when (1) the licence is subject to preferential, low taxation, meaning taxation below 25 per cent, and (2) where such low taxation does not require substantial business activities of the licensor, substantial business activity being in particular IP development with own resources.

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.

Furthermore, 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 starting 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 PhD economists, 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. But, in view of the increasing aggressiveness of German tax authorities with regard to transfer pricing, taxpayers are becoming more willing to take their cases to court. Indeed, the number and frequency of court decisions on transfer prices has already 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 are used successfully to resolve double taxation.

ii Recent cases

The following are a few 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, appeal lodged with the Federal Tax Court, I R 22/14) the Local Tax Court of Muenster 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 on trademark usage. 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.

f In 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.

VIII SECONDARY ADJUSTMENT AND PENALTIES

Where adjustments result in increased taxes, 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, and ending on the date when the tax assessment becomes final.

If transfer pricing documentation is not put forward or is 'essentially unusable,' the statute establishes a rebuttable presumption that the income of the German taxpayer has been underreported.

Tax authorities are thought to be authorised to rely on estimates if the taxpayer fails to submit (or submits insufficient) documentation, or if extraordinary transactions have not been recorded contemporaneously. German tax authorities are then authorised to adjust transfer prices at the upper end of the arm's-length range. This also applies where there are indications that a German taxpayer's income has been underreported and a foreign related party does not disclose sufficient information to establish the true, undistorted income.

If the taxpayer fails to submit documentation, or if the submitted document is insufficient, the tax authorities have to impose a penalty amounting to at least 5 per cent, but not exceeding 10 per cent of the income adjustment. However, in any case, the minimum penalty amounts to €5,000. Penalties will also be imposed if income adjustments do not result in additional taxes, for example, due to losses.

On failure to submit on time, the tax authorities may impose late fees or penalties of up to €1 million. The minimum penalty amounts to €100 per 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.

IX BROADER TAXATION ISSUES

i Diverted profits tax

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.

iii Consequential impact

In practice, transfer price adjustments generally neither affect VAT 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.

Chapter 7

ISRAEL

Yariv Ben-Dov and Eyal Bar-Zvi[1]

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.

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. We note that 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, singly or jointly with other individuals.

'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:

a the right to profits;
b the right to appoint directors or the general manager or other similar positions;
c the right to vote in the general shareholders' meeting;
d upon liquidation of the company, the right to a share in the equity after all debts are paid; or
e the right to determine which party will have one of the above-mentioned rights.

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A relative is a spouse, sibling, parents, grandparents, children, spouses' children 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, etc.); and financing (e.g., capital notes, guarantees, captive insurance, loans, etc.) 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 to 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:

a identify the cross-border controlled transactions within the group;

b identify the tested party for each respective transaction;

c 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;

d select the appropriate transfer pricing method(s);

e select the comparable companies and establish an arm's-length range, determined by the comparable companies; and

f 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 transacting on a non-arm's length basis, 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 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 intercompany loans or cash pooling or non-repayment of intercompany 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, *infra*), 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 (as detailed in Section VII.i, *infra*).

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 (#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 intercompany agreement relevant for the fiscal year end. Form #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; it should be noted that 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 #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, intercompany 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 regarding 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 principle intercompany transactions and the parties involved in these 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 intercompany transactions (including functions performed, risks assumed and resources employed);
- selection of the pricing method(s) 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.

b Additional documents that corroborate the data described above such as:

- intercompany 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(s) 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 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.

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/ 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/residual); or
d transactional net margin method (TNMM, similar to the comparable profits method (CPM) in Section 482).

In the event none of the above methods can be applied, other methods should be used that are the 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[2] of values derived from comparable uncontrolled transactions when the CUP method is applied (under the assumption that no comparability adjustments were performed), or the interquartile range (the values found between the 25th and 75th percentiles in the range of values) 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 however 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 instead of the TNMM, for example. 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.

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

2 Full range is spread between the minimum and maximum prices or percentile.

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 that include the provision of significant services that contribute to the creation of profits and value (e.g., R&D, marketing, etc.). In this respect, ITA officials have also recently noted that as the OCED 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 mark-up 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., mark-up) 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 mark-up 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 in order 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 to 20 comparables should suffice and the minimum is around five comparables. We note that 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 and/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 on a case-by-case basis.

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. Furthermore, 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 in order 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 and expected to be adjudicated within 2017. 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, albeit 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. In the event 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 seems to align 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, unique business model, etc.) 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 (development, enhancement, maintenance, protection and exploitation of intangibles) has been 'on the table' of the ITA in recent years, mainly with regard to the exploitation of R&D originating in Israel and with regard to 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, those 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 also 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 ITA's TPD. The process is normally initiated by a request for the applicable transfer pricing study or studies, and the intercompany 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, 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 and 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 those 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 intercompany 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 #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

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 or 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

VAT and intercompany 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.

We can see measures carried out concerning serval subjects:

a As was mentioned, 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.

c 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.

d 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, etc.).

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.

Chapter 8

ITALY

Franco Pozzi, Lisa Vascellari Dal Fiol, Stefano Grossi and Roberta D'Angelo[1]

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.[2] There are no separate rules for capital transactions.

Article 110, paragraph 7 has been recently restated by Law Decree No. 50/2017[3] 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[4] 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 thereby. Reductions in taxable income are allowed only in the specific cases expressly indicated by the new Article 31 *quater*[5] of Presidential Decree No. 600/1973:

a on the basis of mutual agreement procedures (MAPs) or the European Union Arbitration Convention (Convention 90/436/EEC of 23 July 1990);

b after the tax inspections carried out upon international cooperation activities whose outcomes are shared by the participating countries; or

c 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.

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2 Transfer pricing rules apply to resident companies and permanent establishments of foreign companies resident in Italy.

3 Law Decree No. 50/2017 was published in the Official Gazette on 24 April 2017 and is still to be converted into law by Parliament (within 60 days), but it is already in force for the time being. The previous wording referred to the concept of 'valore normale' (corresponding, in substance, to 'arm's-length principle'), which is defined by Article 9, paragraph 3 of the CTA as the average price or consideration paid for goods and services of the same or similar type, carried on at market conditions and at the same level of business, at the time and place in which the goods were purchased or the services were performed. The revised wording is more in line with the OECD Guidelines, even though it does not introduce substantial changes in the transfer pricing methodologies to be applied.

4 Please note that entities controlled by the same individuals are within the scope of the provision.

5 Introduced by Law Decree No. 50/2017. Implementing provisions are expected in the coming months.

On 22 September 1980, the Ministry of Finance issued Circular Letter No. 32/9/2267, which provides 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. No further clarification about the application of transfer pricing provisions has been issued by the Italian Tax Administration (ITA) since the issuance of the Circular Letter.

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 dated 29 September 2010 and by Circular Letter No. 58/E of 15 December 2010. The latter expressly refers to the OECD Guidelines 2010 ('Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations'), although it does not add any new technical clarification to Circular Letter 32/1980 mentioned above.

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 (i.e., due to overpayment of goods or services or accounting fraud, etc.).

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. It should be considered that this approach can be challenged by the ITA if the taxpayers are not able to produce a reconciliation with the statutory data.

In addition, the new Italian accounting principles, deriving from Legislative Decree No. 139/2015, will have an impact mainly on financial transactions, as a direct consequence of the application of the amortised cost method.

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 intercompany transactions. Furthermore, if the documentation complies with specific regulations, it allows the taxpayer access to the penality 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 (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. In order to obtain penalty protection, the documentation must be compliant from a substantial point of view and it must follow the structure required.[6]

As a general rule, documentation for penalty protection must be updated on an annual basis, including the economic analysis, before filing the tax return for each financial year (e.g., deadline 30 September for companies with financial year ending 31 December).

6 Decision of the Commissioner of the Revenue Agency dated 29 September 2010.

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).

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 the cost plus methods. 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 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': 'Agenzia delle Entrate' (the Italian Revenue Agency) and 'Guardia di Finanza' (the Tax Police) and they are both entitled to carry out inspections aimed at detecting infringement of the 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 intercompany 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, 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 also 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 as a whole is expected to increase following the implementation of the CBCR.[7]

IV INTANGIBLE ASSETS

As a general rule, intangible assets held by each single company involved in intercompany 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. Furthermore, 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 (i.e., the know-how, the positive impact from synergies, the positive effects of networks, etc.). 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.

In Italy, in recent years, there has been growing attention to matters concerning intangible assets from both sides (taxpayers and the ITA), with particular focus on the 'DEMPE' functions (developing, enhancing, maintaining, protecting and exploiting intangibles). 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, in order to establish the tax benefit. To this aim, taxpayers have to show both the costs incurred in

7 See BEPS Action 13.

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 should also be considered that Circular Letter No. 32/1980 (see Section I, *supra*) 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,[8] the taxpayers have 60 days to challenge the assessment before the tax court or to submit a request to the ITA in order to reach an agreement. During the 90 days subsequent to the settlement request,[9] 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.[10] The settlement involves the year(s) and the matter(s) under assessment; in the event 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, *infra*). 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[11] are reduced in case of settlement; the reduction varies depending on the timing of the agreement (reduction to one-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).

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8 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 position and taxable income. After the PVC notification, the taxpayer has 60 days in which to reply with comments, observations and requests. Otherwise, the taxpayer has the opportunity to settle the audit by correcting its tax return and paying (in part or in full) the liability contained in the PVC. In such cases, the applicable penalties are reduced to one-fifth of the original amount.

9 During the 90-day period of discussion, the deadline to challenge the assessment is suspended. Note that the opportunity to request a settlement cannot be used in an opportunistic way to increase the time frame or to delay the opposition period; in case of abuse, tax authorities can decide to stop the discussion even before the 90-day period has elapsed.

10 An instalment plan can also be granted.

11 In principle, penalties should not be applicable for transfer pricing assessment, provided the taxpayer is compliant with the penalty protection regime (see Section II, *supra*).

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 in order to reduce the risk of future assessments.[12] 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, *infra*).

VI INVESTIGATIONS

Tax auditors involved in transfer pricing investigations have ordinary and broad audit powers provided by law[13] (see Section III.ii, *supra*).

Law No. 212 of 27 July 2000 provides taxpayers subject to tax audits with several rights and protections (see in particular 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.[14]

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 inherence[15] rather than on the basis of transfer pricing provisions (with consequent 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: (1) the penalty protection regime is not granted; (2) access to MAPs and arbitration is excluded; and (3) under certain conditions, criminal penalties could be applicable too.[16]

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, etc.).

12 Rulings for multinational enterprises have recently been modified by Article 31 *ter* of Presidential Decree No. 600 of 29 September 1973; the new procedure is regulated by the Decision of the Commissioner of the Revenue Agency issued on 21 March 2016.

13 Reference is made to Presidential Decree No. 600 of 29 September 1973.

14 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.

15 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.

16 However, it must be noted that different tax offices could assume inconsistent positions on such matter.

As a general rule,[17] a tax assessment must be issued by the end of the fifth year of the date of filing of a tax return;[18] as a practical example, the assessment for a tax year ended on 31 December 2016 has to be completed by 31 December 2022 (since the tax return must be filed by 30 September 2017).[19]

VII LITIGATION

i Procedure

Tax assessments may be settled by reaching an agreement with the ITA (see Section V, *supra*) or directly challenged before the tax court.

The typical litigation process involves the following steps (briefly described):[20]

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[21] 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;[22]

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.[23]

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.

17 Reference is made to Article 43 of Presidential Decree No. 600 of 29 September 1973.

18 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.

19 For previous fiscal years different terms are applicable.

20 The relevant provisions regarding the tax litigation procedure are contained in Legislative Decree No. 546 of 31 December 1992.

21 Summer holiday suspension (from 1 to 31 August) should also be considered.

22 The term is reduced to 60 days in case of formal notification of the decision by the winning party.

23 The term is reduced to 60 days in case of formal notification of the decision by the winning party.

After the decision of the Supreme Court, in principle there are no further opportunities to discuss the litigation.[24] Partial payments are imposed by law during the judicial procedure;[25] in the event the taxpayer is the winning party, such payments are reimbursed by the ITA.

ii Recent cases

Generally speaking, transfer pricing litigations by the Supreme Court in Italy have 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 (e.g., 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; Supreme Court No. 6311, 1 April 2016; Supreme Court No. 7493, 15 April 2016; Supreme Court No. 13387, 30 June 2016; Supreme Court No. 26545, 21 December 2016): the main position of the Supreme Court is to consider transfer pricing regulation as a safeguard of the principle of fair competition among 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 most cases stated that it shall be fulfilled by the taxpayer, based on the assumption that the latter has a closer and deeper knowledge of facts, with particular reference to the deduction of costs;

b the scope of domestic transfer pricing provisions (Supreme Court No. 17955, 24 July 2013; Supreme Court No. 8849, 16 April 2014; Supreme Court No. 13475, 13 June 2014): 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,[26] which expressly excludes the application of transfer pricing provisions to domestic transactions;

c intra-group services and shareholders' loans (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): the Supreme Court position confirms the applicability of transfer pricing provisions even to non interest-bearing loans granted by shareholders.

24 In exceptional and specific cases identified by law, even the decision of the Supreme Court could be reviewed.

25 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.

26 See, in particular, Article 5, paragraph 2.

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 and/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, *supra*).

From a criminal law perspective, 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 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

There are no current provisions in Italy regarding diverted profit tax. Profits that are deemed to be realised in Italy (even by non-resident entities)[27] are subject to IRES and – to the extent they are related to activities performed in Italy – to IRAP.

There are specific additional anti-avoidance provisions aimed at addressing possible profits shifted to foreign countries, among which are: controlled foreign corporation rules; presumptions regarding the residence of foreign incorporated entities; and permanent establishment provisions. Such 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, due to a lack of human resources. In principle, there are two different applicable procedures: (1) the EU

27 With the exception of individuals.

Arbitration Convention,[28] in case of disputes concerning cross-border issues involving other EU countries; and (2) 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[29] there is no mandatory arbitration, consequently the dispute might not be resolved in event the litigating countries are not able to reach an agreement; and

c interactions with domestic litigation procedure:[30] 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.[31]

In both cases (1) and (2), a recent provision regarding suspension of the domestic litigation procedure should apply.[32]

In addition, further guidance is expected after the implementation of the recent OECD multilateral convention; reduction of double taxation cases is also expected further to the new Article 31 *quater* of Presidential Decree No. 600/1973 (see Section I, *supra*).

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. On the other hand, it is worth remarking that in the current framework there are countries with which a bilateral agreement cannot be actually reached according to ITA feedback (e.g., China) and that bilateral and multilateral APAs take a longer time to be concluded than unilateral APAs.[33]

In principle, there is no possibility to avoid double taxation in cases of unilateral settlements (i.e., agreements concluded after tax assessments among the taxpayers and tax administration of a specific country).

28 Reference is made to EU Convention No. 90/436/CEE, which has been implemented in Italy with Law No. 99 of 22 March 1993.

29 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).

30 The matter is analysed in depth in Circular Letter No. 21/E issued by the Italian Revenue Agency on 5 June 2012.

31 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, *supra*).

32 Reference is made to Article 39, paragraph 1 *ter* of Legislative Decree No. 546/1992.

33 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).

iii Consequential impact

Italian legislation does not expressly address the VAT impacts of adjustments made for transfer pricing purposes; pursuant to the applicable law, the VAT taxable base is represented by the contractual consideration;[34] 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 the VAT side (both in case of products sold and services rendered) as well as on the customs side; instead, in the second case (profitability adjustments) the adjustment should be excluded from VAT and from the customs taxable base.

From a customs perspective, on 6 November 2015 a circular was issued by the Italian Customs Authority in order 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 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.

Furthermore, 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 letter 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

In the above scenario, the following issues should be highlighted.

The increasing attention of the ITA to multinational groups and cross-border matters in general has entailed a greater focus on the tax risks deriving from transfer pricing matters. The ITA has become more skilled in transfer pricing matters and the OECD Guidelines; 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. On the other hand, domestic judicial procedures are very long and uncertain, and at the same time, international dispute resolution instruments are not

34 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).

effective; as a consequence, multinational groups very 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 uncertain in the absence of the relevant implementation provisions.

In such circumstances, the importance of APAs is growing so as 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 also released additional guidance regarding specific issues and business sectors consistent with the OECD Guidelines. In fact, the only substantial documentation (Circular Letter 32/1980) still applied by the tax auditors (see, for example, the safe haven rules for royalty payments) was issued a long time ago and is anachronistic with respect to the current worldwide market conditions.

Chapter 9

LUXEMBOURG

Alain Goebel and Mehdi Fernane-Jallier[1]

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, namely (1) business income, (2) agriculture and forestry income, (3) income from independent professional services, (4) employment income, (5) pension and annuities income, (6) investment income (i.e., interest and dividends), (7) rental and royalty income, and (8) miscellaneous income including capital gains. Companies limited by share capital are as a rule 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 *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 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 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.[4] Accordingly, if (1) an enterprise participates directly or indirectly in the management, control or capital of another

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2 Income Tax Law dated 4 December 1967.
3 General Tax Law dated 22 May 1931.
4 OECD Model Tax Convention on Income and on Capital 2014.

enterprise, or if (2) 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).[5]

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[6] 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.

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

5 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations dated July 2010, as amended by the BEPS Reports.

6 Administration des contributions directes.

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 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 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.

7 Article 59 of the Law dated 21 June 1999.

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.

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/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,[9] unless the documentation has been provided previously (e.g., in case of an APA request). Since they follow the OECD TPG[10] 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 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, *supra*). 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

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).

necessary information to clarify the situation[11] and in a second step to communicate relevant supporting documents.[12] 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.[13] 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.[14, 15]

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 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.

11 Paragraph 206(2) GTL.
12 Paragraph 207 GTL.
13 Paragraph 209 GTL.
14 Paragraph 217 GTL.
15 See also Alain Goebel/Monique Adams, The practical protection of taxpayers' fundamental rights, IFA Cahiers de droit fiscal international, Volume 100B.

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.[16] The tax authorities have to investigate the factual and legal situation that is substantial for the determination of the tax[17] 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.[18] 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.

The tax authorities must also observe the principle of proportionality throughout the verification process: (1) they may only use means that are appropriate to achieve the relevant goal, (2) within the means at their disposal they have to select the one that least impairs the private interests, and (3) 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

16 Paragraph 166 GLT.
17 Paragraph 204 GLT.
18 Paragraph 205 GLT.
19 Paragraph 211 GLT.
20 Paragraph 210b GLT.

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.

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

21 Paragraph 222 GLT.

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.

ii Recent cases

Luxembourg courts have issued abundant case law in transfer pricing matters over the past decades. A considerable amount thereof regards adjustments on the basis of the recognition of hidden profit distributions[22] (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).[23]

Transfer pricing disputes tend, however, to become increasingly complex. A debatable decision was recently rendered[24] 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).

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, *supra*). 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.

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.

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:

a the administration for direct taxes is mainly competent for CIT, MBT and NWT, as well as withholding taxes;

b the administration for registration duties and VAT[25] is mainly competent for VAT and registration duties; and

c the administration for customs and excise duties[26] is mainly competent for customs and excise duties.

25 Administration de l'enregistrement et des domaines.

26 Administration des douanes et accises.

Pursuant to the Law dated 19 December 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 disputes will increase.

Chapter 10

MEXICO

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I OVERVIEW

Since 1997, Mexican tax authorities have recognised the arm's-length principle for benchmarking related-party transactions, establishing for such purposes the 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 in 1995, or those that substitute them, 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.

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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 undertook transactions with related parties on a non-arm's length basis, 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 foreign related 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 on an arm's-length basis. 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 which demonstrates that transactions carried out with related parties were made on an arm's-length basis 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 that in the immediate previous year obtained operating revenues equal to or exceeding 644,599,005 Mexican pesos,[3] as well as those that in such year had shares exchanged

2 Statutory criterion 00/2012/ISR.

3 Amount will be updated for every fiscal year.

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 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[4]), 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).

4 DIM is an annual filing for companies, regarding their main information for tax purposes.

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.

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 intercompany 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.

In order 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. In order 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 on an arm's-length basis, 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 intercompany 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 utilised in order 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 asset. 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., *ex ante* and *ex post* approaches).

The *ex ante* approach relates to the relevance, enforceability and sustainability of a project in order to make an investment; on the other hand, the *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

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, in 2014 the Federal Tax Code was amended introducing a new 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.

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 on an arm's-length basis or not. As mentioned above, if the tax authorities determine that the transactions under consideration were made on a non-arm's length basis, 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, in order to start an audit process.

Nowadays, 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,[5] verifying that such expenses' deductions fulfil the requirements issued by the tax authorities, which in practice are very difficult for taxpayers to comply with.

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

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 in order 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.

In the event of obtaining an unfavourable resolution, 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

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 were 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.

In the event of 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,

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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.

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.

Taking into consideration the facts and circumstances, the best alternative to challenge ruling letter SF/TDF/SF/A/0101/2016 would be filing an administrative appeal, because that allows the company to provide additional evidence and avoid posting a guarantee for the tax deficiency.

ii Recent cases

There are some cases being discussed concerning transfer pricing disputes in regard to the following fees: (1) research and development; (2) cost sharing; (3) services fees; (4) information and technology; (5) advertising and promotion; and (6) 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, in order 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, 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. In order 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) in order 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 said 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.

Note that 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

It is fundamental to point out that there are international mechanisms between jurisdictions in order for taxpayers to avoid double taxation; in addition to tax treaties between jurisdictions to avoid double taxation, the most used mechanism is the MAP. MAPs allow 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, in order to file an MAP application, Appendix 1-A of Fiscal Miscellaneous Resolution for 2017 establishes the requirements to be fulfilled in order 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.[6] 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.

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.

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.

Regarding dispute resolution mechanisms, in Mexico 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 new risk model is being implemented in order 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.

It will be important to bear in mind that 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 11

NETHERLANDS

Bas de Mik and Frank Pötgens[1]

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 (subsidiaries with a joint parent) between entities. Both direct and indirect relationships are taken into account. Relationship thresholds have intentionally been omitted from the statute. Instead, an approach that looks at the substance of the relationship has been adopted. The Dutch legislature wanted to avoid that taxpayers would have the ability to influence their tax position by planning around clearly defined statutory thresholds. This 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 whether or not they are related for the purposes of Article 8b CIT.

The application of Article 8b CIT is not limited to cross-border transactions. Article 8b CIT also applies to transactions between related entities within the Netherlands.

Article 8b CIT also contains the requirement for taxpayers to document the arm's-length nature of the transfer prices used.

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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 14 November 2013, 2013/184M (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. 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 (EC). The EC claims that some of the agreements the Dutch tax authorities have entered into constitute state aid that is prohibited under EU law. In one case, *Starbucks*, the EC rendered a final decision that an APA entered into between the Dutch tax authorities and Starbucks represented state aid. The decision of the EC has been appealed by the Dutch government and Starbucks before the European Court of Justice.

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 DOCUMENTATION AND 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 at arm's-length conditions. 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. In the event 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 that has 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:

a the number of employees;
b the amount of the net turnover, including turnover in transactions with related parties;
c the amount of profit or loss before income tax;
d 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;
e 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;
f the capital of the companies in a particular jurisdiction;
g the assets other than cash or cash equivalents; and
h 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.

The CBCR needs to be filed with the Dutch tax authorities within 12 months after 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 (1) the characteristics of the property or services transferred; (2) the functions performed by the parties (taking into account assets used and risks assumed); (3) the contractual terms; (4) the economic circumstances of the parties; and (5) 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 on an individual basis. 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 at arm's-length transfer price is within a range, the Dutch tax authorities will take the position that the median (i.e., the middle point of the range) 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, taxpayers 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 Tax authority scrutiny and evidence gathering

The Netherlands has implemented CBCRs and will actively exchange information with other countries. CBCR data are 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 AND OTHER TOPICS

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 Ministry of Finance has taken the position that the Dutch Transfer Pricing Decree already 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 hard-to-value 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 6.34 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.

The Dutch Transfer Pricing Decree also contains specific guidance on (1) the transfer of intangibles to a related non-Dutch company in the event the usage of the intangible by the Dutch company exceeds 50 per cent of the total usage; (2) contract research; and (3) cost contribution agreements.

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 from 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, which 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, a so-called 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 so-called '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 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 date can be extended by the court with 12 weeks. Further extension is also possible under certain conditions.

The taxpayer and the tax authorities can both 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.

ii 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.

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 EC's final decision of 21 October 2015 that the Netherlands had granted state aid to Starbucks. In its decision of October 2015, the EC 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.

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 the 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 taxpayer lodged an appeal and the case has not been resolved yet.

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 as required by Article 8b CIT available upon audit.

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 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.

As of 2016 larger companies will be required to prepare additional transfer pricing documentation as part of the country-by-country reporting 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.

Chapter 12

POLAND

Sławomir Łuczak and Magdalena Polak[1]

I OVERVIEW

Polish transfer pricing (TP) regulations refer to and link directly to OECD principles. Moreover, TP regulations 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 TP documentation (master file, a local file and CBCR) and guidelines on low value adding services. Despite that, 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 TP 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. Furthermore, there are also TP regulations implemented on the grounds of value added tax (VAT).

i CIT/PIT

Polish TP 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;

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2 Act dated 15 February 1992.

3 Act dated 26 July 1991.

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;

e 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

f there are family relationships (marriage or a relationship or affinity to the second degree[4]), 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 those companies.

Summing up, 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);

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 TP 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.

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.

The criteria regarding thresholds and significant influence amounts are presented in the table below:

Exceeded threshold	Relations with entities in tax havens	Significant influence of transactions and other events
€2 million to €20 million	€20,000	€50,000 + €5,000 per €1 million of revenue above the amount of €2 million
€20 million to €100 million	€20,000	€140,000 + €45,000 per €10 million of revenue above the amount of €20 million
€100 million	€20,000	€500,000

TP regulations also allow tax authorities to request a taxpayer to prepare and present TP documentation covering transactions or other events whose value does not exceed the limits defined as 'significantly influencing'. The tax authority's 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 TP documentation. Tax authorities must then indicate the circumstances that justify the suspicion of understating the value of the transaction or other event.

ii VAT

A slightly different definition of related parties is provided for in the VAT Act.[5] The qualified relationship exists when among contracting parties or persons performing management, supervisory or control functions, there are links based on:

a family (which means marriage, consanguinity or relations to the second degree) or adoption;

b 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);

c property;

d employment; or

e where any of the aforementioned persons join management, supervisory or control functions performed for contracting parties.

Having mentioned the above, transfer price 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 CIT/PIT regulations, VAT does not recognise any thresholds and significant influence amounts.

II FILING REQUIREMENTS

As mentioned, since 2017, a three-step approach to TP documentation has been introduced in Poland. This means that depending on a taxpayer's situation, they may be obliged to prepare TP documentation that meets the requirements of a local file, a master file or a CBCR. Besides documentation requirements, there exist other tax obligations to fulfil, 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/costs calculated as indicated in Section I, *supra*).

5 Act dated 11 March 2004.

The documentation requirements and other obligations are presented in the table below:

Threshold	TP documentation	Other obligations
€2 million	The taxpayer is obligated 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 obligated to prepare TP documentation no later than 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 TP documentation to the pertinent tax office. On the request of the tax authority, the taxpayer is obligated to prepare and present TP 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 obligated 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 obligated 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 TP 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. Furthermore, 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, TP 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 TP 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 in particular: (1) the characteristics of goods, services or other benefits; (2) the course of the transaction (parties' functions, engaged assets, human capital and incurred risks); (3) the terms of the transaction; (4) the economic conditions present at the time and place the transaction is executed; and (5) 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.

Regarding pricing methods, TP 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]

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.

7 Wójcik Zbigniew, 'Metoda porównywalnej ceny niekontrolowanej' in: Nykiel Włodzimierz, Strzelec Dariusz, 'Podmioty powiązane. Ceny transferowe. Dokumentacja podatkowa', LEX 2014.

8 Kosieradzki Tomasz, Piekarz Radosław, 'Ceny transferowe. Nowe zasady dokumentacji, Rozdział 6 Metoda ceny odsprzedaży', WK 2016.

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] It must be mentioned that under previous TP 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 TP method. When choosing the TP 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. Although the first CBCR forms should be filed by the end of 2017, there are no clear guidelines as to the content and structure of the CBCR form to date. The regulation on this matter is still in the legislative phase. The draft presented by the Minister of Development and Finance is consistent with the forms recommended by the OECD in BEPS Action 13 – 2015 Final Report.[12] 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 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.

9 Kosieradzki Tomasz, Piekarz Radosław, 'Ceny transferowe. Nowe zasady dokumentacji, Rozdział 5 Metoda rozsądnej marży (koszt plus)', WK 2016.

10 Wójcik Zbigniew, 'Metoda marży transakcyjnej netto' in: Nykiel Włodzimierz, Strzelec Dariusz, 'Podmioty powiązane. Ceny transferowe. Dokumentacja podatkowa', LEX 2014.

11 Judgment of the Administrative Court in Wrocław dated 14 January 2011, case no. I SA/Wr 1253/10.

12 See: The draft 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 CBC report dated 24 October 2016, in Polish: 'Rozporządzenie Ministra Rozwoju i Finansów w sprawie szczegółowego zakresu danych przekazywanych w informacji o grupie podmiotów'. The draft of regulation was published at: http://legislacja.rcl.gov.pl/docs/2/12285652/12354106/12354107/dokument253090.PDF.

IV INTANGIBLE ASSETS

Polish TP 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 TP 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, TP 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, *supra*, are applied. The only distinction for intangible assets provided in TP 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, TP 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 or not: (1) 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 (2) 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 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, those 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 a being multilateral to being bilateral.

The APA decision may be issued for no longer than five years, which period may be renewed for subsequent periods, not 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 which 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 exempted from the obligation to prepare TP documentation for the transaction. However, the formal requirements are limited. The TP 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 of all, 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. Secondly, 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.

Concluded APAs			
Year	**One-sided APAs**	**Bilateral APAs**	**Multilateral APAs**
2006	1	0	0
2007	2	0	0
2008	6	0	0
2009	2	0	0
2010	7	0	0
2011	2	2	0
2012	5	0	0
2013	4	0	0
2014	0	0	1
2015	5	1	0
2016	5	1	0
APA proceedings in progress			
	6	13	1

13 Dowgier Rafał, 'Commentary on Article 20(k) of the Tax Ordinance Act' in: Brolik Jacek and others, 'Ordynacja podatkowa. Komentarz', LEX 2013.

14 Statistics dated 21 February 2017 presenting already concluded APAs and those that are still in progress, www.finanse.mf.gov.pl/cit/ceny-transferowe1/uprzednie-porozumienia-cenowe-apa/statystyki-apa.

VI INVESTIGATIONS

Tax authorities are entitled to investigate taxpayers to assess whether transactions or other events between related parties were performed in accordance with TP regulations. Therefore, the subject of the TP 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 TP 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 more in Section VIII, *infra*).

It is important to note that 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 as a result of the flow 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: (1) agree with the tax authority and correct its tax settlements and tax return; or (2) 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, those 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 voivodship administrative court (see more in Section VII, *infra*).

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 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 subsection ii, *supra*.

VII LITIGATION

i Procedure

TP 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 courts[15] 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 invalid fully or partially.

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 (1) the violation of substantial law – due to an erroneous interpretation or incorrect application of law, or (2) the breach of procedural regulations if that 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 takes up to 18 months.[16] A taxpayer lodging a complaint at the voivodship administrative court in Warsaw or Cracow 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.[17]

ii Recent cases

As of 1 January 2017, TP 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 will be subject to juridical interpretation starting from 2018. Nevertheless, the recent judgments may continue to be relevant.

15 Act of 30 August 2002.

16 Sławomir Łuczak, Karolina Gotfryd, *The Tax Disputes and Litigation Review*, Fifth Edition (Law Business Research), Poland, Section III.

17 Ibidem.

The TP documentation obligation

Judgment of the Supreme Administrative Court, Ref. No. II FSK 4000/13, 8 March 2016

The case regarded the obligation to prepare TP 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 TP 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, TP 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

The case regarded the consequences of not fulfilling the taxpayer's obligation to prepare TP 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.

TP estimation

Judgment of the Voivodship Administrative Court in Warsaw, Ref. No. III SA/Wa 2017/14, 23 April 2015

The 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

The 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 Voivodship Administrative Court in Wroclaw, Ref. No. I SA/Wr 1107/11, 24 November 2011

The 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, *supra*), 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 TP documentation. In such case, the taxpayer should present the TP documentation within seven days of delivery of the request. Where the taxpayer does not submit the TP documentation on time, the tax authorities can levy a sanction tax rate of 50 per cent. The conditions to impose such penalty are: (1) the taxpayer failing to provide TP documentation, and (2) tax authorities determining the taxpayer's income amount from the TP 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 TP 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[18] 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

18 Kosieradzki Tomasz, Piekarz Radosław, 'Ceny transferowe, Mechanizmy ustalania i zarządzanie ryzykiem, Rozdział 18. Sankcje w zakresie cen transferowych'.

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 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.

ii 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,[19] 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 TP 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).

19 Act dated 10 September 1999.

IX BROADER TAXATION ISSUES

i Double taxation

All double taxation treaties (DTT) concluded by Poland provide the possibility to evoke the Mutual Agreements Procedure (MAP). MAP has been implemented into Polish domestic law in the Minister of Finance's Regulations.[20]

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 which 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.

ii Consequential impact

VAT

Please see Sections I.ii and VIII.i, 'VAT obligations correction', *supra*.

Import and customs duties

The customs aspect of TP remains unnoticed – at least in Poland – both by doctrine and the customs and tax authorities. However, there are binding customs system regulations covering TP (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 of such tools is the extension of TP obligations and their effective enforcement by tax authorities. The number of tax investigations in this matter has increased in recent years; for example, in mid-2016, a total of 222 investigations were launched.[21] 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 in 2017 and the following years, reaching the levels seen on an international basis.

20 Ibidem, 5.

21 https://home.kpmg.com/pl/pl/home/insights/2016/08/tp-alert-wzrost-skutecznosci-kontroli-skarbowych-w-i-polowie-2016-r.html.

Chapter 13

PORTUGAL

Patrícia Matos and Filipe de Moura[1]

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).

Those rules are based on the OECD Transfer Pricing Guidelines and Portaria does even state that 'for its application, in cases of greater technical complexity, it is advisable to consult the OECD Transfer Pricing Guidelines'.

Portaria 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 both 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 do goven taxation of individuals. This situation has triggered some yet to be resolved 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:

a one entity or individual holds (directly or indirectly) at least 20 per cent of the share capital or voting rights of another entity;

b both entities are at least 20 per cent owned (directly or indirectly) by the same legal entity or individual;

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c 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, (1) foreign entities and Portuguese PEs, (2) Portuguese entities and correspondent foreign PEs, and (3) 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. Artice 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: the first being 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 secondly 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 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 needs to be mandatorily 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/local file structure.

Complementarily, 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, 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 Portuguese tax authorities by the end of the relevant tax period.

At the time of writing, a proposal to amend the law has been submitted to Parliament. That proposition has not yet been voted on. Among several changes, that text proposes to change the deadline for the communication of the CbC reporting entity to 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 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:

- *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 CUPM.

When 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).

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. In some cases, tax auditors have contacted third parties (e.g., clients or providers) to gather evidence or to confirm statements made by the taxpayer.

The implementation of CbC reporting (see Section II, *supra*) 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 and/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, 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.º-A and 50.º-A of the Corporate Income Tax Code. Article 45.º aimed at recognising tax effects for intangibles with an indefinite life. 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. Those 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 re-characterise 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 the 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:

a design and control of research and marketing programmes;
b direction of and establishing priorities for creative undertakings and research;
c control over strategic decisions regarding intangible programmes;
d management and control of budgets;
e decisions regarding defence and protection protection of intangibles; and
f 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:

g risk related to the development of intangibles, namely that it may end up not being successful;
h risk that other technological advances might make the research obsolete;
i infringement risks;
j liability risks; and
k 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 sucessful.

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 roll-back 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 (1) 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 (2) 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 (1) 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 (2) 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), (1) 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 (2) 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:

a a decision on which process type to follow (i.e., judicial or arbitration court. Please note that 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: (1) application of indirect methods in the administrative procedure; (2) value of the process is higher than €10 million; (3) 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 (4) 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;

b thorough identification of all means of evidence that sustain the taxpayer's position;

c identification of all possible lines of technical argumentation, including subsidiary requests; and

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:

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

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:

a an appeal to the Constitutional Court to require an assessment of a potential unconstitutionality;

b 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

c a challenge to the Central Administrative Court based on (1) the lack of specification of the factual and legal grounds that justify the arbitration decision; (2) opposition between the grounds and the decision; (3) a decision on undue matters or lack of decision on necessary matters; and (4) 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:

a 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

b 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:

a penalties for inaccurate declaration ranging from €150 to €5,750 (per transaction);

b penalties for negligent or low-value activities ranging from €500 to €165,000 (per transaction);

c a fine of up to €180,000 or three years' imprisonment, for intentional acts; and

d 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 (1) a reference to the original invoices to which the adjustment refers, and (2) 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.

However, 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 up 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

i Double taxation

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 MNEs 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 MNEs 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 and the European Union and OECD regarding this issue may imply lengthy negotiations and require adaptations to the current proposed measures.

Chapter 14

RUSSIA

Irina Dmitrieva[1]

I OVERVIEW

i General

Transfer pricing rules were introduced in Russia in 2000 and were substantially revised with effect from 1 January 2012 (now contained in the Tax Code, Part One, Chapter V.1).[2]

The rules do not refer to the OECD Transfer Pricing Guidelines, but broadly follow these principles (though not all of them). The Ministry of Finance[3] is of the view that the OECD Guidelines can be applied to the extent no contradiction with the domestic rules arises.[4]

The Russian transfer pricing rules are based on the arm's-length principle, which is stated in Article 105.3(1) of the Tax Code (reproducing this principle as defined in Article 9 of the OECD Model Tax Convention and in Article 9 of the Russian Tax Treaty Model).

The transfer pricing rules focus on legal entities, private entrepreneurs and professionals in private practice (notaries, attorneys and a few others), with regard to the following taxes:

a corporate profits tax (for legal entities) and personal income tax (for individuals);

b value added tax (VAT) – in transactions with non-VATable (or VAT-exempt) persons; and

c mineral extraction tax (MET) – in transactions with producers of minerals that are taxed at *ad valorem* (per cent) MET rate (i.e., currently excluding producers of oil, natural gas, gas condensate, anthracite and coal, as well as multi-component complex ore).

ii Related persons

Persons are deemed to be related (or interdependent) if the peculiarities of their relationship may influence terms or results of their transactions or economic results of their activities (in this regard, 'influence' means the ability of one person to determine the other person's decisions (directly or indirectly, on its own or jointly with third persons), by virtue of participation in capital, contractual arrangement or otherwise. Along with this general definition, the Tax Code describes 11 cases whereby persons are deemed to be related:

a by reference to participation: direct or indirect participation of more than 25 per cent; and a direct chain of participations each exceeding 50 per cent;

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2 The old transfer pricing rules as defined in Article 40 of the Tax Code are outside of the scope of this chapter.

3 The Russian Ministry of Finance is responsible for forming the tax policy and interpretation of the tax laws.

4 Letter of the Ministry of Finance dated 16 June 2013 No. 03-01-18/22698.

b by reference to management: company and person(s) entitled to appoint the company's sole executive body or at least 50 per cent of the company's collective executive body; and company and its sole executive body;
c by reference to common control or management: companies under common control, by reason of participation of more than 25 per cent, or entitlement to appoint the respective companies' sole executive body or at least 50 per cent of collective executive body; and companies under common management, by reason of the same person acting as the sole executive bodies or at least of 50 per cent of the same persons being on the collective executive bodies;
d by reference to subordination: employment and organisational structure; and
e family members: spouses, parents, children, siblings.

On other grounds where the critical 'influence' is present, the respective persons may recognise the interdependence on their own; otherwise, the court may do so (with sufficient evidence brought by the Federal Tax Service).[5] Participation by the state or a dominant market position (in the absence of other groups) is insufficient to recognise the interdependence.

Recent court practice shows that in order to prove the interdependence between parties to a transaction, the Russian tax authorities may request the competent authorities of foreign states to exchange information on ultimate beneficial owners of legal entities.[6]

iii Controlled transactions

The scope of controlled transactions encompasses, in addition to transactions between related parties, the following three types of transactions:
a complex transaction through an unrelated intermediary that undertakes merely resale without using its own assets or assuming risks (such transaction is deemed to be made between related parties to whose benefit it is concluded, ignoring the intermediary);
b cross-border commodity transaction (with oil and oil-based products, ferrous and non-ferrous metals, mineral fertilisers, precious metals and stones); and
c transaction with a person registered or resident in a blacklisted country or territory.[7]

Upon the Federal Tax Service's claim, a court may recognise a transaction as 'controlled' if it is one of a group of similar transactions all of which are structured with the aim of circumventing transfer pricing control.

5 Section 4 of the Overview of Transfer Pricing Disputes, approved by the Presidium of the Supreme Court on 16 February 2017 (the Overview of Transfer Pricing Disputes).
6 Cases A56-55281/2014; A56-55287/2014; A56-55290/2014 (*Avtotor* entities).
7 In accordance with the list of countries and territories, approved by the Order of the Ministry of Finance No. 108n dated 13 November 2007 (as amended). This list includes, among others, Crown dependencies and several British overseas territories, the Cayman Islands, Lichtenstein, Monaco and the United Arab Emirates. Cyprus and Malta were removed from this list in 2013 and 2015 respectively. Hong Kong is expected to be removed from this list shortly.

Safeguarding from the transfer pricing rules (and exclusion from the scope of controlled transactions) is provided for:

a with reference to the value threshold: domestic transactions with an annual total value of less than 1 billion roubles;[8] and transactions with blacklisted countries or cross-border commodity transactions with an annual value of less than 60 million roubles;

b with reference to the parties: transactions within the Russian consolidated taxpayers' group (except for sales of extracted commodities taxed at *ad valorem* MET rate); and transactions between related parties that are registered and operate within the same region and are not loss-making; and

c with reference to the type of transaction: suretyships (guarantees) and interest-free loans between Russian non-banking entities; up to seven-day interbank credits or deposits; loans between related parties insofar as the interest rate is within the minimum-maximum range;[9] certain transactions with regard to hydrocarbons extraction on offshore deposits; and cross-border transactions in the sphere of military and technical international cooperation.

For transactions with securities and derivatives between related parties, the special transfer pricing rules (and the safe harbour pricing ranges) are detailed in Article 280 of Chapter 25 of the Tax Code. There is no exclusion for capital transactions.

In addition, the Tax Code requires that for certain types of transactions (such as for no consideration or for in-kind consideration, and exchange/barter transactions) the tax base is calculated based on the arm's-length principle. The Supreme Court explained that in such instances, the tax base should be determined in accordance with transfer pricing methods.[10]

iv Transfer pricing and the domestic anti-abuse doctrine ('unjustified tax benefit')

The judicial doctrine of 'unjustified tax benefit'[11] presumes the taxpayer's good faith, but supports the deprival of tax benefits in the circumstances where the taxpayer's activities are artificial or aimed mainly at achieving tax benefits or where the form of transaction (and the way it is reflected in tax returns) does not correspond to its substance. In the context of this doctrine, the following principle has been developed by courts: the deviation of the transaction price from the arm's-length price is, as such, not sufficient to indicate that

8 Special value thresholds are established for domestic transactions entered into by the following taxpayer categories: (1) the threshold of 60 million roubles – for *ad valorem* MET taxpayers, and residents of Skolkovo or corporate R&D centres that operate under the Law 'On the Skolkovo Innovative Center' and are eligible to Skolkovo-related tax incentives; (2) the threshold of 100 million roubles – for taxpayers that opted for the special taxation regimes providing for the unified agricultural tax and the unified imputed tax; and (3) no value threshold – for residents of special economic zones, participants of regional investment projects (RIP), and taxpayers involved in hydrocarbon extraction on offshore deposits.

9 For foreign currency loans – within the range of the applicable interbank rate for the respective currency (such as LIBOR, EURIBOR, SHIBOR) plus 4 per cent up to 7 per cent (for loans in Swiss francs or Japanese yen – 2 per cent up to 5 per cent). For rouble loans – between 0.75 and 1.25 per cent of the Russian Central Bank key rate (which, as of 19 June 2017, is set at 9 per cent). Article 269(1) of the Tax Code.

10 Section 2 of the Overview of Transfer Pricing Disputes. Articles 154(1.2), 250(8) and 274(4-6) of the Tax Code.

11 This doctrine was formulated by the Supreme Commercial Court in Resolution No. 53 dated 12 October 2006.

unjustified tax benefit is derived, but if it is significant, then the non-arm's length price, taken together with other circumstances, may serve as evidence of the receipt of unjustified tax benefit.[12] When proceeding based on the 'unjustified tax benefit' concept, the local tax authorities are not restricted by the transfer pricing control rules and are able to enforce tax assessments through ordinary tax audits and may deviate from the transfer pricing methods.

v Transfer pricing and the director's corporate law liability

Directors (i.e., members of the sole and collective executive body and the supervisory body) and controlling persons (i.e., persons who may determine the company's activities through giving instructions) are required to act in the company's interest reasonably and in good faith, and may be held liable for the company's losses caused by wrongful actions or by failure to act.[13] As explained by the Supreme Commercial Court, this principle applies, in particular, with regard to transactions 'at unbeneficial terms' such as where the price or other terms are substantially worse than those in analogical transactions in comparable circumstances.[14]

vi Transfer pricing and Russian accounting rules

Russian accounting rules generally provide for the historical cost method. The market value method is applicable in explicitly defined circumstances, namely: with regard to purchases for no consideration, inventories remaining upon liquidation of fixed assets, and quantity excess revealed through inventory control; with regard to reflection (in financial reporting) of investments in publicly traded securities and, if so elected, fixed assets and groups of homogeneous intangibles; for preparation of the liquidation balance sheet; and, if so elected, for transfer of assets upon the company's reorganisation.[15]

Notes to financial reporting must disclose information on dependent parties[16] and transactions with such parties.[17]

II FILING REQUIREMENTS

Taxpayers must file annual notifications with regard to a controlled transaction or a group of homogeneous transactions (by disclosing the subject matter and the parties to the respective transaction(s), and the amount of income generated and/or expenses (losses) incurred). Filing (digitally or on paper) must be made by 20 May of the following year through the local tax authority, which forwards all notifications to the Federal Tax Service.

In addition, if so requested by the Federal Tax Service, the taxpayer must file the transfer pricing documentation. The transfer pricing documentation should be prepared

12 Ruling of the Supreme Court dated 22 July 2016 No. 305-KG16-4920, Case No. A40-63374/2015, *Minaevskiy*; Section 3 of the Overview of Transfer Pricing Disputes.

13 Article 71 of the Joint Stock Company Law, Article 44 of the Limited Liability Company Law, Article 53.1 of the Civil Code.

14 Section 2 of the Resolution of the Supreme Commercial Court Plenary Session, dated 30 July 2013 No. 62.

15 Russian Accounting and Reporting Order No. 34n; Russian Accounting Standards: RAS 5/01; RAS 6/01; RAS 9/99; RAS 14/2007; RAS 19/02; RAS 16/02; Recommendations on Accounting and Reporting upon Reorganisation.

16 The scope of 'dependent parties' is defined in corporate laws and may differ from the scope of 'related parties' as defined in the Tax Code.

17 RAS 4/99; RAS 11/2008.

with regard to a particular transaction or a group of homogeneous transactions, and should, at the minimum, contain information on the parties, subject matter and commercial terms; the functions performed by the parties, assets used and risks assumed; the pricing methods applied (justifying the selected method and providing further details on sources of information, comparables, calculation of the price and ranges of the profitability indicators); the amount of income (profit) and/or amount of expenses (losses), profitability; the economic benefits resulting from receipt of information and various intellectual property rights; other factors impacting the pricing (profitability), for example, pricing strategy; and voluntary (compensating) adjustments in tax returns. As a general rule, the complexity of the transfer pricing documentation should be appropriate for the complexity and the value of the respective transaction. The transfer pricing documentation may be requested after 1 June and is then to be filed within 30 calendar days; such short filing deadline implies the necessity to annually prepare or update the transfer pricing documentation (in advance of 1 June).

Furthermore, when making adjustments (compensating (voluntary), corresponding or reversed) in the tax return, the taxpayer must provide explanatory details on respective controlled transactions.

III PRESENTING THE CASE

i Pricing methods

Parties to a transaction are free to agree on the transaction price, and this price is deemed to be at arm's length unless the Federal Tax Service proves otherwise or the taxpayer makes compensating (voluntary) adjustments in the tax return.

In line with the OECD principles, the Tax Code provides for the following five transfer pricing methods (to be used in isolation or in combination, for controlling the transaction price and making the adjustments):

a comparable uncontrolled price method (in Russian terminology: 'comparable market price' method): this is a priority method, unless the resale price method applies. It is applicable if there is at least one comparable transaction (including internal comparable);

b resale price method: this is a priority method where goods purchased from a related party are resold to unrelated party with no processing, and as explained by the court, if the ultimate unrelated buyers are known.[18] This method focuses on the resale price margin;

c cost plus method (in Russian terminology: 'cost' method): this method is recommended with regard to works or services (including management services), sale of raw materials and semi-manufactured products, and long-term contracts. It focuses on the seller or supplier's cost mark-up;

d transactional net margin method (in Russian terminology: 'comparable profitability' method): this method is applicable if there are no comparable transactions (or if the comparability cannot be construed through reasonable adjustments on contractual terms or functional analysis) and therefore none of the first three methods can be applied. This method focuses on the tested party that performs the fewest functions

18 Case A40-123426/2016, *Dulisma*.

(and undertakes the least risk and does not possess any materially important intangible assets) and that party's net profit margin (related to an appropriate indicator such as sales, costs, selling and administrative costs, or assets); and

e transactional profit split method (in Russian terminology: 'profit split' method): this method is recommended where neither of the four other methods can be applied, and where there is a tight interdependence between the parties' activities, or where the parties possess intangible assets of material impact on their profitability.

The methods are not binding on the taxpayers (in their commercial pricing). When the taxpayer, however, selects a method (or combination of methods) for justifying and adjusting the transaction price, then the Federal Tax Service has to follow this method in transfer pricing audit unless it can prove that this method does not provide for appropriate comparability or justification.

In accordance with the Tax Code, the court is expected to take into account 'other circumstances important for comparability analysis' of the transaction price.[19] The Supreme Court clarified this point such that while it does not permit deviation from the methods (and other principles as defined by the transfer pricing rules), it is meant to avoid situations where the formally correct application of the methods does not allow for a proper result to be achieved (i.e., a price that is not influenced by the parties' interdependence). As an illustrative example, this provision permits the taxpayer to bring evidence to the fact that the understated profits were not a result of parties' interdependence but rather had proper economic justification (e.g., understated profits were embedded into results of other transactions).[20]

With regard to one-off transactions outside of the taxpayer's main line of business, an independent appraisal may be used, but as clarified by the Supreme Court, provided that it follows the transfer pricing principles (i.e., follows the arm's-length principle).[21]

Each of the methods implies the use of comparables. Certain comparability aspects have already been considered by the courts (though so far only in disputes resolved under the 'unjustified tax benefit' doctrine):

a loans: deposit and credit rates on the banking market may not serve as comparables for loans between non-banking entities;[22] rates in interest-bearing loans may not serve as comparables for interest-free loans;[23]

b lease of real estate: the comparability factors include functionality, size, location, conditions and technical characteristics of premises/buildings and lease term;[24]

19 Article 105.7(11) of the Tax Code.

20 Section 6 of the Overview of Transfer Pricing Disputes. For instances, in Case A40-7536/2015, *Lexmark*, the court paid attention to the fact that the taxpayer had been operating in its first few years after entering the quite price-competitive market in Russia and has applied a pricing strategy with gradual (year-by-year) price increases.

21 Section 7 of the Overview of Transfer Pricing Disputes.

22 Cases A29-195/2014, *KTK*; A55-6976/2015, *Tarkett*; A55-27937/2014, *StalExpress*; A55-25768/2014, *Viktor&Co*.

23 Cases A05-4564/2015, *Titan*.

24 Cases A62-3086/2014, *Beton Art*; A41-32826/2014, *MobService*; A03-3786/2015, *GorPo*; A72-4131/2015, *PisheTorg*.

c sale of real estate: the comparability analysis should take into account the market trends and demand (i.e., pricing in the growing market is not comparable to pricing in the decreasing market);[25]

d commodity transactions: the comparability factors include the type and technical characteristics of the commodity, sales volume, risks undertaken, and the seller's market strategies;[26]

e supply of goods: the delivery terms such as 'ex-works', on the one hand, and the supplier's responsibility for transportation, on the other hand, are not comparable; new and second-hand goods are not comparable.[27]

ii Authority scrutiny and evidence gathering

For the application of the transfer pricing methods and control, only publicly available sources of information may be used (i.e., use of information that is protected by the 'tax secrecy' regime or is of limited access is prohibited).[28] The Tax Code lists in particular the following sources of information:

a main sources: quoted prices of Russian and international exchanges; Russian customs statistics; prices (price ranges) and quoted prices obtained from Russian or foreign official databases or publicly available publications or databases; prices (price ranges) and quoted prices obtained from price reporting agencies; and internal comparables (i.e., information about the taxpayer's transactions); and

b secondary sources: data derived from accounting/financial and statistical reporting (including reporting contained in Russian or foreign publicly available publications or databases or on corporate websites); and independent appraisals.[29]

Recent court practice shows that the price ranges for oil obtained from the price reporting agencies such as S&P Global Platts and Argus Media (both focused on physical energy markets) qualify as comparables in particular, since these agencies publish the minimum-maximum transaction price ranges (rather than the average prices).[30] On the contrary, the average bank deposit rates published by the Interfax-SPARK database as well as the credit rates published by the Central Bank of Russia do not qualify as comparable.[31] Local databases with no visible track record are not viewed as a reliable source of information.[32] Furthermore, the mere reference to price ranges obtained from a publicly available source is not sufficient for adjustments; instead the price information should be used within a particular method.[33]

25 Case A12-3349/2015, *Prestizh AM*.

26 Cases A10-2463/2014, *Gornaya Kompania*; A26-7861/2014, *Granit DomDorStroy*.

27 Cases A53-14016/2015, *Stanchenko*; A55-10734/2015, *SpheraS*.

28 This principle has been acknowledged by the Federal Tax Service and the court in the recent case A40-123426/2016, *Dulisma*.

29 Notably, the Tax Code referred to an independent appraisal as a method and as a source of information.

30 Case A40-123426/2016, *Dulisma*. The price indicators published by Argus Media are also for determining the export customs duties for crude oil.

31 Cases A29-195/2014, *KTK*; A81-165/2015, *Muravlenkovskoye*; A40-204810/2014, *Itera*.

32 Case A53-32459/2015, *Kamensk Volokno*.

33 Case A81-165/2015, *Muravlenkovskoye*.

In January 2017, Russia joined the Multilateral Competent Authority Agreement on the Exchange of the Country-by-Country Reporting (CbC MCAA). The implementation of CbC reporting into the Tax Code is under way; the respective draft law (generally in line with the OECD recommendations in BEPS Action 13) is in discussion.

IV INTANGIBLE ASSETS

The transfer pricing rules are not yet detailed with regard to transactions with intangible assets; and the available court practice is not yet sufficiently developed to provide respective guidelines. Therefore, the implementation of the recent OECD recommendations (including in BEPS Actions 8-10, with regard to the DEMPE principles) in the Russian practice is yet to be seen.

The current transfer pricing rules contain only limited references to intangible assets, as follows:

a with regard to functional analysis: the intangible assets (including intellectual property rights) possessed by the parties are to be taken into account when analysing the parties' functions;

b with regard to transfer pricing documentation: the information on economic benefits derived from acquisition of intellectual property, rights to the firm name, trademarks, service marks and other intellectual property rights is to be provided along with the information on economic benefits from the controlled transaction; and

c with regard to selection of the transfer pricing method: if the tested party possesses materially important intangibles, neither of the resale price method, the cost plus method, or the transactional net margin method may be used; instead, the transactional profit split method is recommended in such circumstances.

V SETTLEMENTS

Generally, settlements with the tax authority are possible in court proceedings (at any stage of proceedings). The settlements are not permitted to deviate from the Tax Code rules (i.e., they are not meant to reduce tax assessments or penalties, but rather to address certain additional information or evidence).[34] Settlements in tax disputes were made in 2012 for the first time; and so far only a few of such cases have taken place (though none of those concerned transfer pricing matters).

The possibility of entering into a transfer pricing agreement with the Federal Tax Service is available only for major Russian corporate taxpayers that meet certain substantial economic thresholds (i.e., only for a few Russian corporates). The content of the transfer pricing agreement is regulated by the Tax Code. It is meant to define controlled transactions, pricing methods and information sources as well as evidence for confirming the compliance with terms of the agreement. Settlements on pricing through such agreement are unlikely to be permitted.

34 Letter of the Federal Tax Service dated 2 October 2013 No. SA-4-7/17648.

VI INVESTIGATIONS

The Tax Code regulates transfer pricing control as a special tax audit procedure that is conducted by the Federal Tax Service (the top-level authority within the tax administration) and that is separate from the ordinary tax audits conducted by the local tax authorities (desk tax audits, field tax audits or tax monitoring).

The transfer pricing audit can be initiated either on the basis of the taxpayer's annual notification on controlled transactions (see Section II, *supra*) or upon an alert by the local tax authority when it revealed controlled transactions in the course of an ordinary tax audit. Generally, the audit may be initiated within two years after the receipt of such notification or alert. The scope of the transfer pricing audit is limited to controlled transactions performed during three calendar years preceding the year when the audit is initiated. Generally, controlled transaction performed in a particular year may be audited only once and only with regard to one party.

The transfer pricing audit is expected to be completed within six months, unless it is extended to 12 months. An additional extension for up to nine months is possible for obtaining information from foreign competent authorities, additional examinations or translation of documents. The Federal Tax Service may involve an expert or specialist as well as a translator. Information and documents related to the audited transactions may be requested from the respective counterparties.

In the event the deviations from the arm's-length price and the tax base understatements are revealed, the tax audit results are documented with a tax audit report (to be presented to the taxpayer within two months after the audit is completed). The taxpayer may then file, with the Federal Tax Service, written objections to the tax audit report (within 20 days). Following the consideration of the tax audit report and the objections, the Federal Tax Service issues the tax audit decision. (For court proceedings with regard to the tax audit decision, see Section VII, *infra*.)

While the Tax Code defines explicitly that the transfer pricing audit may be conducted by the Federal Tax Service only, both the state authorities (the Ministry of Finance and the Federal Tax Service) and courts share the view that it is permissible for the local tax authority to review transfer pricing in the context of the 'unjustified tax benefit' doctrine during an ordinary tax audit (see Section I, *supra*).[35]

VII LITIGATION

i Procedure

With regard to the results of an ordinary tax audit, the tax audit decision is issued by the local tax authority and may be brought for appeal in court only if the respective decision has undergone the appeal with the superior tax authority (through the administrative or general appeal procedure).

On the contrary, the transfer pricing audit is conducted by the Federal Tax Service, and the decision issued as a result of the transfer pricing audit can be appealed in court directly (without going through the administrative or general appeal procedures). Furthermore, the

35 E.g., letter of the Ministry of Finance, dated 26 October 2012 No. 03-01-18/8-149, letter of the Federal Tax Service dated 16 September 2014 No. ED-4-2/18674; Section 3 of the Overview of Transfer Pricing Disputes.

enforcement of tax claims resulting from transfer pricing control, including from recognition of parties as related parties or recognition of transactions as 'controlled transactions', is possible only through court proceedings. Therefore, unless the audited taxpayer voluntarily discharges the tax assessments, the Federal Tax Service would be required to initiate court proceedings in order to enforce the tax claims.

Generally, the procedure for tax matters in commercial courts takes approximately a year, including the following instances: in the commercial court of first instance – examination of a case on its merits; in the appellate commercial court – consideration of an appeal; in the cassation commercial court – consideration of a cassation appeal; in the Supreme Court – review of court decisions in case of contradictions with the court practice, breach of human rights or representation of public interests; and in any commercial court that adopted the latest decision – review of a case due to newly discovered circumstances.

In the court proceedings, an expert or a specialist may be appointed by court. However, their involvement should be limited to either resolving doubts on the credibility of evidence (where there are discrepancies in such evidence brought by the taxpayer or the Federal Tax Service), or providing an expert opinion on specific questions that require professional knowledge (e.g., specific questions raised by the court in an attempt to resolve discrepancies in views on the appropriate method to be selected (such as questions related to profitability indicators)).[36]

ii Recent cases

Although the current transfer pricing rules have been in effect since 2012 and there have been several transfer pricing audits conducted by the Federal Tax Service under these rules, only two known cases[37] have reached the court.

The remaining (significant) number of transfer pricing cases concern tax claims assessed by the local tax authorities as a result of ordinary tax audits, based on the domestic anti-abuse concept (the 'unjustified tax benefit' concept), with the transfer pricing rules having played rather a secondary role. Still, several such cases offered a substantive discussion on certain elements of the transfer pricing rules (mainly on sources of information and comparability criteria, as discussed in Sections I to III, *supra*).

VIII SECONDARY ADJUSTMENT AND PENALTIES

i Adjustments

If the contractual price in a controlled transaction is not at arm's length, resulting in an understatement of the tax base, the taxpayer is allowed to make year-end compensating adjustments (in the annual corporate tax return and by refiling quarterly VAT and MET returns).[38]

36 Section 8 of the Overview of Transfer Pricing Disputes.

37 A40-123426/2016, *Dulisma* (the important positions from this case are discussed above); A40-29025/2017, *Uralkaliy*.

38 The Tax Code defines the annual tax period for corporate profit tax, the quarterly tax period for VAT and the monthly tax period for MET.

Furthermore, the Tax Code regulates the corresponding adjustments for primary adjustments made by the tax authority or for compensating (voluntary) adjustments made by the counterparty in its tax return.

Secondary adjustments are not yet considered in Russian tax practice.

For cross-border matters, several (but by far not all) Russian double tax treaties regulate the corresponding adjustments; however, there are very few practical cases on such cross-border adjustments.

ii Liability for transfer pricing violations

Where the tax authority discovers a tax base understatement in a controlled transaction, the following penalties may be imposed:

a a fine of 40 per cent (assessed on the underpaid tax amount; in the amount of at least 30,000 roubles). In accordance with the transition provisions of the transfer pricing rules (in effect from 2012), no fines are assessed for violations in the years 2012–2013, and a reduced fine of 20 per cent is assessed for violations in the years 2014–2016; and

b late-payment interest (under general rules).[39]

Neither fines nor late-payment interest may, however, be imposed in the circumstances of primary adjustments on a voluntary basis.

A fine of 5,000 roubles is imposed for failure to submit or for submission of a false notification on controlled transactions.

IX BROADER TAXATION ISSUES

i Diverted profits tax or similar tax rules

While Russian tax laws do not have an equivalent to diverted profits tax, several other tax rules and concepts (in addition to the judicial doctrine of 'unjustified tax benefit', see Section I, *supra*) have been used by the tax authorities to combat profit shifting.

Historically, the tax authorities have focused on intra-group services and administrative cost sharing agreements that require the domestic subsidiaries of MNEs to pay compensation for various central administrative functions. In an attempt to deny deductions for intra-group service fees, the tax authorities usually refer to various technical deficiencies in documenting the services' or functions' deliverables (rather than to pricing); most of these cases were resolved in the taxpayer's favour.[40] Where the intra-group agreements referred to the cost split in accordance with the OECD Transfer Pricing Guidelines, the courts decided in the tax authorities' favour, explaining that the Russian tax laws do not permit deductions for cost allocation within the MNE group (indeed such cost allocation is permissible only with regard to permanent establishments).[41] In fact, all such known cases concerned the tax years prior to

39 Currently, the late-payment interest is payable at a rate of 1/300th of the Russian Central Bank key rate for each day of delay in making the tax payment. As of October 2017, from the 31st day of delay in tax payment, the rate of late-payment interest will be doubled (i.e., 1/150th instead of 1/300th of the Russian Central Bank key rate per day (however, this rule will be applicable only to companies)).

40 Cases A56-94331/2009, *RBS*; A56-50454/2010, *Deutsche Bank*; A40-132387/2013, *Commerzbank*.

41 Cases A40-62131/2012, *MUMT/BAT*; A40-60626/2012, *BAT-STF*; A40-28065/2013, *Equant*.

the enactment of the new transfer pricing rules (and in all of these cases, the court explicitly stated that 'in the respective tax periods' the cost allocation was not permitted), therefore it is hard to foresee how the similar cases related to the recent tax periods will be resolved.

With the development of the beneficial ownership concept in the Russian tax practice, recently the tax authorities have increasingly focused on cross-border intra-group loans and IP licences in attempt to deny deductions or tax treaty relief for withholding tax (or both). In reasoning the tax claims, usually the tax authorities refer to the back-to-back nature of arrangements, the insufficiency of functions performed and the risks assumed by the respective income recipient, the conduit nature of the recipient and its missing 'beneficial owner' status (rather than to pricing).[42] In the majority of such cases, the Russian tax authorities utilise exchange of information mechanisms in order to collect evidence on the income recipient's substance and its ultimate beneficial owners.

With regard to permanent establishments (PEs), the Tax Code permits the allocation of the income and cost to be made based on functions performed by the Russian PE, assets used and economic (commercial) risks assumed. The principle of determining the PE income by applying the fiction of an independent enterprise (as usually provided in the Russian double tax treaties) is generally acknowledged, but is not yet consistently applied by the tax authorities and courts (often restricting the deductions to costs incurred by the PE itself).[43]

ii Impact on VAT and customs duties

As mentioned above (see Section I, *supra*), transfer pricing adjustments for VAT purposes are allowed in a rather limited number of circumstances, such as performance of works or services, or sale of goods to non-resident persons or to domestic persons who are VAT-exempt.

With regard to customs duties and import VAT, the 'customs value' rules are defined in the customs legislation of the Russian Federation and the Eurasian Economic Union.[44] The transfer pricing rules and the customs value rules are the two separate sets of rules.

The Ministry of Finance confirmed that the recognition of a transaction price as at arm's length by the customs authorities may not serve as evidence for recognition of the transaction price for taxation purposes.[45] On the other hand, the court practice indicates that the tax authorities may disallow the offset of the input VAT paid upon goods' import on the basis that the customs value exceeds the resale price. In two such known cases, the court sided with the taxpayer, mostly for the reason that the customs value does not justify questioning the resale price for transfer pricing purposes.[46]

Transfer pricing control is conducted by the Federal Tax Service and customs clearance and customs value control are conducted by the Federal Customs Service; these two bodies are both subordinate to the Ministry of Finance. However, the Federal Tax Service has been making significant progress in automatisation of the tax-relevant information flows and tax

42 Cases A40-28065/2013, *Equant*; A40-241361/2015, *Intesa*; A40-12815/2015, *Petelino*.

43 Cases A40-138835/2010, *CMS*.

44 The Eurasian Economic Union is an international organisation aimed at regional economic integration of its Member States that currently include Russia, Belarus and Kazakhstan (the founding members) as well as Armenia and Kyrgyzstan (which joined recently).

45 Letter of the Ministry of Finance dated 6 June 2012 No. 03-01-18/4-72.

46 Cases A40-152870/2013, *Russian Towers*; A40-17536/2015, *Lexmark*.

control as well as in integration of its electronic databases and IT systems with those used by the Federal Customs Service. It is possible that over time these processes will make the convergence of these two sets of pricing rules more apparent and critical.

X OUTLOOK AND CONCLUSIONS

The transfer pricing practice in Russia is in the early stages of development. It seems that other anti-abuse concepts such as beneficial ownership as well as the domestic 'unjustified tax savings' concept offer easier instruments for preventing cross-border profit shifting (including to related parties' 'cash boxes' and 'IP boxes'). The implementation of CbC reporting is likely to enhance this trend.

Chapter 15

UNITED KINGDOM

Steve Edge and Orlaith Kane[1]

I OVERVIEW

Parts 4 and 5 of the Taxation (International and Other Provisions) Act 2010 (TIOPA) contain the main UK 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:

a an actual provision has been made or imposed between two persons by means of a transaction or series of transactions;

b one of those 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;

c the actual provision differs from the arm's-length provision that would have been made between independent enterprises; and

d 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 in order for the UK rules to apply. While the term 'provision' is not defined in the legislation, HM Revenue & 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).[2] 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

1 Steve Edge is a partner and Orlaith Kane is an associate at Slaughter and May.

2 HMRC International Manual (INTM412050).

impact shareholder transactions.[3] However, the FTT declined to follow this decision in a subsequent case[4] 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.[5]

'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.[6] Indirect control will arise in any of the following scenarios:

a 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;

b 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

c 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 are stated to 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 UK-UK transactions come within the scope of the 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

3 *Abbey National Treasury Services plc v. HM Revenue & Customs*, TC/2012/02613.

4 *Union Castle Mail Steamship v. HM Revenue & Customs* [2016] UKFTT 526.

5 Section 1124 of the Corporation Tax Act 2010.

6 Sections 157 to 163 of the TIOPA.

'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.[7]

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.[8] 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 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.[9] 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 which 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.[10]

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

7 Section 196(2) of TIOPA.
8 HMRC International Manual (INTM480020).
9 Section 164 of TIOPA.
10 HMRC International Manual (INTM483030).

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.

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 on a case-by-case basis 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

11 HMRC International Manual (INTM483030).

should be made are those for differences that will have a material effect on the comparison 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 in 2016, 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 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, *infra*), 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 HM 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. In order 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, 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 coal face 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. In order 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 and/or documents to help it check the relevant taxpayer's position. Before making such 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/OECD Convention on Mutual Administrative Assistance in Tax Matters, various EU directives and regulations (pending Britain'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.[12] 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 (otherwise known as 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,

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. In order 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 (1) making and agreeing an action plan and timeline with the taxpayer; (2) carrying out a fact-finding exercise; (3) assessing the evidence and engaging in technical discussions with the taxpayer; and (4) resolving the inquiry.

A transfer pricing inquiry is undertaken by large business service or local compliance case teams headed by their respective customer relationship manager (CRM). A transfer pricing specialist is allocated to each inquiry. The CRM 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, *infra*, 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.

In order 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.[15] 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 CRM as to how the case should be settled and a statement about culpability.[16] 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 CRM 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 2015–2016, it considered 22 cases (28 in 2014–2015).[17] The Diverted Profits Board similarly makes recommendations to the TDRB on HMRC's largest and most sensitive cases. The Tax Assurance Commissioner expects to report on the activities of the Diverted Profits Board in future years.

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.[18]

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.[19]

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

15 Section 32 of the Finance Act 1998.

16 HMRC International Manual (INTM481060).

17 The Tax Assurance Commissioner's Annual Report 2015–2016.

18 Section 208 of the TIOPA.

19 HMRC International Manual (INTM483070).

material change in the circumstances of the business or in the market conditions in those 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.[20] 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 precedent.

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.

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, 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.

20 HMRC International Manual (INTM483130).

ii Recent cases

Very few transfer pricing cases have been litigated in the UK.

DSG Retail Ltd v. HMRC[21] 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 (1) an incorrect return is made and a taxpayer has been careless or negligent in establishing an arm's-length basis for the return; or (2) 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 percentage to be applied will depend on a number of factors including, among others, (1) whether the underlying behaviour that gave rise to the inaccuracy was careless, deliberate, or deliberate and concealed; (2) whether the disclosure was prompted or unprompted; and (3) the quality of disclosure.

21 SpC [2009] SSCD 397.

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

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 a UK permanent establishment (PE) enters into arrangements with a related person where that person or the transaction(s) lack economic substance resulting in a reduction of the UK subsidiary's or UK PE's taxable profits; secondly, where a person (whether or not UK-resident) 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 PE. 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 represent a strong stick to accelerate resolution of a transfer pricing inquiry for the following reasons: (1) the DPT rate is considerably higher than the UK corporation tax rate; (2) it is not possible to postpone any DPT payment once a charging notice has been issued; and (3) DPT gives credit for transfer pricing adjustments only if they are made before DPT is assessed.

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 a 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.

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 a MAP and, equally, a 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.[22]

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

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. Furthermore, 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.[23]

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.

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 custom 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.[24]

22 HMRC Statement of Practice 1/2011.

23 HMRC VAT Valuation Manual (VATVAL 15700).

24 HMRC VAT Valuation Manual (VATVAL 15900).

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 so as 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.

Chapter 16

UNITED STATES

Thomas Humphreys and Edward Froelich[1]

I OVERVIEW

i Transfer pricing generally

Given the high corporate tax rate in the United States, transfer pricing is an area of particular concern to the Internal Revenue Service (IRS).[2] Accordingly, the US has a comprehensive regulatory regime that seeks to ensure that related taxpayers engaging in cross-border transactions do so on terms and at prices that are 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 among 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'.[3] 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'.[4] True taxable income is determined by judging transactions between controlled taxpayers against comparable transactions between unrelated persons dealing at arm's length.[5] 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.'[6]

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 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

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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.

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.

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 Whitepaper in 1988.[7] The Section 482 Whitepaper 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]

ii Statutory requirements of Section 482

By its terms, there are three prerequisites for a reallocation under Section 482. First, there must be 'two or more organizations, trades, or businesses'. Second, these organisations 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]

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

7 IRS, A Study of Intercompany Pricing Under Section 482 of the Code, IRS Notice 88-123, 1988-2 C.B. 458 (1988).

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 equalled 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 F.2d 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 F.2d 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 F.2d 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).

taxpayers are acting in concert or with a common goal or purpose.[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'.[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 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, the group's 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.[15]

II 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:

a an overview of the taxpayer's business including an analysis of the legal and economic factors affecting its pricing;

b a description and chart of the organisational structure covering all relevant related parties;

c any documents explicitly required by regulations under Section 482 (for example, Treas. Reg. Section 1.482-7(k) requires that cost-sharing agreements (CSAs) between controlled parties be recorded in writing in a contemporaneous contract);

d a description of the pricing method selected and reasons why the method was selected (i.e., a best-method analysis[16]);

e an explanation why alternative methods were not selected;

f a description of the controlled transactions and any internal data used to analyse them;

g a description of the comparables used, how comparability was evaluated and any adjustments that were made;

h an explanation of the economic analysis and projections used to develop the pricing method;

i a description or summary of any relevant data obtained after the close of the tax year but before filing the tax return; and

13 Treas. Reg. Section 1.482-1(i)(4).

14 Id.

15 See, e.g., *Liberty Loan Corp v. US*, 498 F.2d 225, 229 (8th Cir. 1974); *H Group Holding, Inc. v. Comm'r.*, T.C. Memo. 1999-334, 21; *Kenco Restaurants Inc. v. Comm'r*, 206 F3d 588, 593-94 (6th Cir. 2000).

16 In general, the best method is the method that provides the most reliable measure of an arm's-length result.

j 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 obligated 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

i 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 comparable uncontrolled price (CUP), the 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. Furthermore, 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 include 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 Organisation 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 three foreign tax agencies, including in the Netherlands, have entered into competent authority agreements to exchange taxpayers' global tax and profit reports with foreign jurisdictions.

These bilateral agreements would allow US multinationals to file their 2016 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: (1) patents, inventions, formulae, processes, designs, patterns, or know-how; (2) copyrights and literary, musical, or artistic compositions; (3) trademarks, trade names, or brand names; (4) franchises, licences, or contracts; (5) methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, or technical data; and (6) other similar items. For the purpose of Section 482, an item is considered similar to those listed in paragraph (b)(1) through (5) 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 license 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]

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.[26] There is one method that is unique to determining transfer pricing for licences and other transfers of intangible property – the CUT method.[27] As in the case

21 Treas. Reg. Section 1.482-4(b).

22 Treas. Reg. Section 1.482-1(f)(2)(ii)(A).

23 Treas. Reg. Section 1.482-1(d)(3)(iv).

24 We discuss, *infra*, the *Amazon* case in which the realistic alternative approach was rejected where the taxpayer appropriately applied and followed the CSA regulations.

25 Treas. Reg. Section 1.482-4(f)(2).

26 Treas. Reg. Section 1.482-4(f)(5).

27 Treas. Reg. Section 1.482-4(a).

of the determination of tangible property transfer pricing, the CPM and profit split method may be used for intangible property transfers.[28] 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.[29] 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.[30] 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.[31] A third method of settlement is through the competent authority (CA) process. The CA 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.[32] 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 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.

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 United States 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).

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.[33] 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 which 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 manner. Campaign issues typically are those that present a high risk of non-compliance in the view 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.

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.

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 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 choice of forum.

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.

ii Recent cases

Several major companies are disputing proposed IRS adjustments, including Coca-Cola, Inc, which filed a petition in the Tax Court in December 2015 disputing a US$9 billion proposed transfer pricing adjustment, Amazon.com, Inc, Microsoft Corp, and The 3M Company. Recent major decisions include *Amazon v. Commissioner* and *Medtronic 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 CSAs 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.[35] 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. 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.

35 *Veritas Software Corp v. Commissioner*, 133 TC.297 (2009).

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: (1) whether the Commissioner abandoned a prior position and (2) 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. To the contrary, the court determined that MPROC had significant independent responsibility, particularly in 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.

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

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 CA 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. CA can assist taxpayers under the mutual agreement procedure articles of US tax treaties through consultations with the applicable foreign CAs 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

CA 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 CA, the Advance Pricing and Mutual Agreement or APMA programme office and the Treaty Assistance and Interpretation Team 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

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 US. 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 (in-bound distributors) as a formal campaign audit issue but has also indicated that transfer pricing generally is a top enforcement issue.

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, lists guidance under Section 482 including with respect to the treatment and allocation of risk.

Furthermore, the US participation in the BEPS project will continue to form the landscape for transfer pricing. However, with the current change in Administration and majority by Republicans in the House and Senate there is a chance for significant tax reform which could completely change the transfer pricing landscape.

Chapter 17

VENEZUELA

Alberto Benshimol and Humberto Romero-Muci[1]

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 TP 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 TP 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 other 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:

a the related parties involved;

1 Alberto Benshimol and Humberto Romero-Muci are partners at D'Empaire Reyna Abogados.

b the type of transactions;
c the transaction amounts; and
d 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:

a 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;
b an organisational and functional overview of the taxpayer;
c information regarding the foreign related parties, including the type of business, the main clients and shareholdings in group companies;
d an overview of the controlled transactions, including activities carried out, dates, prices and the relevant currency;
e 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;
f financial statements prepared according to generally accepted accounting principles;
g agreements entered into between taxpayers and their foreign related parties;
h the method(s) used to set the transfer prices, indicating the criteria and objective elements considered to determine that the method used is the most adequate;
i information regarding the operations of uncontrolled comparable companies; and
j 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:

a the comparable uncontrolled price (CUP) method;
b the resale price method;
c the cost plus method;
d the profit split method; and
e 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 may 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, C.A. 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 TP 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. In the event 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 the 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 *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 TP 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, uphold 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 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

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 re-characterised as equity and, therefore, interests paid on such debts are not deductible for tax purposes.

Venezuela has no diverted profits tax.

ii 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:

a 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;

b a list of agreements or measures that states can settle under a MAP; and

c 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'.

iii Consequential impact

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.

X 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.

Appendix 1

ABOUT THE AUTHORS

EYAL BAR-ZVI

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Eyal Bar-Zvi is the co-head of transfer pricing with a focus on high-tech ventures. Eyal has over 10 years of experience in drafting, negotiating and defending transfer pricing documentation, and often participates in transfer pricing due diligence processes as part of mergers and acquisitions involving Israeli companies. Eyal also performs cost allocation analysis for the firm's clients.

Eyal represents Israeli companies in their audits in Israel and abroad, and often lectures at the Israeli CPA Association on matters related to transfer pricing. Eyal has published numerous articles on those subjects, both online and offline, and is also an adjunct professor at the Haifa University Faculty of Law, where he teaches a workshop on transfer pricing.

Eyal speaks Hebrew, English and German, and is a member of the German-Israeli Chamber of Commerce and the German-Israeli Legal Association. Eyal acts as a mentor and *pro bono* legal counsel to IDF intelligence and air force corps programmes.

DOMINIC C BELLEY

Norton Rose Fulbright Canada LLP

Dominic Belley is a partner and chair of Norton Rose Fulbright's Canadian tax team. He has represented taxpayers against federal and provincial tax authorities in civil, commercial, criminal and constitutional matters before the Court of Quebec, the Quebec Superior Court, the BC Supreme Court, the Quebec Court of Appeal, the Tax Court of Canada, the Federal Court, and the Federal Court of Appeal. He was lead counsel before the Supreme Court of Canada in four cases. Mr Belley has argued over 100 cases on behalf of clients in Quebec, Ontario, New Brunswick, British Colombia and Manitoba. His areas of practice include income tax, GST, collection measures, access to tax information, cancellation of penalties and judicial review of ministerial decisions. He has vast experience in rectifications. Mr Belley has taught taxation for more 10 years at the University of Sherbrooke and at the Quebec Bar School. He has published articles and given speeches on tax topics in Canada, the United States, the United Kingdom and France. Currently, he is Governor of the Canadian Tax Foundation, a member of the Bench and Bar Committee of the Tax Court of Canada and author of *The Tax Disputes and Litigation Review*'s Canadian chapter.

YARIV BEN-DOV

Herzog Fox & Neeman Law Offices

Yariv Ben-Dov is the head of the transfer pricing and valuations department. He is an expert in drafting and defending transfer pricing studies and intercompany agreements, with over 15 years of experience. Yariv counsels both multinational conglomerates and small start-ups on their transfer pricing matters, including multinationals that have no activity in Israel.

Yariv formerly served as the transfer pricing manager and as the head of the transfer pricing unit in Teva Pharmaceuticals, and has published articles on the subject of transfer pricing and has been asked to keynote as an expert in transfer pricing at several conventions in Israel, Europe and the US.

Yariv is a member of the board of the Israeli-LATAM Chamber of Commerce and also serves on the board of the Arthur Rubinstein Music Society and as the head of the Society's NYC branch. Yariv counsels (*pro bono*) the Israeli Navy Association. Yariv speaks Hebrew, English, French and Italian.

ALBERTO BENSHIMOL

D'Empaire Reyna Abogados

Alberto Benshimol has been a tax partner at D'Empaire Reyna Abogados since 2005. Alberto received his law degree *summa cum laude* from Universidad Católica Andres Bello in 1996 and a master of laws degree (LLM) in international taxation from New York University in 1997. He is admitted to practise in Venezuela and in the State of New York.

Alberto has represented corporate clients on domestic and international tax matters, including Bristol-Myers Squibb, Brown Brothers Harriman, Citigroup Private Bank, Henkel, Coca-Cola Femsa, GE, HSBC, JPMorgan, Procter & Gamble, Mexichem, Rolex, Rosneft and Toshiba.

He has been recognised by numerous surveys such as *Chambers and Partners*, *Who's Who Legal*, *World Tax*, *Latin Lawyer* and *Practical Law Review* as a leading Venezuelan tax practitioner. Alberto was a member of the Venezuelan team that conducted and completed the negotiations of the US–Venezuela tax treaty in 1998. In 1997 he was an international associate at Wilmer, Cutler, Pickering, in Washington, DC.

JOÃO FRANCISCO BIANCO

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João Francisco Bianco has an LLM and a PhD in tax law from the University of São Paulo. He is a professor at the Brazilian Institute of Tax Law, a member of the International Association of Tax Judges, a former judge of the Administrative Council of Tax Appeals and a visiting professor on various postgraduate courses in Brazil.

GÉRY BOMBEKE

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Géry Bombeke is a partner in the tax practice group of Baker McKenzie's Brussels office. He was admitted to the Brussels Bar in 2001 and joined the firm in 2004. He became a partner in 2010.

Géry advises multinationals and Belgian companies on international tax planning and transfer pricing. He has an extensive experience in advising on different transfer pricing models and assisting clients with obtaining advance pricing agreements. Together with the tax dispute resolution team, he also assists his clients in administrative and judicial procedures following transfer pricing adjustments. Géry has great experience with mutual agreement procedures.

Géry is a lecturer at the University Center Leuven Limburg. He has a law degree from the University of Ghent, a master's degree in tax law from the Vlerick Management School, a master's degree in company law from the Catholic University of Brussels and a degree in international tax planning from ULB Solvay Business School.

OSCAR CAMPERO P SAN VICENTE

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Oscar Campero is a graduate of the Instituto Tecnológico Autónomo de México (ITAM), where he obtained his degree in economics. Subsequently, he obtained an executive master's degree in business and administration from the University of Texas at Austin and of the Instituo Tecnológico y de Estudios Superiores de Monterrey.

Throughout his career, Mr Campero has taken several taxation, transfer pricing and valuation courses, particularly at ITAM, the Council for International Tax Education and the Financial Analyst Mexican Society.

He is an active member of the Transfer Pricing Commission of Instituto Mexicano de Contadores Públicos and has collaborated on several articles on transfer pricing matters, published by different institutions.

Mr Campero's professional practice began in 1995 in the special projects department of Acer Computer Mexico. In 1998 he joined Chevez, Ruiz, Zamarripa y Cia, SC, were he was promoted to associate in 2002 and to partner in 2009. With more than 18 years of experience in transfer pricing, Mr Campero has advised clients in countless affairs, including compliance, strategic tax planning and audit procedures, as well as the negotiation and implementation of advanced pricing agreements with tax authorities.

ALEJANDRA CASTILLÓN CONTRERAS

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Alejandra Castillón is a graduate of Universidad Iberoamericana, where she obtained her degree in economics.

Mrs Castillón's professional practice began in 2007 when she joined Chevez, Ruiz, Zamarripa y Cia, SC, where she was promoted to associate in 2015. With more than nine years of experience in transfer pricing, Mrs Castillón has advised clients in many affairs, including compliance, strategic tax planning and audit procedures, as well as the negotiation and implementation of advanced pricing agreements with tax authorities.

Throughout her career, Mrs Castillón has taken several taxation, transfer pricing and valuation courses and has collaborated on several articles on transfer pricing matters, published by different institutions.

ROBERTA D'ANGELO

Studio Legale e Tributario Biscozzi Nobili

Roberta D'Angelo graduated from LIUC University – Castellanza (VA) in 2005 with a degree in economics. In 2010 she completed a master's degree in international tax and transfer pricing at Queen Mary University of London. She has been a member of the Chartered Institute of Taxation of London since 2011. She has worked in at various Big Four consulting firms in Italy and the UK. Roberta has been a chartered accountant and auditor since 2017. She joined Studio Legale e Tributario Biscozzi Nobili in 2014 and specialises in transfer pricing consultancy.

BAS DE MIK

De Brauw Blackstone Westbroek

Bas de Mik is a Dutch tax lawyer for DBBW and lectures on international taxation at the VU University of Amsterdam. He specialises in international taxation, transfer pricing and tax accounting and reporting (including tax risk management). He is the former international tax director of ABN AMRO Bank, as well as head of transfer pricing ad interim at Unilever. He is a member of various advisory committees to the OECD (among which the tax committee and the business advisory group on the Common Reporting Standards). He holds master's degrees in internal relations and taxation from the University of Amsterdam.

IRINA DMITRIEVA

White & Case LLC

Irina heads the tax practice at White & Case's Moscow office. She has been advising on Russian and international tax matters since 1995, primarily focusing on greenfield investments, M&A, private equity, corporate restructuring, real estate and structured finance transactions. Irina is recognised as one of the top tax practitioners in Russia by Chambers and Partners and *The Legal 500*. Irina regularly lectures for up-and-coming lawyers at the Moscow State University of International Relations and the National Research University – Higher School of Economics. Irina graduated from Moscow State University (degree in economics) and from Academic Law University under Institute of State and Law of the Russian Academy of Sciences (law degree).

STEVE EDGE

Slaughter and May

Steve joined Slaughter and May in 1973 and has been a partner since 1982. He advises on the tax aspects of private and public mergers, acquisitions, disposals and joint ventures and on business and transaction structuring (including transfer pricing in all its aspects) more generally. A large part of Steve's practice involves advising non-UK multinationals (particularly those based elsewhere in Europe and in the US) on cross-border transactions and tax issues of various types. In that area of his practice, he works closely with other leading international tax advisers around the world.

In recent years, Steve has been heavily involved in several large-scale interventions under HMRC's high-risk corporates programme and in many in-depth tax investigations of specific domestic or international issues including transfer pricing in particular.

Steve is ranked as a star individual in the most recent editions of *Chambers UK*, *Chambers Europe* and *Chambers Global*. He is listed as a leading individual for corporate tax and is recommended for tax litigation and investigations in *The Legal 500, 2016*. Steve is listed in *Who's Who Legal 2016* and the ITR's *Tax Controversy Leaders Guide 2016*. Steve also appears in the *Tax Directors' Handbook 2016*, *TDH250* (the best individual tax advisers in the world (according to clients)).

MEHDI FERNANE-JALLIER

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Mehdi Fernane-Jallier is a counsel in the tax law practice of Arendt & Medernach where he specialises in transfer pricing matters.

He is mainly involved in financial transactions such as intra-group financing, debt pricing/real estate transactions, cash pooling, goodwill valuations and asset management (split of fees between ManCos, advisory and distribution functions).

Before joining Arendt & Medernach in 2015, Mehdi worked for more than five years as an SAP consultant (SAP BFC certified) on various projects in France and abroad (UK, Morocco, Germany, Switzerland, Netherlands, etc.). Since 2008, Mehdi has specialised in transfer pricing, initially working for Big Four firms in both Paris and Frankfurt. He has been involved in various aspects of transfer pricing covering the full spectrum from compliance to restructuring.

Mehdi holds a master's degree in management from Neoma Business School.

He speaks French, German and English.

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Edward Froelich is of counsel in the Washington, DC office of Morrison & Foerster. Mr Froelich represents clients in audit and litigation on all federal tax issues. He is a former trial attorney of the Department of Justice Tax Division where he litigated numerous cases, including complex corporate refund cases.

ALAIN GOEBEL

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Alain Goebel is a partner in the tax law practice of Arendt & Medernach where he advises an international clientele on the tax and transfer pricing aspects of Luxembourg and cross-border transactions, in particular corporate reorganisations, acquisitions and financing structures.

He has been a member of the Luxembourg Bar since 2002. He is a member of ALFI, LPEA, IFA and AIJA. He acted as President of YIN from 2013 to 2016 and as Luxembourg National Representative for AIJA from 2012 to 2015.

He was a lecturer in business taxation at the University of Luxembourg from 2009 to 2016 and is a regular speaker at tax seminars. He has published several papers on tax law, including national reports for IFA and AIJA, and is co-author of the Luxembourg chapter of the *International Guide to the Taxation of Holding Companies* published by the IBFD (Amsterdam).

Alain Goebel holds a master's degree in business law and a postgraduate degree in tax law (DEA Fiscalité) from the Université Paris II Panthéon-Assas (France), as well as a Master of Laws degree (LLM) in banking and finance law from King's College London (UK).

He is recommended as tax lawyer in the major league tables including *The Legal 500*, *Chambers Europe* and *Best Lawyers*.

He speaks English, French, German and Luxembourgish.

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Stefano Grossi graduated from the Bocconi University of Milan in 2002 with a degree in economics. He also completed a master's degree in international taxation in 2017. He has been a chartered accountant and auditor since 2007. He has worked as a tax consultant for various legal and tax firms in Milan. He has been a tax consultant at Studio Legale e Tributario Biscozzi Nobili since 2017. Stefano's expertise includes transfer pricing consultancy and cross-border tax matters.

LARS H HAVERKAMP

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Dr Lars Haverkamp is a senior associate with the Düsseldorf office of Baker McKenzie. He is specialised in reorganisation and supply chain transformation for multinational groups of companies. He 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.

His practice focuses on transfer pricing, tax planning, permanent establishments and tax dispute resolution. After his law studies at the University of Munster, Germany, Lars Haverkamp has earned a Master of Laws degree from the University of Canterbury in Christchurch, New Zealand before he completed his doctorate in tax law at the University of Mainz, Germany. Next to work experience in the United States, he spent several months at a prestigious law firm in Shanghai, China.

THOMAS HUMPHREYS

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Thomas Humphreys is co-chair of the federal tax practice group and the tax department at Morrison & Foerster. Mr Humphreys has extensive experience with the tax aspects of capital markets transactions, financial instruments, real estate investment trusts, mergers and acquisitions, bankruptcy and reorganisation, tax controversy, including transfer pricing and international transactions. He also works with investment banks and issuers on developing new financial products.

ORLAITH KANE

Slaughter and May

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.

JONATHAN LAFRANCE

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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.

SŁAWOMIR ŁUCZAK

Sołtysiński Kawecki & Szlęzak – Kancelaria Radców Prawnych i Adwokatów Spk

Sławomir Łuczak graduated with a law degree from the University of Poznan. He joined SK&S in 1998 and become a partner in 2007. He previously gained experience in a recognised French audit firm. He has broad experience in international tax law, and in representing clients in tax and customs matters before the tax and customs authorities and administrative courts. He also advises on tax issues in relation to restructuring projects and consolidation. He is a member of the International Fiscal Association, Association Europénne d'Etudes Juridiques et Fiscales and Regional Council of Attorneys in Warsaw.

CONSTANZA MARTÍNEZ-CARRERA CERVANTES

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Constanza Martínez-Carrera Cervantes is a graduate of the Instituto Tecnológico y de Estudios Superiores de Monterrey (ITESM), where she obtained her degree in economics and finance.

Mrs Martínez's professional practice began in 2014 when she joined Chevez, Ruiz, Zamarripa y Cia, SC. With three years of experience in transfer pricing, Mrs Martínez has advised clients in many affairs, including compliance, strategic tax planning, audit procedures and financial valuations. Throughout her career, Mrs Martínez has taken several taxation, transfer pricing and valuation courses.

PATRÍCIA MATOS

Deloitte & Associados, SROC, SA

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.

COSTAS MICHAIL

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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 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.

FILIPE DE MOURA

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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.

JULIE PERMEKE

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Julie Permeke is an associate in the tax practice group of Baker McKenzie's Brussels office. She was admitted to the Brussels Bar in 2011 and joined Baker McKenzie in 2016.

Julie advises multinationals and Belgian companies on all kinds of corporate income tax issues and international tax planning.

Julie provides tax advice regarding mergers and acquisitions, including real estate transactions, and corporate restructurings. Her work includes acquisition and finance structuring, tax due diligences and tax input on contractual documentation.

She also assists clients with their compliance obligations and she is regularly involved in tax procedures, both on an administrative and on a judicial level.

MAGDALENA POLAK

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Magdalena Polak graduated with a law degree from Cardinal Stefan Wyszyński University in Warsaw, in particular obtaining specialisation in the business law programme. She is a three-year advocate trainee at the Warsaw Bar of Advocates. She joined SK&S in 2015. She previously gained experience at the tax line of service at PwC Poland. She is a member of the International Fiscal Association and a board member of the Social & Cultural Association of Yemeni in Poland.

FRANK PÖTGENS

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Frank Pötgens is a tax lawyer at DBBW and is professor and co-chair of the tax law faculty at VU University Amsterdam, lecturing on international and European tax law. He is a deputy judge of the Court of Appeal in 's-Hertogenbosch.

FRANCO POZZI

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Franco Pozzi graduated from the Università Commerciale Luigi Bocconi di Milano in 1993 with a degree in economics. He has been enrolled in the Register of Chartered Accountants of Busto Arsizio since 1993 and has been an auditor since 1999. He joined Studio Legale e Tributario Biscozzi Nobili in 1993 and was made partner in 2001. Franco's expertise includes domestic and international restructuring, transfer pricing, and tax issues related to artists and sportspersons. He regularly speakers at seminars and is the author of a publication on international tax matters. Franco is currently president of the statutory auditors of Poligrafici Editoriale SpA (a listed company).

DOMINIC ROBERTSON

Slaughter and May

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.

Dominic is listed as a leading individual for corporate tax in *Chambers UK, 2017* and is also listed in the ITR's *Tax Controversy Leaders Guide 2016*. 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 Tomazela Santos 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 Niklas J R M Schmidt, TEP, is a partner at Wolf Theiss. He has been admitted as a lawyer and as a tax adviser. His areas of specialisation include tax law. Mr Schmidt is frequently engaged as a speaker at tax conferences and has been a visiting lecturer at various universities. Currently, he is a member of the examination commission for the 'Certified Financial Planner' exam in Austria, and he sits on the editorial board of the *SteuerExpress* magazine. Furthermore, Mr Schmidt is a member of the International Fiscal Association (IFA), the International Bar Association (IBA), the International Tax Planning Association (ITPA) and the Society of Trust and Estate Practitioners (STEP). He has been named one of Austria's top 10 tax lawyers in the Austrian magazine *TREND* and is ranked in band 1 by many international legal directories.

STEPHAN SCHNORBERGER

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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 enforce 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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Kyriacos Scordis graduated from University College London after having completed his studies in law and passed his bar exams in 1994. He joined Scordis, Papapetrou & Co LLC in 1995 and he is a member of Lincoln's Inn, the Inns of Court, the Cyprus Bar Association, the International Tax Planning Association, the AIJA and the International Bar Association. He specialises in international arbitration, international litigation, private international law, tax and tax planning, corporate law, commercial law, mergers and acquisitions and competition law.

EVA STADLER

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Dr Eva Stadler is a senior associate with Wolf Theiss, has been with the firm since 2010 and is admitted as a lawyer in Austria. She specialises in international tax law, taxation of financial instruments and tax planning of international groups. Further, she regularly publishes articles in international and national tax journals and acts as a speaker at international tax conferences. She is a member of the International Association of Young Lawyers (AIJA) and has been involved in numerous tax conferences held by AIJA in the past years.

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Lisa Vascellari Dal Fiol graduated from the Università Commerciale Luigi Bocconi di Milano in 2008 with a degree in economics. She has been enrolled in the Register of Chartered Accountants since 2013. She joined PricewaterhouseCoopers in 2007, then worked at Studio per il Controllo Contabile. She joined Studio Legale e Tributario Biscozzi Nobili in 2011.

In 2012 Lisa completed a master's degree in corporate tax law *cum laude* at the Università Commerciale Luigi Bocconi di Milano. She attends the Law Faculty at Milan University. Her experience includes domestic and international corporate and tax matters, IFRS and transfer pricing.

Appendix 2

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