

THE TRANSFER  
PRICING LAW  
REVIEW

FOURTH EDITION

Editors

Steve Edge and Dominic Robertson

THE LAWREVIEWS

THE  
TRANSFER  
PRICING LAW  
REVIEW

FOURTH EDITION

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# PREFACE

It has been a great pleasure to edit this fourth edition of *The Transfer Pricing Law Review*. This publication aims to give readers a high-level overview of the principal transfer pricing rules in each country covered in the *Review*. Each chapter summarises the country's 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).

Other than Brazil, all the countries covered in this *Review* apply an arm's-length standard and adhere, at least to some extent, to the Organisation for Economic Co-operation and Development Transfer Pricing Guidelines (the OECD Guidelines); and Brazil itself has recently launched a project to align its transfer pricing rules with the OECD norm. However, as the chapters make clear, there remains significant divergence, both in countries' interpretation of the arm's-length standard (e.g., the transactions it applies to, the pricing methods preferred and whether secondary adjustments are imposed) and in the administration of the rules (e.g., the documentation requirements imposed, and the availability of APAs). Transfer pricing practitioners, therefore, cannot simply assume that the OECD Guidelines contain all the answers but must in fact engage with their detailed application within each country.

As we have said in earlier editions of the *Review*, transfer pricing rules will be high on the corporate tax agenda for many years to come, and they are continuing to evolve at a rapid pace. Over the next year or so, we expect the following to be among the main areas of focus.

First, as in so many other areas of endeavour, the covid-19 pandemic raises new challenges for transfer pricing, and may in some cases invert the 'normal' argument between taxpayers and tax authorities. For example, will tax authorities which have previously argued that a company is not a routine service provider, and should be rewarded through a profit split, now accept that the company therefore needs to bear a share of the group's covid-19 losses? Looking further forward, the experience from the 2008 financial crisis suggests that, in the medium term, the need for tax revenues is likely to push tax authorities towards a more assertive approach in transfer pricing cases.

Second, a number of countries may see disputes over the extent to which transfer pricing can be used to recharacterise transactions, rather than merely to adjust the pricing of transactions. For example, the German courts held last year that transfer pricing rules are not limited to pricing adjustments alone; and Ireland introduced rules that enable the Irish Revenue to impose a 'substance over form' principle.

Third, the long-awaited OECD Transfer Pricing Guidance on Financial Transactions was published in February 2020. Although its immediate impact has been rather overshadowed

by the covid-19 situation, many taxpayers, and tax authorities, will need to get to grips with the potential impact of this guidance on them.

Finally, the OECD/G20 project to address the tax consequences of digitalisation continues to work towards its target of presenting an agreed solution by the end of 2020. The current Pillar One and Pillar Two proposals would, if enacted, be the most far-reaching change to transfer pricing principles in close to 100 years, and would mark a significant shift away from the arm's-length principle. The desire to shore up tax revenues in light of covid-19 may well encourage the countries that expect to be 'winners' from the proposals to push for an agreed outcome. It is worth noting, however, that the reforms will not be a silver bullet for public finances. The OECD expects the reform to increase corporate tax revenues by 4 per cent; in the UK, for example, that would raise enough money to fund the National Health Service for only one week.

We would like to thank the authors of all of the country chapters for their comprehensive and illuminating analysis of each country's transfer pricing rules; and 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 2020

# AUSTRIA

*Gerald Schachner, Kornelia Wittmann, Nicolas D Wolski and Lucas Hora<sup>1</sup>*

## I OVERVIEW

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

As a general principle, Section 8(2) of the Austrian Corporate Income Tax Act (which is also applicable to typical domestic deals) provides that constructive dividends from a corporation to its shareholders do not reduce the taxable profit of the corporation. Correspondingly, Section 8(1) of the Austrian Corporate Income Tax Act provides that constructive dividends by a shareholder to its corporation do not increase the taxable income of the corporation (which is – together with the general rules for dividend withholding tax – the basis for secondary transfer pricing adjustments; see Section VIII).

Additionally, the Transfer Pricing Documentation Act<sup>2</sup> and an implementing ordinance<sup>3</sup> were enacted in 2016 on the basis of the OECD and G20's Base Erosion and Profit Shifting (BEPS) Project,<sup>4</sup> which comprises special provisions on transfer pricing documentation for large multinational enterprises whose annual turnover exceeds certain thresholds (see Section II).

The Austrian Ministry of Finance follows the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations for the interpretation of the arm's-length principle. In general, for means of interpretation, the version of the OECD Transfer Pricing

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1 Gerald Schachner and Kornelia Wittmann are partners, Nicolas D Wolski is a senior associate and Lucas Hora is an associate at bpv Huegel.

2 Austrian Transfer Pricing Documentation Act, BGBl. I Nr. 117/2016.

3 Ordinance on the Austrian Transfer Pricing Documentation Act.  
'Verrechnungspreisdokumentationsgesetz-Durchführungsverordnung' – VPDG-DV.

4 OECD final report of 5 October 2015 relating to Action 13 'Transfer pricing Documentation and Country-by-Country Reporting'.

Guidelines that was applicable at the time of the transaction should be used. A more recent version may be used, however, at least to the extent that the more recent version does not deviate from the previous one, but clarifies and specifies it.<sup>5</sup>

Additionally, several decrees and the Austrian Transfer Pricing Guidelines 2010 have been issued by the Austrian Ministry of Finance, all of which are also based on a (dynamic) interpretation of the OECD Transfer Pricing Guidelines.<sup>6</sup> The arm's-length principle interpreted along these lines is applicable for all economic transactions between related parties (i.e., regardless of the assets transferred or services rendered between related parties).

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

## II FILING REQUIREMENTS

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

The transfer pricing documentation should comprise a function and risk analysis regarding the transactions with related parties. The documentation should include the main assets concerned, the contractual conditions agreed upon, the taxpayer's business strategy, the conditions of the market (as far as they are relevant for the pricing), and a chart detailing the position of the taxpayer in the international group.<sup>7</sup> The taxpayer is subject to an increased 'duty of cooperation' in international tax cases, which has been implemented in the national law,<sup>8</sup> but was formerly based on standing case law of the High Administrative Court.<sup>9</sup> On the basis of this increased duty of cooperation, transfer pricing documentation of foreign related parties can be requested by the Austrian tax authorities from an Austrian enterprise in an Austrian tax audit if it is relevant for the Austrian transfer pricing question.

Special rules are set out in the Transfer Pricing Documentation Act, as mentioned above. Austrian group companies are subject to the Transfer Pricing Documentation Act if

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5 See, for example, Independent Fiscal Senate, 30 July 2012, RV/2515-W/09.

6 Austrian Transfer Pricing Guidelines 2010, Paragraph 18.

7 *ibid.*, Paragraph 310.

8 Section 115(1) Federal Fiscal Procedures Act.

9 *Ritz*, Bundesabgabenordnung<sup>5</sup> Section 115(10).

they have an annual turnover of over €50 million over two consecutive years (or €5 million in commission fees from the principal). Such companies must prepare and maintain the master file or their local file and file it directly with the tax administration if so required by the competent tax authority. As far as the contents of the master file are concerned, an Austrian ordinance based on the Transfer Pricing Documentation Act follows the description in Annex I to Chapter V of the OECD Transfer Pricing Guidelines. Annex II to Chapter V of the OECD Transfer Pricing Guidelines describes which core information is expected to be found in the local file.

Large multinational enterprises with a consolidated group revenue of at least €750 million must take part in the country-by-country reporting for accounting periods beginning on or after 1 January 2016. Austrian enterprises that are required to submit a country-by-country report must do so electronically, using the standardised forms to the Austrian Tax Office of the Austrian company responsible for the report, within 12 months of the end of the accounting year (Section 8(1) of the Transfer Pricing Documentation Act). In general, the ultimate parent company of the multinational must annually file the standardised country-by-country report with its tax administration, which then distributes it to all participating jurisdictions where entities of the multinational have been set up. The Austrian Ministry of Finance must exchange the information included in the country-by-country reports 15 months after the final day of the relevant accounting year at the latest. The participating jurisdictions are listed on the OECD's website.<sup>10</sup>

If the ultimate parent company is not legally obliged to file a country-by-country report in its country of residence, the resident country is not a participating jurisdiction. If a 'systematic failure' in submitting country-by-country reports occurs, the Austrian tax administration may request, by formal decree, that an Austrian entity belonging to the multinational group take over the filing responsibility for the group, unless another entity of that multinational is prepared to replace the ultimate parent company with regard to the filing obligation.<sup>11</sup>

### **III PRESENTING THE CASE**

#### **i Pricing methods**

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

With respect to the comparability analysis, Austria strictly follows the comparability analysis of the OECD Transfer Pricing Guidelines. The Austrian Transfer Pricing Guidelines

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10 [www.oecd.org/tax/automatic-exchange/about-automatic-exchange/CbC-MCAA-Signatories.pdf](http://www.oecd.org/tax/automatic-exchange/about-automatic-exchange/CbC-MCAA-Signatories.pdf).

11 Section 5 of the Transfer Pricing Documentation Act.

describe the relevant comparability factors in Paragraph 50 as concerning the product and service,<sup>12</sup> the functions performed,<sup>13</sup> the contractual conditions agreed upon,<sup>14</sup> the market conditions<sup>15</sup> and the business strategy.<sup>16</sup>

In principle, if all methods are evaluated with more or less the same degree of appropriateness, the 'traditional methods' (comparable uncontrolled price method in the first place and then resale price method or cost-plus method based on gross margin comparisons) should be preferred compared to the 'profit methods'.<sup>17</sup> If no reliable data can be identified with respect to the gross margin, the net margin methods should be used.<sup>18</sup>

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

The cost-plus method is, in principle, applied with respect to goods and services, especially for the delivery of semi-finished products to related parties.<sup>19</sup> The Austrian Transfer Pricing Guidelines stipulate a markup of 5 to 15 per cent with respect to routine services.<sup>20</sup> A markup of more than 5 per cent is applied for high-quality services. Markups should always be determined case by case, taking into account the functions, risks borne and assets employed by the relevant tested related party. When using gross markups, comparable enterprises with the same cost base and functions must be given; for example, a routine distribution function cannot be compared with a distribution based on self-generated intangibles (e.g., owing to self-generated market access).<sup>21</sup> In some cases, a cost allocation without a profit margin is admissible for ancillary services.<sup>22</sup>

Whenever a cost-plus method is applied, all costs that are economically related to the controlled transaction (e.g., services rendered or goods manufactured) have to be included in the markup. Hence, in the case of production costs, it is not only all direct costs, but also the indirect costs incurred over the course of the production (with the exception of general overheads such as advertising expenses) that have to be taken into account.<sup>23</sup>

As regards the sale of goods, a distinction must be made between toll manufacturers and distribution companies. Whereas the cost-plus method can be used for toll manufacturers,<sup>24</sup> the resale-minus method or comparable uncontrolled price method should be used for distribution companies.<sup>25</sup> Based on comparability factors, benchmark studies are also used to find the appropriate markup. Benchmark studies are, however, usually based on net

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12 OECD Transfer Pricing Guidelines, Paragraph 1.39 et seq.

13 *ibid.*, Paragraph 1.42 et seq.

14 *ibid.*, Paragraph 1.52 et seq.

15 *ibid.*, Paragraph 1.55 et seq.

16 *ibid.*, Paragraph 1.59 et seq.

17 Austrian Transfer Pricing Guidelines 2010, Paragraph 43.

18 *ibid.*, Paragraph 43.

19 *ibid.*, Paragraph 27; OECD Transfer Pricing Guidelines, Paragraph 2.39.

20 *ibid.*, Paragraph 77 et seq.

21 *ibid.*, Paragraph 32.

22 *ibid.*, Paragraph 77.

23 *ibid.*, Paragraph 28.

24 *ibid.*, Paragraph 70.

25 *ibid.*, Paragraphs 24, 72 et seq.

margins (earnings before interest and taxes) instead of gross margins, and always require exact documentation of the comparability of the compared enterprises with special focus on functions, assets and risks.

## ii Authority scrutiny and evidence gathering

The compliance of a company with transfer pricing rules is reviewed by the tax authorities during ordinary tax audits. The competent tax authorities have the obligation to investigate the tax positions *ex officio*. For the same period, only one tax audit is admissible. The taxpayer has an increased obligation to cooperate and to fully disclose any information requested by the tax authorities in cross-border matters.<sup>26</sup> Therefore, sufficient and structured documentation on transfer pricing is mandatory to provide evidence of arm's-length pricing. Such evidence may, for example, also be obtained through expert opinions or transfer pricing studies in the case of extensive transactions. If the taxpayer violates its obligation to cooperate reasonably (e.g., no or insufficient documentation on transfer pricing is available), the tax authorities have the possibility to estimate the tax base on a reasonable basis.

## IV INTANGIBLE ASSETS

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

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

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

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26 Section 115(1) Federal Fiscal Procedures Act; *Ritz*, Bundesabgabenordnung<sup>5</sup> Section 115(10).

## V SETTLEMENTS

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

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

In addition, on the basis of double-tax treaties that include a provision that reflects Article 25(3) of the OECD Model Tax Convention, cross-border advance pricing arrangements can be negotiated by the Ministry of Finance on a bilateral or multilateral basis.<sup>27</sup> In this context, it should also be noted that Austria has signed the Multilateral Convention to Implement Tax Treaty Related Measures (known as the Multilateral Instrument (MLI)) as provided for in BEPS Action 15. Depending on the country, the standards stipulated in Articles 16 to 26 MLI may apply.

In Austria, agreement procedures of this type are initiated by the Austrian Federal Ministry of Finance *ex officio* or upon the request of a taxpayer, and can, for instance, be used to obtain matching (corresponding) adjustments in the other contracting state in the case of primary adjustments in one contracting state.

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

With respect to Member States of the European Union, Council Directive (EU) 2017/1852 on tax dispute resolution mechanisms in the European Union was transposed into national law in September 2019. This new regime provides additional effective instruments to

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<sup>27</sup> Information of the Federal Ministry of Finance, dated 31 March 2015, BMF-010221/0172-VI/8/2015.



resolve disputes concerning different interpretations and applications of bilateral tax treaties. Taxpayers facing intra-EU tax disputes may, within three years of the first notification of the tax dispute, submit a request to initiate a dispute settlement procedure. During this procedure, the Member States involved can find a common solution within two years. If an agreement is reached between the Member States, it constitutes an enforceable decision for the taxable person concerned. If, on the other hand, the Member States involved do not reach an agreement on the dispute within two years (with a possible extension of up to one year), arbitration proceedings must be carried out. The final decision by the Advisory Committee then binds the Member States involved if no agreement can be reached within a further six months.

## VI INVESTIGATIONS

The assessments of corporate income tax and value added tax (VAT) by the Austrian tax authorities, which are made annually based on the taxpayer's annual tax returns, are audited by the tax authorities *ex post* at more or less regular intervals. There are no specific time limits for the tax authorities to conduct a tax audit. Usually, a tax audit covers a three-year period for which tax returns have been filed or tax assessments issued. The taxpayer has to be informed of a tax audit at least one week before it commences, unless this would jeopardise the purpose of the audit.<sup>28</sup> Transfer pricing issues are also audited by the tax authorities in the course of the regular audits on corporate income tax or VAT returns (i.e., together with other issues of these taxes related to the audited taxpayer). Transfer pricing aspects are usually an important issue in tax audits of international groups of companies. However, in the case of a tax audit regarding an individual, a transfer pricing issue in relation to his or her position as a shareholder of a company may also come up.

The tax authorities have to investigate the facts that form the basis for taxation *ex officio*. The taxpayer has a duty to cooperate with the tax authorities and to clarify the taxpayer's standpoint, to prove the statements in the taxpayer's declarations and to provide the tax authorities with all the information required to analyse the alleged facts relevant for taxation. This includes business books, accounts and records, and the information necessary to understand the records, such as, in the case of a transfer pricing audit, adequate transfer pricing documentation. The duty to cooperate is increased in cases of international tax matters, as far as non-Austrian circumstances are concerned.<sup>29</sup>

At the end of the transfer pricing audit, the auditor discusses the tax audit's findings with the taxpayer in a final meeting. The auditor's final report (a copy of which has to be handed over to the taxpayer) is the basis for the adjusted assessment decrees issued subsequently. Upon finalisation of the tax audit, a decree on the re-opening of the original assessment and an amended tax assessment are issued by the tax authorities. Unless the taxpayer opted for a waiver of the appeal, the appeal can be lodged by the taxpayer against both the assessment decree of the tax audit and the adjusted tax assessment decrees within one month of the issuance of the decree. The period for lodging the appeal can be extended upon the request of the taxpayer. If the appeal submission period elapses without any appeal being lodged, it is

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28 Section 148(5) Federal Fiscal Procedures Act.

29 *ibid.*, Section 115(1); *Ritz*, Bundesabgabenordnung<sup>5</sup> Section 115(10).

possible to lodge an extraordinary remedy within one year of the issuance of the re-opening decree or the adjusted tax assessment decrees in the event of mistakes on the part of the tax authority as regards the legality of the decrees (but not regarding wrongful fact-finding).

## VII LITIGATION

### **Procedure**

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

Upon the filing of the administrative appeal, the tax authorities first have the option, in an administrative appeal decision, to amend or withdraw the contested tax assessment, unless the taxpayer has requested a direct referral to the Austrian Federal Fiscal Court in the appeal and the tax authorities (chose to) refer the appeal without an administrative appeal decision, or unless the appeal only pleads issues to be raised before the constitutional court (i.e., that a law is unconstitutional or an ordinance does not correspond to a law).<sup>30</sup>

An administrative appeal decision can be contested by the taxpayer in court within one month, and this period can also be extended. Upon the taxpayer contesting the administrative appeal decision, the Austrian tax authorities have to refer the case without delay to the Austrian Federal Fiscal Court, where it will be heard. Against the decision of the Austrian Federal Fiscal Court, the taxpayer can again appeal to the Austrian Supreme Administrative Court (the second-level judicial appeal is only admissible regarding matters of interpretation of tax law with fundamental importance) or the Constitutional Court (if the assessment or decision violates a constitutional right or guarantee, or an unconstitutional law was applied when rendering the contested decision).

The Austrian Federal Fiscal Court is not bound by the reasons brought forward in the appeal. The court has full power of recognition (i.e., it can either cancel the contested decree or amend it in any way, including to the appellant's detriment). The Austrian Federal Fiscal Court can examine both the fact-finding and the discretion applied by the tax authorities in relation to the fact-finding, as well as examining matters of interpretation. However, the Austrian Supreme Administrative Court (the second and ultimate judicial instance in Austria) will neither investigate the facts, nor will it review the facts and circumstances provided by the Austrian Federal Fiscal Court. If the first instance determined facts and circumstances by violating fundamental procedural rules, the decision of the Austrian Supreme Administrative Court will cancel the Austrian Federal Fiscal Court's decision and refer the case back to the first instance.

After an administrative appeal is filed, the tax authorities have to render their decision within a period of six months, provided that no direct referral was requested (see above). If the decision is not made within six months, the taxpayer is entitled to file a complaint of delay with the Austrian Federal Fiscal Court. If such a complaint is filed, the tax authorities have an additional period of three months to render their decision. The same time frame applies to the tax courts, whereby complaints of delay against the Federal Fiscal Court have to be filed with the Austrian Supreme Administrative Court. In practice, it usually takes courts more

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30 Section 262(2) and (3) Federal Fiscal Procedures Act.

time to come to their decision than envisaged by the statute. First level judicial tax procedures may take approximately from six to 30 months, depending on the competent legal office of the court and the subject matter of the case. A second level judicial appeal before the Austrian Supreme Administrative Court may take from nine to 36 months, whereas the Austrian Constitutional Court is usually quicker to decide on the claims levied that fall within the scope of its competency.

## **VIII SECONDARY ADJUSTMENT AND PENALTIES**

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

Additionally, the following 'secondary adjustments' are made:

- a* In the case of upstream or side-stream profit-shifting to a shareholder, parent or sister company a constructive dividend to the direct shareholder or parent is assumed. Alternatively, the profit adjustment may also result in a transfer pricing receivable:
- a constructive dividend to the shareholder triggers withholding tax of 27.5 per cent (37.93 per cent, if the withholding tax is borne by the company and not charged to the beneficiary of the distribution – 'cascade effect'), respectively 25 per cent (or 33.33 per cent under the cascade effect) in the case of a parent company being the direct shareholder (and treated as dividend at the level of the receiving parent company). The secondary adjustment can fully or partly be relieved according to a double-tax treaty or EU regulation such as the parent-subsidiary directive, if applicable between Austria and the state of residence of the direct parent or shareholder (if the subsidiary is resident in Austria) or the state of residence of the subsidiary (if the shareholder is resident in Austria); and
  - alternatively, the Austrian Ministry of Finance accepts that the profit shift is effectively neutralised by a transfer pricing receivable (in the case of a profit shift made) or liability (in the case of a profit shift received) versus the related party in the balance sheet of the Austrian corporation.
- b* In the case of downstream profit shifts to the direct or indirect subsidiary, the secondary adjustment is either the assumption of a constructive dividend to the subsidiary that leads to an increase of the acquisition costs of the participation at the level of the Austrian parent (for tax purposes) if the parent is resident in Austria, or capital reserve (for tax purposes) if the subsidiary receiving the advantage is resident in Austria. Alternatively, the secondary adjustment can (again) be the booking of a transfer pricing receivable and corresponding liability in the balance sheets of the related enterprises.
- c* In the event of a profit markup due to a primary transfer pricing correction, a matching corresponding adjustment can be made in the other country, in which the related party is resident. This is to avoid international double taxation under a double-tax treaty (see Section IX.ii).

If transfer pricing adjustments lead to the assessment of additional (corporate) income tax, interest for late payment of 2 per cent above the base interest rate (published by the tax

authorities) is assessed.<sup>31</sup> Interest for late payment is calculated from 1 October the following year, and is assessed for a maximum of 48 months of the tax arrears. Upon request, no interest for late payment is assessed if the taxpayer had a surplus on the tax account during the time in which the arrears accrued.

In addition, late payment penalties of 2 per cent can be assessed for arrears of VAT (or withholding tax for constructive dividends), which can be increased by two further percentage points.<sup>32</sup> Upon the taxpayer's request, no late payment penalty is imposed where the taxpayer can prove that the failure to pay the appropriate amount of tax was not the result of gross negligence. This also supports the considered view that the transfer pricing structure should be included in the transfer pricing documentation (see Section II and Section III.ii, above, for transfer pricing documentation information). In the event of deliberate tax evasion through non-compliance with the taxpayer's obligation to disclose truthfully facts and circumstances in connection with transfer pricing rules, prosecution under criminal law can arise.

## **IX BROADER TAXATION ISSUES**

### **i Diverted profits tax and other supplementary measures**

In Austria, there are currently no diverted profits taxes, as well as no BEAT or GILTI provisions in effect. Following the proposal of the European Commission for new rules regarding the taxation of digital business companies (e.g., 'Google tax'), however, the Austrian federal government announced in January 2019 its intention not to wait for co-ordinated action by the Member States but to introduce unilateral measures. The result so far has, however, only been a digital tax passed in September 2019, targeting online advertising services against consideration provided by domestic online advertising providers. In this respect, an online advertising service is deemed to be provided domestically if it is received via the device of a user with a domestic IP address and its content and design are (also) directed at domestic users. A tax of 5 per cent is levied on the consideration received by the advertising provider from its client, whereby only companies with a worldwide turnover of at least €750 million and a domestic turnover of at least €25 million from the provision of online advertising services are affected.

### **ii Double taxation**

In the case of transfer pricing adjustments in Austria, international double taxation can occur if no corresponding adjustment is made abroad in the country in which the related party is resident. It may be possible to achieve a corresponding adjustment upon the request of the related party; otherwise, the parent can request the initiation of a mutual agreement procedure under Article 9(2) OECD Model Tax Convention with the competent authority of its state of residence.<sup>33</sup> In the EU, it is possible to obtain a corresponding adjustment by means of the EU Arbitration Convention. Further, as mentioned above, there is the possibility of dispute settlement under the transposition of Council Directive (EU) 2017/1852 since September 2019.

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31 Section 135 Federal Fiscal Procedural Act; ordinance of the Austrian Ministry of Finance, dated 21 April 2016, number 010103/0072-IV/4/2016, BMF-AV Nr. 62/2016.

32 Section 217 Federal Fiscal Procedural Act.

33 Austrian Transfer Pricing Guidelines 2010, Paragraph 352.

There are no automatic matching adjustments of transfer prices by the Austrian tax authorities in cases of primary adjustments abroad. However, in the case of primary adjustments inflicted to a related party in another contracting state of a double-tax treaty, the Austrian tax authority in charge is, in principle, willing to reopen the relevant tax assessment of the Austrian related party to make a matching primary adjustment either upon request of the Austrian related party<sup>34</sup> or *ex officio*<sup>35</sup> if the Austrian related party can demonstrate and document the correctness of a transfer pricing markup made in the other contracting state.

Otherwise, a mutual agreement procedure with Austria can be initiated. The request has to be made by the parent to which a primary adjustment was made in its resident state<sup>36</sup> or in the case of transactions between sister companies in either of the resident states of the sister companies.<sup>37</sup> On the basis of the EU Arbitration Convention, it should be possible to initiate the arbitration procedure in either of the states.<sup>38</sup>

From the Austrian perspective, double taxation may be unavoidable if it is based on different interpretations of the double-taxation treaty by the contracting states and no solution can be found in a mutual agreement procedure. Furthermore, where the interpretative mismatch is due to differences between the domestic laws of the contracting states, the taxpayer's state of residence will have to provide the relief according to the method for the elimination of double taxation set out in the applicable double-taxation treaty (exemption or credit method).

### iii Consequential impact for other taxes

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

The company's deduction of input VAT is denied insofar as the price for goods or services obtained from a related party is above the market level.<sup>39</sup> The company's deduction of input VAT is denied in total for goods, assets or services, which are acquired primarily from third parties (more than 50 per cent) for the benefit of a related party.<sup>40</sup>

In the case of the sale of goods to a related party below the acquisition cost, only the difference between the sale price and the acquisition cost would be regarded as a deemed turnover subject to VAT,<sup>41</sup> whereas, in the case of a sale at or above acquisition cost, the difference to the fair market value is subject to VAT<sup>42</sup> (unless, in both cases, the place of the supply is outside Austria or an exemption applies).

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34 *ibid.*, Paragraph 324.

35 Austrian Ministry of Finance, dated 19 July 2004, EAS 2493.

36 Austrian Transfer Pricing Guidelines 2010, Paragraph 352.

37 *ibid.*, Paragraph 352.

38 *ibid.*, Paragraph 367.

39 Austrian VAT Guidelines 2000, Paragraph 1930; *Windsteig*, in Melhardt/Tumpel, UStG2 § 1, Paragraph 300; Supreme Administrative Court 27 May 1999, 97/15/0067.

40 Section 12(2)(2)(a) VAT Act; Austrian VAT Guidelines 2000, Paragraph 1929; *Kollmann/Schuchter*, in Melhardt/Tumpel (Ed) UStG2 § 12, Paragraph 202.

41 *Windsteig*, in Melhardt/Tumpel (Ed) UStG2 § 1, Paragraph 297.

42 *ibid.*

In principle, in these cases, for VAT purposes a correction of the invoice would be necessary. However, for the sake of simplicity, the Austrian Ministry of Finance accepts that increases of the taxable turnover do not have to be assessed on the occasion of a transfer pricing correction if the profit shift and the effect of the additional VAT liability is neutralised.<sup>43</sup> This is especially the case if the supply is exempt (as export or intra-community supply)<sup>44</sup> or the counterparty is entitled to an equal deduction of input VAT.<sup>45</sup> Regarding goods received from related parties of third countries, the Ministry of Finance normally dispenses with an assessment of import VAT so long as the assessment would be neutral because of a correspondingly high entitlement to deduction of input VAT.<sup>46</sup> For customs-duty purposes, transfer pricing is relevant and has been subject to increased attention by the customs authorities.

## X OUTLOOK AND CONCLUSIONS

Austria has adopted several OECD BEPS recommendations and has already implemented most of them, such as BEPS Action 13 on ‘Transfer Pricing Documentation and Country-by-Country Reporting’, in the Transfer Pricing Documentation Act and its implementing ordinance (see Section II). Austria was also the first country to sign the MLI, as provided for in BEPS Action 15.<sup>47</sup> Regarding the work of the Inclusive Framework for BEPS Action 1 (Pillar One; and Pillar Two – GloBE proposals) it is likely that the measures presented in the statement issued in January 2020<sup>48</sup> are going to be reviewed and considered as soon as final results are available.

There will be no specific implementations of BEPS Actions 8–10 with regard to transfer pricing rules on value creation. However, these Actions are already respected by the Austrian tax authorities, as they are largely reflected in the update to the OECD Transfer Pricing Guidelines, which are used by the Austrian tax authorities in their interpretation of the arm’s-length principle. As regards the provision in the BEPS Action Plan for controlled foreign company (CFC) legislation, the first CFC regime has been adopted with effect for fiscal years starting as of 1 January 2019. As provided for in the EU Anti-Tax Avoidance Directive (ATAD), low-taxed passive income (interest income, licence income, dividends, income derived from sales of shares, income from finance leasing, and income from activities of banks and insurance companies) realised by controlled corporations and permanent establishments of controlling domestic corporations becomes subject to Austrian corporate income tax. Income is considered to be low-taxed if the effective rate of taxation is less than or equal to 12.5 per cent. With respect to provisions denying the deduction of interest and royalty payments to related parties in cases where low taxation abroad is an issue, the Austrian government took the position that the Austrian rules limiting interest deduction are equally as effective as the interest deduction regime introduced by the ATAD. The EU Commission,

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43 Austrian Transfer Pricing Guidelines 2010, Paragraph 338.

44 *ibid.*, Paragraph 339.

45 *ibid.*, Paragraph 340.

46 *ibid.*, Paragraph 341.

47 *Bendlinger*, SWI 2018, 172.

48 Statement by the OECD/G20 Inclusive Framework on BEPS on the Two-Pillar Approach to Address the Tax Challenges arising from the Digitalisation of the Economy as approved by the OECD/G20 Inclusive Framework on BEPS on 29–30 January 2020.

however, took a divergent view and opened formal infringement proceedings against Austria. As of April 2020, there is still no implementation in effect and due to the recent covid-19 crisis a transposition in the near future is not foreseeable. As regards transfer pricing conflicts between jurisdictions, Austria has opted for the arbitration provision of the MLI. In its double-tax treaties, Austria has comprehensive provisions that provide for the mutual agreement procedure between contracting states according to Article 25 of the OECD Model Tax Treaty, and it is ready to further extend the arbitration procedure in treaty negotiations.

As mentioned above, adjustments in accordance with the EU Arbitration Convention are possible and Council Directive (EU) 2017/1852 on tax dispute resolution mechanisms was implemented at the end of 2019.

Finally, due to the major changes in the OECD Transfer Pricing Guidelines in recent years, it is likely that the Austrian Transfer Pricing Guidelines will either also undergo a major makeover or are going to be completely renewed. However, no specific information or timetables are available in this context yet.

# BELGIUM

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## I OVERVIEW

Although the arm's-length principle, which forms the basis of the framework of transfer pricing rules, has had a long international history, it was only explicitly introduced into Belgian legislation in 2004.<sup>2</sup> The Belgian legislature used the Organisation for Economic Co-operation and Development (OECD) Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations Guidelines (the OECD Guidelines) and the OECD Model Tax Convention as inspiration.

Belgium does not incorporate all OECD principles and guidelines into law. Nevertheless, the tax administration recognises that the latest version of the OECD Guidelines is especially relevant in practice. The tax authorities use continuously revised and updated guidelines whereby the most recent version of the OECD Guidelines was issued in 2017, including the outcomes of the final 2015 Base Erosion and Profit Shifting (BEPS) Reports on Actions 8–10 'Aligning transfer pricing outcomes with value creation' and on Action 13 'Transfer pricing documentation and country-by-country reporting'. In that respect, in the recently published Circular Letter concerning transfer pricing,<sup>3</sup> the Belgian tax authorities confirmed the application of the 2017 version of the OECD Guidelines. The tax authorities even go one step further given that the date of entry into force of the Circular Letter, published in February 2020, is set retroactively for intercompany transactions taking place as from 1 January 2018. By way of exception, some paragraphs of the Circular Letter enter into force as from 1 January 2020, mainly parts related to interpretation by the Belgian tax administration or Belgian-specific issues.

Article 185, Section 2 of the Belgian Income Tax Code (ITC) allows for a unilateral adjustment of a company's taxable basis, both upwards (Article 185, Section 2(a) ITC) and downwards (Article 185, Section 2(b) ITC). This provision is aligned to Article 9 of the OECD Model Tax Convention for transactions whereby conditions are made or imposed between two enterprises in their commercial or financial relations that differ from those that would be made between independent enterprises. Article 185, Section 2 ITC has been

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2 Article 185, Section 2 ITC, introduced by Article 2 – 21 June 2004; Law amending the Belgian Income Tax Code 1992 and the Law of 24 December 2002 amending the system for companies with regard to income taxes and instituting a system of advance decisions on tax matters, Belgian Official Gazette 9 July 2004 (ed. 1); Parl. St. Chamber, 2003–2004, 1079/1.

3 Circular Letter 2020/C35 dd. 25 February 2020 concerning guidance with regard to transfer pricing for multinational enterprises and tax administrations.



slightly revised, applicable as of 1 January 2018, to eliminate the basis for granting excess profit rulings (EPRs), which the European Commission has considered to be state aid.<sup>4</sup> The General Court of the European Union decided in February 2019 that the EPR regime is not a state-aid scheme.<sup>5</sup> The story is, however, not over since the European Commission launched in September 2019 in-depth investigations to determine whether the EPRs granted to 39 companies are in breach of the EU state-aid rules. In addition, the European Commission appealed the General Court judgment before the Court of Justice of the European Union.<sup>6</sup> In any case, the Belgian tax authorities will not re-introduce such rulings in favour of Belgian taxpayers.

The arm's-length principle is an integral part of Belgian tax legislation and applies to both legal entities and permanent establishments. In addition, Belgian law covers all types of transactions without differentiation of the nature of the transaction between associated companies, including those between two Belgian taxpayers. In this regard, it is interesting to note that some form of fiscal consolidation, impacting the level of direct taxes of Belgian taxpayers in the same group of companies, has entered into force as of fiscal year 2020.<sup>7</sup> In practice, the tax authorities tend to focus on transactions with related foreign parties.

The Belgian concepts of 'associated enterprise' and 'control' are not comparable to the terms used in the OECD Model Tax Convention and must be explained by Belgian company law. The definition of associated enterprise in the EU Arbitration Convention requires direct or indirect participation in the management, control or capital of the other enterprise. Control can be described as a power to decide or to have a decisive influence on the appointment of the majority of the directors or managers, or the course of corporate policy, whether legally or factually. Further, reference should also be made to Belgian company law<sup>8</sup> and case law for more guidance on the notion of control and other concepts, such as 'parent company', 'subsidiary', 'consortium' and 'affiliated enterprise'.

In addition to Article 185, Section 2 ITC and the recently enacted transfer pricing documentation rules,<sup>9</sup> other articles of the ITC<sup>10</sup> are relevant when performing a transfer pricing analysis in Belgium. Reference can be made to Article 26 ITC dealing with the possibility of the Belgian tax administration to add abnormal or gratuitous advantages granted to an individual or enterprise located in Belgium or abroad to the taxpayer's taxable base. Article 49 ITC sets general rules for tax deduction of expenses which require, inter alia, that the expenses relate to the taxpayer's activity and that they are incurred to maintain or increase taxable income. Articles 54 to 56 ITC contain specific rules for tax deduction of interest, royalties and some other fees. Article 79 and 207 ITC together form a specific anti-abuse provision preventing that 'abnormal or gratuitous advantages' obtained can be offset against certain tax deductions (e.g., carried-forward tax losses). High court case law

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4 Article 4 of the Programme Law dd. 17 December 2017 containing various fiscal provisions, Belgian Official Gazette, 22 December 2017.

5 Judgment in joined cases T-131/16 *Belgium v. Commission* and T-263/16 *Magnetrol International v. Commission*.

6 C-337/19 P – *Commission v. Belgium and Magnetrol International*.

7 Fiscal consolidation in Belgium is similar to a Scandinavian consolidation model whereby each group member retains its own taxable basis, but can contribute to the losses of other group members.

8 Articles 1.14–1.23 Belgian Company and Associations Code.

9 Articles 321/1–321/7 ITC.

10 These Articles were already included in the Belgian ITC before the arm's-length principle itself was included in 2004.

has confirmed that any non-arm's-length advantage received by a Belgian taxpayer has to be subject to Belgian corporate income tax in any event.<sup>11</sup> This rule may result in double taxation.

Other sources of law are the Royal Decree of 10 August 2009 and official Circular Letters,<sup>12</sup> which are administrative guidelines issued by the Belgian tax administration. These guidelines are, however, not binding sources of tax law.

## II FILING REQUIREMENTS

Belgium has introduced specific transfer pricing documentation requirements applicable as of 1 January 2016.<sup>13</sup> The Program Law, which introduced these documentation requirements, includes a three-tiered approach, aligned, allegedly (i.e., according to the legislator) with the OECD BEPS Action 13 Final Report, consisting of a Master File Form (Form 275MF), a Local File Form (Form 275LF) and country-by-country reporting. This section II will only deal with Form 275MF and Form 275LF, particularly focusing on the latter as it is to be considered an integral part of a company's tax return.

Statutory transfer pricing documentation requirements currently exist for a Belgian entity or permanent establishment when one of the following thresholds is exceeded based on its annual (unconsolidated) financial statements for the accounting period immediately preceding the most recent accounting period:

- a* operating and financial revenues<sup>14</sup> of €50 million (excluding non-recurrent revenue);
- b* a balance sheet total of €1 billion; or
- c* an annual average number of employees of 100 full-time equivalents.

Hence, the assessment of the statutory thresholds and the requirement to submit Forms 275MF and 275LF should be fulfilled every year. The content of Form 275MF is similar to the OECD content requirements. The Belgian legislator has indicated that this form can be filed by reference to a separate Group Master File, to be attached to Form 275MF. Form 275MF is not part of a taxpayer's corporate income tax return, but it should be filed with the Belgian tax authorities no later than 12 months after the final day of the applicable reporting period for the group concerned.

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

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11 Cass., 10 March 2016 TFR No. 507, p. 736.

12 Circular Letter AFZ/98-0003 dd. 28 June 1999; Circular Letter AFZ/INTERN.IB/98-0170 dd. 7 July 2000 (and addendum AFZ 6/2003 dd. 25 March 2003); Circular Letter Ci.RH.421/580.456 (AOIF 40/2006) dd. 14 November 2006; Circular Letter 2020/C/35 dd. 25 February 2020.

13 Programme Law dd. 1 July 2016, Belgian Official Gazette 4 July 2016 incorporating Articles 321/1–321/7 ITC; Royal Decrees dd. 28 October 2016 with regard to CbCR, Local File and Master File. The Programme Law is supplemented by Circular Letter 2017/C/56 dd. 4 September 2017 concerning the additional declaration obligations with regard to transfer pricing. Royal Decree dd. 29 June 2019 concerning administrative penalties; and Circular Letter 2019/C/14 dd. 8 February 2019.

14 Reference has to be made to gross revenues.

The information to be reported in Part A concerns general company information, and includes:

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

The information to be reported in Part B concerns the intra-group transactions between the local entity and its foreign affiliates, including, in particular, financial data, comparability analyses checkboxes and a selection of the most appropriate transfer pricing methods, mainly presented in table formats. The requirement for completing Part B (i.e., the detailed information form) only applies when at least one business segment of the Belgian group entity has cross-border intra-group transactions exceeding €1 million in total.<sup>15</sup>

In the optional Part C, the taxpayer may add any information that 'may be useful', such as transfer pricing studies. Looking forward, the benefits of Part C should become apparent in evaluating the level of documentation to be added by a taxpayer, as the requirements currently in place (e.g., completing lists of tables) do not provide sufficient room for the correct amount of 'storytelling', which is a key item in the revised OECD Guidelines whereby more focus is put on the global value chain within a multinational group context.

All statutory transfer pricing documentation should be electronically filed in an XML format via the 'MyMinfin' platform. This is a platform developed by the Belgian tax authorities specifically for transfer pricing documentation purposes. Guidance exists with regard to submission format and those authorised to file the transfer pricing documentation because it differs from the 'BizTax' platform (which is used for the filing of corporate income tax returns).

### III PRESENTING THE CASE

#### i Pricing methods

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

For the selection of the most appropriate transfer pricing method, no hierarchy is in place; however, in line with the OECD Guidelines, there is preference for the selection of traditional transaction methods given that they are regarded as the most direct means of establishing whether conditions in the commercial and financial relations between associated enterprises are at arm's length. The CUP method is the most preferred method where it can be

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<sup>15</sup> The Part B questions are mandatory as of 1 January 2017.

applied in a reliable manner, but based on experience, the TNMM method is used in many cases since it often proves to be the only method that can be applied in practice. TNMM is also accepted by the tax authorities, in particular for tangible goods and services transactions.

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

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

## **ii Authority scrutiny and evidence gathering**

The Belgian tax authorities are increasingly interested in global tax transparency as it would ease their access to the relevant information thanks to the successful exchange of information between various jurisdictions and the availability of the information included in country-by-country reporting, which is mandatory in Belgium for multinational group companies with consolidated annual group turnover equal to or exceeding €750 million. The impact of the huge flow of data available at the level of the tax authorities will become apparent in the coming years. Similarly, an increased number of joint or multilateral transfer pricing audits can also be expected.

Taxpayers must be attentive to the information requested by the tax authorities, especially in relation to information for which they have no need-to-know basis, such as group information documented outside Belgium. The tax authorities tend to request group information regarding multinational groups headquartered abroad, or specific company information on foreign group companies that are Belgian counterparties. Specific procedures exist regarding such requests for information, regulating the exchange of information between the tax authorities concerned, which are carried out through Federal Public Services Foreign Affairs. Therefore, in certain circumstances, the taxpayer can refuse to provide the requested information to the tax authorities, although this may negatively impact the relationship between the taxpayer and the tax authorities (who therefore may want to scrutinise the taxpayer's situation more deeply).

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

Furthermore, based on Belgian tax law,<sup>16</sup> witnesses can be heard. Although hearing witnesses is not common practice in transfer pricing cases, it is possible from a legal perspective. The same applies for the use of expert witnesses – other than the taxpayer’s own advisors – in pre-litigation transfer pricing discussions. Hence, during pre-litigation (or even litigation) transfer pricing discussions, the advice of expert witnesses might be invoked in theory, but note that transfer pricing litigations before a court are rather uncommon in Belgium.

#### **IV INTANGIBLE ASSETS**

Neither Belgian tax law nor administrative guidelines include specific provisions with regard to dealing with intangibles from a transfer pricing perspective. Nevertheless, the development, enhancement, maintenance, protection and exploitation (DEMPE) functions, as recently introduced by the OECD in the framework of the BEPS project, are taking precedence when assessing the correct transfer price to be applied, especially given that Belgium closely follows the OECD Guidelines. Therefore, it is highly recommended that taxpayers ensure a transfer pricing set-up in accordance with the DEMPE functions with regard to intangibles. Consequently, a taxpayer having only the pure legal ownership of an intangible, without being the economic owner significantly involved in the DEMPE functions, should be entitled to a relatively small (passive) return. The economic owner, assumed to have sufficient substance to demonstrate it is actively involved in the DEMPE functions, should be entitled to intangible-related (non-routine) returns.

#### **V SETTLEMENTS**

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

The Service for Advanced Decisions, an autonomous service of Federal Public Service Finances (FPS Finances), provides advance decisions on all questions relating to the application of tax law, including transfer pricing provisions. An advance decision provides legal certainty as it is binding for all services of FPS Finances (including the inspection services).<sup>17</sup>

A formal advance pricing agreement can only be requested for a transaction that has not yet taken place, namely, a transaction related to a fiscal year that is not formally closed. Therefore, a settlement outside the formal advance pricing agreement cannot automatically be incorporated in an advance pricing agreement.

#### **VI INVESTIGATIONS**

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

This RFI, in general consisting of a standard questionnaire, is sent annually to approximately 250 multinational companies, mostly in the first months of each year. As of

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<sup>16</sup> Article 325 ITC.

<sup>17</sup> For more information on the procedures of obtaining an advance decision in Belgium, see [www.ruling.be](http://www.ruling.be).

the beginning of 2020, new tax and transfer pricing audits have been initiated, and there is a tendency to limit the traditional standard questionnaires but to have tailor-made questionnaires on information included in the transfer pricing documentation and country-by-country reporting filed (and therefore at the disposal of the tax authorities). As a consequence, the bulk of questionnaires will be spread more evenly throughout the year instead of being sent within the first months. To select companies, the Belgian tax authorities use data-mining techniques and employ software tools to carry out a risk-assessment exercise. The indications are that companies incurring structural losses, undergoing business restructurings or having a presence in tax havens or low-tax-rate countries, or companies with declining results, are potential targets. Nevertheless, all taxpayers might be subject to a tax or transfer pricing audit and receive a RFI, going from large multinational companies to small and medium-sized enterprises. The likelihood of being selected as a targeted company increases each year given that the STPT is growing by hiring additional inspectors. Furthermore, inspectors of the Large Companies<sup>18</sup> team will be responsible for both transfer pricing and international tax audits. The STPT trained them to get up to speed on transfer pricing-related issues. Finally, the Special Investigation Squad has also been trained by the STPT to cover transfer pricing-related matters.

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

The audited taxpayer should generally reply to the RFI within one month. In practice, an extension of this deadline can be requested if the taxpayer is able to provide legitimate reasons for the non-timely provision of the requested information. Usually, an extension of a maximum of one additional month is granted; however, no formal timing is included in Belgian tax law on this matter. The taxpayer can, therefore, only count on the willingness of the tax inspector.

Before formally submitting the requested information, the taxpayer can request a pre-audit meeting with the inspector to define and discuss the scope of the transfer pricing audit. This pre-audit meeting might give an interesting opportunity for the audited taxpayer to set the scene of the audit and to provide an oral presentation of the company and its business, which may help the tax inspector in the reading and interpretation of the written reply to the RFI. Nevertheless, one should be careful, as the pre-audit meeting cannot serve as a fishing expedition and the inspector might invoke all information received or noticed during the meeting (e.g., when visiting the audited company). This pre-audit meeting should take place within the initial term of one month (or the extended period) as it does not suspend this term.

Once the written reply to the RFI has been submitted, there is no period fixed in Belgian tax law for the tax authorities to take a position in the transfer pricing audit. In general, there is a back-and-forth communication between the inspectors and the audited taxpayer, consisting of additional information requests, follow-up meetings, etc., before a final position is taken. Typically, this process takes almost one year, but may be longer or

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<sup>18</sup> A company is considered a large company (and thus falling within the purview of the Large Companies team) when it exceeds at least two of the following thresholds: annual average full-time equivalents of 50 employees; annual turnover, excluding VAT, of €9 million; or a balance sheet total exceeding €4.5 million.

shorter depending on the complexity of the file. This can lead to uncertainty for the taxpayer. Again, there is no time limit within which the tax inspectors should take their final position; they are bound only by the Belgian statute of limitations, which is of three years.<sup>19</sup>

The next and, in principle, last step in the audit process is the receipt of the notice of adjustment, sent by the tax authorities to the audited taxpayer. This notice amends the taxpayer's taxable base as declared in its tax return.<sup>20</sup> The taxpayer then has one month to react promptly to this notice of adjustment, a term that can be extended if there are legitimate reasons. The tax inspectors' final position is made available in the final assessment, which includes the justification of their opinion and should take into account any relevant comment made by the taxpayer.

Thereafter, the taxpayer has six months to file an administrative claim before the General Administration of Taxes. The decision of the General Administration of Taxes, explaining sufficient and sound reasons for the taxation, is addressed to the taxpayer. Notwithstanding the fact that the taxpayer has a strict time limit to lodge the administrative appeal, again, the General Administration of Taxes is not bound by any time limit. This may again cause uncertainty at the level of the taxpayer. To avoid further delay, the taxpayer can start a judicial procedure before the Court of First Instance after a six-month term passed without final decision of the General Administration of Taxes. If the General Administration of Taxes did not process the administrative appeal during the six-month period and assuming that the taxpayer launched the judicial procedure, the General Administration of Taxes is no longer competent to decide, and the case is submitted to the opinion of a judge.

## VII LITIGATION

### i Procedure

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

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19 Pursuant to Article 354, Paragraph 1 ICT the period during which the tax authorities are authorised to perform a tax audit and adjust the taxable basis is three years (with the exception of cases of fraud, where the statute of limitations is extended to seven years), starting from the first day of the assessment year, at least for companies whose financial year correspond to the calendar year.

20 Article 346 ITC.

**ii Recent cases**

Belgium does not have a long history of transfer pricing in its tax law. Therefore, court decisions on this subject are rather scarce. In most cases, in part because taxpayers do not want to enter into an open-ended (and, for sure, long) process, transfer pricing audits are closed by an agreement. From a legal perspective, all parties are allowed to invoke expert witnesses during the litigation, but the court will take the final decision.

**VIII SECONDARY ADJUSTMENT AND PENALTIES**

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

Failure to submit statutory transfer pricing documentation on time may result in administrative penalties ranging from €1,250 to €25,000. These penalties will only apply as of the second infringement, unless it can be proven that the violation is made in bad faith or with tax avoidance purpose. Moreover, it is expected that the likelihood of a transfer pricing audit increases by non-compliance with the new transfer pricing documentation requirements. Further, specific consequences are inherently linked to the non-submission of Form 275LF, as it is considered by the Belgian tax authorities to be an integral part of the corporate income tax return. As well as administrative penalties or tax increases that may apply in cases of late or incomplete filing, there may, from a procedural perspective, be significant consequences (e.g., if the local form is incomplete, the tax authorities could consider that the corporate income tax return is not correctly filed). In such cases, the Belgian tax authorities could send *ex officio* assessments to the taxpayer which add an incomplete Form 275LF to its corporate income tax return.<sup>21</sup>

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

Recently, a new measure was introduced as part of the Belgian corporate tax reform. As of financial year 2018, the tax adjustments imposed by the tax authorities after an audit will be effectively taxed, since the increase of the taxable basis linked to an audit can no longer

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



be sheltered with available tax deductions (e.g., current year losses). This rule applies if a tax increase of at least 10 per cent is effectively applied. However, current-year dividend-received deduction on inbound dividends can still be offset against the increase of the taxable basis.

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

## **IX BROADER TAXATION ISSUES**

### **i Diverted profits tax and other supplementary measures**

Belgium does not have any diverted profits tax in its legislation. The recent introduction of controlled foreign company (CFC) provisions in Article 185/2 ITC seems to capture partly the same goal, given the increasing focus on substance and, hence, taxable presence as one of the criteria to determine that the applications of CFC are relevant key functions.

### **ii Double taxation**

There is no doubt that transfer pricing adjustments can trigger double taxation in the case of an upward adjustment. Belgian taxpayers facing the issue of double taxation can invoke the relevant double-tax treaties (DTT), which have been concluded by the Belgian state with foreign jurisdictions explicitly for the avoidance of double taxation. Most of the DTTs entail a mutual agreement procedure (MAP), whereby the treaty partners are encouraged to endeavour to resolve the case by mutual agreement by entering into negotiations with their respective competent authorities. Despite encouraging both treaty partners' efforts towards achieving resolution, the majority of DTTs do not stipulate an obligation to come to an agreement effectively eliminating double taxation. As a precaution against the possibility of disagreement between the competent authorities of the treaty partners, some DTTs (although these are the exception rather than the norm, notwithstanding the Belgian model tax convention) include an arbitration clause whereby a final and binding decision on the elimination of the double taxation is taken by an independent arbiter. In this respect, when ratifying the multilateral instrument, Belgium opted to implement mandatory binding arbitration as a dispute resolution mechanism in the event no solution is found through a mutual agreement procedure within a certain timeframe.

For EU Member States, the arbitration resolution mechanism is regulated in the EU Arbitration Convention, whereby taxpayers can impose the binding opinion of an independent advisory body upon the competent authorities of the treaty partners.

### **iii Consequential impact for other taxes**

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

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

adjustments, consider up front the impact on their VAT and customs duties to avoid difficult discussions with the VAT and customs tax authorities, as these issues are gaining increasing attention from the Belgian tax authorities. In this respect, the Circular Letter concerning customs value<sup>22</sup> provides additional guidance on the interaction between transfer pricing and customs value, stating, for example, that a transfer pricing study can serve as proof that the transaction value is not affected by the fact that parties are related.

## **X OUTLOOK AND CONCLUSIONS**

The key outlook for future transfer pricing concerns the significantly increased focus of the Belgian tax authorities on: (1) the access to a huge data flow from the exchange of information with foreign jurisdictions and statutory documentation requirements; (2) the additional number of trained members of the STPT; (3) the involvement of the large companies' team to perform tax and transfer pricing audits; and (4) the training of the Special Investigation Squad. Therefore, it is crucial to not consider transfer pricing as a (tax-) juridical or economic issue, but consider from the outlook one's optimal legal-economic position in an integrated manner.

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

In conclusion, Belgian taxpayers are urged to put transfer pricing high on their agenda. The OECD's work on developing proposals to address the challenges of the digitalised economy – better known as Pillar One and Pillar Two proposals – should also be closely monitored by taxpayers. As an OECD member, Belgium contributes to the discussions held at the Inclusive Framework level, but will probably not take any individual initiative to implement a digital tax (unlike, e.g., France, Italy and Spain). Belgium will more than likely follow the EU law initiative in this respect.

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22 Circular Letter 2018/C/9 concerning customs value dd. 24 January 2018.

# BRAZIL

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## I OVERVIEW

Brazil only introduced transfer pricing regulation in the mid-1990s. The concern to properly tax profits from transnational businesses emerged immediately after Brazil began taxing Brazilian companies on income derived from activity carried out abroad, in a clear move from territorial to worldwide taxation.

Inspired by international practices, Brazil enacted transfer pricing control through Law No. 9,430 of 1996, with the aim of assessing whether the prices applied in transactions with certain foreign parties corresponded to market parameters. The Law's main purpose is to avoid Brazilian companies improperly reducing the amount of their returns subject to Brazilian corporate income tax, which comprises corporate income tax and the social contribution on profits (collectively CIT).

Over the years, several pieces of legislation on this topic have been introduced by federal authorities, resulting in a thorough, almost exhaustive legal framework, aspects of which have faced legal challenges in the courts.

Brazilian transfer pricing rules are mainly focused on Brazilian corporations. Trusts do not exist under Brazilian law and, although resident individuals fall within the scope of the rules governing persons, in practice there are no rigid filing requirements to make the rules enforceable for individuals. The exclusion of Brazilian individuals from any tight transfer pricing control may derive from the complexity of the rules and the fact it is not common practice to have individuals directly carrying on substantive, high-level international activities.

The rules apply to transactions between Brazilian persons and foreign directly or indirectly related parties, as well as to foreign deemed-related parties (entities resident in tax havens or that make use of privileged tax regimes). There is a separate set of rules dealing with transactions between Brazilian corporations and other parties domiciled in Brazil (in relation to disguised distributions of profits).

There are several situations in which persons abroad are considered related to a Brazilian entity, including the following:

- a* the entity has its head office or branch abroad;
- b* the parent company or controlling individuals are resident abroad;
- c* the entity has subsidiaries or associated companies abroad;
- d* where any company under common corporate or administrative control, or with at least 10 per cent of the capital held by the same person, is resident abroad;
- e* its exclusive agents or distributors are resident abroad; and

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- f the person that granted the Brazilian entity exclusive agency or distribution rights in Brazil is resident abroad.

As well as having a legally defined concept of tax havens or low-tax countries (mainly jurisdictions that tax income at rates of up to 20 per cent), Brazil also applies a blacklist to countries actually considered tax havens. A couple of years ago, Ireland was listed as a tax haven, while Switzerland was recently excluded from this list. The inclusion of a country on the Brazilian blacklist may trigger an impact on tax far beyond that of transfer pricing rules.

On top of that, foreign entities are deemed to make use of privileged tax features if incorporated under certain (tax) regimes in Austria, Costa Rica, Denmark, Iceland, Malta, the Netherlands, Portugal, Singapore, Spain, Switzerland, the United States and Uruguay. The privileged tax regime classification has implications mainly only for transfer pricing.

In a deviation from the international practices followed in Organisation for Economic Co-operation and Development (OECD) countries, Brazilian transfer pricing legislation sets objective parameters to regulate the prices used with foreign related or deemed-related parties. In some circumstances, the methodology formulated to implement the arm's-length principle may not be considered totally at arm's length according to international best practice. For example, Brazilian legislation does not regulate the deduction limits of transactions concerning royalties and technical, scientific and administrative assistance, which are subject to specific, restrictive parameters. Also, there is no provision in law for transactional profit methods, secondary adjustments, settlements or advanced pricing agreements (APAs).

Furthermore, the best-method rule is not applicable, meaning that Brazilian taxpayers may freely choose a suitable method, namely the one that results in making the least transfer pricing adjustment. Brazilian legislation also provides for safe harbours to exclude either the application of transfer pricing rules themselves or the need for adjustments under certain circumstances. This affords Brazilian transfer pricing rules a high level of administrability, simplicity and feasibility, compared with practices in more developed countries.

The OECD TP Guidelines are not used or accepted by Brazilian tax authorities and courts, although the intensification of the movement of Brazil towards the OECD is forcing rule makers to rethink transfer pricing legislation and its compatibility with OECD standards. The launch in December 2019 of the joint report *Transfer Pricing in Brazil: Towards Convergence with the OECD Standard*, by the Brazilian tax authorities and OECD, constitutes a major step towards a near-future convergence with the TP Guidelines.

The legislation is not applicable to corporate transactions such as dividend distributions, or Brazilian unique interest on equity payments and capital contributions. However, in view of the recent decision by the tax authorities that capital contributions through the assignment of rights by foreign shareholders are subject to tax, the extension of the transfer pricing regime to this kind of transaction may be considered in the near future.

Given that there are restrictive methods in place and several types of major transaction are excluded from the transfer pricing regime, multinational groups must be careful to devise the most suitable planning strategy to distribute returns abroad, otherwise several constraints may apply. The accounting positions that they adopt will play an important role in determining the tax consequences for Brazilian corporations.

Brazilian transfer pricing rules present various peculiarities, which makes them complex and somehow unclear. Over the years, the tax authorities have contributed to creating this uncertainty by issuing regulations aspects of which have been challenged before the administrative and judicial courts as being legally deficient.

## II FILING REQUIREMENTS

Transfer pricing regulation is carried out annually (the tax period is generally the calendar year). On 31 December of each year Brazilian entities are required to make the necessary tax adjustments to the prices and costs registered in their accounting books in connection with transactions performed with foreign related and deemed-related parties.

Relevant information on methods used and corresponding tax adjustments, if any, are rendered in the corporate tax return (ECF) filed in July of the following year. In the ECF, taxpayers are obliged to present preliminary information concerning parties, transactions, prices, methods and tax adjustments.

There is, however, no requirement to file beforehand a thorough, detailed report demonstrating all calculations and supporting documentation. Evidence that taxpayers are fully compliant with transfer pricing rules is only required during a tax inspection, when competent authorities scrutinise the documentation supporting the companies' position.

In the context of concessions made to the OECD Base Erosion and Profit Shifting (BEPS) Action Plan, Brazil introduced country-by-country reporting a few years ago, with country-by-country reports (CBCRs) having to be included in the ECFs filed by certain entities. The CBCR mainly concerns information rendered by controlling Brazilian companies about their group, profit allocation and activities undertaken in countries where the group has a material presence. Groups with a global gross income below the threshold of €750 million are generally excused from the CBCR filing requirement.

Further, corporations whose gross income from foreign related and deemed-related parties is not lower than 90 per cent of the transactions concluded domestically with unrelated parties are also excused from this obligation once no transfer pricing adjustment applies to them. This safe harbour is not applicable to the negotiation of commodities. Also, when controlled export revenues are not representative, or demonstrate a certain level of profitability, there is no transfer pricing adjustment; in these situations, there is no filing requirement.

Although resident individuals are theoretically included in the personal scope of Brazilian transfer pricing rules, they are not required to submit any specific transfer pricing-related information in their annual individual tax return (DIRPF). Individuals must file their DIRPF for the previous year by the end of April.

## III PRESENTING THE CASE

### i Pricing methods

Four methods apply to import transactions and five methods cover export transactions of goods, rights and services. Methods are conceptually similar to traditional methods within OECD practice, despite their several particularities. No transactional methods (transactional net margin or profit split) are provided or allowed under Brazilian transfer pricing rules.

There is no best-method rule under Brazilian legislation. With exceptions for transactions with commodities (for which there are specific import and export methods) and royalties, and technical, scientific and administrative assistance (where restrictive deduction limits apply under a separate set of rules), taxpayers are free to choose transfer pricing methods, and may opt for an applicable method that generates the lesser adjustment, or even no adjustment.

The method chosen by taxpayers shall be used throughout the tax year for the same type of transaction (product by product).

Methods derive from three distinct elements aimed at achieving arm's-length pricing: uncontrolled or independent price, cost, or resale price.

The import parameter price to be compared with the acquisition cost of imported goods, rights and services consists in the following:

- a Compared independent price (PIC): the average of uncontrolled transactions with identical or similar goods, rights or services between unrelated parties under similar payment conditions.
- b Quotation price on imports (PCI): the daily average of the quotation of commodities listed in internationally recognised exchanges.
- c Production cost plus profit (CPL): the average production cost abroad, plus taxes and charges imposed by the foreign country, and a profit margin of 20 per cent.
- d Resale price less profit (PRL): the average resale price for transactions with unrelated purchasers, less unconditional discounts granted, taxes and contributions on sales, commissions and brokerage fees, and a profit margin of between 20 per cent and 40 per cent depending on the business developed.

The export reference price to be considered against the revenue obtained from the sale of goods, rights and services is determined as follows:

- a Export sales price (PVEx): the average sales price on exports to unrelated parties in connection with identical or similar goods, rights or services during the same tax year and under similar payment conditions.
- b Quotation price on exports (PECEX): the daily average of the quotation of commodities listed in internationally recognised exchanges.
- c Purchase or production cost plus taxes and profit (CAP): the average price of acquisition or production costs of exported goods, rights or services, plus taxes charged in Brazil and a 15 per cent profit margin.
- d Wholesale price in the destination country, less profit (PVA): the wholesale market price of identical or similar goods sold in the wholesale market of the country to which the product is exported under similar payment conditions, less sales taxes in that country and a 15 per cent profit margin.
- e Retail price in the destination country less profit (PVV): the average price of identical or similar goods sold between unrelated parties in the retail market of the country to which the product is exported under similar payment conditions, less sales taxes in that country and a 30 per cent profit margin.

In summary:

Criteria	Import methods	Export methods
Uncontrolled price	PIC – compared independent prices PCI – quotation price on imports	PVEx – export sales price PECEX – quotation price on exports
Cost	CPL – production cost plus profit	CAP – purchase or production cost plus taxes and profit
Resale price	PRL – resale price less profit	PVA – wholesale price in the destination country less profit
		PVV – retail sale price in the destination country less profit

In general, a divergence of up to 5 per cent between the price used and the reference price determined using the foregoing methods is accepted. Adjustments are only required if the difference between prices exceeds 5 per cent. If the transaction concerns commodities controlled under PCI or PECEX, the maximum acceptable divergence margin is 3 per cent.

When it comes to export transactions, it is important to add that no transfer price assessment is required in the following situations: (1) where the gross income from transactions with products other than commodities is not lower than 90 per cent of the price used with unrelated parties in the domestic market; (2) where the gross income derived from transactions does not represent more than 5 per cent of the total revenues registered by the company; or (3) where profitability from the transactions is not lower than 10 per cent, unless the total controlled export gross income is higher than 20 per cent of total revenues.

Although in theory it is generally feasible to opt for any one of the available transfer pricing methods, several practical restrictions on the taxpayer's choice usually arise in certain situations.

Methods that rely on the actual existence of identical or similar goods, rights or services are strictly limited to goods, rights and services that are also negotiated with unrelated parties. However, this level of comparison is often unfeasible in some multinational groups, especially in industries with patent-protected products. An example is the high-end technology industry.

For methods based on costs, a detailed description and breakdown of the costs and expenses involved is often not possible because of accounting differences and mismatches between countries, and more frequently on account of internal or external confidentiality reasons.

Resale price methods mandatorily require the existence of subsequent uncontrolled transactions concerning the goods, rights or services under scrutiny. This may create hurdles either because a resale does not occur or because a related party abroad is not able or willing to disclose information on subsequent transactions.

Because of difficulties related to the identification of comparables, and to the disclosure of foreign costs and complex costs information required by tax authorities, the most used method to assess import transactions in Brazil is PRL, which requires an actual resale to a third, independent party.

For exports, the most used Brazilian method is the cost-based CAP, which takes the Brazilian company's cost as the basis for the reference price to be compared with the transaction price. Other methods are less feasible because of the difficulty either in identifying comparables or in obtaining data on resale transactions carried out overseas by other parties.

Interest arising from financial agreements entered into between a Brazilian person and related or deemed-related parties are also subject to transfer pricing rules.

The control of interest through financial instruments is also based on strict, objective parameters. Nonetheless, following amendments introduced a few years ago, Brazilian legislation appears to achieve more accurate market parameters for financial transactions than for business and commercial transactions.

The established base interest rates are:

- a* for prefixed transactions in US dollars, the market rates of Treasury bonds issued by the Brazilian government abroad in US dollars;
- b* for prefixed transactions in Brazilian reais, the market rates of Treasury bonds issued by the Brazilian government abroad in Brazilian reais; and
- c* for other situations, the London Interbank Offered Rate (LIBOR) for six months.

A spread periodically fixed by the Brazilian government shall be added to the rate above to determine the maximum deductible financial expense, or the minimum taxable financial revenue in Brazil. Spreads currently in place are 3.5 per cent for interest expenses and 2.5 per cent for interest revenues.

## **ii Authority scrutiny and evidence gathering**

Considering that the Brazilian approach to transfer pricing is grounded in objective methods and predetermined margins, with no room for transactional methods, tax authorities are not concerned with scrutinising taxpayers' position in relation to foreign companies of the same group.

Except for situations where the adoption of a method requires the analysis of documents and supporting materials from other entities of the same multinational group, Brazilian tax authorities normally do not make requests connected to them. No powers are granted by law for tax authorities to discuss a situation with witnesses or third parties, or even to oblige taxpayers to produce witnesses or documentation outside Brazil. This includes the impossibility of discussing transfer pricing matters with tax authorities by using expert witnesses in a pre-litigation stage.

Unless fraud or dissimulation is alleged, the scrutiny generally concerns ordinary documents normally issued by corporations in connection with their businesses and commercial transactions. Besides, Brazilian rules allow taxpayers to rely on other documents to sustain their tax position, such as official publications and reports and research carried out by distinguished institutions, namely the OECD and WTO.

Confidentiality is a serious issue whenever the adoption of methods that require foreign documents comes into play. Several multinational groups prefer not to disclose confidential data to their Brazilian subsidiaries, even at the cost of an improvement in their tax position. This is why methods such as CPL (for import transactions), and PVA and PVEX (for export transactions) are not used much in practice, since they require the disclosure of foreign information and documents that are very often deemed confidential.

An important confidentiality concern was raised a few years ago with the introduction (and ongoing implementation) of CBCRs. Although in principle CBCRs may not be publicly disclosed, the possibility of leakages of information, due either to information technology complications or wilful misconduct, has resulted in mistrust of CBCRs and this poses the main challenge to their full adoption in practice.

In relation to CBCRs, it is important to highlight that the information they contain is unlikely to be used by tax authorities for transfer pricing scrutiny purposes, as the transfer pricing regime is based on the predetermined margin methods currently in place. It is possible, however, that in future CBCRs may be used to challenge the substance of foreign structures, or even to re-evaluate periodically the appropriateness of the exclusive grounding of the Brazilian transfer pricing regime in traditional methods.

## **IV INTANGIBLE ASSETS**

Intangibles pose a myriad of challenges to transfer pricing control worldwide. In a best-case scenario, tax administrations would accurately require, and have the instruments to ensure, that multinational groups are appropriately attributing the returns derived from the exploitation of a certain intangible to the right entities. Functions, assets and risks (FAR) would then be analysed in combination with the development, enhancement, maintenance, protection and exploitation (DEMPE) of the intangible. However, this is not what occurs in Brazilian practice.

In Brazil, royalties associated with several modalities of intangibles, along with fees for technical, scientific and administrative assistance, are excluded from the transfer pricing regime. There is no need to demonstrate where the substantive activities of developing, supporting or exploiting the intangible asset are carried out to justify the prices applied.



Although transfer pricing is not applied to the remittance of royalties, there are predetermined limits for the deduction of payments in connection with trademarks, patents and know-how abroad. Royalties may only be deducted from 1 per cent to 5 per cent of the net sales income obtained from the provision of products or services connected with the underlying intangible. The exact applicable percentage depends on the nature of the intangible (e.g., 1 per cent applies to royalties for trademarks).

This approach is clearly not in accordance with the arm's-length principle; however, courts have consistently validated the legality of these parameters.

For import transactions Brazil adopts rigid, restrictive percentages, the use of which is separate from the transfer pricing regime; however, the export of intangibles presents taxpayers with the challenge of having to apply traditional transfer pricing methods to evaluate the adequacy of the price applied.

Methods that require the analysis of uncontrolled prices, costs or resales are not adequate for intangible transactions. An intrinsic characteristic of most intangibles is that they do not have comparables. Few intangibles are marketed with independent parties, and cost is not a good basis for evaluating the contribution each business unit may have made in developing a certain intangible. As Brazilian legislation does not provide for transactional methods, the assessment of intangibles in export transactions is extremely challenging. Notwithstanding this, intangibles export transactions are not very common in a developing-country context.

The maintenance of this simplistic approach to intangibles over the decades may be justified by Brazil's position as a developing country and the lack of a wide range of qualified information, technology and know-how available to tax authorities for the proper identification of an accurate return to be allotted to Brazilian functions, assets and risks.

## **V SETTLEMENTS**

The Brazilian transfer pricing framework is still very poor regarding the interaction between taxpayers and authorities to resolve complex situations. Taxpayers cannot rely on specific settlement provisions to pre-empt tax assessments or provide more certainty about the taxpayer's transfer pricing position.

In this regard, there is no legal provision for APAs in Brazil. It is only possible to consult tax authorities about the interpretation of certain legal provisions by filing requests for rulings. This procedure, however, does not grant taxpayers the option of getting together with the competent authorities to predetermine methods, margins, reach and exceptions for certain commercial and business situations.

Although settlements and APAs do not exist, taxpayers may request a change of margin under the PRL method by arguing, and demonstrating, that the predetermined margin allocated to its sector is not applicable in practice. Such a request has to be addressed to the government's Minister of Treasury and assessed accordingly; however, this mechanism has not been used successfully by taxpayers yet.

## **VI INVESTIGATIONS**

Tax authorities have up to five years to open and close transfer pricing investigations into taxpayers, and issue tax assessments, as the case may be.

The tolling of the five years varies according to the character of the transfer pricing context: (1) in regular situations, the five-year term starts from the taxable event (31

December of each year under scrutiny); (2) in situations where fraud, wilful misconduct or dissimulation is demonstrated, tax authorities have about one year more, as the five-year term starts on 1 January of the second year following the tax period under scrutiny.

In general, tax investigations start with a first notification to the taxpayer, warning that its transfer pricing adjustments for a certain year (or years) is under scrutiny. In such a notification, tax authorities normally request documents and information concerning the assessment to be carried out. Other notifications may follow depending on the taxpayer's response and the authorities' findings over the course of the investigation.

No settlements are possible, even if during a formal inspection the tax authorities identify mistakes or controversial application of the rules in force. Any disagreement on methodology or calculations shall lead to a formal tax assessment, charging the deemed underpaid Brazilian CIT, plus interest (calculated using the official index, Selic) and penalties (75 per cent, or 150 per cent in cases of fraud, wilful misconduct or dissimulation). Tax assessments must either be paid within 30 days (with a 50 per cent discount on the penalty imposed) or challenged by the taxpayer at administrative or judicial level.

## **VII LITIGATION**

### **i Procedure**

Transfer pricing litigation may be conducted at the administrative or judicial level. Taxpayers are free to choose the level at which they want to make their case against the tax authorities' assessment.

Generally, litigation starts at the administrative level and, if necessary, proceeds to the judicial level. This is because taxpayers lose the right to have the same matter heard at the administrative level if they start the challenge in the judicial courts and the courts present an objection. An unappealable administrative decision favourable to taxpayers is definitive, therefore the Treasury is not entitled to challenge it in the judicial courts afterwards. Conversely, if taxpayers lose the challenge at the administrative level, they are still able to make their case before the judicial courts.

The administrative challenge does not require the taxpayer to offer any guarantees or security, and concerns two different levels of analysis by Ministry of Treasury governmental bodies. Although the judges are not as independent as career judges, they are generally more technically prepared to handle complex tax matters such as transfer pricing.

At the first administrative level, a tax authority council (DRJ) analyses the assessment in light of the arguments and documents presented by the taxpayer. It is rare for a DRJ to cancel tax assessments, unless the assessment identifies a flagrant error. The DRJ's decision may trigger the following consequences: taxpayers may either appeal an unfavourable decision or terminate the process by paying the outstanding debt (or even starting judicial litigation at this early stage); and decisions unfavourable to the Treasury concerning amounts above 2.5 million reais are subject to mandatory review by the Tax Appeals Board (CARF).

The second administrative level deals with the adjudication of taxpayers' appeals or mandatory reviews of CARF decisions unfavourable to the Treasury. This administrative court is composed of members jointly representing both the Treasury (through career tax authority judges) and the taxpayers (through judges nominated by industry bodies representing myriad sectors). Although CARF's composition is jointly representative of both Treasury and taxpayers, in tie situations the vote of the president (always a career tax authority judge) prevails. Adjudication may be carried out in the lower and the higher chamber.

At the judicial level, the transfer pricing lawsuit is first assessed and decided by a single judge, then the case is scrutinised by the court, as in a taxpayer's appeal or a mandatory review of a decision against the Treasury. The High Court of Justice and the Supreme Court may review all the decisions whenever there is a legal or constitutional matter raised by the parties (no factual analysis is allowed at this stage).

In judicial litigation, taxpayers are required to offer guaranties (court deposit, bank letter and real estate assets are the most usual) to avoid having patrimonial constraints.

During the administrative or judicial litigation, taxpayers may strengthen their case by using different means of proof produced by third parties. Because Brazilian transfer pricing rules have objective parameters, taxpayers generally use expert legal opinions (normally prepared by scholars) either to reinforce their position or to discredit any restrictive application of the rule by the treasury. Tax authorities normally rely only on their own assessments.

## **ii Recent cases**

There have been several cases of transfer pricing-related litigation over the years following Brazil's enactment of transfer pricing rules in 1996. These cases were mainly considered at the administrative level.

It is difficult to refer to specific taxpayers' cases in Brazilian case law, as there are a number of similar cases representing administrative or judicial challenges to certain positions imposed by tax authorities. Therefore, reference is made here to court positions addressing relevant matters that have been considered over the years.

A broad international taxation issue is the discussion of the compatibility of Brazilian rules with Article 9 (associated enterprises) of double-tax treaties because predetermined margins represent a deviation from the arm's-length price demanded by Article 9. CARF maintains the firm position that there is no conflict between domestic rules and Article 9 of double-tax treaties.

CARF has also decided that tax authorities are not obliged to adopt a method that is more favourable to the taxpayer in the course of inspections if the taxpayer has not indicated any method in its return ECF, or if the method indicated in the ECF is not suitable for a particular transaction. Furthermore, CARF has consistently stated that during an administrative tax proceeding the taxpayer is not able to change or indicate another transfer pricing method in relation to the challenged transactions.

In relation to the utilisation of the methods themselves, the discussions have been primarily focused on the legality of restrictive interpretations enacted by tax authorities in regulations concerning the PRL method. The two main discussions undertaken at the administrative level related to calculation particularities concerning the method (proportional calculation and inclusion of freight and insurance in the assessment), and in both cases CARF decided against the taxpayer.

The judicial courts are still at an incipient stage of analysis of these issues.

## **VIII SECONDARY ADJUSTMENT AND PENALTIES**

There are no secondary adjustment mechanisms in the Brazilian transfer pricing framework.

In cases where adjustments are imposed to reflect, from a tax perspective, a more appropriate price, the legislation does not entitle tax authorities to require secondary adjustments to correct the price differences arising.

This means that transfer pricing adjustments result in a mismatch between tax and accounting books. Consequently, the amounts overpaid or under recognised in controlled transactions may not be treated as deemed dividends or loans to related or deemed-related persons abroad.

## **IX BROADER TAXATION ISSUES**

### **i Diverted profits tax and other supplementary measures**

Brazil has still not introduced a specific diverted profits tax or other measure as part of its response to the BEPS project.

No mechanisms have been created to counteract arrangements aimed at diverting profits under the specific circumstances that such a tax would address. Currently, the sole consequence of base erosion arising from artificial arrangements is the readjustment of the taxable basis subject to Brazilian CIT.<sup>2</sup>

### **ii Double taxation**

Brazilian legislation is very rigid when it comes to transfer pricing control. Traditional methods based on predetermined margins leave almost no flexibility to conduct the FAR analysis in the most tax-efficient way.

In several situations, the Brazilian approach leads to overpayment or underpayment of taxes. While administration of the relevant rules is relatively easy, this regime very often fails to produce the fully arm's-length pricing that more flexible, transactional methods would achieve. This is particularly the case as Brazil does not include Article 9(2) of the OECD Model Convention in its double-tax treaties. This Article provides a mechanism for making correlative or corresponding adjustments in one country following adjustments imposed by authorities of the other contracting country.

Until a few years ago, there were neither mechanisms provided by treaties nor unilateral measures to counteract economic double taxation. In general, Brazilian rules do not authorise the tax administration to rely on adjustments imposed by authorities of other countries, which follow a different set of rules.

Notwithstanding this, Brazil has implemented in domestic law the mutual agreement procedure (MAP) contained in double-tax treaties. The domestic legislation refers to the possibility of applying the MAP to transfer pricing matters involving different countries. It remains to be seen whether the Brazilian authorities are actually willing to adopt the MAP in practice or whether this is only a political approach forced by the BEPS scenario. To date, there have been no known cases in which the MAP has been successfully applied in Brazil.

While binding arbitration could be an interesting solution to double taxation issues in some situations, the use of arbitration in tax matters is far from becoming a reality in Brazil. The current understanding is that arbitration would demand a waiver of rights connected with taxation and the Brazilian Constitution would not allow such a situation in tax matters. Arbitration, therefore, may not be invoked.

### **iii Consequential impact for other taxes**

Rules only concern CIT and do not interact with legislation related to import duties, such as customs valuation, and value added tax (VAT).

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<sup>2</sup> Namely IRPJ and CSLL.

Although the purpose of transfer pricing for import transactions and customs valuation is materially the same (the reach of the appropriate arm's-length price on imports), there are two incommunicable sets of rules dealing with these matters separately.

Likewise, any import or export transaction adjustments to CIT taxable bases do not have any impact whatsoever in relation to Brazilian federal, state and local VAT.

This Brazilian approach results in several inconsistencies from a tax standpoint; even the nature of Brazilian federalism and the existence of taxes at three different administrative levels (federal, state and local governments) do not justify this approach, as most customs duties and VAT are administered at the same federal level, which implements transfer pricing rules for CIT purposes.

## X OUTLOOK AND CONCLUSIONS

Brazilian transfer pricing rules are already two decades old, but they still struggle to adhere to the OECD Guidelines and align with the transfer pricing practice of developed countries.

The major consequence of this is the detachment from the arm's-length principle in Brazilian practice in several circumstances: (1) through the use of traditional methods only, and disallowing transactional methods; (2) through the adoption of predetermined margins, without thorough regard to functions, assets and risks; and (3) through the imposition of a rigid, inconsistent set of rules, other than transfer pricing, to assess the deduction of royalties.

Despite this, Brazilian transfer pricing rules are easier to manage both from the taxpayer's and the tax administration's perspectives. No comprehensive economic analyses and reports are needed, as the safe harbours and fixed margins make implementation of the legislation simple compared with what would be required under the OECD settings.

Brazilian legislation provides more certainty and effectiveness for the parties involved, although litigation proceedings frequently arise from the restrictive interpretations enacted periodically by tax authorities. The lack of APAs and settlement mechanisms contributes negatively to most of the discussions currently held in administrative and judicial courts.

The still recent introduction of CBCRs in Brazil poses a question about whether the transfer pricing framework may change in the near future. The information contained in a CBCR is not of much use in a system based on traditional methods and predetermined margins. Perhaps, however, this is a first step towards either improving the system and providing for a wider range of fixed margins, or rebooting it by introducing transactional methods.

In December 2019, the Brazilian tax authorities intensified Brazil's movement towards TP Guidelines standards by launching, together with the OECD, the joint report *Transfer Pricing in Brazil: Towards Convergence with the OECD Standard*. The report concerns the joint assessment of the similarities and differences between the Brazilian and OECD frameworks, and creates milestones and ideas for an imminent change in Brazilian legislation to mitigate existing gaps and divergences. Competent authorities have committed to a full alignment with the OECD, either immediate or gradual over a period of years. Guidance on the next steps is expected soon.

The Brazilian approach to the Inclusive Framework Pillar One and GloBE proposals is also still awaited from the tax authorities.

# CYPRUS

*Kyriacos Scordis and Costas Michail<sup>1</sup>*

## I OVERVIEW

As an internationally recognised business centre, Cyprus is a jurisdiction largely compliant with Organisation for Economic Co-operation and Development (OECD) standards, as recognised in the latest OECD progress report,<sup>2</sup> and as such follows many of the OECD principles and practices, including the ‘separate legal entity’ approach, which is broadly accepted internationally (see the OECD definition of the international arm’s-length principle).<sup>3</sup>

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

The OECD has, over the years, produced the Transfer Pricing Guidelines<sup>4</sup> and several reports refining their application and broadening their scope. The most recent and comprehensive reports comprise the Final Reports on BEPS Actions 8–10,<sup>5</sup> which largely revise the previous Transfer Pricing Guidelines with the stated aim of taxing profits where economic activities take place and value is created, giving particular weight to the party undertaking and managing economically significant risks. In addition, the OECD issued for the first time additional Transfer Pricing Guidelines on financial transactions, in February 2020.

The OECD’s work in this area (i.e., the OECD Transfer Pricing Guidelines and reports) underpins the arm’s-length principle incorporated in the OECD Model Tax Convention<sup>6</sup> 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 to either domestic or cross-border transactions.

The OECD Model Tax Convention contains the arm’s-length principle under the heading ‘Associated Enterprises’ (Article 9),<sup>7</sup> which states:

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1 Kyriacos Scordis is the managing partner and Costas Michail is a director at Scordis, Papapetrou & Co LLC.

2 Cyprus was rated Largely Compliant in the Phase 2 Peer Review Report of the Global Forum on Transparency and Exchange of Information for Tax Purposes.

3 OECD Model Tax Convention, Article 9.

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

5 OECD/G20 Base Erosion and Profit Shifting Project: Aligning Transfer Pricing Outcomes with Value Creation: Actions 8–10: 2015 Final Reports.

6 OECD Model Tax Convention, Article 9.

7 See footnotes 3 and 4.

*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<sup>8</sup> provides the following:

(1) *Where—*

- (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 businesses;*

*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 note that this definition includes what are described as 'corporations' in other jurisdictions).

Companies, pursuant to the Law, are defined to include under Article 2:<sup>9</sup>

*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 Member States]; but it does not include a partnership.*

Additionally, the Income Tax Law and relevant regulations also explicitly stipulate that certain transactions should abide by comparable open-market terms. These transactions include,

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8 Article 33, Income Tax Law of 2002, 118(I)/2002, as amended, CTR Publications Ltd.

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

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'.<sup>10</sup>

The Cyprus arm's-length principle is in line with the international arm's-length principle that governs controlled transactions and facilitates potential compensating adjustments in the context of investigations into the tax affairs of taxpayers. It should be noted that the arm's-length principle governs a wide range of trading and business transactions but generally does not apply to transactions involving 'uncontrolled relations' or of a capital gains nature involving immovable property located in Cyprus.

In 2017, Cyprus issued detailed transfer pricing regulations governing financial back-to-back (BtB) controlled transactions (the BtB Regulations)<sup>11</sup> (see below). Aside from these regulations, Cyprus has yet to issue detailed transfer pricing guidelines concerning controlled transactions, although in practice the principles underlying the OECD Transfer Pricing Guidelines are commonly cited to support the set transfer price in controlled transactions, in tax examinations; or to potentially initiate a conventional advance ruling application process (although a sophisticated advance pricing arrangement does not exist).

Touching briefly on empirical tax audit cases involving conditions underlying controlled transactions that deviate from open-market terms, the tax authorities do not hesitate in making upward adjustments to the taxable income of a Cyprus company in the absence of satisfactory evidence or an economic and commercial rationale underpinning concluded controlled transactions.

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 tax authorities weigh up the case 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 generally to fall within a reasonable range of expected prices after considering relevant economic circumstances, functions performed, assets used and risks assumed.

It is expected that Cyprus's transfer pricing regulations will be expanded to cover a broad range of items and transactions. This will be achieved either through the enactment of new legislation incorporating transfer pricing regulations or by the Tax Department's Commissioner of Taxation (the Commissioner) issuing a revised transfer pricing decree. The guidance is expected to be aligned with the OECD Transfer Pricing Guidelines<sup>12</sup> (even if in a simplified form). In the interim, the discussion in this chapter is based on the arm's-length principle found in Cyprus law and how transfer pricing applies in practice, and on the BtB Regulations.

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

11 Cyprus Tax Department Circular EE 3.

12 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (July 2017 edition).



## **II FILING REQUIREMENTS**

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

In an exception to the above, and as already noted, financial BtB controlled transactions are explicitly governed by the BtB Regulations and the taxpayer should prepare a transfer pricing study supporting any such transactions. Currently, a transfer pricing study should only be submitted if requested by the tax authorities<sup>14</sup> in the context of a future tax audit or if the taxpayer seeks to commence an advance ruling application process.

However, the general rule applies, namely that the taxpayer has a general obligation under the law<sup>15</sup> 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 transfer pricing applied in controlled transactions.

The evidentiary documentation should be maintained for a period of seven years<sup>16</sup> (including the current year) at the premises of the taxpayer and should be available for any tax audit initiated by the tax authorities.

## **III PRESENTING THE CASE**

### **Pricing methods**

Currently, Cyprus law does not provide guidance on transfer pricing or the methodology to be used in determining the transfer price in a particular controlled transaction. However, the use of or reliance upon the OECD Transfer Pricing Guidelines (albeit in a more simplistic form) by the taxpayer will generally be accepted by the tax authorities.

Thus, at present, and until transfer pricing regulations are issued, taxpayers should expect the traditional transaction methods<sup>17</sup> generally to apply to transfer pricing cases; this methodology consists of the comparable uncontrolled price method using comparables or near comparables, the resale price method, and the cost-plus method. Occasionally it may suffice for the controlled transaction to have implicit or explicit underlying economic and business reasoning within the context of the contemplated controlled transactions.

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

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

14 Cyprus Tax Department Procedural Circular 5, dated 2 January 2019.

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

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

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

### ***Financing arrangements (provision of loans to related parties)***

Financing arrangements such as the provision of loans to related parties mainly make use 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 particular financing arrangement.

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

### ***BtB controlled transactions***

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

- a* Functionality Analysis, concentrating on the functions, assets and risks that the Cyprus company undertakes to perform its financial business; and
- b* Comparability Analysis, by way of which the conditions and circumstances of the BtB arrangement should be consistent with the comparable conditions of a BtB transaction in an uncontrolled transaction.

#### *Functionality Analysis*

The authorised OECD guidance on permanent establishments (PEs) of banks<sup>18</sup> may be used as a reference point when assessing the functionality of BtB financing of a Cyprus company. This guidance provides a variety of elements that can be used to assess the functions, risks and assets of a PE maintained by a bank, some of which can be applied by analogy to companies even if the object of the transfer pricing analysis is not a bank or a regulated financial institution.

#### *Comparability Analysis*

Moving to the methodology that may be deployed to implement comparability, the trend is to establish the spread on an arm's-length basis that would have applied to the BtB company. In other words, 'rewarding' the BtB company for maintaining sufficient own capital to absorb the future expected loss. This in turn entails:

- a* the determination of the expected loss; and
- b* establishing a market return by using the Capital Asset Pricing Model.

The determining of the expected loss inextricably leads to the determination of the own capital which the company should retain to absorb expected losses, and in this respect the

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18 OECD, *Report on the Attribution of Profits to Permanent Establishments* (2008, 2010), Part II: Special Considerations for Applying the Authorised OECD Approach to Permanent Establishments (PEs) of Banks.

BASEL framework may be applied by analogy. In addition, a key component for determining the expected loss is the use of probability of defaults. The probability of default may be measured by using the credit score models used by credit agencies such as S&P's and Moody's.

Simplification measures also apply, whereby pure intermediary financing vehicles may opt in to these measures and be released from the requirement to perform a comparability analysis. Notwithstanding this, the intermediary financing company should still perform a functionality analysis demonstrating that it undertakes related functions, assets and risks.

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

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

### ***Buying or selling of goods or services***

Transactions involving the buying or selling of goods or services predominantly use a cost-plus or similar method,<sup>19</sup> whereby one applies a reasonable (near arm's-length) gross profit margin or, occasionally, if these services constitute low value-added services, a thin margin earned on the cost incurred for performing this service may suffice.

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

Similarly, if the company is a limited distributor, determined by reference to its limited functions, and risks assumed as well as assets used (not creating or owning any intangible), the common approach is to apply a reasonable gross profit margin. Occasionally, a similar to resale price methodology may apply instead.

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

### ***Transactions involving non-business assets that produce exempt income in Cyprus***

The business and commercial rationale underlying a transaction is very important in relation to the tax impact (and treatment) that may result from any potential 'secondary adjustment' (see below), but not regarding the tax treatment of the transaction itself, which is exempt.

In this respect, it is advisable that transactions involving non-business assets that produce exempt income in Cyprus, such as foreign dividend income<sup>20</sup> or capital gains on sale of corporate titles,<sup>21</sup> are underpinned by a sound business and commercial rationale

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

20 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.

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

relative to the overall context in which they occur. It may be advisable for the taxpayer to obtain an advance tax ruling: an application that sets out the specific facts and circumstances underlying the transaction and seeks the opinion of the tax authorities.

#### IV INTANGIBLE ASSETS

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

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

The tax 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 is no specific oversight on the basis of DEMPE<sup>22</sup> principles and general principles apply. It is expected that transfer pricing regulations will be issued by the tax authorities, which will potentially mark a change in the current approach of both the tax authorities and potentially the taxpayers in controlled transactions. In fact, the tax authorities recently issued a circular<sup>23</sup> stating that for the determination of 'embedded income'<sup>24</sup> 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 in the broader context of settlements with the tax authorities following an examination of the financial (tax) returns of the taxpayer. In this respect, the settlement would involve an agreement on, inter alia, the historical 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 to historical transactions) and not *ex ante*.

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22 Development, enhancement, maintenance, protection and exploitation of intangibles.

23 Tax Department Circular 2017/4.

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

In practice, however, unless a tax ruling can be obtained on the issue (see below), historical settlements may be taken as constituting a precedent and be followed in subsequent years, assuming no substantial change in the applicable facts and circumstances. However, nothing prevents the tax authorities from revisiting, and disregarding, the position taken in prior years.

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

As it stands, the tax authorities<sup>25</sup> will abide by their rulings if the circumstances and parameters on which the conventional ruling is based remain substantially the same. It is expected that the tax authorities will soon extend the scope of the conventional tax ruling process to include transfer pricing studies for financial BtB transactions.

## VI INVESTIGATIONS

The law generally grants the right to the tax authorities to assess a taxpayer's tax return after the applicable submission deadline<sup>26</sup> and to issue a notice of assessment to the taxpayer stating the tax authorities' agreement or disagreement with the tax return submitted.<sup>27</sup>

Likewise, the law provides the taxpayer with the right to dispute an assessment, in which case the objection should be filed by end of the next month, specifying the reason for the objection.<sup>28</sup> Following submission of an objection, the tax authorities and the taxpayer usually exchange views (at meetings or by correspondence), which invariably involves the taxpayer providing additional documentation to support the taxpayer's case.

In the absence of detailed or specific provisions governing transfer pricing investigations, the general provisions of the law also apply to those disputes regarding a set 'transfer price' in which the tax authorities, upon issuing an assessment, potentially challenge the underlying terms of a controlled transaction; the taxpayer should be able to demonstrate to the satisfaction of the tax 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 and the economic and commercial rationale underlying the controlled transactions, and should furnish the tax authorities with these. The tax authorities generally review the documentary evidence provided by the taxpayer detailing the determined transfer price, and they will accept it if it is reasonable and justifiable in light of the specific economic circumstances or in accordance with the OECD reports and Transfer Pricing Guidelines. The tax authorities generally accept near comparables that illustrate that the determined transfer price is within a reasonable range.

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25 Tax Department Circular 2015/13.

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

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

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

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

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

## VII LITIGATION

In the event that a taxpayer wishes to challenge the findings, position or tax assessment of the tax authorities on a specific matter, he or she may apply to the Tax Tribunal<sup>29</sup> or the Supreme Court,<sup>30</sup> or both.

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

The Tax Tribunal will examine the application of the claimant and request a report from the tax 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.

Should any of the parties disagree with the decision of the Tax Tribunal, they may seek recourse to the Supreme Court. If the taxpayer disagrees with the decision, the taxpayer must pursue this action within 75 days of either final notification of the assessment or the issue of the Tax Tribunal decision. The burden of the proof should lie with the taxpayer. Recourse to the Supreme Court is brought under Article 146 of the Cyprus Constitution. The Supreme Court will assess the validity of the Commissioner's decision, but if this is found to be reasonable, the Court will not quash the decision.

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.<sup>31</sup>*

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

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

31 *Costas M Pikis v. The Republic* (1965) 3 CLR. 131, at 149.

Transfer pricing matters are also governed by the above rules; therefore, if the taxpayer and the tax authorities cannot reach an agreement on a controlled transaction, the taxpayer may find recourse to either the Tax Tribunal or the courts, or both.

## VIII SECONDARY ADJUSTMENTS

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

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

## IX BROADER TAXATION ISSUES

### i Diverted profits tax

The arm's-length principle in Cyprus law does not apply to transactions where no controlled relation exists between the parties or to certain transactions that constitute capital transactions.

Although there is no specific diverted profits tax provision, the law enshrines the following general anti-avoidance tax provisions (from the Assessment and Collection of Taxes Law and the Capital Gains Tax Law respectively), which govern applicable situations and complement the arm's-length principle.

*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.<sup>32</sup>*

*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.<sup>33</sup>*

In addition, the new EU Anti-Tax Avoidance Directive (effective from 1 January 2019) may be employed to deny a tax benefit or recharacterise transactions in the event that 'an arrangement or a series of arrangements' is intended, exclusively or mainly, to exploit tax incentives.<sup>34</sup>

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32 Article 33, Assessment and Collection of Taxes Law of 1978, 4/78, as amended, CTR Publications Ltd.

33 Article 9(4), Capital Gains Tax Law, CTR Publications Ltd.

34 Article 6, EU Directive, 2016/1164.

## ii Double taxation

Cyprus has a very broad tax treaty network and generally applies the mutual agreement procedure (MAP) in response to its obligations under its bilateral double-tax treaties (which are mainly based on the OECD Model Convention – therefore giving effect to the specific OECD MAP Article 25, where applicable) or the EU Arbitration Convention<sup>35</sup> pursuing the elimination of double taxation.

Prima facie, the MAP procedure may also be invoked in the context of primary adjustments under transfer pricing for the corresponding adjustment to apply, thereby eliminating or mitigating the possibility of double taxation.

Currently, there is limited practical experience of invoking an MAP for transfer pricing. In addition, the Income Tax Law<sup>36</sup> provides that if the tax authorities make an upward adjustment to a taxpayer's tax calculation during their audit, a corresponding downward adjustment should also be made 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 calculation if, under the normal rules, the subject matter of the corresponding adjustment would have qualified for deduction.

In providing for such a corresponding downward adjustment to be made, 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 in Cyprus law is in line with the international arm's-length principle as envisaged in the relevant OECD Model Convention and Transfer Pricing Guidelines, and it governs controlled transactions in Cyprus; indeed, in practice, the tax authorities accept transfer pricing studies indicating that the set transfer price is not affected by the connection between the parties in a controlled transaction.

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

As a result, the process is relatively less cumbersome from the perspective both of the taxpayer (with regard to preparing and furnishing adequate evidentiary documentation underpinning a set controlled price) and of the tax authorities (with regard to using their limited resources to rigorously examine a particular controlled price), especially where transactions occur primarily within the context of small or medium-sized businesses.

The anticipated issuance of Cyprus regulations stipulating the nature of transfer pricing documentation and methodology to be followed will mark a shift in the tax authorities' current approach, as these will require per se specific documentation to be in place and a certain methodology to be applied with regard to controlled transactions.

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35 Convention 90/436/EEC; CRS decree 161/2016 implemented the automatic exchange of financial account information for Cyprus financial institutions.

36 Article 33(5), Article 9(1)(e), Income Tax Law of 2002, 118(I)/2002, as amended.



# DENMARK

*Martin Bay and Henrik Stig Lauritsen*<sup>1</sup>

## I OVERVIEW

Danish tax legislation contains two sets of primary provisions governing transfer pricing.

First and foremost, Article 2 of the Danish Tax Assessment Act contains the Danish arm's-length provision according to which related parties are obliged to act as if the parties were independent. Corporate bodies are generally considered related for transfer pricing purposes if they are controlled, directly or indirectly, by the same group of shareholders. In this context, control usually implies control over more than 50 per cent of the votes. Shares owned by non-related parties are included in the 50 per cent assessment if there is an agreement establishing joint control over the corporate bodies in question.

In the legislative preparatory work, it was specifically stated that Article 2 shall be interpreted in accordance with the Organisation for Economic Co-operation and Development Transfer Pricing Guidelines (the OECD Guidelines), and the Danish tax authorities generally recognise the link to the OECD Guidelines and as such also acknowledge the principles set out in them.

If Article 2 of the Danish Tax Assessment Act is applicable, all actions between the related parties are covered.

Articles 37 to 52 of the Danish Tax Control Act govern provision of information to the Danish tax authorities about controlled transactions and the preparation of transfer pricing documentation, including country-by-country reporting. See below for a more detailed description of the reporting and documentation requirements.

## II FILING REQUIREMENTS

Pursuant to the Danish Tax Control Act, corporate bodies subject to Danish tax must report the nature of controlled transactions (e.g., interest and royalties) and the aggregate volume of such transactions when submitting their Danish tax return.<sup>2</sup> Reporting is done electronically and the deadline for reporting is linked to the deadline for submitting the tax return.

Furthermore, pursuant to the Tax Control Act, corporate bodies covered by the Danish transfer pricing legislation must prepare and maintain written documentation (transfer pricing documentation) describing how prices and conditions between the related parties

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1 Martin Bay was at the time of writing a lawyer, and Henrik Stig Lauritsen is a partner, at Horten Law Firm. The information in this chapter is accurate as at June 2019.

2 Skattekontrolloven § 38.

have been decided upon.<sup>3</sup> The transfer pricing documentation must be of a quality that allows the tax authorities to assess whether the prices and conditions applied to controlled transactions are of an arm's-length nature.

It is further specified in the accompanying administrative act that the transfer pricing documentation must contain both a master file containing a general description of the group, corporate bodies, nature of transactions and global presence, etc. and a local file containing country-specific information about the local specific corporate bodies.<sup>4</sup> In general, the Danish master file and local file requirements are identical to the recommendations set out in the OECD Guidelines.

The transfer pricing documentation can be prepared in Danish, Norwegian, Swedish or English. The transfer pricing documentation must be prepared on an ongoing basis and written documentation must be in place when the tax return is filed. The transfer pricing documentation must be delivered to the Danish tax authorities within 60 days of receipt of its request.

In addition to the transfer pricing documentation, a Danish ultimate parent company must prepare and file country-by-country documentation if the consolidated annual group turnover exceeds 5.6 billion Danish kroner. The Danish requirements for the country-by-country documentation are identical to the OECD standards.

The country-by-country documentation is prepared in an XML format and must be submitted within 12 months of the end of the income year concerned. It is recommended that the country-by-country documentation is prepared in English because the report is exchanged between tax authorities.

### III PRESENTING THE CASE

#### i Pricing methods

According to administrative guidelines issued by the Danish tax authorities, the transfer pricing methods generally recommended by the OECD Guidelines are also acknowledged under Danish transfer pricing regulations.<sup>5</sup> As such, the traditional transfer pricing methods (comparable uncontrolled price, resale price and cost-plus methods) as well as the transactional transfer pricing methods (transactional net margin and profit split methods) are all accepted by the Danish tax authorities. Furthermore, transfer pricing methods that are not mentioned by the OECD Guidelines can be applied if they provide a reliable result. In practice, however, the OECD recommended methods are applied.

In principle, all methods can be applied equally. However, where traditional transfer pricing and transactional transfer pricing methods are considered equally applicable, traditional transfer pricing methods are recommended over transactional methods. Similarly, where the comparable uncontrolled price method is considered applicable given the reliable data available, it is recommended over the cost-plus and resale price methods.

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3 Skattekontrollloven § 40.

4 Bekendtgørelse om dokumentation af prifsastsættelsen af kontrollerede transaktioner, BEK nr 1297 af 31/10/2018.

5 SKAT's Juridiske Vejledning C.D.11.4.

Regardless of which transfer pricing method is considered most reliable, the backbone of the application of the transfer pricing method is the comparability analysis.<sup>6</sup> The Danish tax authorities generally apply the comparability factors described by the OECD:

- a* the characteristics of the property or services transferred;
- b* the functions performed by the parties (taking into account assets used and risks assumed), in relation to the controlled transaction, an examination of which is often referred to as a 'functional analysis';
- c* the contractual terms of the controlled transaction;
- d* the economic circumstances of the parties; and
- e* the business strategies pursued by the parties in relation to the controlled transaction.

The local file must contain a detailed description of the comparability analysis for each category of controlled transaction.

## **ii Authority scrutiny and evidence gathering**

Despite the significant focus on transfer pricing by the Danish tax authorities, and the number of transfer pricing audits conducted over the past years, surprisingly few cases have been brought before the courts.

During the transfer pricing audit, the Danish tax authorities may pay attention to the country-by-country report but the basis for the transfer pricing audit is the transfer pricing documentation prepared by the taxpayer. The tax authorities will scrutinise the transfer pricing documentation, including scrutinising the selected comparable entities and transactions.

In general, the transfer pricing audit is handled between the tax authorities and the taxpayer. The tax authorities will generally not engage in discussions with third-party witnesses nor will they expect the taxpayer to do so. The transfer pricing audit process is always initiated by the tax authorities requesting the transfer pricing documentation from the taxpayer. The tax authorities do not engage in down raids or similar confrontational initiatives.

As already mentioned, the basis for the transfer pricing audit is the transfer pricing documentation prepared by the taxpayer. The transfer pricing documentation must be of a quality that allows the tax authorities to assess the arm's-length nature of the transactions covered. In general, when making a transfer pricing adjustment, the tax authorities must prove that the transactions concerned are not on arm's-length terms. However, if the transfer pricing documentation is not prepared, or is prepared inadequately, the tax authorities can make a discretionary adjustment to the taxpayer's income.

A decision to adjust the taxable income must be issued no later than 1 August in the sixth year following the end of the income year under consideration.

Transfer pricing audits do not follow a set cycle, and selection of corporate bodies for audits is random. However, in the current environment, corporate bodies exceeding a certain size should probably expect a transfer pricing audit every three to five years.

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<sup>6</sup> SKAT's Juridiske Vejledning C.D.11.5.

## IV INTANGIBLE ASSETS

The administrative guidelines issued by the Danish tax authorities concerning intangible assets specifically refer to Chapter VI of the OECD Guidelines.<sup>7</sup>

When defining intangible assets, the administrative guidelines refer to Section 6.6 of the OECD Guidelines. Hence, an intangible asset is defined as something that is not a physical asset or a financial asset, that is capable of being owned or controlled for use in commercial activities, and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances.

It is recognised that the circumstances concerning transfer pricing related to intangible assets give rise to difficulties in the sense that it is often impossible to identify comparable transactions between unrelated parties. That said, regardless of the difficulties concerning identification of uncontrolled comparables, transactions concerning transfers or use of intangible assets must be handled under the principles set out in Chapters I to III of the OECD Guidelines.

According to the administrative guidelines, attention should be paid to the economic ownership as opposed to the legal ownership. Economic ownership is assessed by identifying the intangibles used or transferred in the transaction with specificity and the specific, economically significant risks associated with the development, enhancement, maintenance, protection and exploitation of the intangibles (known as the DEMPE principles).

With regard to selection of the most appropriate transfer pricing method to analyse the arm's-length nature of transactions involving intangible assets, it is specified in the administrative guidelines that the residual profit cannot per se be allocated to the owner of the intangible asset. Selection of the most appropriate transfer pricing method must be based on a thorough analysis of the corporate bodies in the group entitled to receive profits from the intangible asset. In practice, the comparable uncontrolled price method and the profit split method are generally recognised as the most appropriate transfer pricing methods in relation to transactions involving intangible assets, whereas the resale price method and the transactional net margin method are generally not considered appropriate.

## V SETTLEMENTS

In Denmark, the taxpayer has a variety of options to settle transfer pricing matters with the tax authorities. First of all, the taxpayer has the option to apply for a binding ruling from the tax authorities. When applying for the binding ruling, the taxpayer must disclose all relevant information to the tax administration. When issued by the tax authorities, the ruling is binding to the tax authorities. Normally the binding rulings are published (anonymously).

Supplementarily to the domestic binding ruling the taxpayer may ask the tax authorities to enter into negotiations to obtain an advance pricing agreement on a bilateral or multilateral basis. It is a precondition for obtaining an advanced pricing agreement that the negotiations are supported by the relevant double-tax conventions in place. Obtaining an advance pricing agreement may be time-consuming and burdensome but provides great comfort for the taxpayer, and the Danish tax authorities are generally proactive in this regard.

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<sup>7</sup> SKAT's Juridiske Vejledning C.D.11.6.

## VI INVESTIGATIONS

The assessment of transfer pricing compliance is done randomly. Initially the tax authorities will request the taxpayer's transfer pricing documentation for the relevant income years. A transfer pricing audit typically covers two to four income years but can also relate to one single transaction (e.g., a transfer of intellectual property). Upon receipt of request for the documentation, the taxpayer has 60 days to deliver the transfer pricing documentation to the tax authorities.

Upon receipt of the transfer pricing documentation, the tax authorities will issue a letter of intent if they intend to adjust the taxable income of the corporate bodies under scrutiny. The corporate bodies will be able to comment on the letter of intent but, needless to say, the tax authorities are not bound by such comments. Ultimately the tax authorities will have to issue a final decision before 1 August in the sixth income year following the year under scrutiny.

The taxpayer may appeal the decision to Tax Appeals Agency.<sup>8</sup>

## VII LITIGATION

### i Procedure

If the taxpayer has received an assessment adjusting its taxable income and the taxpayer disagrees with the assessment it may lodge an appeal to the Tax Appeals Agency. The Tax Appeals Agency is an independent authority that handles appeals against decisions made by the Danish tax authorities.

The appeal must be filed within three months of the tax authorities' decision to adjust the income.

Once the Tax Appeals Agency receives the appeal from the taxpayer, it will collect the relevant information, including supplementary information from the taxpayer and the Danish tax authorities. The taxpayer may discuss the case and documentation provided with the person handling the appeal.

When the Tax Appeals Agency has all necessary documentation, it will prepare the case and pass it on to a regional appeals board or the National Tax Tribunal for decision. Only in rare circumstances will the Tax Appeals Agency decide the case on its own. Upon the taxpayer's request, the taxpayer and his representatives may present the case in person before the decision-making agency.

The decision made by the National Tax Tribunal or other decision-making agency may be appealed to the Danish court.

### ii Recent cases

Only a few cases have been decided by Danish courts. In practice, many transfer pricing cases are settled in agreements between the taxpayer and the tax authorities, ultimately through initiating a mutual agreement procedure to avoid double taxation.

However, the Danish Supreme Court recently published its decision in the *Microsoft* case,<sup>9</sup> in which the tax authorities had disregarded the transfer pricing documentation prepared by Microsoft and adjusted the taxable income on a discretionary basis. The Supreme

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<sup>8</sup> Landsskatteretten.

<sup>9</sup> SKM2019.136.HR.

Court found that for the tax authorities to disregard the transfer pricing documentation it must be of a quality similar to what would be available had documentation not been prepared at all.

The case lasted a total of 10 years, across three different courts. During the handling of the case, the transfer pricing legislation has been amended several times and the implications of the judgment can therefore be debated. However, the case will have a definitive impact on transfer pricing adjustments made under the old rules. Furthermore, the case does provide some guidance as to the quality of the transfer pricing documentation, and it is expected that the tax authorities will be more reluctant to adjust the taxable income of Danish entities on a discretionary basis in future.

## VIII SECONDARY ADJUSTMENT AND PENALTIES

Provided that the tax authorities find that the Danish entity has not acted on arm's-length terms and conditions when dealing with related parties, the tax authorities will adjust the income of the Danish entity to reflect arm's-length terms and conditions (primary adjustment).

If a foreign related party is subject to a primary adjustment, the Danish tax authority will follow up with a corresponding adjustment at the level of the Danish corporate body if the Danish tax authorities agree to the primary adjustment. Hence, the primary adjustment and the corresponding adjustment is a zero-sum adjustment at consolidated level.

The primary and corresponding adjustment equalises the tax treatment of the controlled transaction under review as if the transaction was conducted on arm's-length terms and conditions. However, as a supplement to the primary and corresponding adjustment, the tax authorities may subject the transaction parties to a secondary adjustment.

The tax treatment of the secondary adjustment will be derived from the ordinary tax legislation and principles. In general, a secondary adjustment will be characterised as a dividend distribution or a contribution to the subsidiary.

A secondary adjustment can be avoided – subject to certain conditions being met – if the corporate body that benefitted from the non-arm's-length prices agrees to pay to the other party an amount equal to the transfer pricing adjustment.

Pursuant to Danish legislation, the basic fine for not providing information about controlled transactions in a tax return is 250,000 kroner if the Danish corporate body has a maximum of 50 employees. The fine is increased by 250,000 kroner for each 50 employees to a maximum of 2 million kroner if the Danish corporate body has 400 employees or more.<sup>10</sup>

The fine for not preparing transfer pricing documentation is 250,000 kroner plus 10 per cent of the transfer pricing adjustment (if any). The transfer pricing documentation fine is reduced to 125,000 kroner plus 10 per cent of the transfer pricing adjustment (if any) if the taxpayer subsequently delivers transfer pricing documentation that meets the requirements.<sup>11</sup>

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10 Skattekontrollloven § 84.

11 SKATs Juridiske Vejledning C.D.11.13.1.3.3.

## **IX BROADER TAXATION ISSUES**

### **i Diverted profits tax and other supplementary measures**

Danish tax legislation currently has no provisions on diverted profits tax, or other supplemental measures targeted at digital enterprises.

### **ii Double taxation**

If tax authorities outside Denmark initiate a primary adjustment because of non-arm's-length transactions with a Danish corporate body, the latter may ask the Danish tax authorities to issue a corresponding adjustment at the level of the Danish corporate body.

If the Danish tax authorities agree with the assessment issued by the foreign tax authorities, they will adjust the taxable income of the Danish corporate body. However, this simplified approach requires the Danish tax authorities to agree with the assessment made by the foreign tax authorities.

If the Danish tax authorities disagree with the primary adjustment issued by the foreign tax authorities, they will not issue a corresponding adjustment at the level of the Danish corporate body. For the Danish corporate body to eliminate double taxation two remedies are available.

First and foremost, Denmark has entered into a significant number of double-tax treaties with foreign countries. Most of these double-tax treaties include an article governing taxation of associated enterprises (similar to Article 9 of the OECD Double Tax Convention) pursuant to which transfer pricing adjustments can be initiated. Additionally, most double-tax treaties entered into by Denmark contain an article providing for a mutual agreement procedure (similar to Article 25 of the OECD Double Tax Convention), which can be invoked to have the respective tax authorities agree on the taxation of the corporate bodies concerned. The Danish tax authorities generally have a good track record in reaching agreements.

If double taxation arises because of a primary adjustment within the EU, double taxation may be avoided by invoking the EU Arbitration Convention.

Although double taxation has been eliminated through negotiations between the states involved, the result of these negotiations cannot per se be relied upon to be considered arm's-length terms and conditions at a future date.

### **iii Consequential impact for other taxes**

Transfer pricing is first and foremost a discipline concerning direct corporate tax. The pricing mechanisms applied in transfer pricing cannot per se be applied to indirect taxes. Hence, a transfer pricing adjustment does not automatically lead to an adjustment of VAT. Whether VAT should be adjusted must be assessed individually in accordance with the rules governing VAT.

## **X OUTLOOK AND CONCLUSIONS**

In line with the general trend in international tax, Denmark is in the process of implementing the OECD Base Erosion and Profit Shifting (BEPS) initiatives. Most notably Denmark has signed the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI). The overall purpose of the MLI is to effectuate the BEPS Actions 2, 6, 7 and 14.

Along with legislative developments in relation to the BEPS project, a number of transfer pricing cases are pending before the courts and the outcomes of these cases have been long awaited and are expected to shed light on the interpretation of existing transfer pricing legislation.



# GERMANY

*Stephan Schnorberger and Rabea Lingier*<sup>1</sup>

## I OVERVIEW

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

German transfer pricing rules and principles cover all sorts of business transactions concluded between German taxpayers and related parties abroad. In a nutshell, all related-party transactions not based on the statutes of association between (direct and indirect) shareholder (or partner) and company (or partnership) are subject to the arm's-length standard. This is regardless of whether the transactions are income or capital transactions. In addition, all transactions between a head office and its permanent establishment (PE) are covered, whether they are explicitly declared dealings or not. The term 'dealing' refers to fictitious cross-border transactions between a head office and its PE. Examples are inter-company sales (also investments) and services, loans or guarantees and intellectual property (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,<sup>2</sup> as well as on transactions between members of a family.

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

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1 Stephan Schnorberger is a partner and Rabea Lingier is an associate at Baker McKenzie.

2 Section 1(2) FTA.

Germany has started to implement the Organisation for Economic Co-operation and Development (OECD) Base Erosion and Profit Shifting (BEPS) project Final Reports, such as the BEPS 2015 Final Report on Action 13 on transfer pricing documentation and country-by-country reporting. 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. This also applies to the OECD Commentary on the Model Convention and to the OECD Transfer Pricing Guidelines. Nevertheless, OECD guidance constitutes a relevant source of interpretation that can be used to determine arm's-length prices. In 2013, in response to the Authorised OECD Approach (AOA) to the allocation of profits between a head office and its PE, the German legislature adopted the AOA into German law with certain deviations. Even though specific AOA language on head office–PE profit allocation has only been included in a few German double-tax treaties, the administration holds that the AOA takes precedence in the majority of cases, in particular when the contracting state is an OECD member. In addition, the German AOA rules generally prevail over profit allocation rules in the applicable double-tax treaty.

## II FILING REQUIREMENTS

In 2003, the German legislature introduced a statutory obligation to document transfer prices and their arm's-length nature.<sup>3</sup> The statute provides that taxpayers are required to prepare documentation on cross-border transactions with related parties.

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

An exception is that extraordinary business transactions have to be documented contemporaneously, that is, at the latest, six months after the end of the business year in which the transaction took place, and documentation has to be submitted within 30 days of the request. According to legislative regulations, extraordinary transactions are, in particular:

- a* the conclusion and amendment of long-term contracts that have a significant impact on the income the taxpayer derives from its business relations;
- b* the transfer of assets in the context of restructuring measures;
- c* the transfer and use of assets in connection with significant functional and risk changes at the company;
- d* business transactions in connection with changes in business strategy that are significant for transfer pricing; and
- e* the conclusion of cost allocation agreements.

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<sup>3</sup> Section 90 General Tax Code, complemented by Gewinnabgrenzungsaufzeichnungsverordnung (GAufzV).

The documentation regulations (GAufzV) were updated in 2017 to further reflect OECD recommendations. The new rules also put more emphasis on value chain analyses and economic substance requirements. Domestic rules on the preparation of a local file (opposed to the group master file) are generally in line with the OECD BEPS Action 13 recommendations. Additionally, the new law requires taxpayers to document the time of transfer price setting, and to provide detailed information on the database and search strategy used in determining an arm's-length price or margin. Master-file requirements are also in line with the OECD BEPS Action 13 recommendations, and the revised GAufzV are applicable as of fiscal year 2017. It is expected that the Administrative Principles Procedure<sup>4</sup> will also be amended accordingly.

According to Section 6(2) GAufzV, enterprises with inter-company sales of goods of no more than €6 million (paid or received) per annum or inter-company provisions of services of no more than €600,000 per annum (paid or received) are exempt from the documentation requirements.

The documentation requirements also cover head office–PE dealings and the allocation of assets between the head office and PEs.

A German-based entity with a PE abroad and non-German entities with a PE in Germany have 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. However, it is not part of the tax return; it only needs to be submitted upon request. The auxiliary and complementary statement includes (tangible and intangible) allocated assets, allocated free capital, allocated liabilities, associated payables and receivables, and constructive income from internal dealings as well as opportunities and risks transferred from the head office to the PE. In line with OECD guidance, the auxiliary and complementary statement has to record intangible values that are not assets in the tax accounting sense of the term.

In addition, annual country-by-country reporting (CbCR) is required where certain criteria are met. German group parent companies recording consolidated sales revenues of at least €750 million have to prepare annual CbCRs on the group's sales revenues, income tax paid during the fiscal year, equity capital, number of employees, tangible assets, etc. On the other hand, foreign group parent companies are not required to disclose this information in Germany; however, assuming the foreign group parent has recorded revenues of €750 million or more in the preceding fiscal year, 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.<sup>5</sup>

To sum up, according to Section 138a GTA, there are three scenarios in which 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;<sup>6</sup>
- b* a foreign parent company employs the German company for surrogate filing;<sup>7</sup> or

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4 Verwaltungsrundsätze-Verfahren.

5 Section 138a(4) GTA.

6 Section 138a(1) GTA – 'resident group holding company'.

7 Section 138a(3) GTA – 'appointed resident group entity'.

- 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, in which case the German company is obliged to submit the CbCR for the group, or at least CbCR data to which it has access.<sup>8</sup>

In its annual tax filing, the German company has to declare which of the above categories it belongs in.<sup>9</sup> With regard to the procedure, it is important to note that preparing and submitting a CbCR is a reporting or notification obligation, but not a documentation obligation.

Furthermore, the EU mandatory disclosure directive, also known as 'DAC 6', has now been implemented in Germany with effect from 1 July 2020. Mandatory disclosure shall apply to cross-border arrangements implemented after 24 June 2018. The obligation applies to taxpayers or tax intermediaries. Under the wide-ranging DAC 6 regime, intermediaries (such as tax advisers, but in some cases extending to non-tax personnel) with an 'EU connection' and, in certain circumstances, taxpayers, will have to report information to EU tax authorities on certain cross-border transactions going back to 25 June 2018. Transactions are in scope if they involve at least one EU Member State and contain one or more 'hallmarks' that suggest potentially aggressive tax planning. Some of these hallmarks apply even where obtaining a tax advantage is not the main benefit or one of the main benefits of the transaction. It is an administrative offence to deliberately or recklessly fail to provide notification of a cross-border tax arrangement in accordance with the applicable provisions, in particular if the notification is incomplete, incorrect or delayed (Section 379(2), 1e–1g GTA). The administrative offence may be punished by a fine of up to €25,000 for each notification and each intermediary. No penalties apply for notifications for a transitional period. Accordingly, penalties are only applicable to notifications for which the triggering event occurs after 30 June 2020.

### III PRESENTING THE CASE

#### i Pricing methods

In line with the OECD Transfer Pricing Guidelines, Section 1(3) FTA provides for the statutory priority of the standard methods, which are the comparable uncontrolled price (CUP) method, the resale minus method and the cost-plus method. If the data available is fully comparable with the tested transaction prices, the full range of these arm's-length values is used. As the application of the CUP method requires very strong comparability, it is 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 for 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, an appropriate transfer price method (which can be a non-standard method) must be based on partly comparable values. If this is the case, appropriate adjustments must be made, provided they improve

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<sup>8</sup> Section 138a(4) GTA – 'included resident group entity'.

<sup>9</sup> Section 138a(5) GTA.

comparability, and the resulting range of arm's-length values must be narrowed down, usually to the interquartile range. If the actual transfer price is outside 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. Pursuant to administrative regulations, the German tax administration will only accept the TNMM if it is 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 this situation by reference to the global trading of financial products and, more generally, to the situation of two or more market-facing entrepreneurs making unique and valuable intangible contributions that are highly integrated.

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

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

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

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

Although disputed in lower tax courts,<sup>10</sup> the 'Knoppe formula' is a common 'method of last resort' for cross-referencing 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 adopted by 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<sup>11</sup> regarding the selection of companies for an audit.

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10 Lower Tax Court of Münster, 14 February 2014, 4 K 1053/11 E.

11 Tax audit regulations – Betriebsprüfungsordnung (BpO).

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

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

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

German tax authorities keep expanding their resources in the area of transfer pricing. Many local tax offices have dedicated audit teams specifically trained in transfer pricing and international tax matters. Recently, tax authorities have started building up teams of valuation experts. These focus aggressively on valuations of intangibles, functions and businesses, among other things. In the course of a tax audit, the local tax auditor may refer a valuation question to such an expert acting as an adviser to the tax auditor. In matters of international importance, specialised tax auditors of the Federal Central Tax Office may come in. Typically, transfer price auditors of the Federal Central Tax Office have particular industry expertise. External experts, such as specialised economists, are usually not consulted during a tax audit.

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 and compensations for these;
- c* royalty charges: fuelled by recent court decisions, German tax authorities increasingly focus on outbound licences for the use of corporate group names;
- d* transfer prices in the context of principal structures (in particular limited risk distributor and intellectual property structures);
- e* remuneration of non-routine service activities and allocation of synergies (i.e., in the context of central procurement companies);

- f* PEs and profit allocation between head office and PE;
- g* remuneration in line with development, enhancement, maintenance, protection and exploitation functions (known as DEMPE functions), arm's-length intangibles remuneration and the economic nexus approach;
- h* trademarks;
- i* intra-group financing; and
- j* recharacterisation of transfer pricing models to profit split models.

Furthermore, the German tax authorities increasingly initiate and execute joint audit procedures, both within the EU and with the United States.

#### **IV INTANGIBLE ASSETS**

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

Apart from this recent legislative development, tax audits have always focused on the substance underpinning major foreign income abroad and the corresponding deductions made 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 has 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.

APA requests do not prevent tax audits; on the contrary, they tend to trigger audits. 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, which is 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 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 fiscal year covered, the taxpayer must submit a report to the Federal Central Tax Office stating and proving compliance with the critical assumptions of the APA.

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

Further, the EU Mutual Assistance Directive<sup>12</sup> has been implemented into domestic German tax law in the EU Mutual Assistance Act.<sup>13</sup> 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 respect of this function, the Federal Central Tax Office provides certain information on tax rulings issued, changed or renewed as of 1 January 2017, to the respective authorities of the Member States (known as the receiving authority) and the European Commission automatically.

## **VI INVESTIGATIONS**

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

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

Internationally coordinated audits, in either the form of simultaneous or of joint audits, are increasingly practised, be it within the EU or with the US.

## **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,

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12 Council Directive 2011/16/EU of 15 February 2011 on administrative cooperation in the field of taxation.

13 EU-Amtshilfegesetz.



local tax courts may, and the Federal Tax Court is obliged to, refer the case to the European Court of Justice. Once legal court instances are exhausted, the taxpayer may raise a complaint with the Federal Constitutional Court for violation of constitutional rights. The Court decides whether to admit the complaint.

In general, tax courts in Germany are quite timid about appointing expert witnesses to provide an impartial expert opinion. However, as an exception to this rule of thumb, it is common practice that expert witnesses are consulted if valuations (e.g., of intangibles) are concerned. However, in recent years the tax courts seem to have opened up about consulting expert witnesses in all transfer pricing matters.

In addition to this, MAPs and arbitration procedures pursuant to double-tax treaties or the EU Arbitration Convention are used successfully to resolve double taxation. Tax authorities have been making more, and larger, transfer price adjustments, and have increasingly been adopting a more inflexible stance, even in the final audit meeting. At the same time, the Federal Central Tax Office has been seen to raise more and more onerous requirements before confirming the initiation of a MAP. Consequently, after weighing the pros and cons of the dispute resolution options, taxpayers choose tax litigation more often than not.

## ii Recent cases

The following are some of the most important transfer pricing rulings that have been issued by German Tax Courts since 2000:

- a* There have been several decisions on whether or not a group subsidiary can deduct royalty fees for a licence to use a branded corporate group name. In 2000,<sup>14</sup> 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 Lower Tax Court of Munich<sup>15</sup> demonstrates that deducting a royalty charge requires there to be effective legal and practical benefits for the licensee. In a recent decision,<sup>16</sup> the Lower Tax Court of Münster decided that the arm's-length principle requires a licence to be implemented for the use by a foreign entity of a corporate group name when the trademark has value in itself. In a case<sup>17</sup> in 2016, the Federal Tax Court reversed this controversial lower court decision. In essence, the Federal Tax 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 at a corporate level (e.g., in consideration of shares). New administrative regulations on the use of group names, trademarks and logos were published on 7 April 2017. These administrative regulations apply in all pending cases and largely disregard the Federal Tax Court decision. Therefore, it is to be expected that further tax court proceedings will be initiated.
- b* In a landmark decision of the Federal Tax Court in 2001,<sup>18</sup> 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

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14 I R 12/99.

15 6 K 578/06.

16 4 K 1053/11 E.

17 I R 22/14.

18 I R 103/00.

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<sup>19</sup> of the Federal Tax Court 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,<sup>20</sup> the Federal Tax Court confirmed the principles established in prior rulings that losses incurred by a distribution entity over a certain period trigger a rebuttable presumption that the transfer prices are not at arm's length.
- e* In a 2011 decision,<sup>21</sup> the Federal Tax Court confirmed the statutory authority of 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 2012, 2014 and 2015,<sup>22</sup> 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.
- g* In 2013,<sup>23</sup> the Federal Tax Court ruled that the obligation to prepare, and upon request submit, transfer pricing documentation is in line with EU law. In particular, these obligations do not breach the freedom of establishment.
- h* In 2016,<sup>24</sup> the Lower Tax Court of Münster confirmed that standard transfer pricing methods (CUP, resale minus, cost-plus) are, in general, equal to one another. It is up to the taxpayer and the German tax authorities to determine the most appropriate method for each individual case. To determine arm's-length interest rates on loans within the group, according to the court's assessment of the case, cost-plus shall be the best method. This ruling is currently subject to revision by the Federal Tax Court.
- i* In 2016,<sup>25</sup> the Lower Tax Court of Cologne confirmed its position that an EU Member State's requests to another Member State for administrative assistance is in line with the law if the requested information is foreseeably relevant to the administration and enforcement of the domestic laws of the requesting Member State. The Lower Tax Court further clarified that 'foreseeably relevant' means that at the time of the request

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19 I R 87/02.

20 I R 22/04.

21 X B 37/11.

22 I R 75/11, I R 23/13 and I R 29/14 respectively.

23 I R 45/11.

24 13 K 4037/13 K F.

25 2 V 2498/16.

there was a reasonable possibility that the requested information could be relevant for tax purposes. The standards recognised by the Lower Tax Court are very low and therefore nearly anything could be deemed foreseeably relevant.

- j* In 2017,<sup>26</sup> the Lower Tax Court of Cologne confirmed that loans can be secured through guarantees between affiliated entities. The guarantee fee can be determined by application of the CUP method. Furthermore, the Court accepted interest rates determined from bank loans as comparable data for determining an appropriate interest rate for inter-company loans.
- k* On 31 May 2018, the ECJ ruling in C-382/16, *Hornbach* considered the compatibility of Section 1 of the Foreign Tax Act (AStG) with European law. Although Section 1 AStG restricts the freedom of establishment, it is not contrary to European law if the taxpayer is given the opportunity to present ‘economic reasons’ justifying transfer prices deviating from the arm’s-length principle. In this context, the Federal Ministry of Finance published new administrative regulations<sup>27</sup> on the application of the ECJ judgment in the *Hornbach* case. These regulations restrict the criterion of economic reasons to actions related to near insolvency situations. The taxpayer must in particular prove the related party’s or the group’s need and capability for recovery. The regulations are effective as from 6 December 2018 and apply to all open cases.
- l* In 2018,<sup>28</sup> the Federal Tax Court ruled that an agreement between an entity and its shareholder that specifies neither the ‘whether’ and ‘how’ nor ‘at which point in time’ the contractual services are provided does not comply with the arm’s-length standard. Although the case concerned was domestic in nature, the principles should apply for cross-border arrangements as well. It is noteworthy that the Federal Tax Court did not rely on its principles according to which a deemed dividend may also be presumed to exist if an entity provides a service to a controlling shareholder without a clear, prior, legally effective and actually conducted agreement.
- m* In 2018,<sup>29</sup> the Federal Tax Court ruled that tax audit inquiries, even when qualified as ‘mere administrative actions’,<sup>30</sup> could be appealed in court if the tax authorities have formally declined an objection.

In 2019,<sup>31</sup> the Federal Tax Court changed its prior case law according to which Section 9 of the OECD Model Tax Convention limited the scope of application of Section 1 FTA to price adjustments. The Court authorises corrections not only in amount (price adjustments) but also on grounds of principle, such as the neutralisation of a profit-reducing derecognition or write-off of a receivable. In addition, the Court revised its case law on passive integration within the group. Consideration of the benefits of passive group integration in the arm’s-length analysis may violate the arm’s-length principle. Finally, the Court interprets the ECJ *Hornbach* decision (C-382/16). Even if the taxpayer can prove economic reasons and the chosen structure does not qualify as purely artificial, a transfer price adjustment may still be required. Each case has to be analysed on its specific merits.

26 13 K 2302/14.

27 IV B 5 – S 1341/11/10004-09 dated 6 December 2018.

28 I R 77/16.

29 XI B 123/17.

30 *Realakt*.

31 I R 73/16, I R 51/17 and I R 81/17.

On 26 November 2019, the Lower Tax Court of Munich issued a ruling touching upon several transfer pricing related matters. First, the ruling accepts the principles of intentional set-off. Second, the ruling clarifies that, for transfer pricing documentation purposes, a value chain analysis to be prepared by the taxpayer should only focus on the taxpayer's transactions with related parties and their respective value contributions. It shall not cover aspects unrelated to transactions with related parties. Third, the ruling also concerns transfer of functions. A customer's transfer from one group entity to another cannot be deemed to be a taxable transfer of functions if the transferring entity can provide economic reasons for the customer's decision, such as a non-competitive cost position of the transferring entity.

Currently, pending transfer pricing disputes include both procedural and substantive issues, including the following:

- a* the valuation of IP post-acquisition (purchase price allocation); and
- b* exit tax or transfer of functions of a production 'function'.

## VIII SECONDARY ADJUSTMENT AND PENALTIES

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

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

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

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

The interest rate of 6 per cent per annum is currently under review by the German Constitutional Court.

## IX BROADER TAXATION ISSUES

### **i Diverted profits tax and other supplementary measures**

A diverted profits tax is not applicable under German domestic tax law.

### **ii Double taxation**

The EU Arbitration Convention is a potentially useful mechanism to avoid double taxation within the EU. It is also a helpful argument in the course of negotiations with the tax auditors. The Federal Central Tax Office as competent authority has issued administrative

regulations offering guidance on both the MAP and the procedure under the EU Arbitration Convention, and which clarify existing practices and the approach of the Federal Central Tax Office in these matters.

After Brexit, the EU Arbitration Convention will continue to apply with regard to the United Kingdom, even if the United Kingdom were to withdraw from the EU without a withdrawal agreement ('hard Brexit'). The EU Arbitration Convention is a contract subject to international law and therefore independent of both European law and the United Kingdom's status as a Member State of the EU.

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.

Germany has implemented the EU Tax Dispute Resolution Directive into domestic law. The mandatory dispute resolution rules apply to any double taxation of profits arising as of 1 January 2018. The new dispute resolution mechanisms are based on the EU Arbitration Convention and extend its scope beyond transfer pricing disputes. The directive is of particular interest in cases where it is in dispute whether local activities from a permanent establishment are for the benefit of the non-resident entity.

Germany is in the process of implementing the OECD Multilateral Instrument, and draft implementation Acts have recently been published. This is set to modify tax treaties with a select number of countries, such as France, Italy, Spain and the Netherlands, but not with the US or the UK.

### **iii Consequential impact for other taxes**

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

## **X OUTLOOK AND CONCLUSIONS**

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

From a legislative point of view, German transfer pricing regulations are constantly evolving. German legislators generally tend to follow OECD recommendations; however, there are exceptions to the rule. Regarding the OECD's agenda on taxation of digital business models, Germany has great sympathy for the so-called Global Anti-Base Erosion (GloBE, or Pillar Two) proposal, which aims at introducing a global minimum taxation. This position

may be incentivised by the fact that German CFC legislation is suspected to be in conflict with EU regulations. Yet, Germany is also likely to adopt the proposals made by the OECD under their so-called Pillar One approach, if international consent is found. The German government is concerned about excessive taxation of export-oriented German MNEs, but does not want to stand in the way of a consensus on Pillar One.

# GREECE

*Elina Filippou, Elina Belouli and Dimitris Gialouris<sup>1</sup>*

## I OVERVIEW

Transfer pricing provisions were initially introduced in Greece, in a simplified form, in 1980,<sup>2</sup> and the rules were subject to regular revisions, gradually extending their scope of application and aligning them with international taxation trends. However, transfer pricing rules were not commonly considered by the tax authorities, which, until 2008, were known to scrutinise related-party transactions primarily on productivity grounds, with a particular focus on royalties and service fees charged to domestic enterprises. Isolated transfer pricing audits up to that time mostly concerned transactions performed between domestic related parties.

The year 2008 was a milestone one in the field of transfer pricing, as it was the first year that domestic enterprises were required to comply with transfer pricing documentation rules in Greece.<sup>3</sup> Since then, the scope of transfer pricing provisions has been gradually revised and extended, leading to the currently applicable backbone transfer pricing provisions (Articles 50 and 51 of Law No. 4172/2013, the Income Tax Code (ITC)). The current legal framework fully endorses the arm's-length principle, as defined in Article 9 of the Organisation for Economic Co-operation and Development (OECD) Model Tax Convention and interpreted by the latest update of the OECD Transfer Pricing Guidelines, following the revisions introduced as a result of Actions 8–10 of the OECD BEPS project. Article 50 adopts the arm's-length principle with respect to all types of related party transaction, whereas Article 51 refers exclusively to business restructurings involving related parties.

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

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

According to Article 2 of the ITC, an individual or legal entity participating directly or indirectly in the capital or management of an enterprise, is defined as a related party for transfer pricing purposes. A 33 per cent threshold applies with respect to the minimum direct or indirect participation in the capital or the exercise of voting rights (instead of the previously applicable 50 per cent), above which entities are defined as related. The exercise of managerial control or decisive influence over an enterprise is also an element to define

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2 Article 50, Law No. 1041/1980, which was later incorporated in Article 39 of Law No. 2238/1994, the previously applicable income tax code.

3 Article 26, Law No. 3728/2008.

related parties, irrespective of any participation in the controlled enterprise's capital or voting rights. According to tax administration guidelines<sup>4</sup> the exercise of managerial control or decisive influence is to be assessed on a case-by-case basis. The leverage ratio of an enterprise is identified as an indication of the exercise of decisive influence of the lender (excluding financial institutions), over the borrowing enterprise. The same is noted with respect to enterprises entering into supply arrangements on an exclusivity basis, including an end price setting mechanism.

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

## II FILING REQUIREMENTS

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

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

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

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

## III PRESENTING THE CASE

### Pricing methods

All OECD acceptable transfer pricing methods are applicable in the Greek transfer pricing environment, as confirmed by Article 50 of the ITC, which explicitly refers to the OECD Transfer Pricing Guidelines as the appropriate tool to interpret and apply domestic transfer

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<sup>4</sup> POL 1142/2015.



pricing rules. Traditional methods (the CUP, resale minus and cost-plus method) are preferable compared to transactional methods (the transactional net margin method and profit split method).<sup>5</sup> Rejection of traditional methods should be appropriately justified in local transfer pricing documentation, prior to selecting the application of one of the transactional methods. A change to the selected transfer pricing method must be accompanied by a detailed justification.

Both internal and external comparables are acceptable. Contemporaneous comparables are required upon application of a CUP method. As regards one-sided methods referring to profit level indicators, reference to external comparables should cover a three-year test period and should include a set of at least five comparables. Specific guidance is provided on the use of databases for the selection of external comparables. The tax authorities use the Amadeus database (Bureau van Dijk), as do most of the documenting enterprises. Financial data of selected external comparables should be refreshed annually, whereas a new search for comparables should take place once every three years.

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

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

#### **Authority scrutiny and evidence gathering**

Upon audit, Greek tax authorities do not usually take into account the global tax position of the group, in order to formulate their approach in transfer pricing. Greek customers are not often contacted in terms of transfer pricing but may be contacted upon an audit regarding the identification of a permanent establishment of a foreign enterprise in Greece. Greek transfer pricing auditors often receive technical assistance and training from distinguished transfer pricing experts, but the use of expert witnesses is not common in individual cases. Dawn raids are not frequent.

## **IV INTANGIBLE ASSETS**

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

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5 Ministerial Decision POL 1097/2014, as amended by POL 1144/2014.

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

## V SETTLEMENTS

Taxpayers may apply for a unilateral, bilateral or multilateral advance pricing agreement (APA), which comprises a decision of the Governor of the Independent Authority for Public Revenue on the appropriate set of criteria for the determination of transfer prices over a fixed period, which may not exceed four years.<sup>6</sup> Rollback of the APA is not allowed under Greek law. Greek tax authorities have introduced the option of a preliminary procedure that should allow the taxpayer to discuss the case with the competent authority on an informal, non-binding basis. The purpose of the preliminary procedure is to explore whether the initiation of a formal APA procedure would lead to the intended result. Entering into an APA with the Greek tax authorities may require anything between 18 months (for a unilateral APA) and 36 months (for a bilateral or multilateral APA). The Independent Authority for Public Revenue has the right to further extend the timeline, if necessary.

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

## VI INVESTIGATIONS

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

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

While processing the transfer pricing file and related supporting documentation, tax authorities may raise questions and request additional material, particularly in relation to external comparables. Although the law does not encompass an enumerative list of means of evidence that could be used in case of a tax audit from both sides – taxpayers and the tax

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<sup>6</sup> Article 23 CTP and Ministerial Decision POL 1284/2013.

authorities – nonetheless the tax authorities have been vested with broad powers in relation to the evidence-gathering process. In this context, the engagement of expert witnesses cannot be precluded, though such means of obtaining evidence in tax audits is not common.

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

The preliminary tax audit report is officially served to the taxpayer along with the preliminary tax assessments. The taxpayer is entitled to respond to the preliminary tax audit findings in writing, within a 20-day period. This is an evidence-intensive stage of the dispute, whereby the taxpayer's arguments should be supported by pertinent documentation, particularly in relation to the selection of transfer pricing methods, the reliability of external comparables and any proposed adjustments to the financial results of the selected set of comparables. The final tax assessments, upholding or disregarding the taxpayers' views, are issued within one month following the date of submission of the taxpayer's views; or in the case the taxpayer does not submit its views, following the expiry of the aforementioned 20-day period.

In principle, tax audits should be carried out and tax assessments should be issued within five years starting from the end of the year in which the relevant corporate income tax return should have been duly filed. Due to amendments to the law in December 2019, the applicable statute of limitations could be prolonged for up to 10 years in specifically prescribed cases. One such case would be where new evidence, namely, evidence which could not have been known to the tax administration within the standard statute of limitations, emerges after the lapse of the five-year limitation period and results in a greater amount of tax than was initially assessed. Should this be the case, the prolonged statute of limitations relates only to the issue the new evidence refers to.<sup>7</sup> The same statute of limitations (in this case being reduced from the 20-year limitation period initially provided for in law to 10 years) applies also in the case the tax audit findings result in tax evasion.<sup>8</sup> However, according to ministerial guidance, transfer pricing readjustments should not be treated as resulting in tax evasion.<sup>9</sup>

## VII LITIGATION

### i Procedure

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

Once the final tax assessments have been served to the taxpayer, the latter is entitled to challenge them by lodging an administrative appeal with the Dispute Resolution Directorate of the Independent Authority for Public Revenue.<sup>10</sup> This procedure is mandatory for the taxpayer before seeking the judicial review of their case. The Dispute Resolution Directorate should review the taxpayer's administrative appeal on both the law and the merits. The appeal should be lodged within 30 days of the service of the final tax assessment to the taxpayer (and within 60 days for taxpayers seated abroad). The Dispute Resolution Directorate should

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7 Article 36, Paragraphs 1–3 CTP.

8 Article 66, Paragraph 27a of Law No. 4646/2019.

9 Ministerial Decision POL 1209/2017.

10 Article 63 CTP and Ministerial Decision POL 1064/2017.

review the case and deliver its decision in writing within a 120-day period; otherwise, on the expiry of this deadline, the administrative appeal is deemed to have been tacitly rejected. According to law, the 120-day period could be either: (1) suspended if an issue of general interest has been brought before the Supreme Administrative Court, or a preliminary ruling by the Supreme Administrative Court is sought and if, in either case, the decision of the Supreme Administrative Court is critical for the review of the taxpayer's administrative appeal; or (2) extended for 30 days, should the taxpayer provide the Dispute Resolution Directorate with new evidence or raise new facts that have occurred during the final 30 days of the 120-day period.<sup>11</sup>

Filing of an administrative appeal suspends payment of 50 per cent of the amount of tax and penalties imposed on the taxpayer, should the remaining 50 per cent be settled. However, default interest, calculated at an annual rate of 8.76 per cent, accrues on the outstanding amount up to the time of payment to the state. From a practical perspective, therefore, upon filing the administrative appeal, taxpayers may opt to pre-pay 100 per cent of the income tax and penalties imposed.

If the administrative appeal is sustained, the tax assessment is repealed, whereas any amount of tax and penalties already paid to the state is refunded to the taxpayer. In the event of full or partial rejection of the administrative appeal, the taxpayer has the right to seek a review of the case before the administrative courts. The deadline to institute the legal proceedings is within 30 days (90 days for taxpayers seated abroad)<sup>12</sup> of either the date of expiry of the 120-day period or the notification of the rejecting decision of the head of the Dispute Resolution Directorate.

In tax disputes, the judicial competence of the administrative courts is contingent on monetary thresholds: should the tax assessed exceed the amount of €150,000, the case will be heard by the administrative court of appeal; otherwise, where the amount of the tax assessed does not exceed €150,000, the case is submitted to the jurisdiction of the administrative court of first instance. Surcharges, penalties or fines on any other amount additionally assessed do not count towards the above thresholds.<sup>13</sup>

Irrespective of the court in which the case is first heard, the judicial review considers the lawfulness and merits of the case. Administrative court procedure provides a list of means of evidence including in expert witnesses. In practice, courts have the right to call upon one or more expert witnesses in order to be able to decide the case. Law does not provide for a maximum number of expert witnesses who can be appointed by the courts. Should the court call upon an expert witness, each litigant has the right to appoint a 'technical adviser'. Technical advisers ought to have the skills and qualifications to serve also as expert witnesses.

Law provides for the unfettered evaluation of evidence, including as provided by expert witnesses. In this respect, courts should justify their position, including in the case of conflicting expert testimonies being submitted.

Decisions of the administrative courts of first instance can only be reviewed by the appellate court, and only if specific requirements set out in law are met.

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11 Article 68 of Law No. 4587/2018 in conjunction with Circular (IAPR) E2010/2019 of the Independent Authority for Public Revenue.

12 Article 64, Paragraphs 2 and 6 of the Code of Administrative Procedure.

13 Article 6 of the Code of Administrative Procedure.

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

Finally, once all court instances are exhausted, the case may be brought to the Supreme Administrative Court, should specific procedural requirements set out in law be met.<sup>14</sup> The review proceedings before the Supreme Administrative Court are strictly concerned with issues of lawful interpretation of the applicable provisions.

## ii Recent cases

Case law on related-party transactions is built around two pillars: the tax deductibility of intra-group charges, which was a matter commonly raised by tax authorities until 2008; and application of the arm's-length principle and related compliance with transfer pricing documentation rules for the fiscal year 2008 onwards. Owing to the considerable duration of judicial proceedings, a significant number of decisions refer to regimes that are no longer applicable. However, certain decisions of the Supreme Administrative Court still serve as a valuable reference for the interpretation and application of current rules.

A number of Supreme Court cases have dealt with the matter of defining related parties, with a particular focus on elements establishing a relation of managerial control or economic dependence or control.<sup>15</sup> In a recent case brought before the court of appeal, a detailed analysis of the contractual arrangements was used to identify significant economic dependence in a franchise relationship.

Other cases that remain relevant refer to the benefit test conducted for purposes of substantiating the tax deductibility of intra-group royalties, service fees charged to domestic enterprises<sup>16</sup> and domestic branches of foreign enterprises. On a different note, the Court of Appeals of Athens recently upheld the attribution of 100 per cent of revenues from Greek sales as profits to a permanent establishment identified pursuant to tax audit.

A number of decisions have dealt with the question on who bears the burden of proving compliance with the arm's-length principle. Following the introduction of transfer pricing documentation rules, the burden of proof has been shifted to the taxpayer. However, as long as the taxpayer produces the appropriate transfer pricing documentation, the burden is shifted back to the tax authority, which is required to justify any challenge to the taxpayer's position (e.g., by proving the inappropriateness of the selected transfer pricing method or unreliability of the selected comparables). The Administrative Court of Appeal of Athens has verified that the tax authority may not proceed with creating a new set of comparables without justifying the reasons for rejecting the set selected by the taxpayer.<sup>17</sup>

Although fragmented, recent decisions of the courts of appeal seem to set the focus on documentation, and engage in analyses of comparability, but also to touch upon issues regarding the proportionality of documentation-related penalties imposed under previously applicable regimes.<sup>18</sup> Recent decisions of the courts of appeal appeared not to disregard the

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14 Article 53 PD No. 18/1989.

15 Namely, Supreme Administrative Court decisions 3803/1988, 1976/1993, 4413-4/1996, 4464/1997, 1303-4/1999 and 1644/2005.

16 Supreme Administrative Court decisions 2033/2014, 4627/2014, 1290/2017, 2185/2017 and 2190/2017.

17 Administrative Court of Appeal of Athens decision 3677/2017.

18 Administrative Court of Appeal of Athens decisions 2436/2017, 4171/2017, 4596/2019 and others.

impact of centralised decision-making on price setting when judging the intent of domestic wholesalers in evading customs duties in instances where the wholesalers had purchased products at a value lower than in previous and subsequent years.

## VIII SECONDARY ADJUSTMENT AND PENALTIES

Greek law does not provide for secondary adjustments in the field of transfer pricing. Any transfer pricing readjustment resulting from a tax audit shall lead to the increase of the taxpayer's taxable profits and the assessment of corporate income tax (at a rate of 28 per cent with respect to fiscal year 2019). Penalties are also imposed for the initial filing of an inaccurate tax return at a rate of up to 50 per cent over the amount of income tax assessed. Default interest accrues at an 8.76 per cent annual rate, from the time of filing of the initial income tax return for the audited fiscal year and up to the time of full payment of the tax assessed.

Without prejudice to the penalties for inaccuracy of tax returns filed, documentation-related penalties also apply, as follows:

- a* delayed or inaccurate reporting of intra-group transactions triggers a penalty ranging between €500 and €2,000, calculated at a rate of 0.1 per cent over the value of relevant intra-group transactions. In cases of inaccuracy, the penalty is only imposed if the inaccuracy affects more than 10 per cent of the total value of the reported transactions;
- b* revisions to the initial reporting of intra-group transactions are not sanctioned and do not impact the value of the reported transactions. Revisions of values exceeding €200,000 trigger a fine of between €500 and €2,000;
- c* failure to report intra-group transactions triggers a penalty of up to €10,000, calculated at a rate of 0.1 per cent over the total value of intra-group transactions that should have been reported;
- d* failure to submit a transfer pricing file in the event of a tax audit is sanctioned by a fine of €20,000. The same fine applies if the file is submitted later than 90 days following a relevant tax authorities request;
- e* delayed submission of the transfer pricing file in the event of a tax audit is sanctioned by a fine of €5,000 if the file is submitted within 60 days of being requested; the fine rises to €10,000 if the file is presented between the 61st and 90th day following its request by the tax authority; and
- f* failure to file a country-by-country report triggers a penalty of €20,000, whereas a penalty of €10,000 applies in the event of inaccurate or late filing.

The Greek tax authorities have clarified that the assessment of corporate income tax of an amount exceeding €100,000 does not constitute tax evasion to the extent that the assessment results from transfer pricing readjustments.

## IX BROADER TAXATION ISSUES

### **i Diverted profits tax and other supplementary measures**

There is no diverted-profits tax provision applicable in Greece. However, the ITC and the CTP set out a number of rules to effectively combat artificial arrangements whose aim is tax avoidance. For example, Article 38 of the CTP sets out a General Anti-Abuse Rule, according to which tax authorities may reclassify any arrangement whose main purpose, or one of the

main purposes of which, is tax avoidance. In the same context, according to Article 4 of the ITC, the place of effective management is a key element in defining a legal entity's state of tax residence.

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

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

- a* a shareholder holds directly or indirectly more than 50 per cent rights in the capital of the foreign corporation;
- b* the actual corporate tax paid on the CFC's profits is less than 50 per cent of the corporate tax that would have been charged on such profits in Greece; and
- c* 30 per cent or more of the income earned by the CFC is classified as passive income (e.g., interest, royalties, dividends).

CFC rules do not apply to companies or permanent establishments resident in EU/EEA Member States provided that such entities carry on a substantive economic activity.

Article 49 of the ITC sets out an earnings-stripping rule. 'Exceeding' borrowing costs, which is the amount by which interest expenses exceed interest revenues and other economically equivalent taxable revenue, are tax deductible in the tax period in which they are incurred only up to 30 per cent of earnings before interest, taxes, depreciation and amortisation. Moreover, this limitation applies only if the exceeding borrowing costs exceed €3 million per year. The disallowed interest expenses can be carried forward indefinitely, and credit institutions are exempt from these rules.

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

## **ii Double taxation**

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

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

Certain issues regarding access to the MAP remain unresolved, in particular in instances where domestic statutes of limitations apply or where domestic courts have issued decisions. Greece has stated that it is currently considering a shift in its policy regarding these issues, which were identified during Stage 1 of the MAP peer review.<sup>19</sup> A legislative amendment introduced in late 2019 provides for a special extension of the statute of limitations for as long as the taxpayer's right to request a MAP stands, but, given Greece's previous positions, application thereof remains to be seen.

### iii Consequential impact for other taxes

Transfer pricing adjustments do not have an impact on the taxable base for VAT purposes according to Greek law.

However, retrospective price adjustments may impact the value of goods used for customs purposes. On the basis of relevant administrative guidelines concerning the determination of customs value, customs authorities should examine in the context of their audits whether post-import amendments of prices invoiced to importers by related (non-EU) suppliers have taken place. Further, the decision of the Court of Justice of the European Union in the *Hamamatsu* case<sup>20</sup> may give rise to arguments by the customs authorities that the customs value declared upon import does not reflect the actual transaction value (because of the retrospective price adjustments). In this respect, the prospect of filing simplified customs declarations upon import of goods supplied between related parties should be considered in situations like the above.

## X OUTLOOK AND CONCLUSIONS

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

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

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

An increase in transfer pricing disputes is also likely to lead to an increase in MAP proceedings involving the Greek tax authorities, although there is still room for improvement in this field, primarily by securing appropriate resources to handle the proceedings and

19 OECD (2019), Making Dispute Resolution More Effective – MAP Peer Review Report, Greece (Stage 1): Inclusive Framework on BEPS: Action 14, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris.

20 C-529/16.



providing guidance on practical matters to ensure access to the MAP irrespective of domestic judicial decisions or statutes of limitations. It is also expected that the number of APA proceedings will increase in the near future, particularly in relation to new activities or isolated transactions, as enterprises seek certainty with respect to the tax treatment of their operations in Greece.

Finally, the new rule on business restructurings<sup>21</sup> may gradually assume primary significance, as tax authorities move their audits into the fiscal year 2014 and onwards; from the perspective of enterprises doing business in Greece, these have been years of restructuring as a reaction to the economic downturn and the related adverse conditions of the Greek economy, including the capital controls introduced in June 2015. The compliance of these restructurings with the arm's-length principle is a matter that is likely to be assessed in the course of future tax audits.

Greece has not declared its position on Pillar One and GloBE proposals, and still refrains from enacting unilateral measures regarding digital services taxation.

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21 Article 51 ITC.

# INDIA

*Mukesh Butani*<sup>1</sup>

## I OVERVIEW

Transfer pricing law in India was introduced in April 2001 following an amendment to the Income-tax Act 1961 (ITA), which covered intra-group cross-border transactions, and, from April 2013, the provisions were extended to specified domestic transactions between related enterprises for a limited time until 2017. The law broadly aligns with the Organisation for Economic Co-operation and Development Guidelines on Transfer Pricing (the OECD Guidelines), and definitions of international transactions, documentation requirements, and associated enterprises are broad and expansive.

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

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

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

A relationship between associated enterprises can involve:

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

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<sup>1</sup> Mukesh Butani is a managing partner at BMR Legal Advocates. The author would like to thank Surekha Debata and Shreyash Shah, managing associates, for their assistance in writing this chapter.

The above definition includes deemed international transactions in third-party situations, particularly when the terms of the contract are determinable.

The 2001 transfer pricing provisions remained largely unreformed until 2012, when substantial changes were introduced. In particular, the definition of international transaction was retrospectively expanded to cover an array of other transactions, such as the purchase or sale of tangible and intangible assets, and capital financing. The definition of ‘intangible property’ was given a broad scope at a time when the debate on intangibles at the global level was gathering momentum (see Section IV).

A wave of reforms gathered momentum from 2013 to 2015, and was followed up in 2017 and 2020 with the following material changes:

- a* introduction of safe harbours rules (SHR);
- b* an option to use a ‘sixth methodology’;
- c* eligibility to seek a five-year unilateral or bilateral advance pricing agreement (APA), which subsequently covered rollback of up to four years;
- d* use of multiple years of data for benchmarking purposes;
- e* an Indian version of an interquartile range between 35 and 65 percentile;
- f* thin capitalisation; and
- g* secondary adjustment.

A major development was carried out by the Finance Act 2020 with regard to profit attribution for permanent establishments (PE) and extension of SHR and APA to PE profit attribution.

Although the arm’s-length principle applies if income charging provisions are triggered, the debate regarding its application to the issuance of shares or a capital transaction is now settled.<sup>2</sup> However, the disclosure rules have been amended to disclose such capital transactions. Dividends are not subject to arm’s-length pricing principles because they are an appropriation of profits and exempt from tax at the shareholder level.

Section 188 of the Companies Act 2013 prescribes the consent of the board of directors for specified related-party (domestic and international) transactions. This does not apply to transactions under the ordinary course of business. In November 2019, the capital markets regulator, namely the Securities and Exchange Board of India (SEBI), constituted a working group to review the policy pertaining to related-party transactions (RPTs) for listing entities. Consequently, in January 2020, SEBI announced policy proposals with respect to RPTs to protect the investor’s interest and for ease of doing business.

There are no direct implications of not transacting at arm’s length (such as deemed dividend implications), unlike in other jurisdictions. However, the ITA was amended to provide for secondary adjustments (see Section VIII).

## II FILING REQUIREMENTS

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

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<sup>2</sup> *Vodafone India Services Pvt Ltd v. Union of India* (2014) 369 ITR 511 (Bombay). This decision was accepted by the Government and no appeal was filed against it.

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

The documentation includes information in relation to: functions performed; risks assumed; assets employed; details of relevant uncontrolled transactions; comparability analyses; benchmarking studies; assumptions; policies; details of economic adjustments; and explanations as to the selection of the most appropriate transfer pricing method. The annual documentation must be updated to reflect the latest financial data adjustments on such transactions, and courts have held that commercial wisdom cannot be questioned in this regard.

The second part stipulates documentation authenticating the information and analyses provided in the first part. This documentation must be contemporaneous, maintained for a period of eight years from the end of the relevant assessment year (i.e., nine years from the end of the relevant financial year) and presented to the tax authorities on request, at the audit, assessment or dispute resolution stage.

An accountant's report for all international transactions between associated enterprises is mandatory; it is to be obtained from an independent accountant, who would certify the value of international transactions (in accordance with the books of accounts) and state the arm's-length price based on the documentation and supporting information maintained by the taxpayer. The report has to be furnished in Form 3CEB by the due date of the tax return filing (i.e., on or before 30 November, following the close of the relevant tax year on 31 March). The report requires the accountant to give an opinion on the proper maintenance of prescribed documents and information according to the rules, and to certify the correctness of an extensive list of transactions, including the methodology of the transactions. Failure to supply this report leads to a penalty of 100,000 rupees. A penalty of 2 per cent of the value of the international transaction may be levied for failure to maintain the prescribed documentary report.

India has committed to implementing the recommendations of Action 13 of the OECD Base Erosion and Profit Shifting (BEPS) Action Plan, and consequently the ITA was amended in 2016 to introduce a requirement to furnish a master-file country-by-country report (CbCR) together with the transfer pricing documentation for the year ending 31 March 2017. The master file has to be filed electronically in Form 3CEAA. The master file in Form 3CEAA has two parts: Part A specifies generic information about the constituent entities of a multinational enterprise (MNE) group operating in India; and Part B provides a high-level overview of the MNE group's business structure, operations, transfer pricing policies, etc. The key filing requirements are as follows:

- a* the filing of Part A of the master file in Form 3CEAA is applicable to every constituent entity operating in India, whether it has its parent entity resident in or outside India; and
- b* regarding the threshold for Part B of the master file in Form 3CEAA:
  - the consolidated revenue of the international group according to the consolidated financial statements for one accounting period must exceed 5 billion rupees;
  - the aggregate value of international transactions of the constituent entity during the accounting period must exceed 500 million rupees; or

- the aggregate value of international transactions in respect of purchase, sale, transfer, lease or use of intangible property during the accounting period, must exceed 100 million rupees.

Where an international group has multiple constituent entities operating in India, the group may designate one of its constituent entities as an alternate reporting entity to fulfil the requirement of filing Form 3CEAA on behalf of the group.

To support the documentation, tax authorities at the audit stage require a scientific analysis such as an independent report, particularly for intra-group charges, royalty, intangibles, etc. However, select tribunals have rejected the mechanical approach of the Revenue, namely undertaking mechanical adjustments on such transactions, and held that commercial wisdom cannot be questioned – instead the role of the auditor is to assess the arm's-length principle as per the statutory provisions.

### III PRESENTING THE CASE

#### i Pricing methods

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

- a* the comparable uncontrolled price (CUP) method;
- b* the resale price method (RPM);
- c* the cost-plus method;
- d* the profit split method;
- e* the transactional net margin method (TNMM); and
- f* an unspecified method.<sup>3</sup>

On the choice of methodology, the law prescribes the use of the 'most appropriate methodology'. The transfer pricing rules on this choice of methodology are in line with the OECD Guidelines, except that the methodologies are ranked in a hierarchical manner. Having said that, it is appropriate for taxpayers to choose the most appropriate methodology. If, however, the Department of Revenue believes that the choice of methodology deemed most appropriate by the taxpayer does not arrive at the correct arm's-length price, it may disagree and recalculate the arm's-length price using an alternative methodology. Choice of methodology is the most vexed issue, given the inconsistencies in interpretation and in the policy stance on transactions that involve use of intangibles. Lately, use of the residual profit split method has been gaining prominence.

#### ii Authority scrutiny and evidence gathering

In accordance with prevailing internal administrative guidelines, taxpayers are subject to risk-assessment rules (which are not made public) before being referred to a transfer pricing officer (TPO) for assessment or audit. Cases are selected for detailed audit by the issue of a notice under Section 143(2) of the ITA to the taxpayer within six months of the end of the

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<sup>3</sup> The unspecified methodology was introduced as from financial year 2011–2012.

financial year of the compliance calendar. There is a statutory requirement for the assessing officer (AO) to refer relevant transactions under Section 92CA of the ITA to the TPO for an audit, with prior approval of the jurisdictional commissioner, such that only select cases or transactions are audited. Although the criteria are not defined, a history of audits that resulted in an adjustment comprised of low margins, intangibles, intra-group services, etc. form a basis for cases being picked out for assessment audit. Typically, the TPO specifies the records, documents and details required to be produced for an audit. The TPO has wide assessment powers requiring the production of necessary evidence and material information to support the computation of the arm's-length price of transactions. Audit cases are scrutinised in detail to ensure that all relevant factors, such as appropriateness of the transfer pricing method applied and correctness of data, are verified. After taking into consideration all the information available, the TPO is required to determine the arm's-length price. However, in a situation where the taxpayer has modified the arm's-length price (determined in an APA), the tax officer can merely accept the modification to determine the return of income and cannot do an assessment or reassessment.

TPOs are vested with powers of inspection, discovery, enforcing attendance, examining a person under oath and compelling the production of books of account and other relevant documents and information as part of the assessment function. These powers were further extended, from 1 June 2017, to include conducting surveys for spot inquiries, verification for subsequent investigations, and collation of data. These powers are enshrined in Sections 133A and 133B of the ITA, which empower the TPO to enter any premises to inspect such books of accounts, cash, valuables or any information as the TPO may require that may be useful or relevant for the proceedings. The investigative powers of the tax authorities in general, including in relation to transfer pricing law, are discussed in Section VI. A penalty of 2 per cent of the value of the international transaction has been provided in Section 271AA of the ITA, both for failure to report transactions and for furnishing incorrect documentation at the audit stage.

Enhanced approaches such as adoption of practices suggested under BEPS Action Plans, following a risk-based tax audit approach or a faceless assessment or appeal, have bolstered the transfer pricing mechanism. During the past few audit periods and outcomes from appeals before appellate forums, the Revenue has learnt innovative ways to view a particular transaction and experiences from APA as well as CbCR have also boosted the tax policy framework. Another mode of building capacity is the use of technology, artificial intelligence and data analytics to analyse the complex web of MNE structures and routing of transactions.

In 2017, the concept of thin capitalisation was introduced in line with the recommendations contained in BEPS Action Plan 4. Where an Indian company, or a PE of a foreign company in India, being the borrower, pays interest exceeding 10 million rupees in respect of any debt issued or guaranteed (implicitly or explicitly) by a non-resident associated enterprise (AE), then such excess interest (being above 30 per cent of earnings before interest, tax and depreciation) will not be deductible.

#### **IV INTANGIBLE ASSETS**

The definition of the term 'international transaction' was broadened retrospectively in 2012 to cover transactions for the purchase, sale, transfer, lease or use of intangible property. The definition expanded to practically cover every direct or indirect transaction in relation to

intangible property. The disclosure requirements for international transactions relating to intangibles changed in 2017, when it was made mandatory for taxpayers to disclose details of such transactions with an aggregate value exceeding 100 million rupees in respect of the lease or use of intangible property. These details are to be filed by the taxpayer in Form 3CEAA and be furnished to the Director General of Income Tax (Risk Assessment) on or before the date on which the taxpayer is due to furnish its tax return.

India has not specified any formal policy in response to the principles on the development, enhancement, maintenance, protection and exploitation of intangibles<sup>4</sup> articulated in the BEPS Action Plan other than the 2017 disclosure requirements. The CbCR requirement now mandates listing all multinational enterprise group entities engaged in the development of intangibles and the description of a multinational enterprise's strategy (transfer pricing policy) for development, ownership and exploitation of intangible property.

Well before the BEPS initiative was under way, given the growing disputes over R&D captives, the Central Board of Direct Taxation (CBDT) issued guidelines<sup>5</sup> to TPOs about characterisation of R&D units based on functions, assets and risk assumed. A set of qualitative criteria was laid out to drive decision-making on characterisation with an emphasis on the substance of an arrangement and not the contractual arrangement between the centre in India and its foreign associated enterprise. This guidance has classified R&D centres under the following three categories:

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

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

## V SETTLEMENTS

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

In a move to reduce litigation and boost investor confidence, India introduced unilateral, bilateral and multilateral APAs with effect as of 1 July 2012. In the past seven years since introduction, India has received over 1,000 applications and concluded over 300 APAs of which more than 240 are unilateral and more than 30 bilateral APAs. These APAs cover various transactions, such as software services, IT-enabled services, intra-group payments, business support services commission or indent. The bilateral APA process covers important jurisdictions, such as the United States, the United Kingdom, Japan, Germany, France, Italy and the Netherlands. In recent APA negotiations, the Revenue has been advocating expanding the scope of 'profit attribution' in the source jurisdiction, based not just on Functions, Assets and Risk (FAR) analysis but also considering 'market' analysis, also referred to as Functions,

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4 Known as DEMPE functions.

5 Circular 06/2013, available at [www.incometaxindia.gov.in/pages/communications/circulars.aspx](http://www.incometaxindia.gov.in/pages/communications/circulars.aspx).

Assets, Risk and Market (FARM) analysis. Value creation is positioning centre-stage in APA negotiations, particularly for digital business models. Evaluation of intangibles using development, enhancement, maintenance, protection and exploitation (DEMPE) analysis and focus on significant people function are also important aspects in APA negotiations and transfer pricing audits.

The MAP has often been viewed as a credible resort for settling transfer pricing-related disputes. Under the MAP process, the Indian competent authority allows the foreign associated enterprise, a resident of the treaty country, to submit its MAP request via its country's competent authority. Under various administrative directions, tax demands arising out of adjustments with foreign associated enterprises that are residents of the United States, the United Kingdom, South Korea and Denmark are frozen until the MAP process is concluded, subject to the submission of suitable bank guarantees. Article 19 of the Multilateral Instrument (MLI) provides for mandatory binding arbitration when competent authorities are unable to reach a decision under MAP within two years. With the onset of MLI-based treaties from 1 April 2020, it is pertinent to note that India has not accepted such provision, taking a position that such binding arbitration would adversely impact its sovereignty.

India introduced safe harbour rules in 2009 for resolving disputes for specific industries or transactions, particularly in the area of IT-enabled services, software development, R&D, exports of goods in the auto-ancillaries industry, inbound offshore loan and debt transactions, etc. The 2009 safe harbour limits were set with a higher threshold, and as a result there were fewer takers in the initial years. The safe harbour limits were revised downwards and tweaked further in 2013 to encourage taxpayers to avail of safe harbour, particularly for inbound low value-added services. The tax authorities will accept the transfer price declared by taxpayers opting for a safe harbour within the limits set out without question or scrutiny. In 2020, the law on safe harbour has been expanded to cover non-residents for determining profit attributable to their PE in India.

## VI INVESTIGATIONS

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

The tax authorities, however, have broad powers for assessment (e.g., reopening of past-year assessments, investigations), under the following provisions of the ITA:

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

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

- a* the price charged in an international transaction is not at arm's length;
- b* any information and documentation relating to an international transaction has not been maintained by the taxpayer;



- c* the information or data used in computation of the arm's-length price is not reliable or correct; or
- d* the taxpayer has failed to furnish requested information or documentation within the specified time.

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

The time limit for completing an assessment, which must include a reference by way of notice to the TPO, has been reduced to 24 months from May 2020 onwards as compared to the erstwhile limit of 33 months.

The primary onus is on the taxpayer to maintain documentation to demonstrate that the price charged in an international transaction complies with the arm's-length price, and the method followed to ascertain the price is the most appropriate method. The taxpayer discharges this onus by maintaining the documentation and thereafter the onus shifts to the tax authorities. In the event that the tax authorities disagree with the taxpayers' view and seek additional explanation, the burden of proof again shifts (to the taxpayer) to prove why the method applied by the taxpayer is correct.

After categorically stating reasons for such rejection, the TPO is required to compute the arm's-length price by undertaking a fresh benchmarking analysis. The powers of the TPO have been widened to cover even the transactions not disclosed in the accountant's report.

The Bombay High Court<sup>6</sup> has held that where no such benchmarking exercise was undertaken to determine the value of intra-group services, such approach was not in accordance with the spirit of the law.

## VII LITIGATION

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

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

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<sup>6</sup> *CIT v. Merck Ltd* [2016] 389 ITR 70; *CIT v. Lever India Exports Ltd* [2017] 78 taxmann.com 88 (Bombay); *CIT v. Johnson & Johnson Ltd* [2017] 80 taxmann.com 337 (Bombay); *CIT v. Kodak India Pvt Ltd* [2017] 79 taxmann.com 362 (Bombay).

The DRP as an alternative dispute resolution mechanism was introduced in law by the Finance Act 2009 to expedite resolution of disputes in transfer pricing. Once the taxpayer chooses to opt for the DRP process, no tax demand can be raised, given that the assessment is in a draft form at that stage. The salient features of the DRP mechanism are as follows:

- a* the DRP objections have to be filed within 30 days of the date of the draft assessment;
- b* the DRP, comprising three commissioners, must decide the taxpayer's objections within nine months of the date of reference by issuing written directions to the AO;
- c* these directions are binding on the AO, and it is expected that they shall be incorporated in the final order;
- d* the DRP has wide powers to examine additional evidence, inquire further into the case and, by a majority, issue directions to confirm, enhance or reduce the adjustment;
- e* the DRP cannot, however, compromise or settle a dispute and its powers to adjudicate are limited.

In 2016, the law was amended whereby the Revenue was barred from filing an appeal against the DRP directions. Alternatively, if the taxpayer does not communicate its decision to refer the draft assessment to the DRP within 30 days, the AO shall finalise the assessment without modification of the draft. In summary, the tax demand is finalised only upon the AO's passing of the final order, which is appealable to the Appeals Commissioner (if the taxpayer does not file an objection) and to the Income Tax Appellate Tribunal (ITAT), if it is passed pursuant to the DRP directions.

The taxpayer has the right to appeal to the ITAT within 60 days of the final order pursuant to DRP directions or the order of the Appeals Commissioner. As the ultimate fact-finding authority, the ITAT examines the dispute afresh and adjudicates on most transfer pricing disputes. It has broad powers to decide questions of law or facts, including setting aside an assessment or restoring the order of the TPO or AO for fresh examination, and including admitting additional evidence.

Select ITAT orders travel to the jurisdictional High Court and from there to the Supreme Court. The High Court has to be satisfied that a 'substantial question of law' arises from the ITAT order before admitting an appeal.

### **Landmark cases**

There have been a number of judicial opinions wherein transfer pricing disputes have been examined and crucial legal principles have evolved.

The Bombay High Court in the *Vodafone* case:<sup>7</sup> An Indian subsidiary entity of Vodafone and Shell issued shares to its foreign associated enterprise. The TPO formed an opinion that the shares were issued at an undervalued price. Hence, they treated the shortfall in the premium on the issue of shares as 'income chargeable to tax' in the hands of the Indian entity, and made a transfer pricing adjustment. The TPO held the shortfall in the premium to be a loan given by the Indian subsidiary to its foreign associated enterprise. Hence, notional interest on arm's-length pricing of the deemed loan was charged as interest income by way of a secondary adjustment.

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7 [2014] 368 ITR 1 (Bombay).

The issue before the court (under a writ jurisdiction) was whether the alleged shortfall in share valuation constituted income in the hands of the Indian entity, and was hence chargeable to tax.

The High Court held that transfer pricing provisions allow for recalculation of the arm's-length price to determine the real value of the transaction, but not recharacterisation of the transaction. Hence, there was no question of the transaction resulting in income and there could be no transfer pricing adjustment.

In *SG Asia Holdings (India) Pvt Ltd*<sup>8</sup> the Supreme Court has held that the ITAT was right in observing that by not making reference to the TPO, the AO had breached the mandatory instructions issued by the CBDT. However, the Supreme Court allowed the Revenue's plea for making a fresh transfer pricing audit.

High-pitched transfer pricing adjustments on intra-group services payments to AEs: The Mumbai ITAT in the landmark decision in the case of *CLSA* has held that ad hoc TP adjustments without following the due process of law should be deleted and no second opportunity should be given to the TPO,<sup>9</sup> though a contrary decision has been taken by the Bangalore ITAT. There are other decisions where the ITAT has restored the case back to the tax officer, *only for the limited purpose of verification of margins*.<sup>10</sup>

The Revenue has been appealing against such decisions of the ITAT to the High Court. In 2018, the Karnataka High Court delivered a landmark judgment in the case of *Softbrands India Pvt Ltd*,<sup>11</sup> holding that adjustments on the basis of the comparables are a matter of estimate and cannot be challenged in the High Court unless the findings are *ex-facie* perverse and exhibit total non-application of mind. Subsequently, over 500 appeals were decided following this judgment, the correctness of which is currently being heard by the Supreme Court.

In another case,<sup>12</sup> the High Court, while rejecting the appeal of the Revenue, concluded that 'a party is not barred in law from withdrawing from its list of comparables, a company, if the same is found to have been included on account of mistake as on facts, it is not comparable. The Transfer Pricing Mechanism requires comparability analysis to be done between like companies and controlled and uncontrolled transactions'.

In the case of *Mitsui*,<sup>13</sup> the ITAT upheld the taxpayer's international transactions using TNMM as the most appropriate method and use of the Berry ratio as the profit level indicator (PLI). The Revenue's appeal was rejected by the High Court on the ground that no substantial question of law arose, though the Revenue has appealed to the Supreme Court, which is currently pending.

In another case,<sup>14</sup> the ITAT has held that a Foreign AE can be taken as the tested party if it has a simpler FAR profile for analysing international transactions.

8 TS-775-SC-2019-TP.

9 *CLSA India Pvt Ltd v. DCIT Circle 4(1)(1), Mumbai* [2019] 101 taxmann.com 388 (Mumbai – Trib).

10 *CWT India Pvt Ltd* [2019] 109 taxmann.com 182 (Mumbai – Trib).

11 TS-475-HC-2018(KAR)-TP.

12 *Tata Power Solar Systems Ltd* [2019] 77 taxmann.com 326 and *Lionbridge Technologies Pvt Ltd* [TS-176-HC-2019(BOM)-TP].

13 *Mitsui and India Pvt Ltd* [TS-602-SC-2017-TP].

14 *General Motors India Pvt Limited* [2013] 37 taxmann.com 403 (Ahmedabad – Trib).

It is also held<sup>15</sup> that choice of method available to a taxpayer is not an unfettered choice. The CUP method, if found appropriate in a given situation for determination of arm's-length price, should be preferred over the other methods.

There is also a precedent,<sup>16</sup> whereby the adjustment to a taxpayer's arm's-length price on account of 'location saving' without carrying out a comparability analysis with an uncontrolled transaction to show that location factor materially affected price and profit margin, was rejected.

## VIII SECONDARY ADJUSTMENT AND PENALTIES

To align with the BEPS, India has amended the ITA to provide for secondary adjustments. India's secondary adjustment law came into effect on 1 April 2017. For APAs concluded before the law's effective date, the secondary adjustment law does not apply. Secondary transfer pricing adjustments are applicable for primary adjustments if made in one of the following situations:

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

If the sums arising as a consequence of a primary adjustment are not repatriated to India within the prescribed period, the amount would be deemed an advance by the Indian associated enterprise and imputed interest would be payable on the advance, according to the arm's-length price standard.

A secondary adjustment has to be applied where the primary adjustment is above 10 million rupees and it relates to a primary adjustment for the fiscal years 2015 to 2016 onwards. The adjustment shall also apply in situations where the taxpayer is seeking rollback under the APA process. In 2019, the law was amended to prescribe a tax payment of 18 per cent of the adjustment amount plus surcharge and cess in lieu of the requirement to repatriate the quantum of a secondary adjustment.

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

## IX BROADER TAXATION ISSUES

### i Diverted profits tax and other supplementary measures

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

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15 *Serdia Pharmaceuticals (India) Pvt Ltd* [2011] 9 taxmann.com 13 (Mumbai).

16 *Syngenta India Ltd* [2017] 77 taxmann.com 220 (Mumbai).

In line with the OECD's BEPS Action Plan on taxing e-commerce transactions, India in 2016 introduced an 'equalisation levy' to provide for a charge of 6 per cent in the form of tax from amounts paid to a non-resident not having any permanent establishment in India, for specified services, which include business-to-business services such as online advertising and provisions for digital advertising space. In 2018, India introduced the concept of the 'significant economic presence' test to tax non-residents on profits generated through non-PE traditional rules under applicable double-tax treaties, although its implementation has been deferred following treaty amendments resulting from the OECD BEPS multilateral process. This provision was earlier proposed to be effective from tax year 2020–2021; however, in February 2020 it was deferred to 2021–2022.

In April 2019, India issued a public consultation document on profit attribution to PEs, introducing the concept of the 'fractional formulary approach' to attributing profits to PEs. OECD guidance focuses on the supply-side factors for attribution of profits and ignores factors related to markets and demand, which could have significant adverse consequences for developing economies like India.

## **ii Double taxation**

CBDT has clarified that MAP and bilateral APA applications can be applied by any taxpayer operating in India (regardless of residence) with which India has a double-taxation avoidance agreement even though the agreement does not contain provisions for corresponding adjustment in matters of transfer pricing.

## **iii Consequential impact for other taxes**

Indirect tax implications with regard to transfer pricing adjustments are independent of the ITA and are governed by distinct laws.

Under the Goods and Service Tax (GST) laws, which apply to all supplies of goods and services in India (including imports), the transaction value between the parties is the primary basis of valuation of supplies for the purposes of determining the GST liability. In the case of a related-party transaction, however, the transaction value is not accepted. Consequently, a related-party transaction must be benchmarked based on the stipulated rules, among which is the open market value (OMV) of identical goods or services supplied to an unrelated party. In case such OMV is not available, then the taxable value is to be ascertained on the basis of the value of similar supplies, the cost construction method or the resale price of goods to independent parties, in that order.

Indian customs law, which provides for levy of import and export duties on goods imported into and exported from India, is based on the World Trade Organization's Customs Valuation Agreement in so far as determining taxable value for customs duties purposes is concerned. Basis the same, in case of any related-party transaction, the declared import price is not accepted unless it is established that the relationship between the buyer and the seller has not 'influenced the price' of the imported goods. Upon failure to establish such, the transaction value is rejected, and the valuation of the imports is referred, administratively, to the Special Valuation Branch (SVB) of Customs. The SVB sequentially applies valuation rules prescribed under Customs Valuation Rules to determine the arm's-length transaction value. As per the Customs Valuation Rules, this value is determined based on import value of identical goods or similar goods (with necessary adjustments), the deductive value method or computed value method, and thereafter the residual method.

## X OUTLOOK AND CONCLUSIONS

As an active member of the G20, India has signed multilateral instruments, is a key contributor to the OECD's BEPS initiative and has actively pursued changes in its domestic law policy. A significant step has already been taken to adopt the OECD's recommendations of mandatory filing of a master file and a CbCR.

Further, India has expressed views supporting a consensus-based solution for profit allocation for PEs. A CBDT committee has proposed a fractional apportionment methodology which adopts the entire profit for allocation, as compared to the residual profit approach adopted under the formulary apportionment methodology proposed by the OECD under the Unified Approach.

In addition, India has taken various steps to target anti-avoidance. It introduced General Anti-Avoidance Rule (GAAR) provisions effective from 1 April 2017 which are broad based and counter any 'impermissible avoidance arrangement'. India has also concluded revised tax treaties with Mauritius, Singapore and Cyprus, with the 'limitation of benefits' clause to address the potential of abuse of these treaties. Simultaneously, India has ratified the Multilateral Instrument (MLI) and aligned the ITA to incorporate the 'principal purpose' test and other elements of the MLI in its tax treaties which are part of its 'covered agreements'. India is also presently seeking to overhaul the ITA. The Government is reviewing an expert committee report on the Direct Tax Code, submitted by the committee in September 2019. The report has not been made public, and it is yet to be seen when it will be translated into law.

### **Impact of covid-19 pandemic**

Businesses will have to factor in disruption due to covid-19 and realign transfer pricing policies. Inter-company agreements which impact pricing policies will need to be amended. For limited risk distributors, contract manufacturers and contract R&D service providers, taxpayers will assess the profit margin impact. There is no administrative guidance available in relation thereto, however taxpayers can renegotiate the terms of their APA.

# INDONESIA

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## I OVERVIEW

The legal basis for the arm's-length principle in Indonesia is provided in Article 18(3) of the Income Tax Law (ITL), where it states that the Directorate General of Tax (DGT) is authorised to recalculate taxable income or deductible costs in accordance with the arm's-length principle for taxpayers that have a special relationship with other taxpayers.

According to Article 18(4) of the ITL, the definition of 'special relationship' applies to circumstances where:

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

DGT Regulation PER-22/PJ/2013 regarding transfer pricing audit guidelines further specifies the types of transactions covered under Indonesian transfer rules, which include transactions on:

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

The recent Ministry of Finance Regulation Number 22/PMK.03/2020 (MoF 22/2020) regarding advance pricing agreements (APA), besides regulating regarding APA procedures, also mentions substantive provisions of the arm's-length principle, including an expansion of the transactions covered under Indonesian transfer rules which now also covers independent transactions that are affected by related parties.

In general, the Organisation for Economic Co-operation and Development Transfer Pricing Guidelines (the OECD Guidelines) have been adopted in Indonesian transfer pricing regulations; however, there are several principles related to specific circumstances not detailed in Indonesian regulations.

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The ITL also authorises the Minister of Finance to prescribe the expected ratio of a company's liabilities to its equity, which shall be valid for tax purposes. Further, on 9 September 2015, the Ministry of Finance released Regulation Number 169/PMK.010/2015 (MoF 169/2015) regarding the ratio of debt and equity for income tax purposes. The regulation provides that the acceptable debt-to-equity ratio for Indonesian companies must not exceed 4:1, which means that this provision will deny the deductibility of the interest in connection with the portion of debt that exceeds the 4:1 ratio. In addition, debt-related deductions that could also be denied include fees and charges incurred in respect of the debt. Exclusions from the prescribed debt-to-equity ratio are provided for banks, financial institutions, insurance companies, mining companies, oil and gas companies under production-sharing contracts, taxpayers from the infrastructure sector and taxpayers subject to final income tax.

## II FILING REQUIREMENTS

Since tax year 2016, Indonesia has adopted a three-tiered transfer pricing documentation obligation, in line with agreed standards as set out in Action 13 of the OECD Base Erosion and Profit Shifting (BEPS) Action Plan. Transfer pricing documentation obligations are now governed under Minister of Finance Regulation Number 213/PMK.03/2016 (MoF 213/2016). Transfer documentation now consists of a master file, local file and country-by-country report (CbCR).

Master and local file documentation obligations are imposed on taxpayers that have related-party transactions in the current tax year and that meet the following criteria:

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

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

CbCR reporting obligations are imposed on taxpayers that meet the following criteria:

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

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2 This is in line with the BEPS Action Plan 13 required minimum threshold of €750 million.



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

To provide legal certainty of CbCR reporting obligations by domestic taxpayers that are not ultimate parent entities, the DGT will release a list of treaty partner countries that have a treaty in place containing an exchange-of-information clause, qualifying competent authority agreements (QCAA) and have a QCAA, but their CbCRs are unobtainable by the DGT. Upon the announcement of this list of countries, domestic taxpayers delegated with the CbCR obligation have three months to submit a CbCR. If within that period the taxpayer fails to submit a CbCR, the DGT shall send a formal request letter to the taxpayer and grant a 30-day extension as of the date of the request letter.

### III PRESENTING THE CASE

#### i Pricing methods

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

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

- a* the comparable uncontrolled price (CUP) method;
- b* the resale price method;
- c* the cost-plus method;
- d* the transactional net margin method (TNMM); and
- e* the profit split method.

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

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

**ii Authority scrutiny and evidence gathering**

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

- a* the significance of the affiliated transaction, measured on the basis of it in proportion to sales or net profit;
- b* affiliated transactions with entities located in low-tax jurisdictions;
- c* specific affiliated transactions, such as the transfer of intangibles, payment of royalties, performance of intra-group services and payment of interest;
- d* the taxpayer's net profit being less than that of other companies in a similar industry;
- e* the significance of affiliated transactions that are not included in the taxpayers' net profit component, which could be measured on the basis of the affiliated transactions considered in proportion to the taxpayer's net profit;
- f* interest expense;
- g* gain or loss on the sale of an asset;
- h* gain or loss from foreign exchange;
- i* non-routine affiliated transactions, such as business restructurings that involve or do not involve intangible assets, as well as sales of intangible property; and
- j* the taxpayer suffering losses for several years.

On 13 August 2018, the DGT issued Circular Letter No. SE-15/PJ/2018 (SE-15) concerning tax audit policy. Pursuant to SE-15, various indicators are used in determining taxpayers to be included in the Audit Priority Target List with regard to transfer pricing issues. The following indicators are used:

- a* taxpayers that have transactions with affiliates that are subject to a zero or low effective tax rate;
- b* indications that a taxpayer is involved in a transaction scheme involving entities that do not have business substance or do not add economic value (re invoicing);
- c* taxpayers that have significant affiliate transactions, particularly in relation to the value of sales;
- d* the existence of intra-group transactions such as the provision of services, payment of royalties, and cost distribution arrangements;
- e* the existence of business restructuring transactions such as mergers and acquisitions;
- f* the taxpayer's financial performance differs from the financial performance of the industry; and
- g* the taxpayer has had consecutive losses for three tax years out of the previous five years.

Since 1984, Indonesia has applied a self-assessment system in which taxpayers are required to calculate, pay and report their own taxes in accordance with prevailing tax laws and regulations. In connection with affiliated transactions, taxpayers are expected to prepare a transfer pricing report containing the information required by DGT. The role of the taxpayers

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<sup>3</sup> DGT Regulation PER-22/PJ./2013 and Circular Letter SE-50/PJ./2013.

in any tax audit is to assist in the process by appearing for investigation and producing books of accounts, documents or other relevant records as requested by the DGT for inspection within the specified time limit.

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

#### IV INTANGIBLE ASSETS

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

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

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

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

- a* booked research and development expense as well as marketing expense;
- b* performed research and development and marketing functions;
- c* had borne research and development risks as well as marketing risks;
- d* had employees or personnel with specific capabilities, employed in marketing or manufacturing functions, who contributed to the success of a product in the market; and
- e* had a distribution channel and customer list.

Concerning the determination of arm's-length royalty payment for the licensing of intangibles, DGT and taxpayers commonly use the CUP method. However, in the application of the CUP method, both taxpayers and DGT face the same limitations regarding the availability of reliable comparable, including the comparability of the type of intangible itself and the exclusivity rights; therefore, in some cases of dispute resolution, the TNMM is also commonly used.

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

## V SETTLEMENTS

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

The process of tax litigation in Indonesia takes 12 months each for objection and appeal, while civil review takes six months. However, in appeals and civil review processes, some periods can be longer than stipulated.

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

In domestic proceedings, it is possible to request the commencement of a MAP (i.e., a simultaneous MAP request) when the taxpayer is involved in a litigation process challenging the DGT in court (i.e., filing an objection or tax appeal). However, if the Tax Court has made a decision on an appeal case, the DGT would terminate the MAP process. Any mutual agreement request does not postpone taxpayers' obligations to pay the assessed tax if they have received an assessment notice, regardless of whether they request a MAP. Ministry of Finance Regulation Number 49/PMK.03/2019 (MoF 49/2019) has also made clear that splitting up disputes of one tax assessment (a tax assessment may contain tax audit findings related to transfer pricing, but also other issues) on the one hand by MAP and on the other hand by domestic litigation process is not possible. As such, a simultaneous MAP can only be initiated if the taxpayer has filed a domestic litigation process for the whole tax assessment.

Further, under the current MAP regime, the implementation of a MAP carried out through consultation between the Indonesian tax authorities and the authorities in a tax-treaty partner country may take a maximum of two years, commencing from the first consultation. It is not very clear whether this period may be extended following an agreement between the Indonesian tax authorities and authorities in the tax-treaty partner country if the MAP does not yield a mutual agreement. MoF 49/2019 states that if the time limit of negotiation is exceeded, then the DGT has the authority to terminate the MAP.

APAs can be concluded unilaterally or bilaterally, while a multilateral APA is not specifically regulated. Unilateral and bilateral APAs can cover a period of up to five tax years. By MoF 22/2020, APAs can now also cover a roll-back period for tax years that are not yet expired for assessment by the DGT (i.e., five years under the current regulations).

## VI INVESTIGATIONS

Tax audits concerning assessment of the arm's-length nature of related-party transactions falls within the normal tax audit procedure.<sup>4</sup> A tax audit is automatically triggered for taxpayers that file a tax return claiming a refund position. A tax audit may also be triggered as a result of risk profiling conducted by the DGT to identify transfer pricing risks. The risk profiling

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<sup>4</sup> Ministry of Finance Regulation No. 17/PMK.03/2013 as last amended by Ministry of Finance Regulation No. 184/PMK.03/2015.

takes into account, among others, perpetual losses; significance of related-party transactions; transactions with low-tax countries; and industry profitability benchmarks. Tax audits that include assessments on transfer pricing issues are conducted by the DGT through a field audit, which has a time limit of six months. This six-month period can be extended a maximum of three times.

During the tax audit process, the DGT has broad authority to request information. Taxpayers are required to provide the documents and information requested by the tax auditors within one month. Failure to provide the documents and information within this time limit may result in the tax auditor assessing tax liabilities on a deemed profit basis. If documents and information are not supplied within the one-month period, they cannot be used as evidence at a later stage.

Although tax audits are conducted in relation to overall tax compliance and not specifically subject to transfer pricing transaction, the DGT has issued audit guidelines specifically for transfer pricing.<sup>5</sup> The stated purpose of the audit guidelines is to provide 'simplicity and uniformity for the DGT in performing audits on taxpayers that have special relationships, to ensure the quality of the audit'. The audit guidelines serve as a best-practice toolkit for tax auditors, which is especially necessary since tax auditors throughout the country may have different levels of expertise in handling transfer pricing cases.

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

## VII LITIGATION

### i Procedure

Disputes will typically arise following the issuance of an SKP letter by the DGT with items of adjustments with which the taxpayer does not agree. A taxpayer who does not agree with a tax assessment letter can submit an objection to the tax office within three months of the issue date of the assessment letter. In accordance with the General Provisions and Tax Procedure Law, following receipt of an SKPKB letter, the taxpayer must pay at least the amount agreed during the closing conference before filing the objection. An objection decision letter must be issued by the DGT within 12 months; if a decision letter is not issued within 12 months, the objection is automatically deemed accepted in favour of the taxpayer.

The next stage of the dispute resolution process is the appeal (*banding*). Taxpayers that do not agree with an objection decision can file a letter of appeal to the Tax Court within three months of the receipt of the objection decision letter. To be eligible for the appeal to be heard at the Tax Court, the taxpayer must pay at least 50 per cent of the total tax due (i.e.,

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5 DGT Regulation PER-22/PJ./2013 and Circular Letter SE-50/PJ./2013.

the tax due as agreed by the taxpayer during the closing conference). Therefore, if the taxpayer has not agreed to any items of the adjustments imposed during the closing conference, there is no obligation to pay tax before having the appeal heard by the Tax Court.

If it is deemed necessary, during the hearings in the appeal process, the Tax Court may (on the suggestion of either the DGT or the taxpayer) summon a third party before the court<sup>6</sup> and also allow the use of expert witnesses in the appeal process.<sup>7</sup> It should be noted that the cost incurred shall be borne by the party who suggests it.<sup>8</sup> Should there be conflicting testimonies, judges are free to examine and determine the weight of each testimony.<sup>9</sup> However, judges are endorsed to exhaust written evidence before turning to other forms of evidence such as testimony from expert witnesses.<sup>10</sup>

As Indonesia adopts a civil law system, the courts do not operate on the basis of precedence and their decisions are not fully published. Instead, the Tax Court provides a summary of a Tax Court decision, which is available on its website.<sup>11</sup> However, the decision of the Tax Court is final with full legal force. The only legal remedy left for a taxpayer is to file a civil review request to the Supreme Court.

## ii Recent cases

There are several common disputes in Indonesian transfer pricing. The first example is the problem of the existence and benefit of services or intangibles (or both). In case Put-70118/PP/M.IA/15/2016 (18 April 2016), the existence and benefit of royalty payments made by the taxpayer were challenged by the DGT. In the Tax Court hearing, the taxpayer was able to provide 'tangible' evidence that the use of intangibles had occurred, such as the trademark attached to a product, technical documents regarding provision of know-how, and minutes of meetings, to prove that services had actually been rendered. Based on the tangible evidence above, the judges ruled in favour of the taxpayer.

The second common issue is disputes concerning selection of transfer pricing method. Case Put-099494.15/2012/PPM.XIIA (18 March 2019) concerns a challenge by the DGT on the arm's-length value of the royalties paid by the taxpayer to its affiliated company. The DGT contended that the royalties were not treated on an arm's-length basis following a TNMM analysis demonstrating that the taxpayer's operating margin fell below the arm's-length range. Subsequently, the royalty payments' deductibility was adjusted such that the taxpayer's operating margin fell within the median of the arm's-length range. The taxpayer contended that the royalty payments were made at arm's length, as demonstrated by a CUP analysis using comparable licence agreements. In addition, the taxpayer could demonstrate that the low operating margin was due to abnormal external factors (in this case, costs due to investment in a new factory). Further, the taxpayer was able to conduct a special-factor adjustment to eliminate the effect of these abnormal conditions, and so demonstrate that in normal conditions the taxpayer's operating margin fell within the arm's-length range. The Court decided in favour of the taxpayer and cancelled the DGT's transfer pricing adjustment.

6 Article 33(2) of Tax Court Law.

7 Article 69(1)(b) of Tax Court Law.

8 Elucidation of Article 33(2) of Tax Court Law.

9 Elucidation of Article 76 of Tax Court Law.

10 Elucidation of Article 69(1) of Tax Court Law.

11 Available at [www.setpp.kemenkeu.go.id/risalah](http://www.setpp.kemenkeu.go.id/risalah).

## VIII SECONDARY ADJUSTMENT AND PENALTIES

The authority of the DGT to impose a secondary adjustment is not clearly stipulated in the law. Nevertheless, the concept of 'secondary adjustment' is recognised in audit guidelines in connection with related-party transactions,<sup>12</sup> which the DGT often refers to when conducting audits on taxpayers. The guidelines state that 'if a primary adjustment has been conducted by the DGT, then a secondary adjustment may also be implemented'.

In practice, secondary adjustments are imposed on deductible payments to related parties (e.g., royalties and services), where the excess of the arm's-length amount will be considered as deemed dividends. The amount considered as deemed dividends is not deductible, while still subject to withholding tax at the applicable rates according to domestic tax law or tax treaties. Previously, the application of secondary adjustments by the DGT was quite rare in practice, but recently it has become increasingly common for transfer pricing adjustments to be followed by secondary adjustments. Another recent trend is for secondary adjustments to also be applied for VAT purposes (i.e., because, under domestic law, imports of services and royalties are subject to VAT, when imported services or royalties are adjusted for transfer pricing purposes by the DGT, the corresponding VAT cannot be credited as input VAT).

There is no specific penalty regime for transfer pricing. Penalties imposed as consequence of transfer pricing adjustments follow the general applicable laws on taxation.<sup>13</sup> In transfer pricing cases, generally, penalties are imposed when, as a consequence of a tax audit, an SKPKB letter is issued by the DGT. In this case, a penalty of 2 per cent per month of the underpaid tax amount is imposed for a maximum of 24 months.<sup>14</sup> An additional 50 per cent penalty will apply if the taxpayer files an objection; the taxpayer has not paid the underpaid tax prior to filing an objection; and the objection decision does not rule in favour of the taxpayer.<sup>15</sup> A 100 per cent penalty will be applied instead of the 50 per cent penalty if the taxpayer files an appeal to the Tax Court (after objection); the taxpayer has not paid the underpaid tax prior to filing an objection; and the Tax Court decision does not rule in favour of the taxpayer.<sup>16</sup>

Further, failure to maintain a transfer pricing documentation could be regarded as a failure to maintain appropriate bookkeeping. In accordance with the General Provisions and Tax Procedure Law, failure to maintain appropriate bookkeeping could be imposed with a 50 per cent penalty of the underpaid tax.<sup>17</sup>

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12 The concept of secondary adjustment is explained only in DGT Regulation PER-22/PJ./2013 and Circular Letter SE-50/PJ./2013.

13 For an overview of the general applicable penalty regime see the chapter on Indonesia by David Hamzah Damian and Ganda Christian Tobing in *The Disputes and Litigation Review* (Law Business Research, London: 2019) p. 18.

14 Article 13(2) General Provisions and Tax Procedure Law.

15 Article 25(9), *ibid.*

16 Article 27(5d), *ibid.*

17 Article 13(3), *ibid.*

## IX BROADER TAXATION ISSUES

### i Diverted profits tax and other supplementary measures

Electronic transaction tax (ETT) is introduced under Issuance of Government Regulation in Lieu of the Laws No. 1 Year 2020. ETT is taxes imposed on sales of goods and services originating from abroad through electronic systems to buyers in Indonesia.

There are two requirements for ETT to be applied. First, there is a 'significant economic presence' of the non-resident seller in Indonesia. Second, the non-resident seller is resident in a tax treaty partner country. ETT is primarily designed to circumvent the permanent establishment threshold in tax treaties so that Indonesia can retain its taxing rights in situations where non-resident taxpayers are doing business in Indonesia without physically being present in Indonesia (namely, electronic transactions or e-commerce). Technical regulations on ETT are yet to be issued by the Government.

On the other hand, ETT will not apply for non-resident sellers that are not residing in tax treaty partner countries. Instead, such non-resident sellers will be subject to the expanded definition of permanent establishment according to domestic law. Although the Income Tax Law retains the definition of permanent establishment based on physical presence, nevertheless Government Regulation No. 80 Year 2019 states that non-resident taxpayers are 'deemed' to have a physical presence in Indonesia if certain criteria are met. Those criteria include number of transactions, value of transactions, number of packet deliveries, and amount of traffic from users.

### ii Double taxation

Taxpayers seeking to resolve double taxation issues as a result of transfer pricing adjustments can make use of MAPs. All Indonesian income tax treaties contain a MAP article, similar to that contained in the OECD and UN models, although without an arbitration clause (except in the case of the tax treaty with Mexico). The Ministry of Finance has issued detailed regulations on how taxpayers can apply for the MAP.<sup>18</sup>

There have been a number of tax cases that have been resolved through MAPs. Since 2017 (for reporting period 2016), Indonesia has released its MAP statistics through the OECD website.<sup>19</sup> The DGT has also recently launched a specific website for MAPs and APAs, containing a range of information on the procedural and regulatory aspects of MAPs and APAs in English, including the most recent statistics.

## X OUTLOOK AND CONCLUSIONS

Indonesia is actively changing its regulations on transfer pricing to be more in line with the OECD BEPS package. As a result, transfer pricing documentation requirements in Indonesia have become more comprehensive and are now applicable to almost every taxpayer that is part of a multinational group. It is, therefore, expected that the role of transfer pricing documentation will become even more critical for the following year when the first tax audits under the new documentation rules will take place.

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18 MoF Regulation PMK-49/PMK.03/2019.

19 Available at [www.oecd.org/tax/dispute/2018-map-statistics-indonesia.pdf](http://www.oecd.org/tax/dispute/2018-map-statistics-indonesia.pdf) (accessed on 6 May 2020).



Taxpayers should consider transfer pricing documentation as the first line of defence in the event of an audit. Ultimately, robust transfer pricing documentation can serve well to reduce disputes with the DGT. A major change adopted in its approach to tax audits is the DGT's focus on inter-company pricing policies (*ex ante* approach), and not only on testing the arm's-length principle after the transaction has occurred.

Although the number of tax audits has remained high over the past three to four years, there is also a growing trend for APAs in Indonesia as a means of avoiding disputes or of reaching settlements. Although the APA programme is relatively new, the prospect for APAs is nevertheless promising, since it is reported that Indonesia has already successfully concluded many bilateral APAs with major trading countries.

The covid-19 outbreak and following crisis has significantly accelerated Indonesian policymaking with regard to digital tax. Weeks before the outbreak Indonesia was still talking about the importance of a global consensus in this area with the G20 and OECD.<sup>20</sup> A month later, ETT was introduced. And now, the Government has stated that ETT is a backup plan in case that global consensus cannot be reached this year, and that the Government is also preparing draft legislation for VAT on electronic transactions.<sup>21</sup> If the crisis worsens, it is expected that the taxation potential of digital taxes (that are mainly focused on non-resident taxpayers) will be the focus of the Government, to replace the declining performance or relaxation of other 'domestic' taxes.

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20 See <https://news.ddtc.co.id/kata-menkeu-g20-kebut-kajian-proposal-prinsip-untuk-pajaki-google-cs-19157>.

21 See <https://news.ddtc.co.id/meski-masuk-perpu-1-2020-djp-pajak-digital-tunggu-konsensus-global-20449>.

# IRELAND

*Joe Duffy and Catherine O'Meara*<sup>1</sup>

## I OVERVIEW

Formal transfer pricing legislation was introduced in Ireland for the first time through the Finance Act 2010 for accounting periods commencing on or after 1 January 2011 in respect of transactions, the terms of which were agreed on or after 1 July 2010. Ireland's transfer pricing legislation is set out in Part 35A of the Taxes Consolidation Act 1997 (TCA).<sup>2</sup> The Irish transfer pricing legislation was substantially updated in the Finance Act 2019,<sup>3</sup> with effect from 1 January 2020.

Before the introduction of transfer pricing legislation in 2010, there were limited circumstances in which an 'arm's-length' or 'market-value' rule applied in Irish tax legislation. However, there was certainly some familiarity with the concept. For example, capital gains tax rules always required the imposition of market value on certain transactions undertaken otherwise by means of a bargain and arm's length;<sup>4</sup> interest in excess of a 'reasonable commercial return' may be reclassified as a distribution;<sup>5</sup> and, historically, income or losses qualifying for the (no longer applicable) 10 per cent corporation tax rate for manufacturing operations were calculated as they would for 'independent parties dealing at arm's length'.<sup>6</sup>

The transfer pricing legislation introduced in 2010 certainly broadened the scope of application of transfer pricing in Irish tax legislation, and the changes in the Finance Act 2019 further broadened the scope. As might be expected, where the transfer pricing rules apply, an arm's-length amount should be substituted for the actual consideration in computing taxable profits. The arm's-length amount is the consideration that independent parties would have agreed in relation to the arrangement in question.<sup>7</sup> The transfer pricing legislation applies equally to domestic and international arrangements but does not apply to small and medium-sized enterprises, pending implementation by Ministerial Order which will extend the scope to medium enterprises.<sup>8</sup>

Irish tax legislation requires that the profits or gains of a trade carried on by a company must be computed in accordance with generally accepted accounting practice subject to any

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1 Joe Duffy and Catherine O'Meara are partners at Matheson.

2 Taxes Consolidation Act 1997 (as amended up to Finance Act 2019).

3 Section 27 Finance Act 2019.

4 Section 547 TCA.

5 Section 130 TCA.

6 Section 453 TCA. Deleted by Finance Act 2012 Section 54.

7 Section 835C TCA.

8 Section 835E TCA.

adjustment required or authorised by law.<sup>9</sup> Therefore, Irish transfer pricing legislation may result in an adjustment to the accounting profits for tax purposes. Where a transaction is undertaken at undervalue this may be a deemed distribution by the company for Company Law purposes, and if the company does not have distributable reserves this may be an unlawful distribution by the company.

The Finance Act 2019 substantially reformed the Irish transfer pricing legislation introduced in the Finance Act 2010, and addressed the various shortcomings in the legislation that had been identified as part of an independent review. The key reforms introduced in section 27 of the Finance Act 2019 can be summarised as follows.

First, transactions the terms of which were agreed before 1 July 2010 are no longer ‘grandfathered’ or excluded from Irish transfer pricing legislation. Practically, the expectation of the Irish Revenue Commissioners (Irish Revenue) was that the grandfathering of transactions predating 1 July 2010 would have been lost through the passage of time, where actual trading relationships change, even though contractual terms may not. Nevertheless, this will mean that taxpayers must prepare supporting transfer pricing documentation for previously excluded transactions.

Second, the transfer pricing legislation now applies to non-trading transactions as well as trading transactions. Previously, the transfer pricing legislation only applied to profits or losses arising from the relevant activities that were taxed at the 12.5 per cent rate of corporation tax as the profits of a trade or profession.<sup>10</sup> Now, non-trading transactions that would be subject to the 25 per cent corporation tax rate may be subject to the arm’s length requirement. This is particularly relevant where an Irish company has granted an interest-free loan or royalty-free licence other than in the course of a trading activity. Now, the interest or royalty charged must be arm’s length and supported by relevant documentation. There was some concern about possible negative tax arbitrage in respect of non-trade loans between Irish companies where interest income would be taxable at 25 per cent and interest paid as part of a trade would be deductible at 12.5 per cent. However, the Finance Act 2019 provides for an exclusion from the transfer pricing legislation in such Ireland-to-Ireland transactions where both parties are within the charge to Irish tax and neither company is a section 110 TCA company.

Third, the transfer pricing legislation has been extended to capital transactions (including assets and intangible assets) where the market value of the assets or capital expenditure is greater than €25 million. There are a number of exemptions to the application to capital transactions, in particular where the disposal is treated for the purposes of Irish tax legislation as being at no gain, no loss (e.g., group transaction or reorganisation relief). It is arguable that this change is not significant given that Irish tax legislation did previously provide for an open market value rule on capital transactions between connected persons. However, this requirement is seen as particularly relevant to taxpayers ensuring there is adequate documentary evidence prepared in accordance with OECD guidelines.

Fourth, the 2017 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (2017 OECD Transfer Pricing Guidelines) have been explicitly referenced so that the Irish transfer pricing legislation must be interpreted in so far as is practicable in a manner that is consistent with the 2017 OECD Transfer Pricing Guidelines as supplemented by: (1) the Guidance for Tax Administrations on the Application of the

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9 Section 76A TCA.

10 Section 835C TCA.

Approach to Hard-to-Value Intangibles;<sup>11</sup> (2) the Revised Guidance on the Application of the Transactional Profit Split Method;<sup>12</sup> and (3) such additional guidance, published by the OECD on or after the date of the passing of the Finance Act 2019, as may be designated by the Minister for Finance. This means that as from 1 January 2020 due consideration must be given to development, enhancement, maintenance, protection and exploitation (DEMPE) functionality in pricing intangibles transactions between Irish taxpayers and associated companies resident in non-tax treaty partner countries. Previously the 2017 OECD Transfer Pricing Guidelines were only relevant as an interpretation aid to the arm's-length principle under Ireland's double tax treaties.

Fifth, Irish transfer pricing is now more prescriptive regarding the form of transfer pricing documentation and the timing for production of such documentation. Specifically, there is now an obligation to prepare a master file and a local file in accordance with Annex I and Annex II of the 2017 OECD Transfer Pricing Guidelines where the requisite financial thresholds are exceeded and such documentation must be prepared at the time at which the corporation tax return is due to be filed. Furthermore, specific penalties have been introduced for failure to provide the necessary documentation when requested.

Sixth, the transfer pricing legislation previously excluded small and medium-sized enterprises. Going forward, only small enterprises will be excluded (less than 50 employees and annual turnover/assets of less than €10 million). However, commencement of this provision is subject to Ministerial Order and in the meantime medium, as well as small, enterprises remain exempt.

Seventh, the transfer pricing legislation now includes explicit 'substance over form' provisions whereby Irish Revenue may consider the substance of a transaction where the substance differs from what has been agreed in writing. In addition, Irish Revenue are expressly permitted to recharacterise transactions entered into by associated enterprises if such transaction would not have been entered into by parties acting at arm's length.

## **II FILING REQUIREMENTS**

Prior to the Finance Act 2019, there was very little legislation detailing the documentation requirements for transfer pricing purposes. Irish Revenue had issued guidance on the expectations regarding transfer pricing documentation,<sup>13</sup> which endorsed (though did not make binding) the EU Council code of conduct entitled 'EU Transfer Pricing Documentation' and Chapter V of the OECD Transfer Pricing Guidelines as representing good practice.

However, there is now an obligation that valid transfer pricing documentation should comprise such records as may reasonably be required to support the pricing, and should include (1) a master file (in accordance with Annex I of Chapter V of the 2017 OECD Transfer Pricing Guidelines) where the taxpayer is part of a multinational group with revenues in excess of €250 million; and (2) a local file (in accordance with Annex II of Chapter V of the 2017 OECD Transfer Pricing Guidelines) where the taxpayer is part of a multinational group with revenues in excess of €50 million.<sup>14</sup>

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11 BEPS Actions 8–10, OECD/G20 Base Erosion and Profit Shifting Project, OECD, Paris – approved on 4 June 2018 by the group known as the Inclusive Framework on Base Erosion and Profit Shifting.

12 Inclusive Framework on BEPS: Actions 8–10, *ibid.*

13 Transfer Pricing Documentation Obligations Part 35a-01-02, August 2017.

14 Section 835G as amended by section 27 Finance Act 2019.

There is now an obligation that the transfer pricing documentation be prepared by the time the taxpayer is obliged to deliver its corporation tax return for the period (typically the 21st day of the ninth month following the accounting period end). Furthermore, the documentation must be provided to Irish Revenue within 30 days of a request being made.

There are new transfer pricing penalty provisions for failure to comply with the documentation requirements, though timely preparation and delivery (upon request) of reasonable transfer pricing documentation should protect a taxpayer from penalties even if a transfer pricing adjustment is subsequently made.

Ireland has introduced legislation to implement country-by-country reporting requirements.<sup>15</sup> The Irish country-by-country reporting closely mirrors the OECD model legislation and relies on it for certain definitions. It should be noted that there are some differences between the OECD model legislation and the Irish country-by-country reporting legislation. Primarily in relation to options to appoint a surrogate parent entity or EU designated entity to provide the country-by-country report on behalf of the multinational group. Where there is a conflict, the Irish legislation takes precedence. Currently, there is no Irish legislation in respect of public country-by-country reporting, though this is an area of interest to the European Commission and ultimately may be introduced as an EU directive.

### **III PRESENTING THE CASE**

#### **i Pricing methods**

As mentioned above, the Irish transfer pricing legislation states that in computing the taxable profits and losses of a taxpayer, the legislation shall be interpreted to 'ensure, as far as practicable, consistency' with the 2017 OECD Transfer Pricing Guidelines. The Irish transfer pricing rules do not prescribe any preferred transfer pricing methodology or methodologies. Provided the methodology is appropriate in the circumstances and adheres to general OECD principles, it should be acceptable. Therefore the identification of the most appropriate transfer pricing method, either traditional transaction methods (CUP, resale price and cost-plus) or a transactional profit method (transactional net margin and transactional profit split), and the application of that method should be in accordance with the 2017 OECD Transfer Pricing Guidelines.

Irish Revenue has published guidance on a simplified approach in respect of low-value intra-group services.<sup>16</sup> In summary, where a cost-based method is determined to be the most appropriate transfer pricing method for determining an arm's-length price for low value intra-group services, Irish Revenue is prepared to accept a markup of 5 per cent of the relevant cost base without the a requirement for a benchmarking study. The guidance also sets out the documentation requirements for the taxpayer to avail of this simplified approach for low value intra-group services.

Low value intra-group services are services performed by entities within a multinational group for other entities within the same group and are typically administrative, routine and supportive services that are ancillary to the main business and do not involve valuable

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15 Section 891H TCA and Taxes (Country-by-Country Reporting) Regulations 2016.

16 Guidelines on Low Value Intra-Group Services, Part 35A-01-03, March 2018.

intangibles or risk for the service provider. Irish Revenue is prepared to accept a markup of 5 per cent of the cost base without a requirement for a benchmarking study to be carried out by the taxpayer to support this rate.

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

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

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

## **ii Authority scrutiny and evidence gathering**

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

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

However, as mentioned above, the Finance Act 2019 introduced 'substance over form' provisions whereby Irish Revenue will seek to identify the actual commercial and financial arrangements between the associated entities. Irish Revenue will then consider the transfer pricing on the actual identified arrangement if it differs from the documented legal form. Furthermore, they may even disregard the actual arrangement if it is not an arrangement that third parties would enter into.

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

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

#### **IV INTANGIBLE ASSETS**

As mentioned above, the Finance Act 2019 extended the Irish transfer pricing legislation to transactions involving capital assets, including intangible assets. In addition, the Act requires that the Irish transfer pricing rules are interpreted in so far as is practicable in a manner that is consistent with the 2017 OECD Transfer Pricing Guidelines as supplemented by the Guidance for Tax Administrations on the Application of the Approach to Hard-to-Value Intangibles. Therefore, Chapter VI of the 2017 OECD Guidelines should be considered carefully in all transactions involving the acquisition or disposal of intangible assets and on royalty and other licence fee payments in respect of the use of intangibles.

#### **V SETTLEMENTS**

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

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

Once a settlement is agreed, the outstanding tax plus interest and penalties is paid and the audit is closed. In certain circumstances, where significant penalties are imposed as part of the settlement, Irish Revenue is obliged to publish the name and address of the taxpayer along with the default amount and applicable tax head.<sup>17</sup>

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

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<sup>17</sup> Section 1086 TCA.

## VI INVESTIGATIONS

Irish Revenue maintains scrutiny on the transfer pricing matters within the framework of the existing tax compliance infrastructure with support from a team of economists. Separately Irish Revenue's competent authority team manage international transfer pricing disputes and bilateral or multilateral advance pricing agreements. Irish Revenue has published guidance on its approach to transfer pricing investigations.<sup>18</sup>

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

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

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

An authorised officer can require a taxpayer to deliver, or to make available for inspection, books, records and other documents (including transfer pricing documents) or to furnish information relevant to the taxpayer's tax liability under the legislation. Following the Finance Act 2019, upon request the taxpayer must deliver supporting transfer pricing documentation (including a master file and local file where applicable) within 30 days. An authorised officer can also apply to the High Court for an order directing the person concerned to comply with the officer's requirements in respect of books, records and other information.<sup>20</sup>

The statute of limitations for raising an assessment is four years from the end of the accounting period in which the relevant tax return is delivered.<sup>21</sup> This typically means the accounting period remains open for audit for five years from the end of the accounting period in question.

Once an assessment is raised the taxpayer has 30 days to lodge an appeal to the assessment in writing. The case then moves forward to the Tax Appeals Commissioners for determination. Further appeal on points of law may be made to the High Court, Court

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18 Monitoring Compliance with Transfer Pricing Rules, Part 35A-01-01, June 2018.

19 See Revenue Operational Manual 35A-01-01.

20 Part 38 TCA.

21 Part 41A TCA.



of Appeal and ultimately the Supreme Court through the regular court system. It is worth noting that settlement negotiations can continue during the period following the issuing of an assessment and lodging an appeal.

## **VII LITIGATION**

### **i Procedure**

To make an appeal to an assessment the taxpayer must submit a formal notice of appeal to the Tax Appeals Commission, along with a copy of the notice of assessment or the letter of notification containing the decision to be appealed. The notice of assessment or the letter of notification will state the time limit for making an appeal but it is generally 30 days from the date on the notice of assessment or the letter or notification.

For the Tax Appeal Commissioner to accept the appeal, the taxpayer must have submitted a tax return and paid the amount of tax declared on the return. It is not necessary to pay the tax assessed by Irish Revenue in the notice of assessment. If this condition is not satisfied, Irish Revenue may object to the leave to appeal and will notify the taxpayer of the objection. While Irish Revenue can object to the acceptance of the appeal, it is a matter for the Tax Appeals Commission to accept or refuse to accept the appeal.

Most appeals end up being settled by an agreement between taxpayers and Irish Revenue rather than being decided by the Tax Appeals Commission. The appeal to the Tax Appeals Commission will remain open for the duration of any discussions with Irish Revenue. However, the Tax Appeals Commission may decide to proceed with the appeal if it thinks that it is unlikely to be settled by agreement or it is unlikely to be settled within a reasonable period.

Most appeals that end up with the Tax Appeals Commission are decided following an oral hearing before an Appeal Commissioner. A hearing involves the Appeal Commissioner listening to arguments and evidence presented by the taxpayer and an Irish Revenue official. Both parties may be represented by a tax adviser or lawyer. Before an oral hearing takes place, the Tax Appeals Commission may ask the taxpayer or Irish Revenue to provide additional information about the matter being appealed. The Tax Appeals Commission can decide not to have an oral hearing but, instead, to make a decision based on written material provided by the taxpayer and Irish Revenue. This is more likely to happen where the matter being appealed is straightforward.

During a Tax Appeal Commissioners hearing expert witnesses may be called, the number of witnesses depending on the complexity of the matter at hand. Where expert evidence of a technical nature is likely to be adduced by the parties, the Tax Appeal Commissioners may give a direction that any experts intended to be called by the parties to give evidence at the hearing of the appeal meet in advance of the hearing and prepare an agreed statement detailing those areas in which the experts are in agreement and those areas on which the experts differ.

Whether your appeal is decided with or without an oral hearing, the taxpayer is given a detailed written decision that explains why the Appeal Commissioner made the decision. All decisions are published on the Commission's website<sup>22</sup> but do not identify the particular taxpayer involved. To date, there have been no transfer pricing decisions published.

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22 [www.taxappeals.ie](http://www.taxappeals.ie).

Either party may appeal a decision of the Appeal Commissioners to the High Court on a point of law but this is not a complete re-hearing of the appeal. Therefore, the ability to appeal will depend on the decision made by the Appeal Commissioner and the reasons given for making that decision.

## **ii Recent cases**

There has been no case law or Tax Appeals Commissioners decision on Ireland's transfer pricing legislation, although there are cases awaiting hearing. In a case that pre-dated the transfer pricing legislation, *Belville Holdings v. Cronin*,<sup>23</sup> the High Court considered whether a parent company was obliged to charge for services provided to subsidiaries in circumstances where it was otherwise incurring losses as a result of expenses incurred. The High Court held that the parent company should be obliged to charge expenses incurred managing its subsidiaries but only to bring the transaction within the realm of being a bona fide transaction in the ordinary course of business.

## **VIII SECONDARY ADJUSTMENT AND PENALTIES**

Irish Revenue is not entitled to impose secondary adjustments under transfer pricing legislation where those adjustments do not relate to an understatement of profits.

The Finance Act 2019 provides for specific transfer pricing related penalties. There is a penalty of €4,000 for a failure to deliver transfer pricing documentation within 30 days where requested by Irish Revenue. The penalty is increased to €25,000 (plus €100 for each day) for multinationals with global revenues in excess of €50 million. In addition, normal taxation and penalty provisions will apply. Therefore both fixed and tax-g geared penalties may apply. The applicable tax-g geared penalty can be as much as 100 per cent of the underpaid tax. Irish Revenue is prepared to mitigate penalties to an amount as low as 3 per cent of the underpaid tax. The applicable percentage will depend on whether there has been a qualifying disclosure, it is a first offence, it is careless behaviour or deliberate behaviour and whether consequences are significant.<sup>24</sup>

Where the taxpayer does not agree on the liability to a penalty then it is a matter for the court to determine whether that person is liable to a penalty.

## **IX BROADER TAXATION ISSUES**

### **i Diverted profits tax and other supplementary measures**

Ireland has not introduced a diverted profits tax or other measures to supplement transfer pricing rules.

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23 III ITR 340.

24 See Code of Practice for Revenue Audit and other Compliance Interventions, February 2017.

## ii Double taxation

To avoid double taxation on transfer pricing matters, taxpayers may request mutual agreement procedure assistance under the terms of the relevant double-tax treaty or the EU Arbitration Convention. In addition, taxpayers have access to the EU Tax Dispute Resolution Directive<sup>25</sup> for complaints submitted on or after 1 July 2019 in relation to a question in dispute which involves income or capital earned in a tax year commencing on or after 1 January 2018.

The legal basis for a mutual agreement procedure request falls under the equivalent of Article 25 of the OECD's Model Tax Convention on Income and on Capital in the relevant double-tax treaty. In international transfer pricing matters it is typically advisable for each affected taxpayer to make a separate request for mutual agreement procedure assistance to the competent authority of the country in which it is resident. Under the multilateral instrument agreed as part of the BEPS process Ireland has opted to allow a taxpayer approach the competent authority of either jurisdiction. The mutual agreement procedure request must be submitted in writing within the time limit applicable in the relevant double-tax treaty (which is typically three years, but may vary by treaty) or the EU Arbitration Convention (which is three years from the first notification of the action that results or is likely to result in double taxation). The time period typically begins from the date of the first tax assessment notice or equivalent.

The minimum information to be provided as part of a mutual agreement procedure request under a double-tax treaty includes details of the relevant tax periods, the nature of the action and the names and addresses of the relevant parties. For a valid request under the EU Arbitration Convention, the request should also include details of the relevant facts, copies of assessments, details of litigation commenced and an explanation of why the principles of the EU Arbitration Convention have not been observed.<sup>26</sup>

Double taxation can also be avoided by means of settling an advance pricing agreement. Importantly Irish Revenue is prepared to conclude a multilateral or bilateral advance pricing agreement with double-tax treaty partner jurisdictions. Irish Revenue will not conclude unilateral pricing agreements. Irish Revenue has issued detailed guidelines on the processes for advance pricing agreements.

A request for a mutual agreement procedure can be distinguished from a request for a correlative adjustment where a foreign associated taxpayer has settled a case unilaterally with its foreign tax administration with regard to a transaction with its Irish associated taxpayer, and the associated Irish taxpayer subsequently makes a claim to Irish Revenue for a correlative adjustment. Irish Revenue will consider the appropriateness of such claims and will only allow a correlative adjustment to the profits of the Irish taxpayer to the extent that it considers the adjustment to be at arm's length.

Double taxation may be unavoidable in a situation where a non-negotiable tax settlement has been agreed in one jurisdiction and Irish Revenue does not consider the settlement reached to reflect an arm's-length position.

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25 2017/1852 of 10 October 2017.

26 See Tax and Duty Manual Part 35-02-08.

### iii Consequential impact for other taxes

Where a transfer pricing adjustment is simply booked as an adjustment to taxable profits and there is no adjustment to the actual price charged and invoiced as between the associated entities then there should be no VAT impact. Where the adjustment is charged and invoiced then VAT returns should be amended as appropriate. The VAT recovery consequences will then depend on the VAT profile of the entity in question.

For customs purposes the price paid or payable is taken as the transaction value for customs purposes. So a transfer pricing adjustment that results in a change in the price paid may be relevant to any market valuation used as part of customs reporting. In light of the recent decision of the European Court of Justice in *Hamamatsu Photonics Deutschland*,<sup>27</sup> the impact of pricing adjustments on the customs valuation declared on the importation of the goods is unclear. Irish Revenue has not published guidance or otherwise commented on the decision to date.

## X OUTLOOK AND CONCLUSIONS

The Irish transfer pricing rules were only introduced in 2010, but following the BEPS process, a comprehensive review of Ireland's corporation tax code by an independent expert and extensive public consultation, the transfer pricing rules were significantly updated in the Finance Act 2019. Irish Revenue now has the legislative framework of a modern transfer pricing regime and has recognised transfer pricing as an important tool for raising tax revenues and defending the existing Irish tax base. We can expect an increase in transfer pricing related controversy in coming years.

In the meantime, attention has turned to the ongoing debate on the tax challenges of the digitalisation of the economy. Ireland has been an active participant in tax reform discussions throughout the BEPS process. Regarding the OECD Secretariat proposals under Pillar One and Pillar Two, Ireland has adopted a pragmatic and principled approach. The Irish Minister for Finance is broadly supportive of a collective solution under Pillar One, even though a realignment of taxing rights under the Unified Approach (or a variant thereof) is likely to see a reduction in Irish corporation tax receipts. It is acknowledged that the absence of agreement does not result in the status quo but rather in a variety of unilateral taxing measures and inevitable EU proposals. A balanced global solution to the realignment of taxing rights is likely to provide greater certainty to business and to Ireland in the medium term. The Minister for Finance has expressed some reservations on the GloBE proposal under Pillar Two as going beyond what is needed to address the tax challenges of digitalisation. Nevertheless, Ireland continues to adopt a pragmatic approach given that in the absence of agreement through the Inclusive Framework, proposals on both a realignment of taxing rights and a minimum taxation are likely at EU level.

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27 C-529/16.

# ISRAEL

*Eyal Bar-Zvi*<sup>1</sup>

## I OVERVIEW

Israel's transfer pricing regime is regulated under Section 85A (Section 85A) of the Israeli Tax Ordinance (the Ordinance), which came into effect on 29 November 2006 and applies to corporate tax. Guidance regarding transfer pricing is provided in several tax circulars issued by the Israel Tax Authority (ITA), the most recent at the time of writing being Tax Circular 1/2020 (initially titled Tax Circular 8/2020) with regard to the burden of proof in transfer pricing audits.

The regulations promulgated under Section 85A (the Regulations) adhere to the arm's-length principle and incorporate the approach taken in the Organisation for Economic Co-operation and Development (OECD) Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the OECD Guidelines<sup>2</sup>) and the approach taken in Section 482 of the US Internal Revenue Code (Section 482) towards determination of the correct analysis methods for examining an international transaction between related parties. It should be noted, however, that certain tax circulars offer a 'safe-harbour' mechanism with specific margins.

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. Transfer pricing issues normally arise in relation to transactions carried out by companies that are part of a multinational group; however, the ITA has recently started to implement the principles of Section 85A unofficially with respect to related-party transactions within Israel. According to Section 85A and the Regulations, the tax assessment officer (AO) may issue an approval that certain one-time transactions are 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 that individual's relatives, the control of one party to the transaction over the other, or the control of one individual over the other parties to the transaction, whether directly or indirectly, individually or jointly with other individuals.

'Control' means holding, directly or indirectly, 50 per cent or more of 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;

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1 Eyal Bar-Zvi is a partner and the head of the transfer pricing department at Herzog Fox & Neeman Law Offices. The author wishes to thank Annette Cohen for her contribution to this chapter.

2 In our advisory work we adhere to the new OECD Guidelines issued in 2017, as well as any new complementary guidance of the OECD. The Israeli courts and ITA's issued tax circulars also normally apply the OECD Guidelines.

- 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 has one of the aforementioned rights.

A relative is a spouse, sibling, parent, grandparent, child, spouse's child and the spouse of each of these. Nonetheless, 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 research and development (R&D), manufacturing and marketing); the use or transfer of tangible and intangible goods (i.e., distribution); the use or transfer of intangible assets (e.g., know-how, patents, trade name or trademark); and financing<sup>3</sup> (e.g., capital notes, guarantees, captive insurance, loans) transactions, which are required to be carried out at arm's length.

Because of the nature of the Israeli market, the ITA gives special attention to R&D services provided by Israeli subsidiaries and matters relating to intangibles, which may also involve governmental support. The ITA also focuses its audits on the restructuring of functions, assets or risks (FAR) and on the distinction between marketing services and distributorship activities carried out in Israel by MNEs.

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 must be taken:

- a* identify the cross-border controlled transactions within the group;
- b* identify the tested party for each relevant 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 or methods;
- 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 that do not transact at arm's length, or that do not hold the required transfer pricing documentation (proving their compliance with the arm's-length principle), may be exposed to penalties and to a change of pricing as determined by the ITA at its discretion. These companies 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 taxed in other jurisdictions.

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3 Concerning financing transactions, the provisions of Section 85A explicitly address inter-company credit transactions (loans) and capital notes. However, in practice all types of financial arrangements between related parties must be transacted at arm's length.

Based on recent court rulings, and as recently stated by Tax Circular 1/2020, the burden of proof is normally on the taxpayer, and it does not necessarily shift to the tax assessment officer once a transfer pricing study has been submitted for assessment and where there is a disagreement on the factual background or on the method chosen. Moreover, the tax assessment officer may use Section 85A and transfer pricing rules to *de facto* reclassify a transaction (and the method used).

In rare cases where a transaction between related parties lacks any commercial rationale (namely the same transaction under similar economic circumstances would not have been 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; a type of transaction that, in its view, would reflect the business reality of the transaction in a more adequate manner. This type of reclassification of a transaction can relate, inter alia, to the treatment of inter-company loans or cash pooling or non-repayment of inter-company debts, as dividends, as well as to the ownership of intangibles. Non-recognition can be contentious and a source of double taxation and, while derived from Section 85A, it is based also on Section 86 of the Ordinance.

With regard to the accounting treatment of transfer pricing positions, one of the main issues currently under discussion in Israel relates to the recognition of expenses with regard to employee stock option plan (ESOP) matters (see also Section VII.i), where the matters of vesting, exercise and cancellation of options granted to the employees of an Israeli subsidiary by the (foreign) parent corporation are considered.

## **Recent developments – Israeli transfer pricing regulations**

### ***Tax Circular 1/2020***

In accordance with Tax Circular 1/2020, the filing of a transfer pricing study, in and of itself, does not shift the burden of proof from the taxpayer to the ITA. The transfer pricing study will first be reviewed by the ITA to verify it complies with the requirements of the Ordinance. For example, where the facts underlying the transaction are in dispute, or the tax inspector disagrees with the type of transactions conducted between the parties, the taxpayer is still required to prove those facts, and the submission of the transfer pricing study is not sufficient to shift the burden of proof to the ITA. The ITA may also request to see how the transaction was recorded by the other (non-Israeli) party to the transaction.

Tax Circular 1/2020 states, as an example which complements the ITA's stand for some time now, that a transfer pricing study implementing the TNMM (in the US, CPM) method (i.e., a cost-plus arrangement), albeit the existence of valuable intangibles with both parties to the transaction, without sufficiently explaining why the profit split method was rejected, may lead the ITA to state that the taxpayer has not met the required standard in order to shift the burden of proof to the ITA.

An additional case in which the burden of proof will not shift from the taxpayer to the ITA, in accordance with Tax Circular 1/2020, albeit the filing of a transfer pricing study, is where there is an incomplete transfer pricing study, namely a study missing, for example, one or more of the following: a complete search process; the reasoning for choosing the applicable transfer pricing method; the reasoning for choosing the comparables; and financial data of comparables.

It is important to state that the position of Tax Circular 1/2020 is that where the ITA rejects the transfer pricing study filed by the taxpayer based on the foregoing, or where the taxpayer has not filed a transfer pricing study at all, the results will be the same, and the ITA

can, inter alia, set the tax assessment without the need to provide a complete study on its behalf. While the ITA inspectors cannot set this arbitrarily, they can base such assessment upon their general experience and past assessments, as well as upon estimations. Additionally, the ITA inspectors may impose fines on the taxpayer.

### ***Tax Circular 15/2018***

Based on the recent *Gteko* court ruling (6 June 2017) and the OECD Guidelines, the ITA published on 1 November 2018 Tax Circular 15/2018 dealing with business model restructuring inside a multinational enterprise (MNE), and involving the FAR associated with the Israeli subsidiary of a MNE. The Circular presents the ITA's position with respect to business restructuring and defines ways for identifying and characterising business restructurings, and offers methodologies that are accepted by the ITA for valuation of transferred, ceased or eliminated FAR commonly involved in the course of a business restructuring (e.g., intangibles, skilled work force). With regard to each FAR transferred in a business restructuring, the Circular sets guidelines for the characterisation of a FAR transfer as a sale transaction or a 'grant of temporary-usage permit' transaction, for classifying it as a capital or ordinary income transaction.

### ***Tax Circulars 11/2018 and 12/2018***

On 5 September 2018, the ITA published two circulars, Tax Circulars 11/2018 and 12/2018, setting out its approach towards classification and transfer pricing methods appropriate for use in connection with certain inter-company transactions between an Israeli entity and related overseas parties that are part of a multinational group. The Circulars focus on inter-company transactions involving marketing services or sales and, in particular, on the approach to be used to classify a given entity as either a marketing services entity or a sales (distributor) entity. In addition, the ITA opined on how to choose the most appropriate transfer pricing method, as well as which ranges of profitability (safe harbours) it sees as appropriate for these types of Israeli entities.

Taxpayers submitting reports in accordance with the approach outlined in Circular 11/2018, and whose results fall within the safe harbours provided under Circular 12/2018, would be exempt from the requirement to provide benchmarking support for the assertion that the transfer prices used are in accordance with market pricing. Nonetheless, the Circular does not otherwise provide an exemption from the existing requirement to prepare transfer pricing documentation. A benchmarking analysis is not required in the event of an exemption, but other parts of the study are still required, together with a rationale for the method and safe harbour applied by the circulars.

### ***Circular 12/2018 safe harbours***

#### ***Distribution activity***

For taxpayers where the analysis of the functions, risks and assets aligns with sales activities for low-risk distributors (LRDs), the exemption would be provided in the event that the entity reports an operating margin of three to four per cent in the domestic market (i.e., an operating margin profit level indicator (PLI) shall be implemented at rates ranging from 3 per cent to 4 per cent).



### *Marketing activity*

For taxpayers where the analysis of the functions, risks and assets aligns with an entity performing marketing activities, and not sales activities, the circulars indicate that an appropriate transfer pricing method would be based on the costs of these activities, with an appropriate markup added. The exemption for supporting the markup over the costs incurred based on benchmarking analysis would be provided for entities reporting a markup of 10 per cent to 12 per cent. (i.e., a net cost-plus PLI shall be implemented at rates ranging from 10 per cent to 12 per cent).

### *Low-value-added services*

The Circulars provide that for taxpayers with transactions involving low-value-added services (generally consistent with the OECD Guidelines), an exemption from some documentation requirements would be provided where the entity reported a markup of five per cent associated with these activities (i.e., a net cost-plus PLI (i.e., a markup) shall be implemented at the rate of 5 per cent).

### ***Tax Circular 4/2016***

In 2016, in Tax Circular 4/2016, the ITA issued an update regarding the operations of foreign multinationals in Israel through the internet. This Circular, inspired by Action 1 of the OECD's Action Plan on Base Erosion and Profit Shifting (the OECD BEPS Action Plan) concerning the digital economy, provided new guidelines and rules under which foreign companies' income derived from selling products or providing services through the internet to Israeli residents (digital activity) will be deemed the income of a permanent establishment (PE) in Israel for tax purposes. The Circular distinguishes between foreign enterprises that are residents of a treaty state (treaty resident companies) and foreign enterprises that are residents of a non-treaty state (non-treaty resident companies) and provides different rules for determining the income attributed to the Israeli PE for each of the aforementioned company types.

### ***Expected circulars***

Currently, the ITA is holding round-table talks<sup>4</sup> on other draft circulars, including in the fields of implementation of development, enhancement, maintenance, protection and exploitation of intangibles (DEMPE) analysis; pricing of options; and profits associated with management functions.

## **II FILING REQUIREMENTS**

Taxpayers engaged in cross-border controlled transactions are required to include a separate form (Form No. 1385) in their annual tax return, specifying their intra-group dealings (such as the volume of the transactions, transaction types, 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. The ITA issued a new version of Form No. 1385, applicable to fiscal year 2019 onwards, that requires additional

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<sup>4</sup> The author's firm, Herzog Fox & Neeman Law Offices, is the only law firm participating in these talks.

details regarding the implemented TP method, the profitability rate used for transactions and whether the transactions are reported based on the new safe harbours set forth in Tax Circular 12/2018.

In practice, this means that taxpayers in Israel are expected, and in fact required, to hold up-to-date transfer pricing documentation, which includes (at a minimum) a transfer pricing study and an inter-company agreement relevant for the fiscal year end. Form No. 1385 is signed personally by an officer of the company (usually the company's chief financial officer), and although no personal liability has yet been claimed by the ITA in cases where the form was inaccurate, the ITA is reviewing its position on this matter. An updated Form No. 1385 is expected, as well as Form No. 1485 (for capital notes).

In addition, the ITA is entitled to demand full transfer pricing documentation within 60 days of a request of this type. 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-day period prescribed under the Regulations.

As noted above, by signing Form No. 1385 the taxpayer's officer declares that the company is compliant with the arm's-length principle and that it maintains up-to-date transfer pricing documentation (i.e., a transfer pricing study, inter-company agreement and also, where applicable, a transfer pricing policy), and it is therefore advisable to have an updated transfer pricing study in place annually. 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 AO and enables the taxpayer to maintain an arguable position regarding any determination made by the AO concerning transfer pricing adjustments. The deadline to prepare transfer pricing documentation is 31 May of the year after the tax year.

Full documentation includes the following:

- a* a transfer pricing study that includes:
  - a description of the parties involved in inter-company transactions, including a description of the management structure of the parties and functional organisational charts;
  - a description of the inter-company transactions;
  - a description of the business environment and the economic circumstances in which the parties operate;
  - a functional analysis of the parties involved in the inter-company transactions (including functions performed, risks assumed and resources employed);
  - selection of the pricing method or methods and the reasons behind the selection;
  - an economic analysis (determination of arm's-length prices); and
  - the conclusions that may be derived from the comparison to uncontrolled comparable companies; and
- b* additional documents that corroborate the data described above, such as:
  - inter-company contracts;
  - any disclosure made regarding the controlled transactions to any foreign tax authority, including any request for an advance 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 one was given.

It is recommended to update the transfer pricing study on an annual basis. Where the facts of the transactions under review have not changed materially (or at all), the entire transfer pricing study can remain the same except for the benchmark results, which should be updated every year. It is best practice to perform a new search every two years and update the results of the original search on an annual basis. From time to time, because of a lack of local comparables, the search may be broadened to a more global search, as long as it abides by the Regulations and the instructions of the ITA.

### **Proposed legislation**

On 4 January 2017, draft legislation was proposed to amend the Ordinance to include new transfer pricing provisions with respect to Action 13 of the OECD BEPS Action Plan. The proposed legislation updates the provisions of Section 85A of the Ordinance and adds Sections 85B and 85C to the Ordinance.

In light of this proposed legislation, the burden of transfer pricing documentation will grow as taxpayers will be required to submit further documentation, reports and data to comply with the new documentation requirements.

Accordingly, in addition to the regular local file (i.e., the transfer pricing study), Israeli taxpayers that are members of a multinational group will also be required to submit data at the corporate level, namely a master file accompanied by related data of the multinational group. In addition, an Israeli taxpayer that serves as the ultimate parent of a multinational group whose consolidated turnover exceeds 3.4 billion new Israeli shekels will be required to submit a country-by-country report as well.

The draft legislation passed the first reading (of three) in the Israeli parliament; however, the applicable effective date of the proposed legislation has not yet been determined. Currently, the ITA expects that this legislation will pass during 2020.

## **III PRESENTING THE CASE**

### **i Pricing methods**

The Regulations incorporate both the OECD Guidelines and Section 482's approach towards the 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 for transactional transfer pricing methods over profit-based transfer pricing methods.

According to Section 85A, the preferred method is the comparable uncontrolled price or transaction (CUP/CUT) methodology, because this method can produce the most accurate and reliable arm's-length results. When the CUP/CUT cannot be used, then one of the following methods should be employed:

- a* resale price method (RPL);
- b* cost plus;
- c* profit split methods (comparable or residual); or
- d* transactional net margin method (TNMM, similar to the comparable profits method (CPM) in Section 482).

If none of the above methods can be applied, other methods should be used that are most suitable under the circumstances. However, this should be justified both economically and legally, and the application of a different method cannot normally be justified when one of the above-prescribed methods is applicable.

When applying a certain transfer pricing method, an adjustment is sometimes required to eliminate the effect of the difference derived from various comparison characteristics between the controlled and comparable uncontrolled transactions.

According to the Regulations, a cross-border controlled transaction is considered to be at arm's length if, following the comparison to similar transactions, the result obtained does not deviate from the results of either the full range<sup>5</sup> of values derived from comparable uncontrolled transactions when the CUP method is applied (under the assumption that no comparability adjustments were performed), or in the interquartile range when applying other methods.

The adoption of post-BEPS measures has been formalised in part in Israel, including guidance concerning restructuring and low-value-adding services, and measures related to the digital economy; other post-BEPS measures are under consideration by the ITA. The ITA places great emphasis on business or economic substance when 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. Consequently, the ITA may deem a transfer pricing analysis to be inappropriate to the application, preferring, for example, a profit split method rather than the TNMM. In other cases, the ITA has retroactively applied different methods from those used by the taxpayer, shifting between CUP and TNMM, in cases where profit split was not applicable.

As mentioned above, where a transaction between related parties lacks any commercial rationality, the ITA may not recognise the transaction in its original form, and may treat it as an entirely different type of transaction that, in its view, would reflect the business reality of the transaction in a more adequate manner. Non-recognition can be contentious and a source of double taxation.

### ***Financing transactions***

The Israeli transfer pricing regulations do not provide specific guidelines for evaluating the arm's-length nature of inter-company financing transactions and thus follow a broader transfer pricing approach provided under the OECD Guidelines and Section 482.

Specifically, for inter-company loans, the evaluation of the arm's-length nature is carried out by establishing an arm's-length interest rate based on those applied in comparable third-party transactions. According to the OECD Guidelines and Section 482, the transfer pricing methodology usually used when setting arm's-length interest rates is the CUP method, applying internal or external CUP analysis. The approach preferred by the ITA is the external CUP method, which is, in fact, a market-valuation method, as it relies on market yields of publicly traded corporate bonds that are comparable to the assessed inter-company loan in terms credit-rating and loan terms when establishing the arm's-length interest rate.

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5 The full range is spread between the minimum and maximum prices or percentile.

Following the issuance of the OECD's final guidance on financial transactions on 11 February 2020, it is likely that inter-company loan transactions will be the focus of increased scrutiny by the ITA. Therefore, Israeli taxpayers are advised to apply a new approach when establishing arm's-length interest rates for their inter-company loan transactions in accordance with the OECD's final guidance. This will combine the synthetic rating approach backed by audit trails and empirical evidence,<sup>6</sup> such as a description of people functions involved, and evidence demonstrating the management and control of risks by relevant parties to the inter-company loan.

In addition to the above, the fact that there are no thin-capitalisation rules in Israel will also contribute to the trend of increased tax audits relating to inter-company loan transactions. Consequently, this enables Israeli borrowers in controlled loan transactions to be highly leveraged and assume high interest payments deductible for tax purposes in Israel. This issue will be resolved when Israel implements the recommendation prescribed under BEPS Action 4 and limits the interest payment amount deductible for income tax by applying a 'fixed ratio' (which equals a borrower's net deduction for interest or earnings before interest, tax, depreciation and amortisation (EBITDA) to 10 per cent to 30 per cent) or a 'group ratio' (which equals a group's net deduction for interest or EBITDA).

### ***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 stages. 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 generally acceptable to tax administrators when it is used in cases where both entities contribute or own significant intangibles, and it has recently been advocated by certain officials of the ITA. The profit split method is most often applied in the context of global value chains, where the global operations of a multinational corporation are significantly integrated.

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<sup>6</sup> Audit trails or empirical evidence may include the number of FTEs on the payroll of the lender; a creditworthiness analysis of the borrower conducted by the lender; evidence of negotiation of the clauses to the inter-company loan agreement, etc.

In Israel, following the OECD BEPS Action Plan, tax practitioners are currently assessing the applicability of the profit split method in service transactions, which include the provision of significant services that contribute to the creation of profits and value (e.g., R&D, marketing, management) as a result of increasing challenges by the ITA to the cost-plus models, and recharacterisation as profit splits. The ITA is implementing a people-orientated analysis when conducting tax audits and, therefore, can, in certain cases, determine management services as being a non-routine activity for purposes of profit splits.

Concerning R&D services, in cases where R&D activity is considered non-routine by the ITA, this activity may be re-characterised as a profit split. The ITA's determination concerning the non-routine nature of the R&D is based on several factors:

- a whether the R&D relates to the development of a whole new product or the continuing development of an existing product;
- b how many employees are involved in the development; and
- c whether the Israeli R&D contractor is free to determine its own R&D budget or whether it is bound by the authorisation of the entity financing the R&D activity.

With respect to marketing services and in accordance with Circular 11/2018, the ITA challenges cost-plus models for marketing activity and re-characterises these as distribution models. This means that an Israeli company that acts as a marketing services provider could be characterised as a distributor by the ITA, and thus be subject to an appropriate profit derived from revenue concerning the sales of the products in Israel.

The characterisation of a marketing service provider as a distributor is dependent on the involvement of the marketing activity in the creation of revenue for the group in terms of, but not limited to:

- a which entity oversees the engagement with customers, and where contracts are signed;
- b which entity oversees the negotiations with customers;
- c which entity is seen by the customers as the one responsible for sales;
- d the entity that approves discounts or unusual credit terms for customers; and
- e whether the employees of the marketing service provider are compensated by a certain percentage from sales of promoted products.

As regards management services, the ITA's determination of management services as an intangible is based on the nature of the services, meaning that a management service incorporating strategic decision-making functions may be considered intellectual property for profit split purposes. As noted, this matter is currently being debated with the ITA.

Further, because of the new value-added services safe-harbour setting (a cost-plus five per cent exemption), a five per cent markup for value-adding services such as R&D services would be difficult to justify.

### ***Application of the cost-plus method***

The cost-plus method compares gross margins of controlled and uncontrolled transactions. The cost-plus method is most often used to assess the markup earned by a service-providing entity that engages with related parties.

The arm's-length price is measured by adding an appropriate gross profit (i.e., markup) to the controlled taxpayer's cost of producing the services involved in the controlled transaction.

The cost-plus method applies where internal data is available, in which a service renderer provides the same or similar services to both controlled and uncontrolled parties and where it provides detailed information concerning comparable transactional costs.

In practice, this method is usually not applicable for evaluating the arm's-length nature of intra-group services, mainly because external data (i.e., transactions between two third parties) found on public databases cannot be reliably used when applying this method. This is due to inconsistencies between companies' financial data, arising from the fact that companies allocate their costs using different accounting methods.

The degree of consistency in accounting practices between the controlled transaction and the uncontrolled comparables materially affects the gross profit markup and the reliability of the result.

### ***Comparables***

When performing comparability analysis, the goal is to reach the most accurate pool of potential comparable companies. In doing so, the search process usually includes a quantitative screening followed by a qualitative screening.

It is first essential to apply Standard Industrial Classification (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, and limitations regarding operating losses.

Depending on the nature of the tested transaction under review, in certain cases, additional quantitative screening criteria are also applied to yield a more accurate set of comparables. This mainly includes the application of different financial ratios such as R&D expenditure sales, intangible-asset sales, inventory sales, or property, plant and equipment sales.

The next step is a qualitative screening, which focuses on examining the business descriptions of all remaining companies and then establishing a set of comparable companies.

The Regulations do not provide a reference to a specific number of comparables required for the establishment of interquartile range results. In our opinion, between 10 and 20 comparables should suffice, with the minimum being around five. There is no quantitative limit; however, the credibility of a range composed of a large number of comparables may be brought into question.

Regarding the locations of selected comparables, local (Israeli) comparables are preferred but are not often available. Practice has shown that the use of European or US comparables is also accepted by the ITA, as well as global benchmarks, as 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 economic analyses to determine the arm's-length price for a taxpayer's transactions. Further, the TPD has been given full authority to review (and tax)

previously approved assessments and to reopen final assessments that were approved up to three years before their inspection. The TPD also gives guidance and instructions to local tax AOs to screen and initiate audits on a wider level. In the event of an audit by a local tax AO, 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 (where relevant).

The matter of ESOPs has gained specific attention in audits performed by the TPD, has involved other departments of the ITA, and has generated a recent ruling issued by the Supreme Court on 22 April 2018 recognising that an Israeli subsidiary operating as a contract R&D services provider and working on a '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 (this may also apply to other types of services). Currently, the ITA is considering a circular on the recharge agreements typical of those arrangements.

### ***Evidence-gathering process***

The ITA does not usually interview persons outside the company undergoing an audit, although this is not prevented by legislation. It is common, however, to allow the professionals who act as consultants to 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. These 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 intra-group information even if it is held outside Israel. If the company fails to present the requested information, it is likely to be viewed negatively throughout the process, including (potentially) in court, thereby preventing the company from providing the information at a later stage.

In January 2017, a proposed amendment to the Ordinance that includes transfer pricing provisions, adopting anti-BEPS measures, passed the first reading (of three) in the Israeli parliament. The proposed legislation aligns with Action 13 of the OECD BEPS Action Plan and follows a formal resolution by the Israeli government to adopt the BEPS principles.

In addition, on 12 May 2016, Israel signed the Multilateral Competent Authority Agreement for Country-by-Country Reporting (MCAA CbCR) 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 indicate that Israel can be expected to amend its documentation requirements to also include the creation and filing of CbCRs, and to implement legislation regarding surrogate filing.

Adoption of the MCAA CbCR may indicate 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 a CbCR in itself could not be used alone by the ITA for determining transfer pricing adjustments.



## IV INTANGIBLE ASSETS

When pricing a transaction involving the right to exploit or the transfer of intangible assets, the Regulations adopt the OECD Guidelines' approach.

In general, the most common transfer pricing methodology implemented in cases of exploitation of intangible assets (such as know-how, proprietary technology, patents, trade name or trademark and unique business model) is the CUP/CUT method. This method uses 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 concurred 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.

On several occasions, the ITA has noted that it intends to adopt the recommendation promulgated under the BEPS Actions 8–10, 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, when conducting a transfer pricing study for transactions involving intangible assets, the recommendation is to delineate the transaction in a manner reflecting the business reality of the transaction, providing a detailed functional analysis with emphasis on important functions that contribute 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 originating in Israel are growing; however, holding supportive documentation has proven to be an effective way to rebut and mitigate any assumed ITA adjustments.

### DEMPE

The matter of DEMPE<sup>7</sup> functions has been 'on the table' for the ITA in recent years, mainly with regard to the exploitation of R&D originating in Israel and R&D subsidiaries established in Israel by foreign entities.

According to ITA officials, DEMPE is one of the matters considered by the ITA when auditing a transfer pricing case, but not necessarily the only one. Moreover, these aspects were relevant to ITA audits even before BEPS. Because of the extensive R&D functions carried out by Israeli companies, DEMPE is a tool used by the ITA and thus should be considered

<sup>7</sup> Development, enhancement, maintenance, protection and exploitation of intangibles.

by any transfer pricing practitioner. Currently, the ITA is engaged in discussions<sup>8</sup> regarding defining the applications of the DEMPE analysis, and a circular in this respect is expected in the coming quarters.

## **V SETTLEMENTS**

Transfer pricing cases are rarely adjudicated in 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 with the ITA out of court.

APAs are not common in Israel, although they exist, and settlement can sometimes also be carried forward as part of an APA. However, settling a past audit cannot guarantee the same treatment in the future, unless an APA is reached.

## **VI INVESTIGATIONS**

Investigations usually stem from either a local tax AO's review or specific audits by the TPD. Normally, the process is initiated by a request for the applicable transfer pricing study or studies, and the inter-company agreements.

The current legal time limit for the presentation of a study is within 60 days; however, often the ITA requests receipt of the study within a shorter period. If this is the case, the taxpayer can request to make the submission within 60 days and not within a shorter period. However, this indicates to the ITA that the study may have not been prepared in time, and may indicate that an audit is required. This time frame normally cannot be extended beyond 60 days.

Following the presentation of the study and review by the ITA, it is likely that if the ITA has any remarks or questions, it will summon the company for a meeting, usually prior to the formalisation of an assessment by the ITA.

Assessments are usually followed by meetings between the ITA, the company and its transfer pricing consultants, to rebut the assessment (and if successful then the assessment is adjusted). It is important to note that the scope of audits is often wider than simply transfer pricing and also involves a review of permanent establishments and controlled foreign companies; however, transfer pricing methods and tools are usually acceptable in such audits.

## **VII LITIGATION**

### **Recent cases**

Very few transfer pricing cases make their way to the courts in Israel. Several adjudicated cases (including by the Israeli Supreme Court) dealt with the inclusion of 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 and the Supreme Court 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 with the

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<sup>8</sup> The author's firm, Herzog Fox & Neeman Law Offices, among other parties, is engaged in these discussions with the ITA.

*Xilinx* case in the United States, as it was irrelevant to the provision of R&D services on a cost-plus (TNMM) basis, and the claim that this grant of options dilutes the shareholders (and thus its cost is already acknowledged) has also been rejected by the courts, as this type of grant is supposed to increase the value of the company and in turn the shareholders' holdings.

Important takeaways from those court rulings are the facts that the court was somewhat reluctant to take a retroactive transfer pricing study into consideration long after the date on which it was supposed to be in place and thus may not have correctly reflected the Regulations. The court was also reluctant to accept results that were not segmented properly.

Additionally, the court rejected the inter-company agreement between the parties since it did not abide by the requirements of the Regulations and the OECD.

A court ruling in the *Gteko* case concerned the tax implications of changing a business model and the transfer of activity and assets from Israel abroad between related parties. The main dispute in the *Gteko* case concerned the scope of the transfer transaction that legally referred to the transfer of IP only and to the market value of the assets sold under the transfer.

The court ruled in favour of the ITA and its decision relied on the following:

- a* the difference between the 2006 share purchase of Gteko's share capital by Microsoft (United States) of US\$90 million (the Share Transaction) in comparison to the IP transfer transaction of US\$26.6 million (the IP Transaction);
- b* the fact that the parties were unrelated when the Share Transaction was completed; and
- c* the fact that following the Share Transaction, Gteko's entire staff was immediately transferred to Microsoft Israel.

On the basis of these facts, the court agreed with the ITA that as a result of the IP transfer, Gteko's interests are subordinated to Microsoft, as the latter dictates Gteko's policy. In light of the specific circumstances of the case, and in accordance with transfer pricing regulations incorporated in Section 85A, the court ruled in favour of the ITA and determined that the IP Transaction is greater in its scope and equals the sale of the entire activity of Gteko to Microsoft (United States) (subject to certain adjustments). Therefore, the transaction should be taxed accordingly, with the starting point for determining the market value for the IP Transaction being the consideration paid in the Share Transaction.

Another case of business restructuring ruled by the district court was the *Broadcom* case, which dealt with the classification of a business restructuring concerning a post-acquisition set of agreements that included the license of intellectual property (IP) in return for royalty and the provision of R&D, marketing and technical support services on a cost-plus basis, provided by the acquired Israeli company to its US parent and other group entities.

The court ruled in favour of the taxpayer and decided that the change of business model does not necessarily lead to the conclusion that the company essentially sold its assets. The general claim of the ITA according to which any business restructuring and change in the composition of FAR results in a capital gain requires a careful analysis and comparison of pre- and post-FAR, and is not automatic.

The implications of this ruling can be very significant for multinationals acquiring Israeli technology companies and performing a business restructuring thereafter. In the *Broadcom* case, the court also referred to the burden of proof issue, which later led to Tax Circular 1/2020 described above. The court ruled that in cases where there is a disagreement concerning the factual background of the intercompany transaction under assessment, the burden of proof remains with the taxpayer and not the tax assessment officer, as the taxpayer

has the full knowledge to justify the facts relating to the assessed transaction. This is relevant in cases where the tax assessment officer reclassifies the form of the transaction or otherwise questions the nature of the transaction or the method applied.

## **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 made an adjustment (the first adjustment) according to its transfer pricing policy and determined its profit to be a certain percentage (based on its transfer pricing study or transfer pricing range), and the ITA disagreed with its policy or benchmark analysis, the ITA could, in that case, carry out a secondary adjustment.

Penalties are uncommon 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 Ordinance, currently apply to transfer pricing as well.

In this respect, it is also important to note that, in the past, ITA officials have indicated that submitting a Form No. 1385 that includes a personal affidavit by a company's officer subsequently found to be erroneous can lead to criminal liability, although such liability has not been imposed to date.

## **IX BROADER TAXATION ISSUES**

### **i Diverted profits tax and other supplementary measures**

As noted above, the ITA may use either Section 85A and the Regulations, or other means such as Section 86; however, no specific measures relating to transfer pricing matters have been enacted, since, among other reasons, the current measures (i.e., Section 86) are general enough to be implemented (also with regard to transfer pricing). However, certain reportable tax positions, which list is amended from time to time by the ITA, require the taxpayer to state the transaction and report it to the ITA.

### **ii Double taxation**

Double taxation would seem to be unavoidable in cases where another jurisdiction has taxed the company on account of transfer pricing issues. For example, in the event a related party in a foreign jurisdiction is characterised as a permanent establishment, or accused of having inadequate transfer pricing documentation or failing to implement it, the foreign jurisdiction will tax it accordingly and the ITA will not take this into consideration, which will result in double taxation. Still, a MAP process is available where applicable.

### **iii Consequential impact for other taxes**

VAT and inter-company transactions have been the focus of several recent ITA audits, and of a recent court ruling, which imposed VAT on sales performed from Israel. Although this matter is tied heavily to transfer pricing, the issue 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, as 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

As is appropriate in this post-BEPS era, the ITA announced that it would adopt the BEPS principles as an amendment to the Ordinance with respect to transfer pricing matters. At this stage, the amendment has already passed the first of three readings in the Israeli parliament and is expected to be adopted by 2020. The applicable effective date of the proposed legislation has not yet been determined. Additionally, the ITA regularly publishes circulars announcing its position on various matters, such as safe harbours and applicable methods for pricing inter-company transactions, business restructuring and digital economy measures.

Measures have been carried out concerning several subjects, including the following:

- a* The signing of the MCAA CbCR, as well as the steps being taken regarding proposed legislation, implementing Action 13 of the OECD 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 many Israeli MNEs to be subject to CbCRs given the size of the Israeli market, we do anticipate that subsidiaries of foreign MNEs may be required to file in the event that the parent MNE is obligated to file in its jurisdiction. Furthermore, the ITA's increased focus on business or economic substance when analysing value chains and transactions involving the transfer or use of intangible properties, indicates that functions contributing to the creation of value, as well as geographic locations, constitute important criteria when determining the appropriate attribution of profits among group members in MNEs. This is also affecting the government subsidies granted to R&D centres in Israel.
- b* The ITA's intention regarding the adoption of the recommendation promulgated under Actions 8–10 of the OECD BEPS Action Plan, with respect to intangibles, should be taken into consideration by Israeli tax practitioners when conducting their inspections of transactions in accordance with the new rules for HTVI. Greater emphasis should be placed on the attribution of profits based on value creation, and consideration should also be given to the DEMPE principles. Taxpayers are therefore recommended to conduct transfer pricing studies in accordance with the OECD's recommendation. Particular emphasis should be given to appropriate delineation of the tested transaction to reflect the business reality of the transaction, providing a detailed functional analysis with emphasis on important functions that contribute to the creation and value of the intangible assets under review, as well as related risks.
- c* The ITA's intention regarding the adoption of the recommendations promulgated under Actions 8–10 of the OECD BEPS Action Plan with respect to inter-company financing transactions should be taken into consideration by taxpayers when constructing their intra-group financing. It is therefore recommended that financing transactions be properly constructed and documented in accordance with the BEPS Actions 8–10 guidelines, focusing on a detailed description of people functions involved and empirical evidence demonstrating the management and control of risks by relevant parties involved in a controlled financing transaction.
- d* The ITA has reviewed its assessment concerning the applicability of the profit split method in service transactions that include the provision of significant services contributing to the creation of profits (e.g., R&D, marketing and management). Nonetheless, this is more of an evolution than a revolution as, because of the significant level of R&D activity in Israel, the ITA has already been focusing on, inter alia, lines similar to those presented by the BEPS principles, and thus we do not expect the nature of the audits to change, but rather their intensity and scope.

- e* The ITA has recently carried out audits on marketing services providers that do not, in the ITA's view, adhere to the circular issued by the ITA in this respect.
- f* The ITA has recently carried out audits on MNEs whose management (or parts thereof) is located in Israel.
- g* With respect to Pillar One of the OECD's Unified Approach, the Unified Approach covers mainly (but not only) highly digital companies, with a broad focus on consumer-facing businesses (sales of goods or provision of digital services that are consumer facing). Under the Unified Approach, economic nexus is no longer dependent on physical presence in order to acquire taxation rights over a non-resident taxpayer's revenues from digital activities. Rather, economic nexus can be established based on a certain sales threshold (adjustable based on the size of a particular market to ensure smaller markets get their fair share), while taking into account additional factors such as online advertising targeted at a specific market.
- h* While Israel has not yet enacted laws addressing digital economy taxation rights, the ITA published Tax Circular 4/2016 which takes somewhat aggressive positions that, practically speaking, may subject almost every non-Israeli company active in the Israeli market to Israeli corporate income and value added taxes and registration obligations. For treaty-partner countries, the circular expands the interpretation of a PE through a 'fixed place of business' or a 'dependent agent' in such tax treaties in the context of the digital economy.
- i* For companies resident in non-treaty jurisdictions, the circular notes that the ITA will acquire taxing rights over a non-Israeli taxpayer based on domestic law principles (namely, business activity conducted in Israel, which generally requires a lower threshold than the PE treaty standard). One of the examples that the circular cites as meeting this standard is the existence of 'significant digital presence' even without a physical presence in Israel.
- j* Given that the circular interprets existing law and PE definitions, it applies retroactively. On this basis, many multinational companies with digital activities in Israel are undergoing audits for all open tax years, which are supervised by a special tax force at the ITA national office.

# ITALY

*Franco Pozzi, Lisa Vascellari Dal Fiol and Stefano Grossi*<sup>1</sup>

## I OVERVIEW

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) and to regional tax on productive activities (IRAP), pursuant to Article 1, Paragraphs 281 to 284 of Law No. 147/2013.<sup>2</sup> There are no separate rules for capital transactions.

Article 110, Paragraph 7 was amended by Law Decree No. 50/2017 and it presently states that an enterprise's income-statement items that derive from operations with non-resident corporations that directly or indirectly control the enterprise (or are controlled by the enterprise or are controlled by the same entity<sup>3</sup> 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<sup>4</sup>. Reductions in taxable income are allowed only in the following specific cases expressly indicated by Article 31 *quater*<sup>5</sup> of Presidential Decree No. 600/1973:

- a* on the basis of mutual agreement procedures (MAPs) or the EU Arbitration Convention;<sup>6</sup>
- b* after tax inspections carried out in relation to international cooperation activities whose outcomes are shared by the participating countries; or
- c* upon the filing of a specific request by the taxpayer, if the transfer pricing adjustments involve a state with which Italy has in force a tax treaty to avoid double taxation that provides for an adequate exchange of information.<sup>7</sup>

Previous guidelines from the Ministry of Finance were issued in 1980 in Circular No. 32/9/2267, which provided principles and methods, based on the Organisation for Economic

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

3 Note that entities controlled by the same individuals are within the scope of the provision.

4 Circular Letter No. 53/1999 and Legislative Decree No. 147/2015 state that – in principle – transfer pricing rules do not apply when both the parties involved in an intercompany transaction, even if they belong to the same group, are resident in Italy for tax purposes.

5 Introduced by Law Decree No. 50/2017.

6 EU Convention No. 90/436/EEC, implemented in Italy by Law No. 99 of 22 March 1993.

7 On 30 May 2018, the Director of the Italian Revenue Agency released a decision containing guidance on the requirements and procedure for implementing this correlative adjustment. See Section IX.ii. for further details of this new regime.

Co-operation and Development (OECD) Transfer Pricing Guidelines applicable at that time ('Transfer Pricing and Multinational Enterprises', OECD 1979), to be used in determining arm's-length prices.

After a process of public consultation, the Ministry of Finance issued on 14 May 2018 a document on Italian guidelines for transfer pricing (the Italian Guidelines). The document aims at making Italian tax practice consistent with the 2017 OECD Transfer Pricing Guidelines and, among the issues covered, provides a specific definition of associated enterprises, a brief description and priority of the methods to be used, and a definition of low value-adding services, and introduces a definition of the arm's-length range.

With regard to the applicable version of the OECD Transfer Pricing Guidelines, as a general rule, the Italian Tax Administration (ITA)<sup>8</sup> and courts refer to the version in force in the tax period under review; the use of a new version of the Guidelines with reference to previous tax periods is not explicitly considered under Italian tax practice. Thus, it is common practice that, in case of topics not considered in a previous version of the OECD Transfer Pricing Guidelines, suggestions reported in a new version can also be extended to issues related to the past, subject, however, to specific analysis to be performed case by case.

The provisions on transfer pricing documentation included in Law Decree No. 78 of 31 May 2010 remain relevant, as subsequently implemented by the Decision of the Commissioner of the Italian tax authorities of 29 September 2010 and by Circular Letter No. 58/E of 15 December 2010. The latter expressly refers to the 2010 version of the OECD Guidelines ('Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations').

In Italy, where a transaction is found not to be compliant with the arm's-length principle, there are no specific corporate law implications; however, this could trigger legal or judicial actions to protect the stakeholders' rights (e.g., on account of overpayment for goods or services, or accounting fraud).

As a general rule, ITA requires the use of data from the public balance sheet and profit-and-loss (P&L) accounts for transfer pricing analysis. However, taxpayers carrying on several activities can use management data (taken from enterprise resource planning systems) to obtain a breakdown of the P&L accounts for areas of business. This approach can be challenged by ITA if the taxpayers are not able to produce a reconciliation with the statutory data.

In addition, Italian accounting principles, as amended by Legislative Decree No. 139/2015 to align them with IFRS standards, had an impact mainly on financial transactions as a direct consequence of the application of the amortised cost method. Additional work is also required for the proper identification of the relevant profit level indicator (PLI) in respect of transfer pricing analysis because of the new representation of the extraordinary (positive and negative) items of income now included in the operating income.

## II FILING REQUIREMENTS

In Italy, there are no specific transfer pricing returns and there are no mandatory reports to be prepared, but transfer pricing documentation is recommended as evidence of compliance with the arm's-length principle in inter-company transactions. Further, if the documentation complies with specific regulations, it allows the taxpayer to access the penalty

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8 Namely the Italian Revenue Agency and the Italian Finance Police.



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 (the local file). However, the documentation requirements change depending on the taxpayer (i.e., subsidiaries are only required to prepare the local file, while sub-holdings and holdings are required to prepare both the local file and the master file).

If taxpayers wish to take advantage of the penalty protection regime, they must communicate the availability of the transfer pricing documentation in their annual income tax return. To obtain penalty protection, the documentation must be compliant from a substantial point of view and it must follow the structure required.<sup>9</sup>

As a general rule, documentation for penalty protection must be updated annually, including the economic analysis, before filing the tax return for each financial year (e.g., by 30 November for companies with financial year ending 31 December).

Small and medium-sized enterprises, defined as enterprises with an annual turnover of less than €50 million, are entitled to update the economic analysis included in their documentation every three years, provided that no significant modifications in the comparability factors have occurred.

The filing of the documentation with ITA must be executed within 10 days of being requested to do so. Tax auditors may also request additional information or documentation, in which case the supplementary information must be provided within seven days of the request (or within a longer period depending on the complexity of the transactions under analysis) to the extent that the above period is consistent with the time frame of the audit. Once these terms have elapsed, ITA is not bound to apply the penalty protection.

On 23 February 2017, the Italian government issued a ministerial decree that sets out the terms and conditions for filing the country-by-country report (CbCR); implementing provisions were published in the decision of the Commissioner of the Revenue Agency, dated 28 November 2017. In particular, the CbCR must be filed by the end of the 12th month following the end of the taxpayer's financial year (the consolidated accounts). The information required is aligned to the OECD standard (except in respect of some minor issues, which mainly concern mismatches in Italian translation).

### 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 that method, and a statement justifying the results as consistent with the arm's-length principle. According to the Italian Guidelines, transaction-based methods are preferred over profit-based methods, and the comparable uncontrolled price (CUP) method, if applicable, is preferred over the resale price and cost-plus methods. However, ITA is aware of the difficulties that application of the CUP or resale price method present to operators, and so profit-based methods (especially the transactional net margin method (TNMM)) are accepted.

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<sup>9</sup> The structure indicated by the decision of the Commissioner of the Revenue Agency dated 29 September 2010.

When a TNMM is selected, ITA's approach is often to perform a new benchmark analysis to check the results obtained by the taxpayer, and tax challenges are, in practice, based on the median value of the set of comparables resulting from the benchmark analysis. However, in accordance with the 2017 OECD Guidelines, the Italian Guidelines state that each point in the interquartile range should be compliant with the arm's-length principle, provided all the items included in the benchmark have a sufficient degree of comparability.<sup>10</sup>

Since 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, 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, and also considering the actual economic conditions that characterise intra-group transactions. This approach is also required in managing possible relationships with foreign tax administrations within MAPs.

In delineating a transaction, and in accordance with the 2017 OECD Guidelines, the Italian Guidelines stress the importance of the investigation of the actual conduct of the parties where this differs from written agreements (i.e., the principle of substance over form).

## **ii Authority scrutiny and evidence gathering**

ITA consists of two entities, the Italian Revenue Agency and the Italian Finance Police, and they are both entitled to carry out inspections aimed at detecting the infringement of tax law.

In recent years, ITA has increasingly been carrying out inspections of companies that belong to multinational groups, with the aim of checking the consistency of the transfer prices applied in inter-company transactions.

The approach of ITA during tax audits is mainly oriented towards understanding the role of the Italian companies under scrutiny in the group's value chain, but also through requests for clarification about the activities performed by their foreign related counterparts. This is to check the consistency of the transfer pricing methods applied and the results of the benchmark analysis. The procedure for acquiring the information usually starts from the analysis of transfer pricing documentation, agreements in force and a breakdown of their figures. Face-to-face interviews can be held with the heads of the relevant departments, also for the purposes of tax rulings or advance pricing agreements (APAs).

If necessary, additional information may be requested from the employees of the Italian company. However, in complex cases, and when the audit is carried out by the Finance Police, the tax auditors can look for evidence for the information provided by the company by asking for confirmation from third parties, such as customers or suppliers, and by seeking access to and inspections of the taxpayer's premises.

Under Italian tax rules, the use of expert witnesses is not explicitly provided for. However, in the pre-litigation phase the taxpayer can provide the tax auditors with any useful documents or information that lead to a better understanding of the specific case.

For confidentiality reasons, audit results are not published.

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<sup>10</sup> Recent regional tax court and provincial tax court judgments (Regional Tax Court of Lombardy, No. 5005 of 19 November 2018, and Provincial Tax Court of Milan, No. 5445 of 26 November 2018 respectively) recognised this principle as stated in the Italian Guidelines.

The option to ask questions or request documents from taxpayers outside the Italian tax jurisdiction is, however, limited to cases of joint tax audits conducted with foreign tax authorities.

Nevertheless, attention paid to the group is expected to increase following the implementation of CbCRs.

#### IV INTANGIBLE ASSETS

As a general rule, intangible assets held by each single company involved in inter-company transactions must be considered when setting the correct pricing. To this aim, when taxpayers prepare the transfer pricing documentation (master file), they are required to provide a complete list of such assets with a separate indication of any royalty received and paid or any other type of compensation for intellectual property assets, and to specify the licensor's and the licensee's names. Further, the list of the assets used in a specific transaction must also be reported in the local file, together with the contractual terms.

Given the importance of intangible assets, for completeness, taxpayers are also required to describe any intangibles not reported in the financial statements (e.g., the know-how, the positive impact from synergies and the positive effects of networks). Any business restructuring that involves a reallocation of intangibles must also be included, in addition to the analysis related to the legal ownership and the time of creation of the assets.

Recently in Italy, growing attention has been paid to matters concerning intangible assets from both sides (taxpayers and ITA), with particular focus on the DEMPE<sup>11</sup> functions. These 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 ITA when taxpayers apply for rulings, or where MAPs are concerned.

In an addition to transfer pricing regulations, as of 2015, Italian taxpayers may elect for a 'patent-box' regime; to establish the tax benefit, taxpayers that apply for the patent-box tax relief are required to explain to ITA the contribution made by the intangibles owned to the creation of value. To this aim, taxpayers must show both the costs incurred in creating, developing and protecting the intangibles, and the extra profits deriving from the intangibles. The methods deemed to be acceptable by ITA for the calculation of the tax relief derive from transfer pricing criteria (CUP or profit split). Even if 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. Note that, for new applications filed since 1 January 2017, in accordance with the implementation of the OECD recommendations, trademarks are no longer subject to tax relief.

Note also that, regarding arm's-length remuneration for the use of intangible assets, Circular No. 32/1980 (see Section I) provides for safe-harbour ranges with respect to royalties paid by Italian companies for intangibles (royalties higher than 5 per cent must be justified by the legal and economic conditions of the relevant agreement).<sup>12</sup>

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11 Developing, enhancing, maintaining, protecting and exploiting intangibles.

12 Actually, safe harbours are not consistent with the BEPS project, and their application during a tax audit by ITA is often disregarded notwithstanding no formal instructions have so far been issued by the competent tax authorities.

## 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,<sup>13</sup> taxpayers have 60 days to challenge the assessment before the tax court or to submit a request to ITA to reach an agreement. During the 90 days subsequent to the settlement request,<sup>14</sup> taxpayers and ITA can meet several times to discuss their positions and to exchange proposals. In the event that an agreement is reached (before the deadline for filing the appeal against the assessment with the competent tax court), the settlement agreement is signed by both the taxpayer and ITA; the taxpayer is then obliged to pay the related liability immediately.<sup>15</sup> The settlement covers the years under assessment and related matters. If there are multiple years under assessment, they can be dealt with either together or separately. Normally, in the case of unvaried conditions, it is in the interest of both the taxpayer and ITA to settle all the years under assessment in the same manner.

Where an agreement is not reached, litigation continues before the tax court (see Section VII). However, a settlement can be reached even after the judicial procedure has begun and until the hearings take place before the second instance tax court.

Applicable penalties<sup>16</sup> are reduced in the event of settlement; the reduction varies depending on the timing of the agreement (reduction to a third of the original amount before the beginning of the judicial procedure; to 40 per cent before the first instance tax court hearing; and to 50 per cent before the second instance tax court hearing).

After the signature, the settlement cannot be disregarded either by 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, the use of APAs is recommended to reduce the risk of future assessments.<sup>17</sup> ITA is currently encouraging the use of APAs to prevent litigation and avoid recourse to MAPs (for further details see Section IX.ii).

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13 After investigative activities are concluded, and before the notification of an assessment notice, tax authorities usually issue a preliminary report (PVC) addressing the proposed adjustments to the taxpayer's position and taxable income. After the PVC notification, the taxpayer has 60 days to reply with comments, observations and requests. Otherwise, the taxpayer has the option to settle the audit by correcting its tax return and paying (in part or in full) the amount liable in the PVC, in which case the applicable penalties are reduced to one-fifth of the original amount.

14 During the 90-day discussion period, the deadline for challenging 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 cases of abuse, tax authorities can decide to stop discussions even before the 90-day period has elapsed.

15 An instalment payment plan can also be granted.

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

17 Rulings for multinational enterprises have 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.

## VI INVESTIGATIONS

Tax auditors involved in transfer pricing investigations have ordinary and broad audit powers provided by law (see Section III.ii).<sup>18</sup>

Law No. 212 of 27 July 2000 provides taxpayers subject to tax audits with several rights and protections (see Article 12).

A tax audit could take several months to be completed; there is a time limit, but this is often surpassed by tax inspectors.<sup>19</sup>

A common issue that is deeply investigated during multinational-enterprise 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 these types of services, ITA often questions their deductibility, on the basis of the general 'principle of inherence'<sup>20</sup> rather than on the basis of transfer pricing provisions (consequently with a higher risk of non-recognition of the full costs borne by the Italian entity, rather than restatement of the pricing of the transaction).

The option for tax authorities to challenge costs related to intra-group services or management fees based on the general principle of inherence (instead of transfer pricing) gives rise to three main negative consequences for taxpayers; in particular, there is no penalty protection regime available; access to MAPs and arbitration is excluded and, under certain conditions, criminal penalties could be applicable.<sup>21</sup>

Therefore, it is very important to keep adequate documentation regarding the detailed activities performed by foreign group entities for the benefit of the Italian entity (e.g., emails, meeting reports, flight tickets, hotel bills, contracts).

The Finance Police issued operative internal instructions in relation to tax inspections applicable as of 2018 (Circular No. 1/2018). Among other things, the Circular provides specific guidelines on transfer pricing assessments, such as the acquisition of information regarding the method followed by the taxpayers for drafting the transfer pricing documentation; for example, by inspecting emails regarding the previous versions of the documentation, to identify any possible omission or fraud.

As a general rule,<sup>22</sup> a tax assessment must be issued by the end of the fifth year following the year when the tax return was filed;<sup>23</sup> as a practical example, the assessment for a tax year ended on 31 December 2018 has to be completed by 31 December 2024 (since the tax return must be filed by 30 November 2019).<sup>24</sup>

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

19 In principle, investigations based on physical access to the taxpayer's premises cannot last more than 30 days – even when the 30 days are not consecutive. This can be extended for an additional 30 days only, in cases of particular need.

20 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.

21 However, different tax offices may assume different positions on this matter.

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

23 In the event that the tax return has not been filed, the deadline for the tax assessment is the end of the seventh year following the year in which the tax return should have been filed.

24 For fiscal years prior to fiscal year 2016 different terms apply.

## VII LITIGATION

### i Procedure

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

According to Italian tax law, witness evidence is not allowed in tax litigations as well as during the public hearings. Thus, declarations made during the tax audit or before the judicial hearing (or both) can be taken into account by the competent tax court.

In brief, the typical litigation process involves the following steps:<sup>25</sup>

- 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<sup>26</sup> 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 for filing the appeal is six months after the decision has been issued;<sup>27</sup>
- 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.<sup>28</sup>

Tax litigation usually takes at least five years. Decisions of the courts of first and second instance are based on facts, while the Supreme Court's decisions refer only to matters of law. Before assuming their positions, the tax courts are allowed to engage independent experts to analyse the case, although this is not a very common practice.

After the decision of the Supreme Court, there are, in principle, no further opportunities to discuss the litigation.<sup>29</sup> Partial payments are imposed by law during the judicial procedure;<sup>30</sup> in the event that the taxpayer is the winning party, these payments are reimbursed by ITA.

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

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

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

28 *ibid.*

29 In exceptional and specific cases identified by law, even the decision of the Supreme Court could be subject to review.

30 Under certain conditions, a petition to suspend the collection of the partial payments can be submitted either to the competent court or to ITA.

**ii Recent cases**

Generally speaking, transfer pricing litigation by the Supreme Court in Italy has been limited; the reason is that the tax courts do not have specific and in-depth knowledge of transfer pricing matters and consequently taxpayers often prefer to settle the assessment (before or during the judicial procedure) with ITA, rather than bear the risk of an adverse decision.

The following are the main issues related to transfer pricing dealt with by the Supreme Court in recent years:

- a* The transfer pricing regime as an anti-avoidance provision, and the burden of proof in transfer pricing assessments:<sup>31</sup> the main position of the Supreme Court is to consider the transfer pricing regime a safeguard of the principle of fair competition between countries, rather than as an anti-avoidance provision (regardless of the tax rate of the foreign countries involved). As far as the burden of proof is concerned, the Supreme Court, in the most recent cases, stated that this should be borne by the tax authority to the extent that an inter-company transaction occurred for a consideration that was not consistent with the arm's-length principle. The burden of proof that the transaction occurred at arm's length is then transferred to the taxpayer, on the basis of the assumption that the latter has a closer and deeper knowledge of the facts.<sup>32</sup>
- b* The scope of domestic transfer pricing provisions:<sup>33</sup> formerly, the main position of the Supreme Court was to view transfer pricing provisions as general rules, applicable even to transactions between resident entities. The issue has finally been clarified by Legislative Decree No. 147 of 14 September 2015,<sup>34</sup> which expressly excludes the application of transfer pricing provisions to domestic transactions.
- c* Intra-group services and shareholders' loans:<sup>35</sup> the Supreme Court position confirms that costs deriving from intra-group services (i.e., in application of a cost-sharing agreement) are deductible provided that the benefit for the receiver is proved by the taxpayer. With regard to interest on inter-company loans, the Supreme Court and the provincial and regional courts have taken different positions on the applicability of transfer pricing provisions to non-interest-bearing loans.

The positions of the provincial and regional tax courts are very fragmented and do not represent reliable precedents since Italy is a civil law country. Recent tax court decisions have made reference to the new Italian Guidelines and provide more detailed interpretations on

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31 See, for example, the following decisions: 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. 6656, 6 April 2016; Supreme Court No. 7493, 15 April 2016; Supreme Court No. 13387, 30 June 2016; Supreme Court No. 26545, 21 December 2016; Supreme Court No. 28335, 7 November 2018.

32 See, for example, the decision of the Supreme Court No. 2387, 29 January 2019.

33 See, for example, the following decisions: Supreme Court No. 17955, 24 July 2013; Supreme Court No. 8849, 16 April 2014; Supreme Court No. 13475, 13 June 2014.

34 See, in particular, Article 5, Paragraph 2.

35 See, for example, the following decisions: Supreme Court No. 16480, 18 July 2014; Supreme Court No. 27087, 10 December 2014; Supreme Court No. 15005, 17 July 2015; Supreme Court No. 7493, 15 April 2016; Supreme Court No. 13387, 30 June 2016; Supreme Court No. 9466, 12 April 2017; Supreme Court No. 11094, 5 May 2017; Supreme Court No. 25566, 29 October 2017.

territoriality of comparables, period of reference for the calculation of the PLI, inclusion of loss-making companies, and compliance with the arm's-length principle where the PLI of the tested party falls within the whole interquartile range.<sup>36</sup>

## VIII SECONDARY ADJUSTMENT AND PENALTIES

In Italy, there are no specific provisions for secondary adjustments and, in practice, they are not usually applied.

With specific reference to financial transactions or transactions involving intangibles (or both),<sup>37</sup> primary adjustments may have a consequent effect on withholding taxes. In particular, in the case of outbound interest or royalties on which no withholding rate (based on the EU Interest and Royalties Directive) or a reduced withholding rate (based on double taxation treaties) has been applied, the amount paid in excess to the arm's-length value is challenged as subject to the ordinary withholding rate provided by national legislation (i.e., 30 per cent).

As far as penalties are concerned, if, in the event of a tax assessment, the documentation provided (master file or local file) is considered not to be compliant with Law Decree 78/2010 by ITA, ordinary administrative penalties are applied, ranging from 90 per cent up to 180 per cent of the assessed higher income. No specific reduction or increase is provided for transfer pricing adjustments. On the other hand, where transfer pricing documentation is considered to be compliant, the 'penalty protection' grants the non-application of the above-mentioned penalties. The penalty protection applies also for withholding taxes purposes, in the case of assessment based on the arm's-length value.

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, penalties can be challenged during subsequent litigation (see Section VII).

Regarding criminal law, penalties are applicable to any director signing the relevant tax returns if certain conditions, set out in Article 4 of Law 74/2000, are jointly met. In principle, provided that transfer pricing documentation complies with the Italian regulations, criminal 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 ITA before starting formal litigation in the competent tax courts, it is becoming common practice for public prosecutors to stop any criminal law proceedings.

## IX BROADER TAXATION ISSUES

### i Diverted profits tax and other supplementary measures

Profits that are deemed to be realised in Italy (even by non-resident entities)<sup>38</sup> are subject to IRES and – to the extent they are related to activities performed in Italy – to IRAP.

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36 See, for example, the following decisions: Regional Tax Court of Lombardy No. 5005 of 19 November 2018, and Provincial Tax Court of Milan No. 5445 of 26 November 2018 and No. 188 of 22 January 2020.

37 Increasingly under scrutiny by ITA.

38 With the exception of individuals.



There are also specific additional anti-avoidance provisions aimed at addressing possible profits shifted to foreign countries, such as: controlled foreign corporation rules; presumptions regarding the residence of foreign incorporated entities; and permanent establishment provisions.<sup>39</sup> These provisions have a broader scope than transfer pricing regulations, since they are enforceable even in the absence of controlled transactions.

Under Italian tax regulations, no other specific rules such as diverted profits tax or BEAT/GILTI provisions are in force.

## ii Double taxation

Double taxation represents a very critical issue for multinational enterprises in Italy, since international dispute resolution instruments are not always effective. In principle, at the moment there are two different applicable procedures: (1) the EU Arbitration Convention, in the 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<sup>40</sup>) in cases involving non-EU countries.<sup>41</sup>

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 litigation only, while the procedure under (2) is applicable to all 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 between the litigating countries; in contrast, in respect of the procedure under (2), the majority of the current tax treaties signed by Italy<sup>42</sup> do not stipulate mandatory arbitration, consequently the dispute might not be resolved if the litigating countries are unable to reach an agreement; and
- c interactions with the domestic litigation procedure:<sup>43</sup> the procedure mentioned at (1) is an alternative to domestic litigation, meaning that the result is binding both for the taxpayer and tax administrations; in contrast, in principle, any agreement reached pursuant to the procedure under (2) is not binding for the taxpayer, who can decide to refuse it and elect to go through the domestic litigation procedure.<sup>44</sup>

39 The domestic definition of a permanent establishment was recently amended to make it consistent with BEPS Action 7; moreover, a new specific tax provision regarding digital transactions ('web tax') was introduced by the 2019 budget law (replacing the web tax previously introduced by the 2018 budget law). See footnote 52 for additional details.

40 Most of the tax treaties signed by Italy are still based on the 2008 OECD Model Tax Convention and they do not include a mandatory 'arbitration clause' in case the contracting states are not able to find a positive solution to the MAP request.

41 On 9 April 2020 the OECD released the document *Making Dispute Resolution More Effective – MAP Peer Review Report, Italy (Stage 2)*. This document reports the 'state of the art' relating to the implementation in Italy of the Minimum Standard required by Action 14 of the BEPS project.

42 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).

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

44 If this is the case, particular attention has to be paid to the expiry of the terms within which the assessment must be challenged if it is to be disputed before the national courts (for more details, see Section VII).

In both cases (1) and (2), provisions regarding suspension of the domestic litigation procedure could apply,<sup>45</sup> and also the actual effectiveness of MAP procedures should be further improved through the adoption of EC Directive 2017/1852, whose text has been submitted for preliminary opinion of the parliament.

Further guidance is expected after the actual implementation of the OECD Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (Multilateral Instrument or MLI). Italy was a member of the group that developed the OECD MLI and signed the agreement on 7 June 2017. As far as options are concerned, Italy has for the moment adopted a minimalist position, limited mainly to accepting the minimum mandatory changes, and during the ratification process the choices made may still be subject to amendments. Thus, it is worth noting that, under the MLI version presently adopted by Italy, the arbitration phase will be mandatory and the positive outcome of a MAP procedure should be implemented notwithstanding domestic statutory limitations.

Reductions are also considered in double taxation cases, pursuant to the new Article 31 *quater* of Presidential Decree No. 600/1973 (see Section I). More specifically, Letter (c) of the new Article allows ITA to grant unilateral corresponding downward adjustments where a foreign tax authority makes a primary adjustment under the arm's-length principle. On 30 May 2018, the Director of the Italian Revenue Agency issued Decision No. 108954/2018 on practical provisions regarding the application procedure for filing requests under Letter (c). To commence this procedure, the following conditions must be met:

- a* the primary adjustment in the foreign country must be final (or at a final stage);
- b* the primary adjustment in the foreign country must be compliant with the arm's-length principle; and
- c* the jurisdiction where the primary adjustment is set must be a party to a double-tax treaty with Italy that provides an adequate exchange of information.

In the initial filing, the taxpayer must also choose a suitable instrument for the resolution of international disputes concomitant with the requested downward adjustment (i.e., MAP, EU Arbitration Convention or other instrument, including mechanisms provided by the Tax Dispute Resolution Directive,<sup>46</sup> once implemented in Italy), as a precaution against the unilateral adjustment not being granted directly by ITA. The request shall be filed within the specific deadline established by the instrument selected.

The Italian Revenue Agency may invite the taxpayer to further discuss the issues examined or may require additional documentation when examining the matter. The procedure should be concluded within 180 days with a recognition or denial of the unilateral corresponding adjustment. In the case of recognition, the Italian Revenue Agency notifies the tax administration of the foreign country of the downward adjustment. After the acquisition of a certificate issued by the foreign tax authorities or similar documentation proving that the (foreign) upward adjustment is final, the central Revenue Agency office issues a statement of recognition of the downward adjustment as corresponding to a definitive adjustment performed by foreign tax authorities. The Revenue Agency then notifies its decision to the competent local Revenue Agency office, which then implements the decision through the necessary further procedure.

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45 Article 39, Paragraph 1 *ter* of Legislative Decree No. 546/1992.

46 Council Directive (EU) 2017/1852 of 10 October 2017 on tax dispute resolution mechanisms in the European Union.

Bilateral or multilateral APAs provide alternative means to prevent double taxation; ITA is currently encouraging these types of agreement and the number of cases submitted to the competent revenue office has recently increased. It should be noted that within the current framework there are countries with which a bilateral agreement cannot be reached (e.g., China), according to ITA feedback, and also that bilateral and multilateral APAs take longer to be concluded than unilateral APAs.

Following the entry into force of Legislative Decree No. 32/2017, Italy has engaged in the exchange of APAs with foreign tax authorities. To this effect, 'new rulings' (issued, modified or revised as of 1 January 2017) are automatically exchanged and 'old rulings' (issued five years prior to 1 January 2017) are exchanged under certain conditions only.<sup>47</sup>

### iii Consequential impact for other taxes

Pursuant to the applicable law, the VAT-taxable base is generally represented by the contractual consideration due.<sup>48</sup>

In general, adjustments made for transfer pricing purposes can take the form of either 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 value added tax (VAT) (both for products sold and services rendered); in the second case (profitability adjustments), the adjustment should be excluded from VAT and from the customs-taxable base, in line with the VAT Expert Group working paper VEG No. 071 REV2. Italian legislation does not expressly address the VAT impact of such adjustments; however, in a recent request filed by a taxpayer (Ruling No. 60/2018) ITA expressed a position aligned with that of the VAT Expert Group.

From a customs perspective, on 6 November 2015, Circular No. 16/D was issued by the Italian Customs Authority (Customs) 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 be declared, the Circular states that the OECD methods are deemed 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.<sup>49</sup>

Further, the Circular proposed the use of two alternative procedures provided by European customs legislation (i.e., the European Customs Code and its implementing provisions) to handle the transfer pricing adjustments problem. These procedures are contained in the following legislation:

- a Article 76(a) of the European Customs Code Customs Code and Article 254 *et seq.* of EU Commission Regulation (EEC) No 2454/93, according to which the business

<sup>47</sup> Old rulings are exchanged only if they meet specific requirements, as provided in Directive 2011/16/EU: (1) if they were issued, amended or renewed between 1 January 2012 and 31 December 2013, the exchange shall take place under the condition that they were still valid on 1 January 2014; and (2) if they were issued, amended or renewed between 1 January 2014 and 31 December 2016, the exchange shall take place irrespective of whether they are still valid.

<sup>48</sup> 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).

<sup>49</sup> During the meeting for the public consultation for the introduction of the Italian Guidelines, it was explained that new specific dispositions are expected with regard to VAT and customs matters.

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 Regulation (EEC) No 2454/93, stating the option for the business operator, only in import transactions, to make a lump-sum payment.

Both procedures have to be authorised by Customs; additional practical matters have been dealt with by Customs in Circular No. 5 of 21 April 2017.<sup>50</sup>

## X OUTLOOK AND CONCLUSIONS

The increasing attention that ITA is paying to multinational groups and cross-border matters has entailed a greater focus on the tax risks deriving from transfer pricing matters. ITA has become more skilled in matters concerning transfer pricing, intellectual property and the OECD Guidelines, and moreover, particular attention has been paid to intangibles since the introduction of the patent-box regime.

On the other hand, domestic judicial procedures remain lengthy and uncertain, and international dispute resolution instruments are still ineffective; consequently, multinational groups often face a high risk of double taxation. The actual impact of the new Article 31 *quater* of Presidential Decree No. 600/1973 is unknown as yet, as it is a new instrument and there is no public case law available to date.

In these circumstances, the importance of APAs has grown, such that they are now being used with a degree of assurance, even though timing remains a material issue.<sup>51</sup>

The new Italian Guidelines have aligned Italian tax practice with the 2017 OECD Guidelines and further provisions are expected to clarify practical issues. Moreover, following the release of the OECD's final guidelines concerning the transfer pricing issues related to financial transactions, a new Circular Letter is expected to be issued by ITA in respect thereof, since the applicable rules governing Italian practice are very limited and date back to the above-mentioned Circular No. 32/9/2267 from 1980.

With respect to the Inclusive Framework on Pillar One and Pillar Two, except for wide discussions within the community of Italian tax practitioners, no official position from ITA is presently available.<sup>52</sup>

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<sup>50</sup> As regards transfer pricing, VAT and customs, a recent Circular (Circular 1/2019) issued by Assonime, the association of Italian joint-stock companies, states that, even if efforts have been made by authorities, further aspects should be clarified with regard to: (1) valuation of goods in customs and transfer pricing rules, which often lead to the recognition of different values for the transactions; and (2) additional coordination on transfer pricing adjustments and VAT and customs matters, to allow companies to set consistent transfer pricing policies for the purposes of direct and indirect taxation.

<sup>51</sup> See footnote 41.

<sup>52</sup> Starting from 1 January 2020, a new tax on digital services (Italian web tax) is applicable. The Italian web tax is equal to 3 per cent and it applies to revenues deriving from the supply of certain digital services by those business entities which, individually or as a group, in the previous calendar year obtained revenues exceeding certain thresholds. Revenues subject to the Italian web tax do not include positive items of income from services provided to entities that are controlled by or control the taxable person and such items provided to entities controlled by the same controlling entity. The tax will be abolished when any international agreements on the taxation of the digital economy are adopted.

Finally, considering that currently enterprises are facing hard challenges worldwide due to the emergency caused by covid-19, specific transfer pricing considerations shall be due in the near future to find out the proper way to split the exceptional losses (or, in certain cases, exceptional profits) involved; an accurate functional and risk analysis shall of course be the starting point, but specific guidance both from the OECD and national authorities is expected.

# JAPAN

*Shigeki Minami*<sup>1</sup>

## I OVERVIEW

### i General

The principal Japanese transfer pricing legislation is Article 66-4 of the Special Taxation Measures Law (the Law) and Article 39-12 of the Enforcement Order thereof (the Order). For a taxpayer who files a consolidated tax return, Article 68-88 of the Law and Article 39-112 of the Order are applicable. While they are not legislation, the National Tax Agency of Japan (NTA) published detailed interpretations in respect of these statutory provisions in Chapter 12 of the Basic Circular of the Law (the Circular) and in the Commissioner's Directive on the Operation of Transfer Pricing (the Directive), under which the transfer pricing legislation is enforced.

The Japanese transfer pricing rules only cover income tax on corporations (under the Corporation Tax Law), and do not cover individuals or trusts (with certain limited exceptions).<sup>2</sup> The rules are applicable to transactions between a Japanese corporation (or a foreign corporation subject to the Japanese corporation income tax) and its 'foreign related corporation' (as defined by the Law). A foreign related corporation is defined, in essence, as a foreign corporation, controlling, controlled by or under common control of a Japanese corporation (i.e., a parent–subsidiary or brother–sister relationship), as measured by 50 per cent or more direct or indirect ownership, or by effective control through officers, business dependency or finance.

### ii Conformity with OECD Guidelines

The Law and the Order spell out a set of transfer pricing methodologies that effectively follow the Organisation for Economic Co-operation and Development Transfer Pricing Guidelines (the OECD Guidelines). Specifically, the Japanese transfer pricing rules were overhauled in 2011 in response to the amendments to the OECD Guidelines in 2010, confirming the prevalence of the transactional net margin method (TNMM) as well as introducing the 'most appropriate method' rule and the 'range' concept. The 2013 amendment to the Order adopted the Berry ratio as another net profit indicator, in line with the OECD Guidelines. In 2016, in line with Action 13 of the OECD Base Erosion and Profit Shifting (BEPS) project, the Japanese government introduced new legislation adopting the three-tiered documentation approach, consisting of a master file, a country-by-country report (CbCR)

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2 The Japanese transfer pricing rules cover individuals who are trustees for a trust treated as a corporation, or non-resident individuals doing business in Japan through their permanent establishments in Japan.

and a local file. In 2019, in line with the OECD Guidelines as revised in 2017, the Japanese government introduced new legislation adopting the discounted cash flow method as another transfer pricing method, and price adjustment measures for hard-to-value intangible assets (see Section III.i below). The 2017 edition of the OECD Guidelines is used in practice, and the Japanese tax authority and courts can refer to paragraphs in that edition to help them determine whether transactions predating such Guidelines were at arm's length, as long as a specific paragraph in that edition is understood to clarify the rules and principles which were adopted in prior editions, rather than creating a new rule in the 2017 edition.

### **iii Covered transactions**

The Japanese transfer pricing rules cover 'foreign related transactions' conducted between a Japanese corporation and its foreign related corporation; the rules cover any types of transactions that include, among others, purchases or sales of inventory or other property, leases, provision of services, sales or licensing of intangible assets, and borrowing or lending of money.

While the Japanese transfer pricing rules cover any income transactions, they are unlikely to be applied to capital contributions, even if it is theoretically possible. For example, when a Japanese parent company was deemed to have received shares in its Thai subsidiary in excess of the value of the new capital money that the Japanese parent contributed, the NTA invoked the rules for 'gift', not resorting to the Japanese transfer pricing rules, which was affirmed by the Tokyo High Court judgment, dated 24 March 2016.

## **II FILING REQUIREMENTS**

In 2016, the new documentation rules introduced in line with Action 13 of the BEPS project adopted the contemporaneous documentation requirement, under which taxpayers have to prepare a local file by the filing date of a final corporation income tax return, which is within two months of a fiscal year end (or later if an extension is granted).

The legislation adopted the three-tiered documentation approach, under which separate master and local files, as well as a CbCR, are required. Any Japanese corporations and foreign corporations with permanent establishments in Japan that are a constituent entity of a multinational enterprise (MNE) group with total consolidated revenues of ¥100 billion or more in the previous fiscal year (specified MNE group) are subject to the foregoing documentation rules.

Such corporations must file (1) a notification for their ultimate parent entity, (2) a CbCR and (3) a master file with the Japanese tax authority online (e-tax). A local file is mandated for transactions with a foreign related corporation where the sum of the payments and receipts is ¥5 billion or more; or where the sum of the payments and receipts for intangible transactions is ¥300 million or more, in the previous fiscal year. Therefore, relevant companies must prepare a transfer pricing file every year (as long as the foregoing conditions are met) even if there is no change in circumstances (including the functions and risks of the relevant parties).

In a master file, a taxpayer is required to report, among other things, a description of the MNE's businesses, intangible assets, inter-company financial activities, and financial and tax positions.

In a CbCR, a taxpayer is required to report, among other things, an overview of income, taxes and business activities by tax jurisdiction, and a list of all the constituent entities of the MNE group per tax jurisdiction.

In a local file, a taxpayer is required to report, among other things, a description of the local entity, a description of foreign related transactions (controlled transactions) and relevant financial information. The key component is the description of the taxpayer's foreign related transactions, in which functions regarding the material foreign related transactions must be provided (such as procurement of manufacturing services, purchase of goods, provision of services, loans, financial and performance guarantees, and licensing of intangible assets), accompanied by a detailed comparability and functional analysis and an indication of the most appropriate transfer pricing method with regard to the transactions and the reasons for selecting the applicable transfer pricing method.

As for the acceptable language, a master file can be prepared either in English or Japanese, and a CbCR must be prepared in English, while a local file must be prepared in Japanese.

Although the Japanese government will provide the CbCRs to tax authorities in other jurisdictions in accordance with the conditions and limitations under the relevant tax treaties, the law does not allow, nor is it expected to be amended to allow, disclosure of CbCRs to the public, as called for by some advocates.

### III PRESENTING THE CASE

#### i Pricing methods

##### *Current rules*

The following methods are applicable to tangible property transactions, including the sale of inventories:

- a* the comparable uncontrolled price (CUP) method;
- b* the resale price method;
- c* the cost-plus method;
- d* the transactional net margin method (TNMM);
- e* the quasi-CUP, quasi-resale price and quasi-cost-plus methods, and quasi-TNMM; and
- f* the profit split method.

Methods equivalent to those methods listed above are applicable to transactions other than tangible property transactions, namely, intangible property transactions, services transactions and loans or advances.

The most-appropriate-method rule, which is equivalent to the best-method rule, has been employed in Japan. Japanese transfer pricing rules identify the following factors as relevant in selecting the most appropriate method in line with the OECD Guidelines:

- a* the respective strengths and weaknesses of the transfer pricing methods codified in the rules;
- b* the appropriateness of each potential transfer pricing method considered in view of the nature of the controlled transaction at issue, determined in particular through a functional analysis;
- c* the availability of the information needed to apply each potential transfer pricing method; and
- d* the degree of comparability between the controlled transaction at issue and comparable transactions (including the reliability of the comparability adjustments).



In recent years, the TNMM has been the most prevalent method in practice, and accounts for 60 per cent of the mutual agreement procedure (MAP) cases, including advance pricing agreement (APA) cases, completed by the Japanese tax authority in 2018. For service transactions, the cost-plus method is often used if no significant intangible asset is involved. For loans or advances, the quasi-CUP method is often applicable by referring to the terms and conditions of similar transactions under similar conditions. For transactions involving intangible assets, see Section IV below.

### ***Introduction of the discounted cash flow method in 2019***

Under the 2019 Tax Reform, the discounted cash flow method (the DCF method) was introduced as another transfer pricing method for producing arm's-length prices. The DCF method will be the most appropriate method when a transaction involves intangible assets and comparable transactions cannot be identified, as would be the case with most intangible-asset transactions. A typical example would be the transfer of a valuable patent from a Japanese company to its foreign related corporation, where comparable technologies are not traded in the open market. Although the DCF method has been prevalent in the business community, the OECD Guidelines indicated concerns over its practical applications in the context of transfer pricing, citing its considerable volatility subject to even small changes in the underlying assumptions or the valuation parameters. Specifically, the Guidelines point out, 'Under this approach, valuation requires, among other things, defining realistic and reliable financial projections, growth rates, discount rates, the useful life of intangible assets and the tax effects of the transaction', which would be closely examined by the Japanese tax authority if the DCF method were to be adopted by the taxpayer.

As symmetrical treatment, the DCF method may be adopted by the Japanese tax authority when presumptive taxation is triggered (see Section III.ii below).

### ***Introduction of price adjustment measures for hard-to-value intangible assets in 2019***

In line with the OECD Guidelines as revised in 2017, Japan adopted price adjustment measures for hard-to-value intangible assets under the 2019 Tax Reform. The new rules are typically applicable when unique intangible assets are transferred from a taxpayer to its foreign related corporation in consideration for a price calculated by the DCF method. The adjustment will be triggered when the actual results are different from the *ex ante* projections used for the calculation of the arm's-length price, in which case the Japanese tax authority will be allowed to make assessments by presuming the amount calculated using the transfer pricing method the tax authority deems the most appropriate after considering the actual results of the subject transaction and the likelihood of the events that caused the difference; however, if the difference between the adopted price and the price (not revenue) calculated by the foregoing method is within 20 per cent, the adjustment will not be triggered.

The foregoing price adjustment measures are not triggered if the following documents are filed by the taxpayer within a certain fixed period:

- a documents that describe details of projections used for calculating the arm's-length price, and documents that demonstrate that the events that caused the difference between the projections and the actual results were extremely difficult to foresee (such as natural disasters or other similar events) or that the arm's-length price was calculated after appropriately considering the likelihood of the foregoing causal events at the time of the transaction; or

- b* documents that demonstrate that there is a difference of less than 20 per cent between (x) the projected revenues (not price) and (y) the actual results for the five-year period after the subject intangible assets begin to generate revenues from third parties.

### ***Effective date for the new rules***

The new rules set out above will be effective and applicable to corporate income tax for fiscal years beginning on or after 1 April 2020.

### **ii Authority scrutiny and evidence gathering**

The Japanese tax authority does not necessarily ask to have discussions with witnesses within or outside the taxpayer group, including the taxpayer's customers. However, the taxpayer definitely needs the assistance of experts or professionals within or outside the taxpayer group in preparing the transfer pricing documentation or during audits by the tax authority, as the demonstration of an appropriate transfer pricing methodology involves highly sophisticated economic analysis and extremely technical legal arguments.

The Japanese tax authority does not use dawn raids for transfer pricing audits in general, as transfer pricing audits concern evaluation or judgement on pricing, not factual issues involving hiding or disguising assets or documents.

Under the documentation rules introduced in 2016, the Japanese tax authority is allowed to resort to 'presumptive taxation' and may inquire about and inspect third parties operating similar businesses ('secret comparables'), if a taxpayer fails:

- a* for non-exempt transactions (see below), to submit a local file by the day designated by the tax examiner that falls within 45 days of the tax authority's request, or to submit documents 'important for calculating the arm's-length price' by the day designated by the tax examiner that comes within 60 days of the tax authority's request; or
- b* for exempt transactions (see below), to submit documents important for calculating the arm's-length price by the day designated by the tax examiner that falls within 60 days of the tax authority's request.

For this purpose:

- a* non-exempt transactions (subject to the local-file obligations) are transactions with a certain foreign related corporation with which:
  - the sum of payments and receipts is ¥5 billion or more; or
  - the sum of payments and receipts for intangible transactions is ¥300 million or more, in the previous fiscal year; and
- b* exempt transactions are transactions with a certain foreign related corporation with which:
  - the sum of payments and receipts is less than ¥5 billion; and
  - the sum of payments and receipts for intangible transactions is less than ¥300 million, in the previous fiscal year.

## **IV INTANGIBLE ASSETS**

### **i Definition of intangible assets**

Under the 2019 Tax Reform, intangible assets are defined as 'assets other than tangible assets and financial assets that are owned by companies, for which consideration would be paid in the event they were transferred or lent out in accordance with ordinary terms entered

into between independent parties' for the purposes of Japanese transfer pricing rules. This definition is in line with the amended OECD Guidelines.<sup>3</sup> This clarification is intended to distinguish intangible assets from market conditions or local market circumstances. For example, if a non-Japanese company asserts that its Japanese affiliate earns excess profit in Japan on account of the intangible assets owned by the non-Japanese company (for which the non-Japanese company should be compensated), the Japanese tax authority may take the position that the excess profit is due to the market conditions proper to Japan, and not attributable to the intangible assets owned by the non-Japanese company (for which the non-Japanese company should not be paid). Under the 2017 edition of the OECD Guidelines, the latter position is no longer sustained unless such market conditions are reflected in profitability of comparable companies.

## ii Licensing of intangible assets

Under Japanese transfer pricing rules, for transactions involving intangible assets, the following methodologies can be applied.

### *Quasi-CUP method*

For a licensing transaction, the quasi-CUP method is likely to be the most appropriate method as long as a comparable transaction can be identified. However, since each intangible asset has its own unique character and varies from others, it would be rare for it to be the most appropriate method, except where the internal comparable transactions are identified.

### *TNMM*

In the context of licensing transactions, when only one party contributes to the development, enhancement, maintenance, protection and exploitation<sup>4</sup> of the subject intangible asset, and the other party's functions are simple, such as only manufacture or sale, the TNMM is likely to be the most appropriate method. In such cases, the party not involved with the intangible asset will be examined, and it is necessary to identify companies comparable to the examined party, whose operating profits relative to sales or full costs, or Berry ratio (i.e., the ratio of gross profit to operating expenses), will be the net profit indicator (benchmark) for the examined party.

### *Residual profit split method*

When both parties subject to a transaction perform 'unique functions' by engaging in the 'creation, maintenance or development' of the intangible asset, the NTA has a tendency to apply the two-stage residual profit split method (RPSM), which is presumably the most appropriate method. The OECD Guidelines<sup>5</sup> state:

*The functional analysis should identify the relevant intangibles at issue, the manner in which they contribute to the creation of value in the transactions under review, the important functions performed*

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3 OECD Guidelines as revised in 2017, Chapter VI, Paragraph 6.6.

4 Known as DEMPE functions.

5 OECD Guidelines as revised in 2017, Chapter VI, Paragraph 6.12.

*and specific risks assumed in connection with the development, enhancement, maintenance, protection and exploitation of the intangibles and the manner in which they interact with other intangibles, with tangible assets and with business operations to create value.*

The Japanese transfer pricing rules adopted similar rules before the OECD Guidelines were revised in 2017. Specifically, Section 3-12 of the Directive indicates how an intangible asset is recognised in the context of the transfer pricing, stating that the degree of contribution by the parties to the ‘creation, maintenance or development’ of the intangible asset needs to be examined.

For example, if a certain party has made a decision with substantial discretion in conducting the research and development (R&D) services, and takes risks associated with the R&D activities, that party will be found to have significantly contributed to the creation of an intangible asset. If both parties are found to be involved in the creation, maintenance or development of the intangible asset, the RPSM is likely to be the most appropriate method. Under the two-stage RPSM, the combined profits from the subject transaction are identified, from which ‘routine profits’ are assigned to each party based on the benchmark analysis (using companies comparable to each party). The ‘residual profits’, which are produced by subtracting the foregoing routine profits from the combined profits, will be assigned to each of the relevant parties in proportion to the ‘degree of contribution’, which can be presumed based on the value of the intangible assets owned by the relevant parties, or the expenses paid for the development of the intangible assets. However, in practice, the Japanese tax authority usually adopts the relevant expenses (such as those paid by the respective parties for R&D) as the parameters and the ‘value’ of the intangible asset is rarely used.

### **iii Sales of intangible assets**

For sales of intangible assets, the Circular lists the quasi-CUP and quasi-cost-plus methods as candidate transfer pricing methods. However, it is extremely difficult and practically impossible to identify comparable transactions for the sale of intangible assets given the uniqueness inherent in each intangible asset. Therefore, if the arm’s-length price of an intangible asset is at issue during a tax audit, the audit tends to become more controversial than normal. In line with the revised OECD Guidelines, suggesting the viability of the DCF method, the Japanese tax authority has adopted this method as being applicable to sales of intangible assets (see Section III.i above). Apparently, however, the Japanese tax authority is reluctant to apply the DCF method to license of intangible assets.

## **V SETTLEMENTS**

Under Japanese tax law, the prevailing view is that the Japanese tax authority is not supposed to enter into a settlement with taxpayers, not only for transfer pricing cases, but also for any tax disputes; this is based on the idea that tax law should be applied impartially, without the tax authority exercising any discretion. However, in practice, the Japanese tax authority may suggest during a tax audit that the taxpayer voluntarily amend the original tax return to the tax amount that the tax authority indicates. After discussions, if the taxpayer and the tax authority agree on a middle ground, and the taxpayer makes a corrective filing in accordance with their mutual agreement, it will effectively close the case. Although this is not a ‘settlement’ in a legal sense, the end result is similar.

Even if a settlement is reached for a certain fiscal year, it will not automatically be incorporated into an advance pricing agreement (APA). Therefore, if the settlement is acceptable, even if not desirable, to a taxpayer, an APA could be a recommended course of action to ensure that the tax authority will not take a more disadvantageous position to the taxpayer in the future.

## **VI INVESTIGATIONS**

The Japanese tax authority's assessments based on the Japanese transfer pricing rules must be made within six years (or seven years for fiscal years beginning on or after 1 April 2020) of the deadline for the filing of the relevant corporation income tax return. Within this period, the tax authority may review a transfer pricing filing without any other time limitations. Generally, a transfer pricing audit takes a significant amount of time, and may take one year, or even two or three years in some cases.

When the Japanese tax authority makes an assessment by issuing a correction notice, the taxpayer has two options. The first is to seek administrative remedies, followed by judicial review (which can be initiated before the final resolution of the administrative remedies under certain conditions). The second is to seek competent authority relief from double taxation if a relevant tax treaty so provides.

Generally speaking, with respect to a transaction involving a country where competent authority relief is effective, taxpayers tend to seek it. The Japanese tax authority has received a number of requests for competent authority relief (including APAs) with OECD member countries. Particularly with Australia, Germany, Korea, the United Kingdom and the United States, most of the requests have been successfully resolved by agreements between both relevant governments. In addition, the Japanese government has had APAs with non-OECD member countries, including China, Hong Kong, India, Indonesia, Singapore, Taiwan, Thailand, Malaysia and Vietnam; however, with respect to competent authority relief with non-OECD member countries, precedents are relatively few.

With respect to a transaction involving a country where competent authority relief is ineffective (even if a relevant treaty allows such relief) or not available in the first place, administrative remedies and judicial review will be the only practical option that the taxpayer may seek.

## **VII LITIGATION**

### **i Procedure**

In response to a transfer pricing assessment, when a taxpayer does not or is not able to seek competent authority relief, the taxpayer may resort to the administrative appeals process to dispute the assessment. The taxpayer is required to exhaust the administrative appeals process before seeking judicial review. In general, the administrative appeal consists of two steps: a request for re-examination, and an appeal to the National Tax Tribunal (the Tribunal). The taxpayer is able to choose to proceed with the entire process, namely a request for re-examination, followed by an appeal to the Tribunal if the re-examination decision is unsatisfactory. Alternatively, the taxpayer is able to unconditionally skip the request for re-examination and file an appeal with the Tribunal directly. For a request for an initial administrative appeal, the filing period (either for a request for re-examination or for direct appeal with the Tribunal) is three months from the date of delivery of a correction notice.

In the litigation, expert witnesses are rarely called to testify, although taxpayers (commonly), and the tax authority (less frequently), submit analytical evidence prepared by economists or other transfer pricing experts. The courts review all of the evidence and decide to adopt that which the courts hold is persuasive.

## ii Recent cases

During the 2000s, the Japanese tax authority tended to apply the RPSM to cases involving valuable intangible assets, resulting in assessments being made for significantly large amounts of income. However, the courts have taken a stringent position in finding comparability between an examined party and comparable companies for the purpose of calculating routine profits under the RPSM, which was shown in the Tokyo High Court judgment dated 13 May 2015, where Honda Motor Company Limited, a major Japanese automobile manufacturer, obtained a cancellation of an assessment of ¥25.4 billion in taxable income. In the judgment, the Court held that the tax authority's selection of companies allegedly comparable to the examined party (the taxpayer's foreign subsidiary) was illegal, based on the finding that the examined party was doing business where tax incentives had been offered – specifically, in the Manaus Free Trade Zone in Brazil – whereas the alleged comparable companies identified by the Japanese tax authority had been located outside the Zone. The judgment is significant since it indicated that market conditions (including governmental regulations and interventions) are material in a comparability analysis.

In contrast, in support of the continued use of the RPSM by the Japanese tax authority, the Tokyo District Court judgment dated 24 November 2017 affirmed the assessment made by the Japanese tax authority applying the RPSM to licensing and sales transactions between a Japanese manufacturer, C Uyemura & Co, Ltd, and its Taiwanese, Malaysian and Singaporean subsidiaries. The Court recognised that the Japanese parent had intangible assets created by its research and development activities and its technical support provided to its foreign subsidiaries and customers. The Court also recognised that the Taiwanese, Malaysian and Singaporean subsidiaries had created intangible assets by penetrating the regional markets and cultivating and maintaining customers. This is the first case in which a Japanese court has affirmed the application of the RPSM adopted by the Japanese tax authority following the tax authority's losses in high-profile cases such as the *Honda* case (discussed above) and the *Takeda Pharmaceutical Company Limited* case (where the National Tax Tribunal cancelled a transfer pricing assessment based on the RPSM in the amount of ¥24.6 billion).

Another noteworthy case was a taxpayer's successful challenge of a transfer pricing assessment involving very significant intangible assets, namely Disney characters. The Tokyo District Court judgment dated 11 April 2016 cancelled the assessment based on the resale price method, in which the Japanese tax authority had found the gross margin obtained by the Japanese reseller (named 'Disney World of English') to be below the benchmark that the tax authority calculated by averaging the gross margin earned by the other resellers that the authority identified as comparable. The Court disagreed with the Japanese tax authority and held that the use of Disney characters by the Japanese taxpayer reseller was idiosyncratic and distinguished the taxpayer from the other resellers since the Disney characters were far more widely recognised and had an even stronger customer appeal than any intangible assets used by the other allegedly 'comparable' companies. Therefore, the Court held that the 'comparable' transactions the Japanese tax authority had identified were not in fact

comparable and thus no arm's-length price had been demonstrated by the tax authority. This exemplifies the significance of intangible assets in measuring the profitability of taxpayers and determining comparability of potential 'comparable' transactions.

## **VIII SECONDARY ADJUSTMENT AND PENALTIES**

Under Japanese transfer pricing rules, if a cross-border payment of interest or royalties is recalculated and decreased as a result of a transfer pricing assessment, the transfer pricing assessment has no effect on the underlying substantive transactions. Therefore, for example, even if a royalty payment from a Japanese licensee to its foreign related corporation as a licensor is decreased for Japanese transfer pricing purposes, it will not oblige the Japanese licensee to receive the difference back from its foreign related licensor, and the Japanese licensee is not eligible for a refund of any part of the withholding tax that was paid based on the original royalty amount notwithstanding the decreased amount of the royalty for transfer pricing purposes. In addition, a reduced rate under a relevant tax treaty may not be available with respect to the amount in excess of the arm's-length price, which will result in additional withholding tax. However, if the Japanese licensee does choose to receive back the difference, under a certain clause in the Circular, provided that a certain report is filed with the relevant tax office, the amount that the Japanese licensee receives back will not be subject to the Japanese corporation income tax, while the analysis for the withholding tax set out above will not change.

## **IX BROADER TAXATION ISSUES**

### **i Diverted profits tax and other supplementary measures**

There are no diverted profits taxes or similar taxes under Japanese law and no immediate proposals have been made for such taxes. There is no multinational anti-avoidance law or anything similar to the US BEAT/GILTI regime.

### **ii Double taxation**

Japan has an APA programme, which may be effective depending upon the counter-party countries (see Section VI above). Bilateral as well as unilateral APAs are available; in practice, multilateral APAs are rare.

In general, any transaction types or issues with foreign related corporations can be covered by APAs. A taxpayer must submit to the relevant regional tax bureau of the NTA a proposed method to calculate the arm's-length price and the relevant materials to support the proposed method, for review by the relevant section of the regional tax bureau. The taxpayer needs to pay no user fees for an APA application.

Roughly speaking, it often takes approximately two to three years to obtain a bilateral APA. According to the NTA, it took 34.1 months on average for a bilateral APA or MAP in 2018. In practice, APAs often cover five years. Rollback is also available. The key advantage of obtaining an APA with the tax authority is the avoidance of transfer pricing disputes in the future; the key disadvantages are that it is time-consuming and costly.

### **iii Consequential impact for other taxes**

In practice, transfer pricing assessments do not affect value added tax ('consumption tax' under Japanese tax law), or import or customs duties.

## X OUTLOOK AND CONCLUSIONS

In 2017, there were 178 enforcements, assessments or amendments in respect of transfer pricing imposed or suggested by the Japanese tax authority, amounting to ¥43.5 billion, which represented a significant increase in number but a decline in monetary amount compared to 2005, in which there were 119 enforcements, assessments or amendments, amounting to ¥83.6 billion. This shows that the investigations are now being directed at a wider range of companies, encompassing not only large companies, but also small to medium-sized companies, while the amount involved in each case has become smaller, possibly because of the tax authority's more prudent approach.

In applying the two-stage RPSM to Japanese companies, the Japanese tax authority tended to assign considerably low operating profit margins to their foreign related corporations on the grounds that they have only simple and limited functions, resulting in the assessment of significantly large amounts of income for the Japanese companies. The validity of this approach was questioned after a series of cancellations ordered by the National Tax Tribunal and the courts (see the *Honda* case in Section VII.ii). In recent years, the Japanese tax authority appears to have changed its strategy and adopted a relatively 'soft' approach, namely to incentivise taxpayers to comply with the transfer pricing rules; however, it remains to be seen if past aggressive enforcements will re-emerge.

The BEPS initiative could significantly change transfer pricing in Japan. Before the introduction of CbCRs, the Japanese tax authority had no effective measures to obtain information regarding the taxpayer's global tax position, which is necessary to assess the profit share per jurisdiction in respect of Japanese taxpayers. However, as the first CbCRs were due on or after 31 March 2018, depending on the taxpayer's fiscal year, the Japanese tax authority is expected to be keen to examine the CbCRs to find potential imbalances of taxable income per jurisdiction and identify revenue losses due to inappropriate transfer pricing so that it can pursue transfer pricing audits more effectively.

With respect to the Inclusive Framework Pillar One and GloBE proposals, the Japanese government has been proactively participating in and leading discussions. Still, considering the potential impacts on Japanese companies operating internationally, the Japanese government argues that companies that allocate profits appropriately in market countries should not be materially affected by the reform, while it argues that minimum tax should be imposed on MNE groups regardless of where they locate their activities anywhere in the world.

### **Covid-19 implications for transfer pricing**

After the World Health Organization recognised covid-19 as a potential pandemic on 11 March 2020, governments around the world, including the Japanese government, took emergency action. Lockdowns and other preventive measures worldwide have restricted economic activity with an enormous impact on the global and Japanese economies. Companies will certainly suffer tremendous losses, raising the question of which parties will assume such losses, or, if both parties are to assume such losses, an issue will arise as to how the losses will be allocated between the parties for transfer pricing purposes. It is likely that parties will have to deal with possible disagreements with the respective governments in relation to transfer pricing calculations determined after the crisis impacted the economy. In accordance with the transactional net margin method (TNMM), which is the prevailing transfer pricing method in Japan, a party who performs simple or routine functions is deemed as a contractor who does not assume business risk and could supposedly be compensated based on fixed fees regardless of any economic losses from an overall transaction. If some



governments take such a position, the taxpayer will be required to pay corporate income tax despite its financial losses. Even if a taxpayer tries to defend itself by benchmarking based on comparable companies, identifying comparable transactions may not be easy given the extraordinary nature of the crisis. Taxpayers are encouraged to delineate specifically how covid-19 caused their sales to drop and to identify justifiable reasons as to why the taxpayer, as opposed to the other party, is taking losses.

The challenges taxpayers face will be exacerbated by governments' strong revenue demands in order to finance the massive stimulus measures implemented by them, and discussions between the relevant governments for APAs may not be as harmonious as they were before. Under the current circumstances, it is premature to speculate on how the tax authorities will react to transfer pricing issues. However, taxpayers are advised to take extra precautions in preparing for upcoming tax audits.

# LUXEMBOURG

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## 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:

- a* business income;
- b* agriculture and forestry income;
- c* income from independent professional services;
- d* employment income;
- e* pension and annuities income;
- f* investment income (i.e., interest and dividends);
- g* rental and royalty income; and
- h* miscellaneous income, including capital gains.

Companies limited by share capital are subject to corporate income tax (CIT), which generally follows the computation rules of business income. Both income tax and CIT are governed by the Income Tax Law (ITL).<sup>2</sup> 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 Organisation for Economic Co-operation and Development Transfer Pricing Guidelines (the OECD Guidelines)<sup>3</sup> and is provided by Articles 56, 56 *bis* and 164 of the ITL, as well as Paragraph 171 of the General Tax Law (GTL).<sup>4</sup> Accordingly, the transfer pricing rules apply to business income subject to either income tax or CIT and to MBT. Transfer pricing adjustment may, however, also affect NWT and trigger dividend withholding tax (e.g., in the case of a requalification of a controlled transaction as a 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,

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2 Income Tax Law, dated 4 December 1967.

3 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, dated July 2017.

4 General Tax Law, dated 22 May 1931.

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.<sup>5</sup> Accordingly, if (1) an enterprise participates directly or indirectly in the management, control or capital of another enterprise, or (2) if the same persons participate directly or indirectly in the management, control or capital of two enterprises, and in either case, the two enterprises are, within their commercial or financial relations, bound by conditions agreed or imposed that differ from those that would be made between independent enterprises, the profits of these enterprises are determined and taxed on the basis of the conditions agreed upon between independent enterprises.

Article 56 *bis* ITL provides further guidance as to the methodology regarding the application of the arm's-length principle, based on the conclusions of the Report on Actions 8–10 of the Base Erosion and Profit Shifting (BEPS) Action Plan, revising Chapter I, Section D of the OECD Guidelines.

Although Articles 56 and 56 *bis* ITL follow the OECD Guidelines, it is generally admitted that the OECD Guidelines are 'soft law' only and have no direct binding effect on taxpayers. This being said, the Luxembourg Inland Revenue and courts usually refer to the OECD Guidelines regarding the application of the Luxembourg transfer pricing rules. For the sake of a continued legal security, the OECD Guidelines applicable at the time the transaction was entered into or occurred are typically relevant in this context.

Article 164(3) ITL qualifies as a hidden profit distribution any advantage that a shareholder, member or other interested party receives directly or indirectly from a company or an association that he or she would normally not have received in the absence of his or her status as an interested party.

Finally, Paragraph 171 GTL requires that, upon request, taxpayers have to provide evidence of the accuracy of their tax return and provide clarifications, including the relevant documentation. This includes transfer pricing documentation in the case of transactions between associated enterprises.

In addition, the Luxembourg Inland Revenue has issued certain circular letters and internal notes regarding transfer pricing:

- a* Circular Letter LIR No. 164 *ter*/1, dated 4 March 2020 on controlled foreign companies' rules;
- b* 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;
- c* Circular Letter LIR 164/1, dated 23 March 1998 relating to the interest rates on shareholders' corporate current accounts; and
- d* Internal Note LIR/NS-No. 164/1, dated 9 June 1993 relating to hidden profit distributions within the context of shareholders' corporate current accounts.

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5 OECD Model Tax Convention on Income and on Capital 2017.

## 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.<sup>6</sup>

The transfer pricing documentation must further be compliant with Article 56 *bis* ITL, which refers to the arm's-length principle and the OECD Guidelines. The transfer pricing documentation must be updated if the factual or legal circumstances change. Where the arm's-length pricing of a controlled transaction is secured by an advance pricing agreement (APA), the validity of the APA is limited to five years in accordance with Paragraph 29a GLT.

Note that Paragraph 171 GLT operates a reversal of the burden of proof, whereby the taxpayers must prove that the pricing of their controlled transaction is at arm's length. This is an exception to the general principle according to which the burden of proof regarding the facts that trigger a tax liability lies with the tax authorities, while the proof of facts that release the taxpayer from such a tax liability or reduce the tax liability lies with the taxpayer.<sup>7</sup>

In addition, Luxembourg has implemented with effect from 1 January 2017 the conclusions of Action 13 of the OECD's BEPS Action Plan regarding country-by-country reporting obligations. Accordingly, Luxembourg entities falling within the scope of the CbCR Law, dated 27 December 2016, will be required to communicate economic, financial and tax information for financial years as of 1 January 2016 in the form of a country-by-country report (CbCR) to the Luxembourg tax authorities, which will in turn exchange the information received with the other EU and non-EU jurisdictions concerned. If a Luxembourg resident reporting entity fails to file the CbCR, files it late or files false or incomplete information, or fails to inform the Luxembourg tax authorities that the ultimate parent refuses to provide key information for the purpose of the CbCR filing, it could be fined up to €250,000.

## III PRESENTING THE CASE

### i Pricing methods

Article 56 *bis* ITL follows the OECD Guidelines. 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 the transaction is not at arm's length.

The determination of the arm's-length price is based on the comparability analysis.<sup>8</sup> A comparison has to be made between the conditions of a controlled transaction and those

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6 At the time of submission of their income tax returns, taxpayers must disclose whether they have entered into any related-party transactions, whether these include financing, and if so whether the permitted 'simplified approach' has been used. The answers will be used in the taxpayer's transfer pricing risk assessment.

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.

that would have been imposed to a comparable transaction between independent parties. 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 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.

Article 56 *bis* ITL does not impose any specific transfer pricing method to be used.<sup>9</sup> 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 Guidelines 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;<sup>10</sup>
- 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;

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9 However, the Circular of December 2016 (LIR No. 56/1 – 56 *bis*/1) on related-party financing requires credit scoring and calculation of loss-given-default, and the application of a cost of equity to be recovered in the interest rate.

10 It is notable that Article 28 Section 3 of the Luxembourg VAT Law introduces a new concept of 'open-market value', which applies to transactions between related parties. It allows the valued added tax (VAT) authorities to disregard the consideration between related parties if it differs from the open-market value, where the consideration produces underpayments of VAT by one of the parties. This could happen where a low consideration is charged to a party that does not have a full right to deduct input VAT, or where a low consideration is charged, the supplier does not have a full right of deduction of input VAT and the supply is VAT exempt, or where a high consideration is charged by a supplier that does not have a full right of deduction. Experience in other EU jurisdictions suggests that this will have the effect of bringing the CUP method into Luxembourg VAT law.

- c the TNM method, and in particular the net cost-plus method, is most often applied for manufacturing and certain intra-group services (e.g., human resources, IT, marketing, advertising, accounting); and
- d the resale price method is usually deemed more useful for determining an arm's-length price for distribution or selling functions.

## ii Authority scrutiny and evidence gathering

The Luxembourg tax authorities typically review the transfer pricing documentation within the course of the verification of the tax return,<sup>11</sup> unless the documentation has been provided previously (e.g., in the case of an APA request). Since they follow the OECD Guidelines,<sup>12</sup> 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 the 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). CbCRs are, however, not publicly available.

In the event that the taxpayer has not spontaneously provided the transfer pricing documentation (generally as an appendix to the annual tax return), the tax authorities can request the production thereof in accordance with Paragraph 171 GTL. Also, if they have reasonable doubts regarding the tax return, they must request the taxpayer to provide the necessary information to clarify the situation<sup>13</sup> and in a second step to communicate relevant supporting documents.<sup>14</sup> 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.<sup>15</sup> 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 that the taxable income may still not be determined, the tax authorities may proceed to a lump-sum estimation thereof.<sup>16, 17</sup>

The Luxembourg courts admit that transfer pricing documentation may be prepared and submitted as late as during the litigation itself.

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11 Pursuant to Paragraph 100a GTL the tax authorities may issue a provisional tax assessment on the basis only of a tax return and such an assessment remains subject to a later verification within the five-year statute of limitations. Accordingly, the transfer pricing documentation may in certain cases only be reviewed by the tax authorities up to five years after the filing thereof.

12 In particular the requirements regarding the functional analysis provided for by Actions 8–10 of the BEPS (1.51).

13 Paragraph 206(2) GTL.

14 Paragraph 207 GTL.

15 Paragraph 209 GTL.

16 Paragraph 217 GTL.

17 See also Alain Goebel and Monique Adams, 'The practical protection of taxpayers' fundamental rights', *IFA Cahiers de droit fiscal international*, Volume 100B.

#### IV INTANGIBLE ASSETS

The Luxembourg tax authorities follow the OECD Guidelines, 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 Guidelines 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. 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. This approach could be used more often in Luxembourg.<sup>18</sup>

On 22 March 2018, the Luxembourg Parliament passed a law to introduce a new regime in relation to intellectual property (IP) and intangibles – the IP Box regime – featuring the ‘modified nexus’ approach. The calculation of the income that will benefit from the special tax treatment involves the calculation of the income that should be attributed to

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18 Luxembourg has implemented the Controlled Foreign Company (CFC) component of the EU Anti-Tax Avoidance Directive through the ‘artificial diversion’ approach. The resulting new article of the Luxembourg ITL allows for the taxation of any undistributed income of a CFC that arises from ‘non-genuine’ arrangements that have been put in place for the essential purpose of obtaining a tax advantage; non-genuine here means an entity or permanent establishment owning assets or undertaking risks for which the ‘significant people functions’ (SPFs) are carried out by its Luxembourg parent company. Clearly, where the SPFs relate to intangibles, they will be DEMPE functions, so the DEMPE concept will be applied in both transfer pricing and CFC cases.

any marketing intangibles (as opposed to the technical intangibles created by the qualifying research and development expenditure). This is likely to require a transfer pricing analysis of the licence fees that could have been charged for any such marketing intangibles).

## 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 to third parties regarding a taxpayer.

## VI INVESTIGATIONS

The collection of income tax and CIT in Luxembourg is based on a reporting system, whereby the taxpayer completes a tax return that is reviewed by the tax authorities.<sup>19</sup> The tax authorities have to investigate the factual and legal situation that is substantial for the determination of the tax<sup>20</sup> and have a duty of an objective and impartial control in this regard.

In the event of there being 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.<sup>21</sup> 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 that 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:

- a* they may only use means that are appropriate to achieve the relevant goal;
- b* within the means at their disposal they have to select the one that least impairs the private interests; and
- c* the gravity of the chosen measure has to be compared to the expected impact regarding public interest.

In cases of a violation of the principle of proportionality, the administrative decision of the taxation office is voidable.

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19 Paragraph 166 GLT.

20 Paragraph 204 GLT.

21 Paragraph 205 GLT.



The tax assessment also has to observe several formal conditions;<sup>22</sup> for example, it has to be made in writing,<sup>23</sup> contain the amount of taxes assessed and indicate how, when and where an appeal may be lodged. Once the tax assessment notice has been issued, the tax authorities may only amend it in limited cases (e.g., new facts have emerged that would change the taxation).<sup>24</sup> In the event that the taxpayer objects to the tax assessment, he or she must lodge a written claim with the direct tax authorities within three months of the notification of the assessment.

The tax authorities may decide – in the event that 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 limitations. 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 limitations. Regarding income tax and CIT, the statute of limitations 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 of 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 of its notification. In the event that 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

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22 Paragraph 211 GLT.

23 Paragraph 210b GLT.

24 Paragraph 222 GLT.

chartered accountant or an auditor. Luxembourg courts have admitted that transfer pricing documentation could be prepared and submitted as late as during the litigation proceedings. Expert witnesses are, however, generally not requested before courts.

The judgment of the administrative tribunal is subject to an appeal before the administrative court within 40 days of the notification of the judgment. The administrative court re-examines the judgment of the administrative tribunal, taking into account both the factual and legal background. During the course of the procedure before the administrative court, the taxpayer has to be represented by a lawyer admitted before the courts of appeal. The administrative court is the highest and final judicial power in tax matters. It renders its decision in the last resort and no further revision is possible. Hence, from a timing perspective, a tax dispute in Luxembourg may usually be settled within 20 months, as strict deadlines are followed.

## **ii Recent cases**

Luxembourg courts have issued abundant case law in transfer pricing matters over the past decades. A considerable amount of this relates to adjustments on the basis of the recognition of hidden profit distributions<sup>25</sup> (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).<sup>26</sup>

Recent case law stresses the importance of having appropriate transfer pricing documentation in place from the outset. In the first case,<sup>27</sup> a Luxembourg company financed the acquisition of a French real estate property by means of a 12 per cent shareholder loan. The tax authorities partially dismissed the interest, considering that the arm's-length rate was limited to 3.57 per cent for the year 2011 and 2.52 per cent for the year 2012, with the excess being a hidden profit distribution subject to 15 per cent withholding tax. The taxpayer filed a complaint and produced a transfer pricing analysis that had been prepared after the reassessment. This first analysis, however, indicated an interquartile range for the arm's-length interest of between 2.39 per cent and 7.88 per cent and the tax authorities confirmed their position, since their valuation was within that range. During the court proceedings, the taxpayer had a second transfer pricing report prepared, which indicated an increased interquartile range of between 9.95 per cent and 19.95 per cent. Although the administrative tribunal also accepted the second report for consideration, it concluded that the taxpayer had failed to explain the difference between the two transfer pricing analyses and hence had not brought any evidence as to the absence of a hidden profit distribution, so the case was dismissed.

In the second case,<sup>28</sup> a Luxembourg company had waived outstanding loans against two foreign subsidiaries that were in financial distress, and depreciated the relevant participations. However, the Luxembourg tax authorities considered that granting loans to subsidiaries over several years without any hope of being reimbursed did not accord with the arm's-length principle, and hence was constitutive of a hidden profit distribution. It applied the same reasoning to the depreciation of the participations, which the company had acquired over the

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25 See, e.g., administrative court, 26 March 2015, 34024C; administrative court, 19 January 2012, 28781C; administrative court 12 February 2009, 24642C.

26 See, e.g., administrative court, 1 February 2000, 11318C, administrative court 17 February 2011, 27172C.

27 Administrative tribunal, 22 October 2018, 40348.

28 Administrative tribunal, 7 January 2019, 40251.

years at significant value. The taxpayer failed to prove the arm's-length character of the waivers and the depreciation before the administrative tribunal, in particular the economic reasons and therefore the benefits for the company, and hence the case was dismissed. On appeal, the administrative court overruled the decision of the administrative tribunal and decided that since the taxpayer had provided sufficient evidence that the subsidiaries were without activity and financially distressed, the waivers were not unusual and hence not constitutive of a hidden profit distribution.<sup>29</sup>

## **VIII SECONDARY ADJUSTMENT AND PENALTIES**

Luxembourg has not enacted any specific legislation or other regulations on secondary adjustments. However, depending on the case, the tax authorities may impose secondary adjustments in the form of hidden profit distributions or hidden capital contributions (see Section VII). Accordingly, any non-arm's-length advantage granted by a Luxembourg company to an affiliate may be requalified as a hidden profit distribution (in the 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 that the participation exemption does not apply. No further penalties are foreseen.

## **IX BROADER TAXATION ISSUES**

### **i Diverted profits tax**

Luxembourg has not enacted any diverted profit tax.

### **ii Double taxation**

Luxembourg tax treaties generally follow Article 25 of the OECD Model Tax Convention, which provides for a mutual agreement procedure. In cases where none of the contracting states provide for unilateral relief, they 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.<sup>30</sup> 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 of 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 that the Member States are 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.

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<sup>29</sup> Administrative court, 31 July 2019, 423264C.

<sup>30</sup> EU Convention No. 90/436/EEC on the elimination of double taxation in connection with the adjustment of profits of associated enterprises.

Luxembourg has also signed the Multilateral Instrument (MLI)<sup>31</sup> 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 if 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 Indirect Tax Authority is mainly competent for valued added tax and registration duties; and
- c* the Customs and Excise Agency is mainly competent for customs and excise duties.

As from 2008, information that is relevant for the accurate assessment of taxes must be exchanged between 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 the adjustment is not barred by the expiry of the statute of limitations.

## **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 the 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.

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31 The OECD Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (Multilateral Instrument or MLI).

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 transfer pricing legislation, the need to file for an APA to obtain certainty as to tax treatment has mostly gone and consequently, the number of APA requests is expected to diminish over time. However, given the complexity of the rules and the lack of more precise guidance, it is equally expected that transfer pricing audits and disputes will increase. In addition, transfer pricing documentation obligations have been introduced under the controlled foreign companies' rules in order to determine the net profits of the controlled foreign company to be attributed to the Luxembourg taxpayer. Also, the new Guidelines on financial transactions which were published on 11 February 2020 are likely to significantly impact certain aspects of the Luxembourg transfer pricing practice, in particular regarding acceptable debt-to-equity ratio, classification of financial instruments as debt or equity and more generally the content of the transfer pricing documentation. Finally, Luxembourg has officially confirmed its support of the OECD's digital taxation project.

# MEXICO

*Oscar Campero P San Vicente and Alejandra Castellón Contreras<sup>1</sup>*

## I OVERVIEW

Since 1997, Mexican tax authorities have recognised the arm's-length principle for benchmarking related-party transactions, establishing transfer pricing provisions for these purposes.

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 Organisation for Economic Co-operation and Development (OECD) Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the OECD Guidelines) and 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 those persons, or when there is a link between them pursuant to customs legislation. In this sense, an individual may also be a party related to another person and therefore subject to Mexican transfer pricing provisions.

For the interpretation of the Mexican transfer pricing provisions, the OECD Guidelines approved by the Council of the OECD in 1995 will be applicable, or those that replace them, as long as they are consistent with the provisions of the MITL and the treaties entered into by Mexico.

The Mexican transfer pricing provisions 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.

Article 179 of the MITL states that the tax authorities may determine the accumulated income and authorised deductions of taxpayers that have not been determined in transactions performed between related parties, taking into account the prices that would have been established with or between independent parties in comparable transactions. Moreover, if

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the tax authorities determine that a taxpayer did not undertake transactions with related parties at arm's length, the median of the price, amount or margin range obtained from the application of any of the transfer pricing methods is considered to be the price or amount of the consideration that independent parties would have established.

## 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 this is formally required in an audit process.

There is certain documentation that taxpayers must file with the Mexican tax authorities regarding transactions with 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<sup>2</sup> 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. This documentation shall contain the following:

- a* name, domicile and tax residence of the related parties and documents showing the direct and indirect relation between the related parties;
- b* functions, assets and risks assumed by the taxpayer per type of transaction;
- c* information and documents on transactions with related parties and amounts per type of transaction; and
- d* method applied in accordance with Article 180 of the MITL, including information and documents on comparable operations and enterprises, per type of transaction.

In practice, and on the basis of a statutory criterion issued by the tax authorities,<sup>3</sup> the requirement to procure and maintain supporting documentation that 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.

Pursuant to Article 76-A of the MITL, which has been in force since fiscal year 2016, taxpayers that in the immediately previous year obtained operating revenues equal to or exceeding 791,501,760 Mexican pesos,<sup>4</sup> those that had shares exchanged in the stock market, companies that applied for the optional tax regime for corporate groups, state companies of the federal public administration and foreign residents with a permanent establishment in Mexico that undertook transactions with related parties in that year, 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* master file: information on the business multinational enterprise group (MNEs), including overview of the companies, overall transfer pricing policies, global allocation of revenue and economic activities;

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2 They are not required to submit this information.

3 Statutory criterion 00/2012/ISR.

4 Amount for tax year 2018, which will be updated each tax year.

- b* local file: information on related parties, including specific transfer pricing information on the group in Mexico; and
- c* country-by-country report: aggregate tax jurisdiction-wide information on the business MNEs, related to, for example, global allocation of revenue, taxes paid and indicators of the location of economic activities. This report must be submitted by Mexican taxpayers that qualify as multinational controlling entities (the ultimate holding resident in Mexico) if the annual consolidated revenue of the MNEs in the immediately previous fiscal year is greater than 12 billion Mexican pesos.

Non-controlling Mexican taxpayers may still be required to file this report when appointed by the foreign parent company. In addition, the Mexican tax authorities could request other foreign tax authorities to share the country-by-country report through an information exchange mechanism.

Specific administrative rules for master and local files, as well as for 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),<sup>5</sup> which requests information on the related party, percentage of profit or loss obtained by operation, rate or percentage agreed, income statement by operation, type of range used, interquartile range and SIC codes used. The transfer pricing analyses required in this Appendix must be performed for each type of transaction carried out by the taxpayer and must be submitted before the Mexican tax authorities on an annual basis.

### III PRESENTING THE CASE

Article 180 of the MITL establishes that, for the purposes of the transfer pricing provisions, the following methods should be applied:

- a* comparable uncontrolled price method (CUP);
- b* resale price method (RPM);
- c* cost-plus method (CPLM);
- d* profit split method (PSM);
- e* residual profit split method (RPSM); and
- f* transactional net margin method (TNMM).

As can be seen, the MITL establishes six transfer pricing methods, differentiating the PSM from the RPSM, which in the OECD Guidelines are a single method.

Article 180 of the MITL also states that for the determination of prices for transactions between related parties, taxpayers should consider the CUP as the first option and only use 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 must 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.

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.

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<sup>5</sup> DIM is an annual filing for companies, regarding their main information for tax purposes.



The CPLM is mainly used to analyse manufacturing and rendering of services transactions since it compares the markup obtained over the cost of goods sold by independent parties in comparable transactions, in connection with the markup obtained over the cost of goods sold by a company.

The PSM and RPSM are usually applied when inter-company transactions are broadly related, and for this reason it is not possible to segregate financial information related to the operation. Additionally, the RSPM is applied to analyse transactions that involve non-routine intangible assets.

The TNMM is used to analyse transactions with a significant level of costs and expenses, since this method takes into account transactional factors such as assets, sales, costs of goods sold, operating expenses and cash flows.

To determine the most appropriate transfer pricing method and the suitable profitability factor, the business approach of the transaction and its business cycle should be considered.

Article 179 of the MITL establishes that the operations or companies used in the application of a transfer pricing methodology should be comparable when there are no important differences between them that distort the price or amount of the consideration, or margin established. To assess any differences, it is necessary to take into account 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 by each of the related parties involved, as well as the unique contributions of value involved in the controlled transactions,<sup>6</sup> and 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, and they can use import summaries information. The analyses performed by the Mexican tax authorities focus on the functions performed, assets used, risks assumed and unique and valuable contributions in the transactions scrutinised.

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.

On 30 November 2018, the Mexican tax authorities issued a specific statutory criterion<sup>7</sup> for the application of the interquartile method making it an improper practice for taxpayers to modify considerations that are already within the adjusted range obtained by the interquartile method with the sole purpose of obtaining a benefit.

In order to introduce the best-practice approach recommended by the OECD, on 30 October 2019 an additional limitation on deductibility of interest was included in the MITL for 2020.<sup>8</sup> This limitation applies to interest payments to related and non-related parties, either Mexican or foreign resident, and it establishes that taxpayers must consider as non-deductible the net interest exceeding 30 per cent of the entity's adjusted tax profit.<sup>9</sup>

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6 Statutory criterion 39/ISR/NV.

7 Statutory criterion 40/ISR/NV.

8 Section XXXII of Article 28.

9 Adjusted tax profit is the tax profit plus interest accrued, depreciation, amortisation and pre-operative expenses.

Additionally, a new Title of the Federal Tax Code (FTC) was incorporated,<sup>10</sup> through which various obligations are established for tax advisers and taxpayers regarding disclosure of reportable schemes. The schemes that must be reported are those that generate or may generate, directly or indirectly, tax benefit in Mexico. In the case of transactions between related parties, Section VI of Article 199 of the FTC states that the following transactions must be reported:

- a* transfer of hard-to-value intangible assets;
- b* restructures without consideration or as a result of which the operating profit is reduced by more than 20 per cent;
- c* transactions without consideration;
- d* operations without reliable comparable; and
- e* MAPs or APAs obtained by foreign-based related party.

#### IV INTANGIBLE ASSETS

Article 179 of the MITL recognises that transactions between related parties involving the exploitation or transfer of intangible assets should be determined at arm's length, taking into consideration not only the type (patent, trademark, trade name or transfer of technology), but also the duration and degree of protection of the intangible.

In accordance with the transfer pricing provisions, the RPSM should be used to analyse inter-company transactions that involve non-routine intangible assets, which in general terms consist in the determination of a minimum profit generated by each company involved in a transaction to determine the minimum profit that each party must generate by routine contributions. The excess profit of the routine profit is defined as the residual profit, which is attributable to intangible assets owned by one or more of the parties involved in the transaction. The residual profit is split among the parties according to the relative value of the intangible property that each party involved contributed to or utilised in the transaction.

In practice, financial valuation methodologies are used to establish arm's-length considerations for transactions between related parties that involve intangible assets, since the results reflect the prices at which independent third parties would be willing to acquire such assets. The price of an asset determined with a valuation methodology would be consistent with CUP application, and it would comply with the arm's-length principle.

As discussed, the 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 transfer pricing issues that may arise.

To have a broader understanding of the intangible assets' analysis, Mexican transfer pricing provisions on intangible assets should be regarded as complementary to Chapter VI of the OECD Guidelines, as contemplated in Action 8 of the OECD's BEPS Action Plan. However, queries arise regarding certain valuations 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).

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<sup>10</sup> Articles 197–202.

The *ex ante* approach to pricing arrangements relates to the relevance, enforceability and sustainability of a project considered before making an investment; in contrast, the *ex post* approach is taken after the investment is concluded, namely when there is no information available before the implementation of the project in question.

The Mexican tax authorities, when scrutinising taxpayers' choice of the CUP or the RPSM method to analyse transactions involving intangibles, usually focus on the differences between the taxpayers' projected income used in the chosen methodology and their actual income.

## V SETTLEMENTS

In 2014, as part of the effort by the Mexican government to provide relief and support to taxpayers faced with a complex tax system with excessive formal requirements and subject to periodic amendments, the FTC was amended to introduce a settlement procedure called a 'conclusive agreement'; this procedure is conducted by the Mexican taxpayers' ombudsman, which acts as a mediator between the taxpayer and the tax authorities.

This procedure is intended to allow taxpayers to submit evidence to the tax authorities to clarify alleged omissions identified during an 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. The agreement reached in cases of this kind is binding and cannot be challenged by the parties.

If a petition of a conclusive agreement is filed, the audit procedure is suspended, and in the event that ultimately 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 FTC 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 of 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 perform the review of the annual tax return in assessment and to request information from the taxpayer. Likewise, the tax authorities have two years to issue an official letter of observation or a final act with the results of the transfer pricing audit.

During a transfer pricing audit, the tax authorities may determine whether a transaction carried out by a taxpayer with related parties was made at arm's length or not. As mentioned above, if the tax authorities were to determine that the transactions under consideration were not made at arm's length, they would make a transfer pricing adjustment.

Once the official letter of observations or final act with the results of the transfer pricing audit is received, the taxpayer will have two months to appeal and present evidence

or liquidate the tax assessment. In the event the taxpayer presents additional evidence or appeals, the tax authorities will have six months to determine the final tax regarding the transfer pricing adjustments.

In practice, the tax authorities review a series of economic indicators based on the taxpayer's transactions with its related parties, such as the leverage level, to start an audit process.

Recently, the number of transfer pricing audits has increased following the alignment of 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, and ensuring the provision of various services with the intention of transferring profits to non-resident entities. These taxpayers may be audited by the Mexican tax authorities, with a view to changing these structures and returning the taxable profits to Mexico.

The Mexican tax authorities also focus on auditing pro rata expenses,<sup>11</sup> verifying that such expense deductions fulfil the tax authorities' requirements, which in practice are very difficult for taxpayers to comply with. Additionally, the Mexican tax authorities have been auditing certain restructurings performed in the mining sector in past years, as well as royalty payments to foreign-based related parties for the use of trademarks and other intangibles.

Currently, the Mexican tax authorities have adopted another mechanism to perform its verification attributions, issuing an invitation letter to taxpayers to encourage them to comply with its tax obligations, or to review some information or figure in which the authorities recognise inconsistencies. These invitation letters could derive from a tax self-assessment.

## VII LITIGATION<sup>12</sup>

### i Procedure

There are two legal remedies by which taxpayers can challenge a tax-deficiency assessment. The first is by filing an administrative appeal with the tax authorities, and the second option is through an annulment complaint before the Federal Tax Court (the Court).

#### *Administrative appeal*

##### *Ordinary procedure*

Before going to court, the taxpayer can challenge a tax-deficiency assessment through an administrative appeal, which must be filed within 30 business days of the date on which the taxpayer is notified of the tax assessment, and which should include any additional evidence that the assessment is illegal.

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11 Expenses incurred abroad on a pro rata basis by a Mexican taxpayer will not be considered deductible for income tax purposes. However, this consideration may not apply if certain requirements are met, such as: demonstrating that the services that generated the expense have been effectively rendered; the consideration has been determined on an arm's-length basis; and there is a reasonable relationship between the expenses and the benefit obtained or expected to be obtained.

12 The authors are grateful for the collaboration of Diego Marvan Mas, associate at Chevez, Ruiz, Zamarripa y Cia, SC, in the production of this section.

After all the evidence is submitted, the tax authorities are required to issue a resolution within a three-month period.

One of the benefits of the administrative appeal under the FTC is that the taxpayer is not compelled to lodge any kind of security (such as a bond deposit, or administrative asset seizure) with the tax authorities prior to the resolution of the appeal.

In the event of obtaining an unfavourable resolution in this procedure (or in the substantive procedure), the taxpayer may file an annulment complaint before the Court within 30 business days of the date of notification of the ordinary procedure decision.

#### *Substantive procedure*

In 2017, a new procedure was created whereby taxpayers can challenge tax-deficiency assessments exceeding approximately 5 million pesos through an optional procedure in which only substantive arguments against the legality of the deficiency assessment can be made (with no consideration to be given to questions regarding procedural formalities).

Pursuant to the FTC, substantive arguments are understood as those that relate to the taxpayer, the activities subject to taxation, and the rates and payment period.

This type of administrative appeal must also be filed within 30 business days of the date on which the tax assessment is notified to the taxpayer, and should include any additional evidence to demonstrate that the assessment is illegal; as in the ordinary procedure, taxpayers are not required to lodge any kind of security with the appeal.

As with the ordinary procedure, in the event of obtaining an unfavourable resolution, taxpayers may file an annulment complaint before the Court within 30 business days of the date of notification of the substantive procedure decision.

#### ***Annulment complaint***

##### *Ordinary procedure*

The annulment complaint must be filed before the Court within 30 business days of the tax assessment or of the notification of the (ordinary or substantive procedure) administrative appeal decision.

In the event of an administrative appeal decision in favour of the taxpayer, the tax authorities may file an appeal or, in the event of a decision in favour of the tax authorities, the taxpayer may file an *amparo* lawsuit, challenging the first appeal decision; the appeal or the *amparo* lawsuit challenging the first decision must be filed within 15 business days of the date of the notification of the decision, and will be decided definitively by a collegiate tribunal.

When filing an annulment complaint, the taxpayer should lodge security with the tax authorities in one of the forms established in the FTC (bond, deposit, administrative asset seizure, payment, etc.) within 30 business days of the date of the notification of the decision to the company, or within 10 business days of the resolution of the administrative appeal.

##### *Substantive procedure*

In 2017, a new procedure was created whereby taxpayers can challenge tax-deficiency assessments exceeding approximately 5 million pesos through specialised judges in an optional procedure in which only substantive arguments against the legality of the deficiency assessment can be made (with no consideration to be given to questions regarding procedural formalities).

This claim must also be filed within 30 business days of the date on which the tax assessment is notified to the taxpayer, and an important benefit of this procedure (in contrast to the ordinary procedure) is that the taxpayer is not required to lodge any kind of security until a resolution is rendered.

As in the ordinary procedure, in the event of an administrative appeal decision in favour of the taxpayer, the tax authorities may file an appeal or, in the event of a decision in favour of the tax authorities, the taxpayer may file an *amparo* lawsuit, challenging the first appeal decision; the appeal or the *amparo* lawsuit challenging the first decision must be filed within 15 business days of the date of the notification of the decision, and will be decided definitively by a collegiate tribunal.

## **ii Recent cases**

There are some cases being discussed concerning transfer pricing disputes about the following fees:

- a* research and development;
- b* cost sharing;
- c* services fees;
- d* information and technology;
- e* advertising and promotion; and
- f* 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 the different jurisdictions included in transfer pricing adjustments, which in turn may lead to increases in revenue and decreases in deductions, or decreases in revenue and increases in deductions, for each of the entities involved in the underlying transactions.

In July 2018, the Mexican tax authorities issued administrative rules establishing the definition of transfer pricing adjustments, including both virtual adjustments made for tax purposes only and real adjustments with an effect on the taxpayer's accounting. These adjustments can present the following variants:

- a* voluntary or compensatory;
- b* primary;
- c* corresponding domestic;
- d* corresponding foreign; and
- e* secondary.

These administrative rules include specific regulations on the application of compensatory and corresponding transfer pricing adjustments that increase or decrease the price, amount or margin of the taxpayer, leading to an increase or decrease of taxable income or authorised deductions.

Additionally, Article 184 of the MITL establishes that tax authorities of countries with which Mexico has a treaty to avoid double taxation may determine an adjustment to the prices or considerations of a taxpayer resident in that country; in this context, the Mexican related party may perform the corresponding adjustment, provided that the Mexican tax authorities accept the adjustment.

This should not be taken to mean that Mexican taxpayers are not allowed to perform transfer pricing adjustments for Mexican tax purposes, but tax uncertainty exists when implementing such adjustments. To obtain tax certainty, taxpayers may request rulings from the Mexican tax authorities providing legal certainty for diverse tax implications, and taxpayers have even entered into MAPs to obtain a higher level of security from a tax perspective.

Article 184 of the MITL establishes a mechanism whereby a Mexican taxpayer can apply a corresponding adjustment derived from a primary adjustment, determined for a foreign-based related party resident in a country with which Mexico has 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. This adjustment would not count for tax-return-submission limitation purposes.

Furthermore, on this basis, the MITL recognises the application of corresponding adjustments, although at this stage it only recognises those derived from primary adjustments that have been performed by the tax authorities in a country with which Mexico has a tax treaty. Such recognition may be obtained by means of a MAP involving the Mexican and foreign tax authorities. Therefore, in a non-tax-treaty context this situation may lead to double taxation.

Recently, the Tax Authority issued specific rules with respect to primary and corresponding adjustments.

Current Mexican legislation does not include specific rules regarding secondary adjustments, so should Mexican taxpayers have to apply these adjustments, there are no rules providing certainty of their application. In fact, there are recent cases in which the Authority is already determining secondary adjustments.

## **IX BROADER TAXATION ISSUES**

In addition to tax treaties between jurisdictions to avoid double taxation, the most used mechanism is the MAP, which allows designated representatives from the governments of contracting states to interact to resolve international tax disputes.

In these international disputes, most transfer pricing MAP issues concern associated economic double taxation incurred by companies in multinational enterprise groups because of an adjustment by one or more tax administrations to the income from intra-group transactions.

Currently, Appendix 1-A of Fiscal Miscellaneous Resolution for 2020 establishes the filing requirements to initiate a MAP application procedure.

Action 6 of the BEPS Action Plan stipulates, among other measures, an inter-country agreement to adopt a series of minimum standards in tax treaties to avoid treaty shopping.<sup>13</sup> 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

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<sup>13</sup> 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.

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 context, in general, transfer pricing methods and customs methods are different, although in certain cases they are similar in their application. Therefore, in general, transfer pricing analysis or documentation is not valid for customs valuation purposes, and vice versa.

## **X OUTLOOK AND CONCLUSIONS**

Mexican legislation follows the OECD Guidelines regarding transfer pricing issues. Adjustments have recently been made to adopt properly the BEPS Action Plan. Regarding dispute resolution mechanisms, the conclusive agreement procedure has proven very effective in the audit process, since it offers an alternative to mediation between the taxpayer and the tax authorities.

Currently, because of the Mexican tax authorities' focus on transfer pricing matters, a risk model is being implemented to address audit processes from a transactional and business perspective, focusing on the substance and not on the form and presentation as used to be the case in the past. This risk model includes further detail given the information filed by taxpayers through local file, master file and country-by-country report.

The number of transfer pricing audits has increased following the alignment of 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 potentially involved in aggressive tax planning strategies, and they have shown significant interest in transfer pricing matters.

The Mexican tax authorities have issued specific rules with the aim of enforcing laws to implement transfer pricing adjustments, providing taxpayers with the option to perform certain adjustments; however, secondary adjustments are still not included in the Mexican legislation.

Starting in 2020, taxpayers must comply with additional requirements for the deductibility of interest, as well as certain schemes that must be reported to the authorities.



# NETHERLANDS

*Bas de Mik and Maarten van der Weijden*<sup>1</sup>

## I OVERVIEW

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 laid down in case law.

Article 8b CIT includes both vertical relationships (parent–subsidiary) and horizontal relationships (sister companies with a joint parent) between entities; both direct and indirect relationships are taken into account. Relationship thresholds have intentionally been omitted from the statute, and instead, an approach that looks at the substance of the relationship has been adopted. This is to avoid taxpayers having the ability to influence their tax position by planning around clearly defined statutory thresholds, and also ensures that entities that do not have a capital divided into shares, such as foreign trusts or Dutch foundations, are covered by the arm's-length principle.

Taxpayers may apply for an advance determination of whether they are related for the purposes of Article 8b CIT.

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The application of Article 8b CIT is not limited to cross-border transactions. Article 8b CIT also applies to transactions between related entities in the Netherlands, and contains the requirement for taxpayers to document the arm's-length nature of the transfer prices used.

The Dutch government has on multiple occasions stated that, in its view, the Organisation for Economic Co-operation and Development 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 application of Article 8b CIT can result in an increase or a decrease of a Dutch taxpayer's taxable income. The Dutch government has announced a study into whether the possibility of a decrease of taxable income should be reconsidered within the context of combating tax avoidance.

In 2018, the Dutch Ministry of Finance issued Decree 22 April 2018, No. 2018-6865 (the Dutch Transfer Pricing Decree), which contains explanatory guidance in areas where the OECD Guidelines leave room for interpretation by individual countries or where the OECD Guidelines are unclear. The Dutch Transfer Pricing Decree has been amended to bring it in line with the revisions that the OECD Transfer Pricing Guidelines have undergone in connection with the outcome of the OECD's Base Erosion and Profit Shifting (BEPS) project.

Another decree issued by the Dutch Ministry of Finance, Decree IFZ2010/457M, contains guidance on the allocation of profits to permanent establishments.

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 practice for issuing tax rulings and APAs was most recently amended in July 2019. Under the amended practice, only taxpayers with an 'economic nexus' with the Netherlands are eligible for a ruling or an APA. Furthermore, rulings and APAs will not be issued if avoiding Dutch or foreign tax is the sole or decisive reason for entering into a transaction, if the transaction covered involves entities that are resident in certain low-tax or non-cooperative jurisdictions.

The rulings and APA practices have come under scrutiny of the European Commission, who claim that some of the agreements the Dutch tax authorities have entered into constitute state aid that is prohibited under EU law. In *Starbucks*, the Commission rendered a final decision that an APA entered into between the Dutch tax authorities and Starbucks represented unlawful state aid. The General Court of the European Court of Justice has decided against the Commission. The decision has not been appealed. In another case, *IKEA*, the Commission has rendered an opening decision concerning alleged state aid granted by the Netherlands. In January of 2019, the Commission announced that it had started an in-depth investigation to examine whether tax rulings granted by the Netherlands to Nike may give rise to unlawful state aid.

Cooperative compliance agreements between the Dutch tax authorities and taxpayers are very common for large and medium-sized corporate taxpayers. Under the agreement taxpayers commit to notify tax authorities of issues that could give rise to disagreement on a current basis. The tax authorities commit to timely state their position with respect to these issues. The purpose of the agreement is to have fewer disputes in the assessment phase, thus assuring that the taxpayer's tax position is more certain on a current basis. One of the effects of these agreements is that taxpayers are less likely to take aggressive tax positions, or play the audit lottery. Another effect is that conflicts, including conflicts in the transfer pricing area, less frequently reach the stage where they are brought to court.

## II FILING REQUIREMENTS

There are three levels of statutory documentation and filing requirements in the transfer pricing area.

### i General transfer pricing documentation

Pursuant to Article 8b CIT, every taxpayer is required to maintain transfer pricing documentation in its administration, from which it can be derived whether transactions with related entities have been conducted under arm's-length conditions. In the context of an M&A transaction, the Dutch Transfer Pricing Decree states that the acquisition file of the buyer is part of the transfer pricing documentation.

There is no requirement to prepare a transfer pricing report. Taxpayers are free to substantiate their transfer pricing in any form. The information should be available at the time of filing of the tax return and must be provided to the Dutch tax authorities upon request. If the transfer pricing relates to transactions between a Dutch taxpayer and an associated enterprise outside the Netherlands, the documentation may be retained outside the Netherlands. Notwithstanding this, the Dutch taxpayer must provide the requested information to the Dutch tax authorities upon request.

### ii Medium-sized multinational groups

Entities that are part of a multinational group with a consolidated turnover in excess of €50 million are required to maintain in their administration a group file and a local file. The group file should contain a description of the nature of the activities of the group, the general transfer pricing policy of the group and a worldwide allocation of income and economic activities. The group file should enable the tax authorities to make a transfer pricing risk assessment. The local file should contain all information to assess whether the company has fulfilled its documentation requirements under Article 8b CIT. The local file and the group file should be available in either Dutch or English. The tax authorities may give additional guidance on the contents and format of the files. The files should be available at the latest at the time of filing of the tax return.

### iii Large multinational groups

A Dutch resident ultimate parent of a multinational group with a total consolidated turnover exceeding €750 million is required to prepare a country-by-country report (CbCR). The CbCR should contain the following aggregate information for each jurisdiction in which the multinational group is active:

- 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* 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, and must be filed with the Dutch tax authorities within 12 months of the balance sheet date.

Decree DB/2015/462M contains detailed regulations on the required content of the documentation and filing requirements for large and medium-sized multinational groups referred to above.

In addition to the above statutory requirements, a taxpayer and the tax authorities may agree as part of an APA that the taxpayer files a report annually that enables the tax authorities to review the taxpayer's compliance with the APA.

In 2017, legislation became effective to enable the Dutch tax authorities to automatically exchange CbCRs received from multinational groups with other countries.

### **III PRESENTING THE CASE**

#### **i Pricing methods**

The Dutch tax authorities apply the guidance of the OECD Guidelines on comparability factors. These factors include the characteristics of the property or services transferred; the functions performed by the parties (taking into account assets used and risks assumed); the contractual terms; the economic circumstances of the parties; and the business strategies pursued by the parties.

The Dutch tax authorities allow the use of both internal and external comparables. There is no specific guidance with respect to comparables. Because of the relatively small size of the Dutch economy, benchmarking analyses on the basis of international data are acceptable. Data from commercial databases made available by parties such as Bureau van Dijk, Bloomberg, Moody's and Thomson Reuters are generally accepted.

The OECD Guidelines, in principle, look at transactions individually. Where there is a large number of comparable transactions, the Dutch tax authorities will apply aggregation of transactions and will expect that the taxpayer will demonstrate that its dealings are at arm's length on an aggregate basis.

In cases where the arm's-length transfer price is within a range, the Dutch tax authorities will take the position that the median should be taken as the basis for adjustment.

Taxpayers are, in principle, free to choose a transfer pricing method, provided that the method adopted leads to an arm's-length outcome for the transaction in question. In certain situations, however, some methods will generate better results than others. Although taxpayers may be expected to base their choice of a transfer pricing method on the reliability of the method for the particular situation, they are definitely not expected to weigh up the advantages and disadvantages of all the various methods and then explain why the method that was ultimately adopted generates the best results in the prevailing conditions (i.e., the best-method rule). Certain situations are also suited for a combination of methods. At the same time, taxpayers are not obliged to use more than one method.

The only obligation resting on the taxpayer is to explain the decision to adopt the particular method that was adopted.

#### **ii Authority scrutiny and evidence gathering**

The Netherlands has implemented CbCRs and will actively exchange information with other countries. CbCR data is not public. However, the Dutch government supports the EU initiative for 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.

Taxpayers may offer the use of outside experts (such as economists or valuation experts); however, the Dutch tax authorities are free to weigh the opinion of the expert in their analysis.

## IV INTANGIBLE ASSETS

### i Intangible assets

Dutch tax law does not provide for a definition of intangibles. The Dutch tax authorities will ordinarily take the legal arrangements on intangibles as the starting point for determining a company's taxable profit from intangibles.

In the Dutch Transfer Pricing Decree, it is stated that the transfer of an intangible asset to a related enterprise that is not expected to add value because it lacks the required functionality (skills) is not at arm's length. In this regard, the Dutch Transfer Pricing Decree takes into account the principles regarding development, enhancement, maintenance, protection and exploitation<sup>2</sup> of intangibles introduced in the OECD BEPS project.

If the transaction as such is at arm's length because the buyer also adds functionality, the terms and conditions of the transaction will be tested. In the Dutch Transfer Pricing Decree the Ministry of Finance commented on the transfer of intangibles. Sometimes intangible assets such as patents are transferred, and it is difficult to establish the value at the time of the transfer because insufficient information is available about the future benefits and risks associated with the intangible. The Dutch tax authorities then will apply the principles laid down in Paragraph 6.185 of the OECD Guidelines. If independent enterprises under similar conditions would have demanded a price adjustment clause, the Ministry of Finance takes the position that the Dutch tax authorities must be permitted to calculate the price using this type of clause as well (i.e., an arrangement whereby the consideration for the transfer is commensurate with the benefits that the intangible asset will generate in the future). An example would be a situation in which a new intangible asset has been developed that is sold to an associated enterprise at a time when there are very few guarantees as to its future success, for instance, because it has yet to generate any revenue and any estimates of future revenue are surrounded by major uncertainties.

With respect to hard-to-value intangibles, it is stated in the Dutch Transfer Pricing Decree that deviations of 20 per cent or more of the projections used to determine the value at the time of the transfer will be a reason for the tax authorities to use *ex post* data to test the

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2 Known as DEMPE principles.

reliability of the *ex ante* projections, in line with Paragraphs 6.186 to 6.195 of the OECD Guidelines. However, as a safe harbour, if the deviation does not occur until five years after the transfer, the intangible will not be treated as a hard-to-value intangible.

Further, in the Dutch Transfer Pricing Decree it is confirmed that, under certain conditions, the TNMM is an appropriate method to determine the residual profit attributable to the owner of an intangible, provided that all other functions have been properly rewarded.

## ii Other topics

The Dutch Transfer Pricing Decree also addresses the following areas:

- a* intra-group services;
- b* shareholder costs;
- c* centralised purchasing;
- d* intra-group guarantees;
- e* internal reinsurance; and
- f* group finance.

Guidance in these areas generally follows the principles of the OECD Guidelines and the BEPS reports, but may have a higher level of detail. With respect to low-value-adding intra-group services, the Dutch Transfer Pricing Decree stipulates, in deviation from OECD Guidelines paragraphs 7.43–7.65, that these may also be charged on a cost basis without a mark-up. The Dutch Transfer Pricing Decree has not been updated to reflect the OECD report *Transfer Pricing Guidance on Financial Transactions – Inclusive Framework on BEPS: Actions 4, 8–10*, which was published in February 2020.

## 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. To apply retroactively, obviously facts and circumstances have to be comparable.

Alternatively, the Dutch tax authorities may settle audit tax disputes without entering into an APA. A tax inspector would in that case probably also discuss the proposed settlement with the specialists of the transfer pricing team that also is responsible for the APAs.

Settlements are not made public. Summaries of APAs are published in anonymised form and redacted such that the taxpayer involved cannot be identified.

The Dutch tax authorities are not obliged to enter into a settlement agreement or an APA.

## VI INVESTIGATIONS

A corporate tax return must be filed within five months of the close of the taxable year. Upon request of the taxpayer, the statute of limitations for filing a return may be extended.

Once the tax return has been filed, the audit process may start. Transfer pricing is part of the normal audit process. The inspector can raise a final assessment within three years of the close of the year, and the date is extended with extensions of the filing date that were granted to the taxpayer. A regular transfer pricing audit will normally have to take place within this three-year period. During the audit process, the tax authorities have broad authority to ask the taxpayer for information. In essence, everything that could be of relevance to determine the tax liability is subject to discovery. The tax authorities are not, however, allowed to embark on a 'fishing expedition'. If a taxpayer does not cooperate with information requests, an 'information decision' can be issued. An information decision essentially puts the burden of proof that an assessment issued by the tax authorities is incorrect entirely on the taxpayer.

If the transfer pricing audit involves a complex case, the tax authorities may ask the taxpayer to agree to an extension of the statute of limitations for issuing the final assessment. There is no obligation for the taxpayer to grant this request. If the taxpayer is not willing to grant this extension, the tax authorities can issue an assessment that includes the adjustments under 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 of the close of the year plus the period for which the extension for filing the return has been granted, provided new information (a 'new fact') has come to light of which the tax inspector was not aware (and could not reasonably have been aware) at the time that the original final assessment was issued. The five-year period may be extended to 12 years if the taxpayer paid insufficient tax in respect of an asset held or profit that arose abroad. The tax inspector does not have to prove that a new fact has come to light in the event the taxpayer has not acted in good faith and knows, or should have known, that the original final assessment was too low or that, erroneously, no assessment was issued at all. If the amount of tax due on the assessment is at least 30 per cent lower than the amount due based on tax law, the taxpayer is deemed to be aware of the incorrectness.

In the case of a deficiency assessment, the additional amount of corporate income tax due will be increased with interest and possibly penalties. No penalty is due if the fact that the amount of the original assessment was too low cannot be held against the taxpayer. The amount of a penalty depends on the amount of corporate income tax due and the degree of guilt or negligence of the taxpayer.

Taxpayers can lodge an administrative appeal against a final assessment or a deficiency assessment within six weeks of 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 of 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 of the date a decision is rendered in the administrative appeal. The district court must decide on the appeal within 16 weeks of the final due date of the appeal. This 16-week period can be extended by the court by 12 weeks. Further extension is also possible under certain conditions.

Both the taxpayer and the tax authorities can, within six weeks, lodge an appeal against the judgment of the district court with the court of appeal. The court of appeal should render its decision within 16 weeks of 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 with the Supreme Court within six weeks. 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.

Taxpayers may offer the use of expert witnesses in tax proceedings. However, the court is free to weigh the opinion of the expert witness in reaching a verdict in the case.

### ii Recent cases

#### *ECLI:NL:HR:2019:355 (15-03-2019)*

‘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’, an entity related 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 was not required that the guarantee was specifically directed towards C to create a transaction between related entities. The case was referred to the court of appeal to decide. The court of appeal, weighing the evidence brought forward by the parties, decided that the guarantee in part was given because of shareholder relationships, and thus was not taxable, and in part for commercial reasons. The



case was again appealed before the Supreme Court, which held that the court of appeal had failed to require the taxpayer to render proof that an informal capital contribution had taken place. The case has been referred back to a different court of appeal.

***ECLI:NL:GHAMS:2019:1504 (18-04-2019)***

The case involved a Dutch acquisition vehicle that obtained funds from its shareholders, a private equity fund, to finance an acquisition of a Dutch target group. The court of appeal held that the transfer pricing report submitted by the taxpayer was sufficient (counter) evidence against the Dutch tax authorities' position that the interest on the loan was not at arm's length (a deduction for interest was denied on other grounds, though). An appeal has been lodged with the Dutch Supreme Court.

***ECLI:EU:T:2019:669 (24-09-2019)***

The General Court of the EU annulled the European Commission's final decision of 21 October 2015 that the Netherlands had granted state aid to Starbucks. In its decision of October 2015, the European Commission stated that the transfer pricing methodology agreed upon in the APA between the Netherlands and Starbucks led to economically non-justifiable results, providing Starbucks with a selective advantage.

***ECLI:NL:GHSHE:2020:968 (13-03-2020)***

'B', a Dutch resident company engaged in the sale and production of zinc products, entered into an agreement with a Swiss affiliate pursuant to which production planning, procurement of materials, logistics and sales were concentrated in Switzerland. B received a remuneration of €28,351,364 as compensation and after that was remunerated on a cost-plus basis. The tax authorities increased the compensation to €184,627,000. The court of first instance denied the claim of the tax authorities with respect to the compensation, because the activities in respect of which the tax authorities claimed that compensation should be paid had been transferred in earlier years. The court also approved the cost-plus 10 per cent remuneration. The tax authorities have lodged an appeal against the case. The parties reached a settlement which, upon the request of the parties, was assumed by the appeals court as its verdict. In the settlement the parties agreed that the taxpayer and its Swiss affiliate did not conduct routine activities. The profit split method was deemed to be the most appropriate method to determine the amount of profit that had been shifted from the taxpayer to the Swiss affiliate. This amount was set at 28 per cent of the overall profit derived from the sale and production of the zinc activity, resulting in a value shift of approximately €90 million which amount was included in taxable income of the Dutch taxpayer.

## **VIII SECONDARY ADJUSTMENT AND PENALTIES**

### **i Secondary adjustments**

The Dutch tax authorities always require a transfer pricing adjustment to be processed by means of a secondary transaction. A secondary transaction may lead to a secondary adjustment, such as the attribution of interest to the current account or the levying of dividend withholding tax on a deemed distribution of income. Systems differ from one country to another, and this means that the foreign tax authority in question may not be prepared, for example, to credit Dutch dividend withholding tax on a deemed dividend against its own tax because it does

not recognise the deemed dividend. The secondary adjustment, therefore, does not take place if the taxpayer is able to demonstrate that, in light of the difference between the tax systems used by the two states, the dividend withholding tax paid cannot be credited and there is no situation of abuse aimed at the avoidance of dividend withholding tax.

## **ii Interest and penalties**

Late payment of tax will lead to interest being due on the unpaid balance. If the tax authorities adjust the transfer prices the interest will be 8 per cent per annum on the amount of tax that is due. The interest will be due on all unpaid tax six months after the close of the year.

Penalties of 50 per cent of the additional tax due may be imposed if the tax authorities demonstrate that the taxpayer intentionally misrepresented its taxable income. A rate of 25 per cent applies in cases of negligence. In the parliamentary discussion of Article 8b CIT it was stated that penalties would only apply in the case of intentional misrepresentation. There was one district court case where an insurance company was fined for using conditions that were not at arm's length in dealing with a reinsurance company in a tax haven. The Dutch Transfer Pricing Decree explicitly states that penalties may be imposed in cases involving transfer pricing adjustments.

There are light administrative penalties for not having available CbCRs; it may be expected that courts will shift the burden of proof (and will thereby construct negligence) in the event taxpayers do not have transfer pricing documentation required by Article 8b CIT available upon audit.

## **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 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 Arbitration Convention<sup>3</sup> has applied since 1 January 1995.

On 10 October 2017, the EU Council adopted Council Directive (EU) 2017/1852 on tax dispute resolution mechanisms in the European Union. Legislation implementing this directive has been implemented into Dutch law.

Some of the Dutch treaties for the avoidance of double taxation contain an arbitration clause, most notably the treaty with the United Kingdom. Furthermore, the Netherlands has opted for mandatory arbitration as provided for in Part VI of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting. Meetings with the main trading partners (among others, Belgium, France, Germany, the United Kingdom and the United States) to resolve 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.

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3 90/436/EEC: Convention on the elimination of double taxation in connection with the adjustment of profits of associated enterprises.

## **ii Consequential impact (VAT)**

No specific rules for the value added tax (VAT) treatment of transfer pricing adjustments are implemented in the Dutch VAT legislation. This means that general principles of VAT should be applied. VAT is a tax on individual transactions and requires an actual payment for services. Where the transfer price adjustment consists of an adjustment in the taxable amount in conjunction with secondary adjustments, there is no payment for services. Additionally, if the transfer price adjustment involves the application of a profit level indicator, it is highly unlikely that there is an individual transaction that can be identified. Adjustments on CUPs in conjunction with actual flows of cash between related entities as a consequence may be taxable. There is no case law in this area and therefore some uncertainty.

Customs value is based on transaction value. It is common practice in the Netherlands to share transfer pricing reports to demonstrate that the transaction value has not been influenced by a relationship with a related entity and therefore can be applied as the value for customs purposes.

## **X OUTLOOK AND CONCLUSIONS**

Transfer pricing in the Netherlands is generally treated as a cooperative effort between taxpayers and the tax authorities. Most conflicts will thereby be solved in the assessment and internal appeal phase. APAs are an integral part of the tax system and applied very regularly.

The position that the EU has taken that (some of the) rulings issued by the Dutch tax authorities constituted state aid will have a major impact on the ruling practice. The Dutch tax authorities will be more reluctant to issue rulings in the area of transfer pricing and will probably also require more documentation to prove the arm's-length nature of dealings between related entities.

Since 2016, larger companies have been required to prepare additional transfer pricing documentation as part of the CbCR initiative of the OECD and EU. A big unknown is what the tax authorities will do with the transfer pricing information received as a consequence of this reporting. In addition, the Dutch government has announced a study into whether unilateral downward transfer pricing adjustments should be limited to situations in which there is a corresponding pick-up of income elsewhere. Furthermore, as of 1 July 2019, APAs will no longer be entered into in those situations.

The Dutch government supports the work performed by the Inclusive Framework on the Pillar One and GloBE proposals. With respect to Pillar One, the government supports the Unified Approach. The focus of the government is to achieve a system that is administrable and as simple as possible. Also, the government is mindful that the potential loss of revenue by states is taken into account. The government also supports the GloBE proposals, but given the state of these proposals it has not given much guidance on its position on their content, other than that it is in favour of reaching agreement within the Inclusive Framework.

# NIGERIA

*Lolade Ososami, Joseph Eimunjeze and Mojisola Jawando*<sup>1</sup>

## I OVERVIEW

Prior to 2012, there was no comprehensive law regulating transfer pricing in Nigeria. General anti-avoidance rules (GAARs) were included in Nigeria's income tax laws as a means of curbing tax avoidance. Tax authorities relied on GAARs to assess and regulate the pricing of inter-group transactions where such transactions appeared to be artificial or sham arrangements. In August 2012, the Federal Inland Revenue Service (FIRS), Nigeria's Federal tax authority, published Nigeria's first transfer pricing regulations. The Income Tax (Transfer Pricing) Regulations (the 2012 Regulations) were aimed at unifying and implementing the various transfer pricing provisions available in the Nigerian tax laws and providing a more structured regime for assessing related-party transactions. The 2012 Regulations, however, did not provide much certainty in relation to the scope and contents of the reporting requirements or the parameters for the selection of comparables for purposes of benchmarking prices or profits of related-party transactions. The scope of taxes covered did not include capital gains tax (CGT) and value added tax (VAT), and there were uncertainties around the application of safe-harbour rules and penalties for non-compliance.

In 2016, Nigeria joined the Organisation for Economic Co-operation and Development (OECD)/G20 Inclusive Framework on Base Erosion and Profit Shifting (BEPS) and committed to the implementation of the four minimum standards, which included the re-examination of transfer pricing documentation (Action 13). As part of the implementation of the Action 13 minimum standard, the 2012 Regulations were replaced by the Income Tax (Transfer Pricing) Regulations 2018 (the 2018 Regulations). Unlike the 2012 Regulations, which only took into consideration the provisions of the OECD and United Nations (UN) Transfer Pricing Guidelines, the 2018 Regulations also adopted some of the provisions of the African Tax Administration Forum's suggested approach to drafting transfer pricing legislation (the ATAF Approach). The main thrust of the ATAF Approach is to suggest structure and content to African countries seeking to develop transfer pricing rules, based on policy options that aim to address the limitations that African tax administrations often encounter when assessing transfer prices. These limitations include information asymmetries between multinational entities (MNE) and African tax administration and capacity constraints that make it difficult to price complex controlled transactions, especially involving the transfer of rights relating to intangibles.<sup>2</sup> The 2018 Regulations are to be applied in a manner that is consistent with the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax

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2 *Suggested Approach to Drafting Transfer Pricing Legislation* – an ATAF Publication.

Administrations 2017 (OECD TP Guidelines) and the UN's *Practical Manual on Transfer Pricing for Developing Countries 2017* (UN Manual), as may be supplemented and updated from time to time.<sup>3</sup> Where, however, there is any inconsistency between any domestic law, rules or regulations and the UN Manual and OECD TP Guidelines, the domestic laws will prevail. What this means, therefore, is that Nigerian transfer pricing rules may be supplemented by the OECD TP Guidelines as updated from time to time, provided that the Guidelines are not inconsistent with domestic law. Consequently, reference can be made to more recent versions of the OECD TP Guidelines in determining whether transactions predating the updated versions of the Guidelines were at arm's length. Some of the introductions made by the 2018 Regulations include rules on intra-group services, pricing of intangibles, pricing of commodities, exports and imports, and transfer pricing documentation processes.

The 2018 Regulations cover transactions between individuals, sole corporations, entities, companies, partnerships, joint ventures, trusts or any other body of individuals deemed to be 'connected'. Persons will be deemed to be connected where one person has the ability to control or influence the other person in making financial, commercial or operational decisions or there is a third person who has the ability to control or influence both persons in making financial, commercial or operational decisions.<sup>4</sup> The degree of control required is, however, not specifically stated in the 2018 Regulations. Eligible transactions include sale and purchase of goods and services; sales, purchase or lease of tangible assets; transfer, purchase, licence or use of intangible assets; provision of services; lending or borrowing of money; manufacturing arrangements and any transaction that may affect profit or loss or any other matter incidental to, connected with or pertaining to these transactions (eligible transactions).

The scope of application of the 2018 Regulations includes all transactions that have an effect on the taxable profit of connected entities, including distributions of dividend and capital contributions between connected persons. Transactions between connected persons are deemed to be controlled transactions and must be at arm's length. A transaction is at arm's length when the conditions of the transaction do not differ from the conditions that would have applied between independent persons in comparable transactions carried out under comparable circumstances. Where a controlled transaction is considered not to be at arm's length, the FIRS may make necessary adjustments to bring the taxable profits resulting from the transaction into conformity with the arm's-length principle.

## II FILING REQUIREMENTS

The filing requirements under the 2018 Regulations place specific reporting obligations on a taxable person to disclose its relationship with any party that qualifies as a 'connected person' in relation to its business activities. In addition to the filing of contemporaneous documentation prescribed in the OECD TP Guidelines, the filing requirements for a Nigerian company include making a transfer pricing declaration and filing a transfer pricing disclosure. The taxpayer has the ultimate responsibility to prepare its transfer pricing documentation and any liability arising from non-compliance, inadequacies, defects or misstatements is for the account of the taxpayer.<sup>5</sup>

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3 Regulation 18 of the 2018 Regulations.

4 Regulation 12 *ibid*.

5 FIRS Guidelines on Transfer Pricing Documentation.

**i Declaration**

A Nigerian entity is required to declare its relationship with all connected persons resident in Nigeria or elsewhere by filing a declaration in the prescribed form within 18 months of its incorporation or within six months of the end of its accounting year, whichever is earlier. A Nigerian entity that fails to make or submit a declaration within the prescribed period shall pay an administrative penalty in the sum of 10 million naira and 10,000 naira for every day the failure continues. The Nigerian entity is required to file an updated declaration upon the occurrence of any changes in the organisation within six months of the end of the accounting year in which the change occurred.<sup>6</sup> Failure to submit a declaration or notification in respect of such changes will attract a penalty of 25,000 naira for each day in which the failure continues.

**ii Disclosure**

It is mandatory for a Nigerian entity to annually disclose all eligible transactions with connected persons without notice or demand from the FIRS in the prescribed form within 18 months of its incorporation or within six months of the end of its accounting year, whichever is earlier. Failure to file a disclosure in the relevant year of assessment will attract an administrative penalty of 10 million naira or 1 per cent of the value of the controlled transaction not disclosed, whichever is higher; and 10,000 naira for every day the Nigerian entity remains in default.<sup>7</sup> Where the Nigerian entity files an incorrect disclosure, the higher of an administrative penalty of 10 million naira or 1 per cent of the value of the controlled transaction not disclosed, will apply. The Nigerian entity can apply to the FIRS for an extension of time to make the relevant disclosure. Approval is subject to the discretion of the FIRS.

**iii Documentation**

A Nigerian entity has an obligation to keep in electronic format, sufficient data or information, along with an analysis of the information, to verify that the pricing of controlled transactions is consistent with the arm's-length principle and shall make the documentation available to the FIRS upon written request.<sup>8</sup> The documentation shall be available prior to the due date for filing the income tax return for the year in which the documented transaction occurred. The documentation comprises a master file, a local file (contemporaneous documentation) and a country-by-country report (CbCR), where required.

The master file should include a detailed description of the group's legal and ownership structure, geographical location of operating entities, service arrangements between members,

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6 Such changes include a merger of the Nigerian entity's parent company with another company outside the group; acquisition of up to 20 per cent of the Nigerian entity's parent company by persons not connected to the group; merger of the Nigerian entity with another company; acquisition of up to 20 per cent of the Nigerian entity by persons not connected to the group; merger or acquisition of the Nigerian entity by another company outside the group; sale or acquisition of a subsidiary by the person; and any other change in the structure, including a change in directorship, arrangement or circumstances of the Nigerian entity that influences whether it will be considered to be connected or not connected to another person.

7 Regulation 14(4) of the 2018 Regulations.

8 Regulation 16 *ibid*.

sources of business profit, turnover, intangibles owned, all policies from the development to transfer of research within the group, financing arrangements, tax positions, annual consolidated financial statements and tax rulings on income allocation by jurisdiction.

The local file should provide detailed information relating to specific inter-company transactions between the Nigerian entity and connected enterprise, including a functional analysis, value-chain analysis and comparability analysis of the transactions.

A Nigerian entity with controlled transactions of a total value less than 300 million naira is not obliged to maintain contemporaneous documentation unless a notice is received from the FIRS demanding it.<sup>9</sup> In the event that the FIRS makes such a demand, the contemporaneous documentation must be submitted not later than 90 days from the date the FIRS notice was received. A company with controlled transactions of a total value that exceeds 300 million naira is required to submit contemporaneous documentation to the FIRS within 21 days of receiving a written request. Failure to meet the prescribed deadline will attract an administrative penalty of the sum of 10 million naira or 1 per cent of the total value of the controlled transactions, whichever is higher; and 10,000 naira for every day that the failure continues.<sup>10</sup>

In addition to maintaining contemporaneous documentation, a company that is a member of an MNE group with a total group revenue of 160 billion naira and above during the accounting year immediately preceding the year of assessment is required to file a CbCR. A Nigerian group of companies that does not have any affiliation with a foreign company and that does not meet the eligibility threshold is not required to file a CbCR. The filing of CbCRs is governed by the Income Tax (Country by Country Reporting) Regulations of 2018, which are modelled on the OECD CbCR rules. The information in the CbCR is aggregated by tax jurisdiction, showing the MNE's allocation of income, income tax paid, and certain indicators of the location of economic activity among tax jurisdictions in which the MNE group operates.

### III PRESENTING THE CASE

#### i Pricing methods

The FIRS does not favour any particular method over the other provided that the taxpayer can show that the chosen method is the most appropriate in the circumstance.<sup>11</sup> To determine the most appropriate transfer pricing method to adopt in a given circumstance, four factors must be considered. These are:

- a* the strengths and weaknesses of the transfer pricing method on a case-by-case basis;
- b* the nature of the controlled transaction through an analysis of the functions performed, assets, employed, and risks assumed by each person that is a party to the controlled transaction;
- c* the availability of reliable information; and

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<sup>9</sup> Regulation 17(3) of the 2018 Regulations..

<sup>10</sup> Regulation 16(5) *ibid*.

<sup>11</sup> The OECD Transfer Pricing Guidance on Financial Transactions endorses the comparable uncontrolled price method for benchmarking-related party loans.

- d* the degree of comparability between controlled and uncontrolled transaction, including the reliability of adjustments, if any, that may be required to eliminate any differences between comparable transactions.<sup>12</sup>

The 2018 Regulations also recognise that, in considering the factors above, a taxpayer may reach a conclusion that none of the specified transfer pricing methods can be reasonably applied. In these circumstances, a taxpayer may apply a different transfer pricing method provided that sufficient information exists, and the method gives rise to financial indicators that are consistent with that of independent persons engaging in comparable uncontrolled transactions in comparable circumstances.

There is unfortunately a dearth of publicly available data from which local comparables can be drawn for benchmarking analysis in Nigeria because of a lack of centralised data. Thus, taxpayers and the FIRS have had to rely on comparables from other jurisdictions in Africa, Asia, Europe and America.

Where the application of the most appropriate method leads to an uncertainty in the degree of comparability in two or more controlled transactions, a statistical approach shall be used and the interquartile range shall be considered to be an arm's-length range.

Extrapolation from near comparables is also permitted, provided that there is sufficient publicly available information on such comparables, against which the FIRS can verify the benchmarking analysis used to arrive at the arm's-length price. The use of unknown comparables that cannot be verified through information that is publicly available is unacceptable.

## **ii Authority scrutiny and evidence gathering**

The FIRS is empowered under the relevant laws to request any relevant information from taxpayers relating to their income and profits.<sup>13</sup> This power is especially useful prior to and during transfer pricing audits, where the FIRS requests various documents, including internal documents relating to controlled transactions, to determine whether the price fixed is at arm's length. This places the burden of proof on the taxpayer to prove beyond reasonable doubt that the controlled transactions under review have been priced in accordance with the arm's-length principle.<sup>14</sup>

During an audit, a taxpayer would usually be required to provide additional information and documents, such as contract agreements with connected persons and third parties, account statements and receipts. The FIRS may also request to meet with certain officers of the taxpayer to provide information, explanations or justifications for certain actions where necessary. In addition, a taxpayer's professional advisers (for example, auditors or transfer pricing specialists) may be required to provide the FIRS with information on matters that require further clarification. The FIRS may also request information on a taxpayer from its bankers. In addition, in recent times, various government agencies have been known to collaborate with the FIRS with a view to providing information on taxpayer activities. The FIRS also leverages the cooperation agreements that Nigeria has signed with a number of

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12 Regulation 5(2) of the 2018 Regulations.

13 Federal Inland Revenue Service Establishment Act 2007 and the Companies Income Tax Act 2004 (as amended).

14 <https://news.bloombergtax.com/daily-tax-report-international/insight-practical-lessons-from-transfer-pricing-audits-in-nigeria>.



countries that allow for the automatic exchange of tax and financial information between the tax authorities of these countries to obtain relevant information from its counterparts in other jurisdictions where the taxpayer is not forthcoming with information relating to members of its group.

#### IV INTANGIBLE ASSETS

The 2018 Regulations adopt the ATAF Approach, which provides African countries with policy options that provide simplification measures to address capacity constraints that make it difficult to price complex controlled transactions, such as those involving the transfer of rights relating to intangibles.

The determination of arm's-length conditions for controlled transactions involving intangibles differ in terms of whether the intangible asset would be exploited, licensed, sold or otherwise transferred. The general approach when determining the arm's-length price of the exploitation of intangible assets is to consider the contractual arrangements between the parties. Other factors that will be taken into account with regard to the development, enhancement, maintenance, protection and exploitation (DEMPE) of the intangible asset are: (1) the functions performed by the person; (2) management and control of those functions; (3) contribution by the person of assets, including financial assets; (4) management and control regarding the contribution of assets, including financial assets; (5) risks assumed by that person; and (6) management and control of those risks.<sup>15</sup>

In cases where the above-listed factors and the contractual arrangements between the parties differ, regard shall be taken of those factors in determining the arm's-length reward from the exploitation of the intangible asset.<sup>16</sup> In practice, a substance-over-form approach is used when the contractual arrangements underlying the DEMPE functions are being considered.

Regardless of the arm's-length price determined in relation to the exploitation of intangible assets, the consideration that will be allowed as deductible for tax purposes shall not exceed 5 per cent of the taxpayer's earnings before interest, tax, depreciation and amortisation (EBITDA) plus the consideration, derived from the commercial activity conducted by the person in which the rights transferred are exploited.<sup>17</sup>

When there is a transfer of intangible property between connected persons, account shall be taken of both the perspective of the transferor and the transferee of the property, including in particular, the price at which a comparable independent person would be willing to transfer the property and the value of the intangible property to the transferee in its business. Special factors relevant to the comparability of the controlled and uncontrolled transaction will be considered, such as (1) the expected benefits from the intangible property; (2) the commercial alternatives otherwise available to the acquirer of licences derived from the intangible property; (3) any geographic limitations on the exercise of rights to the intangible property; (4) the exclusive or non-exclusive character of the rights transferred; and (5) whether the transferee has the right to participate in further development of the intangible property by the transferor.

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15 Regulation 7(1) of the 2018 Regulations.

16 Regulation 7(2) *ibid*.

17 The ATAF Approach recommends a percentage of the taxpayer's tax EBITDA plus the actual royalty payable for the year of assessment.

## V SETTLEMENTS

The need for settlement arises either where a taxpayer objects to an assessment issued by the FIRS after an audit has been concluded or where the taxpayer and the FIRS need to agree on a criterion, including the method of transfer pricing used to determine whether the taxpayer has complied with the arm's-length principle. In the former case, the 2018 Regulations set out an administrative procedure for settlements to be made through the Decision Review Panel (the Panel). Regarding the latter, the 2018 Regulations contain a provision for entering into an advance pricing agreement (APA) with the FIRS.

A taxpayer who disagrees with the transfer pricing assessment may object to the assessment within 30 days. The head of the transfer pricing function of the FIRS may, upon receipt, refer the taxpayer's objection to the Panel,<sup>18</sup> which, in making a decision, shall take into consideration (1) the adjustment or assessment issued; (2) the basis on which the adjustment or assessment was issued; (3) the taxpayer's objection; and (4) the evidence presented to it by the parties. The decision of the Panel on the adjustment or assessment shall represent the final position of the FIRS in respect of the dispute.<sup>19</sup> However, if still aggrieved by the decision of the Panel, the taxpayer may appeal to the Tax Appeal Tribunal (TAT), and appeal further to the courts.

Although the 2018 Regulations set out elaborate provisions regarding the scope and procedure for concluding an APA, the FIRS has yet to enter into any APAs with taxpayers. It is hoped that as part of its obligations to observe the minimum standards of the BEPS Inclusive Framework, the FIRS will consider entering into APAs with taxpayers that require them.

## VI INVESTIGATIONS

A company liable to pay tax under the Companies Income Tax Act 2004 (as amended) (the CITA) is required to file a self-assessment return. Where the company has engaged in related-party transactions, it is required to file transfer pricing documentation on the basis of self-assessment.

The FIRS would typically conduct an audit on the company's returns to ascertain that it has complied with the provisions of the law.<sup>20</sup> At the end of the audit, the FIRS may call for further returns or may issue an additional assessment against the company within the year of assessment or within six years of the expiration of the assessment year.<sup>21</sup> The company has 30 days within which to object to the additional notice. With regard to transfer pricing assessments, the FIRS may request the company's transfer pricing documentation, which should be maintained contemporaneously with the transactions documented therein prior to the due date for filing the company's income tax return.

The FIRS may subsequently, as necessary, invite the company to make a presentation about the company and its global operations to justify its transfer pricing policy. The FIRS may also visit the company's premises to observe its internal processes, examine the relevant records and compile its report, which is sent to the company. Upon receiving the FIRS report,

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18 Regulation 21(5)(6) and (7) of the 2018 Regulations.

19 Regulation 21(8) *ibid.*

20 Section 60(4) of the CITA.

21 Section 66 *ibid.*

the company may be required to provide additional information to clarify any inconsistencies or deficiencies, which may ultimately lead to an adjustment of the tax assessed. The FIRS would meet with the company to provide relevant clarifications where necessary. Upon the conclusion of its investigation, the FIRS will send its assessment to the company summarising its position on the company's transfer pricing structure.

A tax investigation may be triggered if, after an audit or a series of audits, the FIRS observes that the returns filed by the company are inconsistent with information obtained from third parties or underlying records; or where the FIRS has reason to suspect that the company has been engaged in tax evasion either by way of fraud or wilful neglect. Unlike a tax audit, a tax investigation is not subject to the statutory limitation period of six years.<sup>22</sup>

## VII LITIGATION

### i Procedure

A person aggrieved by an assessment or demand notice made by the FIRS or any action or decision of FIRS under the tax laws (including an action based on transfer pricing assessments), may appeal against the action, decision, assessment or demand notice. If the taxpayer has exhausted all administrative remedies to have the tax authority review its position but does not challenge the assessment at the TAT by way of an appeal within the prescribed period, the assessment is said to become final and conclusive. In that circumstance, the tax due becomes a debt due to the government, and the tax authority may institute proceedings at the TAT for recovery of the unpaid tax.

The TAT is the ultimate fact-finding forum in respect of all tax disputes and is comprised of experts who determine the appropriate tax liability based on all available data and without undue adherence to the strict application of the rules of evidence, while ensuring compliance with the principles of fair hearing<sup>23</sup> and the provisions of the tax laws. To institute an action, the appellant is required to file a notice of appeal at the Registry of the appropriate zone of the TAT and pay the required fees, as stated in the Second Schedule to the TAT Rules. If the appellant wishes to call for the evidence of a witness at the hearing of the appeal, the appellant is required to file, along with the notice of appeal, (1) a list of witnesses to be called at the hearing of the appeal; (2) written statements on oath of the witnesses; and (3) copies of every document to be relied on at the trial. Parties can call any number of witnesses, including expert witnesses, in proof of their case. The evidence given by the expert witnesses will be admitted in evidence if it is relevant to the determination of the case. Where there is a conflict in expert testimonies, the TAT is not bound to accept any of the opinions proffered. In such circumstances, the TAT may choose and rely on the opinion that is most probable. The TAT can also reject the expert opinions if they are not convincing. The respondent is required to enter appearance in respect of the appeal within 30 days of the service of a notice of appeal.

The award or judgment of the TAT is enforced like the judgment of the Federal High Court (FHC), upon registration of a copy of the award with the Chief Registrar of the FHC<sup>24</sup> by the party seeking to enforce the award or judgment.

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22 Proviso in Section 66(1) *ibid*.

23 Appeal No. TAT/LZ/PPT/041/2014: *Mobil Producing Nigeria Unlimited v. Federal Inland Revenue Service*.

24 In Nigeria, the power of a court to enforce and ensure compliance with its judgment or order is derived from Section 6(6)(a) of the Constitution of the Federal Republic of Nigeria, 1999 (as amended). Being

A party who is dissatisfied with the judgment of the TAT may appeal against the decision on points of law to the FHC.<sup>25</sup> The notice of appeal against the judgment of the TAT must be filed at the TAT within 30 days of the date on which the TAT delivered the judgment. After the filing of the notice of appeal, the Secretary of the TAT is required to deliver a copy thereof to the Chief Registrar of the FHC along with the records of proceedings and all exhibits tendered at the hearing before the TAT.<sup>26</sup>

The onus is on the appellant to prove that the assessment complained of is excessive. Under the TAT Rules, an appeal must be filed within 30 days of the date on which the action, decision, assessment or demand notice in question was made by the taxing authority.<sup>27</sup> The 30-day rule, however, is not rigid, as the TAT Rules provide that the Tribunal may entertain an appeal that was filed after 30 days if it is satisfied that there was sufficient cause for the delay.

## ii Recent cases

Since the FIRS commenced transfer pricing audits in 2015, there has been only one court decision that has been concluded and reported. This is the case of *Prime Plastichem Nigeria Limited v. FIRS*,<sup>28</sup> which was recently decided by the TAT.

In that case, Prime Plastichem Nigeria Limited (PPNL) had purchased plastics and petrochemicals from a foreign related-party supplier, Vinmar Overseas Limited, in 2013 and 2014. In determining the arm's-length price for 2013, PPNL used the comparable uncontrolled pricing (CUP) method, and in 2014 the transactional net margin method (TNMM) was used as PPNL claimed that there were no comparables available for that year. PPNL had arrived at the price in line with the TNMM using the operating/net profit margin as a profit level indicator (PLI). PPNL filed the relevant transfer pricing documentation for 2013 and 2014 with the FIRS. The FIRS requested additional documentation from the company covering 2013 and 2014 which it provided. Subsequently, the FIRS served PPNL with an additional assessment totalling over 1.7 billion naira inclusive of interest and penalties. PPNL filed an appeal at the TAT.

The main issues before the TAT were, inter alia, (1) whether the FIRS was right to have benchmarked PPNL's transfer pricing transaction with the TNMM for 2013 and 2014 in view of the 2012 Regulations and the OECD/UN Guidelines; and (2) whether the FIRS was right to have used the gross profit margin (GPM) method as the PLI in view of the 2012 Regulations, OECD and UN Guidelines. The TAT held, inter alia, that:

- a the onus was on PPNL to provide sufficient information to the tax authority to validate the use of any transfer pricing methods. By the provisions of Regulation 5(2) of the 2012 Regulations, availability of reliable information is a necessary condition for a transfer

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a monetary judgment, the award made by the TAT can be enforced by a writ of *feri facias*, garnishee proceedings, a charging order, a writ of sequestration or an order for committal on judgment debtor summons.

25 Order 24 Rule 1 of the Tax Appeal Tribunal (Procedure) Rules 2010.

26 Order 24 Rule 2 *ibid*.

27 Order 3 Rule 2 *ibid*.

28 Appeal No. TAT/LZ/CIT/015/2017. The appeal was decided by the Lagos Zone of the TAT on 19 February 2020.

pricing method to be considered most appropriate. Therefore, the FIRS' rejection of the CUP method was in consonance with the provisions of the 2012 Regulations and OECD TP Guidelines;

- b* the choice of the most appropriate PLI under the OECD TP Guidelines should consider the respective strengths and weaknesses of the various possible indicators. Furthermore, whether the indicator considered is appropriate is determined by considering the nature of the controlled transaction in question, and the availability of reliable information needed; and
- c* it was lawful for the FIRS to have considered the various factors enumerated by the OECD Guidelines in deciding that the GPM was the most appropriate PLI to use in the instant case. Accordingly, the FIRS was correct to have limited its benchmarking analysis to direct sales revenue and direct cost items produced by PPNL in order to avoid distorting the comparability analysis.

## VIII SECONDARY ADJUSTMENT AND PENALTIES

### i Secondary adjustments

The 2018 Regulations do not include any provisions on secondary adjustments.

### ii Penalties

The FIRS is empowered under the 2018 Regulations to impose administrative penalties on defaulting taxpayers for the contravention of filing requirements as discussed previously. There are no penalties imposed in relation to secondary transfer pricing adjustments.

## IX BROADER TAXATION ISSUES

### i Diverted profits tax and other supplementary measures

No additional measures have been adopted or introduced to supplement the 2018 Regulations. Consequently, there is no diverted profits tax or global intangible-low-income regime in Nigeria. However, where a transaction between related parties results in the reduction of tax liability that may have occurred from a diversion of profits, the transaction may be deemed artificial or fictitious and the FIRS may make adjustments as it considers appropriate.

### ii Double taxation

Nigeria has, as at the date of this review, negotiated over 20 double-tax agreements (Nigerian DTAs) with other countries, 13 of which have been ratified and are currently in force.<sup>29</sup> The Nigerian DTAs are a modified version of the OECD Model Tax Convention (OECD MC) and the UN Model Double Taxation Convention (UNMC). The 2018 Regulations are applied in a manner consistent with the arm's-length principle in Articles 9 of the OECD MC and of the UNMC in force at the given time. Thus, the adjustments made under the 2018 Regulations are similar to what is provided in Article 9(2) of the OECD MC.

The interpretation of a connected person under the 2018 Regulations is based on the provisions of Articles 9 of the OECD MC and of the UNMC. The 2018 Regulations

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<sup>29</sup> Nigeria currently has effective DTAs with the United Kingdom, Belgium, Canada, China, the Czech Republic, France, the Netherlands, Pakistan, the Philippines, Romania, Spain, Slovakia and South Africa.

empower the FIRS, upon request by a connected person, to make corresponding adjustments to the amount of tax charged in Nigeria in respect of income earned in a contracting state by a connected person resident in Nigeria. This will apply where an adjustment is made to the taxation of the transactions of a connected person resident in Nigeria by a competent authority in a treaty country that results in taxation in the other country of income and profits that are also taxable in Nigeria.

The Nigerian DTAs provide for the application of a mutual agreement procedure (MAP), which gives a taxpayer the right to present its case to the competent authority of the state of which it is a resident where the taxpayer considers that the action of one or both of the contracting states has resulted or will result in taxation that is not in accordance with the provisions of the DTA.

The Nigerian DTAs contain variations<sup>30</sup> of the MAP provision stated in Article 25 of the OECD MC. Some of the provisions give a taxpayer the right to present its case to the competent authority of the contracting state of which it is a national where the procedure for the application of Paragraph 1 of Article 24 (Non-Discrimination) had previously been set in motion by the taxpayer. The time limit set for presenting an objection to the relevant competent authority also varies from two to five years and, in some cases, no limit is set. Nigeria has indicated its intention to amend its MAP provisions in all its treaties to conform with the wording prescribed in Article 16 of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI). This would eliminate the non-discrimination exception and establish a three-year time limit for filing an objection. Although Nigeria has submitted its MLI position to the OECD, as at the date of this review Nigeria and some of its treaty partners have yet to ratify the MLI.

A MAP can be invoked where a transfer pricing adjustment or corresponding adjustment results in double taxation. Other circumstances that may be resolved by a MAP include an incidence of double taxation due to dual residence status or characterisation or classification of income. In the latter case, a MAP may be invoked to seek clarification from the competent authorities. Other instances for a MAP are where a withholding tax is levied beyond what is allowed within an applicable tax treaty, or where a Nigerian resident taxpayer that is subject to tax in Nigeria on income is taxed by the tax authority of the treaty partner on the business income earned in that country, despite not having a permanent establishment in that country under the tax treaty.

A taxpayer that has invoked a MAP process still has a right of appeal under domestic law and is entitled to the legal remedies available. Nevertheless, where the taxpayer's MAP request has been accepted, the taxpayer is required to suspend all the legal remedies available to it. Upon the conclusion of a MAP, if the taxpayer is not satisfied with the ruling of the FIRS, it can approach the TAT and courts for legal redress and the available remedies will apply. Where a court has determined a tax matter, it becomes final and binding, and the taxpayer can no longer invoke a MAP. Nigerian law does not allow arbitration of tax disputes.<sup>31</sup>

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30 The DTAs between Nigeria and the United Kingdom and Canada respectively do not contain the non-discrimination exemption.

31 *FIRS v. NNPC & Ors.* (2012) 6TLRN1.

**iii Consequential impact for other taxes**

Although the scope of taxes covered by the 2018 Regulations includes CGT and VAT, the Regulations make no explicit provisions on how they will apply to these taxes. However, depending on the nature of the transaction, where a transaction is considered not to have been at arm's length and adjustments are made to arrive at the income tax due, corresponding adjustments will also be made in respect of the aspect of the transaction that is liable to VAT. The same process will also apply in relation to a disposal of capital assets on terms not otherwise at arm's length. In that case, adjustments will be made to the value of the transaction to determine the gains realised from the disposal and the applicable CGT.

**X OUTLOOK AND CONCLUSIONS**

A recent development is the adoption of the OECD Transfer Pricing Guidance on Financial Transactions (the FT Guidance) into Nigeria's transfer pricing regime. The FT Guidance seeks to clarify the application of the principles of the OECD TP Guidelines, particularly on the accurate delineation analysis of financial transactions, with particular focus on the role and remit of treasury functions, intra-group loans, cash pooling, hedging, financial guarantees and captive insurance.

Transfer Pricing in Nigeria is still evolving. Limited availability of comparable data for benchmarking analysis, capacity constraints that make it difficult to price complex controlled transactions, and information asymmetries between multinational taxpayers and the tax administrators all remain a challenge.

The criteria for the application of the safe-harbour rule remain uncertain. Another challenge is that although the 2018 Regulations provide that the FIRS can enter into APAs, in reality the FIRS has been reluctant to enter into APAs even when approached by eligible taxpayers with credible reasons for an APA.

Collaborative efforts of African tax administrators through ATAF has continued and the significance of their influence and the BEPS initiative on the Nigerian transfer pricing regime should not be ignored by taxpayers and their advisors.

Regarding the OECD's Inclusive Framework Pillar One, the ATAF has stated that it is in support of the unified approach objective of revising the allocation of taxing rights between residence and source jurisdictions by allocating more of MNE's taxable profits to the market jurisdictions.<sup>32</sup> The ATAF's position on the 'Nexus Rule' is that it is only appropriate that countries have the right to tax the profits that a foreign entity generates from business activities within a country irrespective of whether it has a physical presence in that country.<sup>33</sup> The ATAF also broadly supports the 'New Profit Allocation Rules' under the unified approach given that the rules are based on the principle of allocating greater taxing rights to market jurisdictions as well as the use of simplified conventions.<sup>34</sup>

In relation to the OECD's Inclusive Framework on Pillar Two – Global Anti-Base Erosion rule, the ATAF recommends that a key focus of the pillar should be on developing

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32 'ATAF's opinion on the Inclusive Framework Pillar One (including the Unified Approach) and Pillar Two proposals to address the tax challenges arising from the digitalisation of the economy'.

33 *ibid.*

34 *ibid.*

rules that address base eroding payments such as excessive interest payments, management fees, royalties and service fees paid by African taxpayers to related entities located in no- or low-tax jurisdictions as these payments reduce the tax base of many African countries.<sup>35</sup>

Nigeria has, however, taken specific steps in addressing the issues of taxation of the digital economy. The Minister of Finance, Budget and National Planning recently issued the Companies Income Tax (Significant Economic Presence) Order 2020, which prescribes the conditions under which a non-resident company that is involved in (1) digital transactions, or (2) the provision of technical, professional, management or consultancy services, offshore to its customers in Nigeria, will be deemed to have a taxable nexus in Nigeria and therefore subject to income tax. Such companies will be subject to tax in Nigeria whether or not they have a physical presence in Nigeria.

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35 *ibid.*



# POLAND

*Sławomir Łuczak, Magdalena Polak and Wojciech Węgrzyn*<sup>1</sup>

## I OVERVIEW

Polish transfer pricing regulations refer to and link directly to the Organisation for Economic Co-operation and Development (OECD) principles. Moreover, they are changing to be in line with current OECD standards: Poland has already incorporated rules on country-by-country reports (CbCRs); a three-step approach to transfer pricing documentation (a master file, a local file and a CbCR); and guidelines on low value-adding services. Despite this, OECD standards are not formally implemented as a part of Polish domestic law. However, they are a source of interpretation in practice, not only for taxpayers or tax authorities, but also for administrative courts. Usually the most recent version of the OECD Transfer Pricing Guidelines is applied, also with respect to transactions predating those Guidelines.

Polish transfer pricing regulations apply to income taxes, both corporate income tax (CIT) and personal income tax (PIT), covering corporations (legal persons or units without legal personality) and individuals. As Polish law does not recognise trusts, there are no specifics applying to them. Further, there are also transfer pricing regulations implemented on the grounds of value added tax (VAT), applicable in specific circumstances.

### i CIT/PIT

Polish transfer pricing regulations provided for in the CIT<sup>2</sup> and PIT<sup>3</sup> Acts cover a wide definition of related parties. Accordingly, a relationship between parties occurs when:

- a* an entity exercises a significant influence on the other entity;
- b* significant influence on both entities is exercised by the same other entity or the spouse or a relative by consanguinity or affinity up to the second degree of a natural person exercising a significant influence on at least one entity;
- c* a partnership without legal personality is established; or
- d* a permanent establishment is created.

The exercise of a significant influence is understood as:

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2 Act dated 15 February 1992.  
3 Act dated 26 July 1991.

- a* holding directly or indirectly at least 25 per cent of shares in the capital or voting rights in the supervisory, decision-making or managing bodies, or shares in or rights to participate in the profits or the property or their expectative, including participation units and investment certificates;
- b* the actual ability of a natural person to influence key economic decisions taken by a legal person or an organisational unit without legal personality; or
- c* being the spouse or a relative by consanguinity or by affinity up to the second degree.

Since 1 January 2017, Polish legislators have implemented a very wide definition of transfer price. As of that date, 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 a transfer price also covers making payments of receivables – whether directly or indirectly – 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.

The CIT and PIT Acts explicitly provide that associated enterprises are obliged to set transfer prices on terms that would be agreed between unrelated entities. Otherwise, the tax authorities are entitled to reassess the reported income tax to align it with the arm's-length principle. As from 2019, the tax administration has also been specifically endowed with the power not to recognise, or to recharacterise, a transaction that is economically irrational, namely a situation in which unrelated entities, guided by economic rationality, would not conclude a given controlled transaction or would conclude a different transaction, or would take another action.

Since 2018, regulations have been introduced that limit costs deductibility from certain services with related parties. According to those regulations, costs from the following are limited to 5 per cent of tax-EBITDA:<sup>4</sup>

- a* advisory services, market research, advertising, management and control, data processing, insurance, guarantee and surety services, and similar;
- b* all kinds of fees and charges for the use of or the right to use rights or values; and
- c* transfer of the risk of debtor's insolvency in terms of debt receivables due to loans other than loans granted by banks and credit unions, including under derivatives agreements and similar.

Excluded from the above are services covered with advance pricing agreements (APAs), as well as costs of intangible services directly related to production of goods or provision of services. Limitations will apply to services in excess of 3 million zlotys.

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<sup>4</sup> The tax-EBITDA of a company is a measure of its earnings before interest, tax, depreciation and amortisation computed according to corporation tax rules.

**ii VAT**

A slightly different definition of related parties is provided for in the VAT Act.<sup>5</sup> The qualified relationship exists when, among contracting parties, there are the links mentioned above or links based on adoption or employment.

The tax authorities are entitled to reassess remuneration for the supply of goods or services established between associated enterprises if it does not satisfy the arm’s-length principle, but only in specific conditions (see Section VIII). Excluded from the above are supplies covered in advance pricing agreements (APAs).

**II FILING REQUIREMENTS**

Since 2017, a tripartite approach to transfer pricing documentation has been introduced in Poland. This means that, depending on a taxpayer’s situation, a taxpayer may be obliged to prepare transfer pricing documentation that meets the requirements of a local file, a master file or a CbCR. As well as documentation requirements, there are other tax obligations.

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

Threshold	Transfer pricing documentation	Other obligations
10 million zlotys (commodity or financial transactions); 2 million zlotys (other transactions)	The taxpayer is obliged to prepare a local file, which should include: <ul style="list-style-type: none"> <li>• a description of the taxpayer;</li> <li>• a description of the transaction, including a functional analysis covering any functions, risks, and assets involved;</li> <li>• an analysis of the transfer prices, including: a benchmarking study or – if preparation of a benchmarking study is not appropriate in the light of a given transfer pricing method or where it is not possible – an analysis demonstrating the conformity of the terms on which the controlled transaction is concluded with the terms that would be agreed between unrelated entities; and</li> <li>• financial information.</li> </ul>	The taxpayer is obliged to prepare a local file no later than the end of the ninth month following the end of a tax year. Within the same term, the taxpayer is obliged to: <ul style="list-style-type: none"> <li>• inform the pertinent tax office, subject to penal fiscal liability, that the local file has been prepared and the prices conform to the arm’s-length principle; and</li> <li>• submit a simplified report on the transactions or other events with related parties.</li> </ul> On the request of the tax authority, the taxpayer is obliged to prepare and present a local file covering a transaction or other event below the threshold. This obligation should be fulfilled within 30 days of the delivery of the request.
200 million zlotys of consolidated revenues	The taxpayer is obliged to prepare a master file, which should include: <ul style="list-style-type: none"> <li>• a description of the capital group;</li> <li>• a description of the important intangible assets of the group;</li> <li>• a description of the major financial transactions of the group; and</li> <li>• financial and tax information of the group.</li> </ul>	The taxpayer is obliged to prepare a master file no later than the end of 12th month following the end of a tax year.
750 million euros (in case consolidated revenues are reported in zlotys: 3,250 million zlotys of consolidated revenues)	The 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 its activities; and the location of the activities of its subsidiaries and foreign establishments that form part of the capital group during a given fiscal year.	The taxpayer is obliged to file the CbCR with the tax office within 12 months of the end of the taxpayer’s fiscal year.

The transfer pricing documentation pertaining to transactions or other events carried over into the next fiscal year has to be periodically reviewed and updated at least once in every fiscal year, before the end of the period for the submission of the annual tax return. Further,

5 Act dated 11 March 2004.

taxpayers are obliged to provide benchmarking studies of transactions or other events, and should also update these studies at least once every three years, unless there is a change of economic conditions that has a significant impact on the analysis of comparative data such that it justifies conducting a review during the year in which the change takes place.

In 2019, Poland introduced a mandatory disclosure regime. In certain cases, transfer pricing settlements may create a reportable tax scheme under these regulations. Specifically, the obligation should arise if hard-to-value intangibles are transferred between the associated enterprises or they carry out restructurings that may significantly impact the future earnings before interest and tax of any of the participating entities. The reporting obligation generally arises within 30 days of (1) the scheme being made available, (2) the scheme being prepared for implementation, or (3) the first step related to the implementation of the scheme being performed – depending which of these events took place earlier.

### III PRESENTING THE CASE

#### i Pricing methods

The conditions under which transactions or other events are performed between related parties should comply with the conditions agreed upon between independent entities, or conditions established by the party with an independent entity in comparable circumstances. Therefore, transfer pricing regulations<sup>6</sup> 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.

The analysis should take into account:

- a* the characteristics of goods, services or other benefits;
- b* the course of the transaction (parties' functions, engaged assets, human capital and incurred risks);
- c* the terms of the transaction;
- d* the economic conditions present at the time and place the transaction is executed; and
- e* an economic strategy – taking all the features of the analysis into consideration, its aim is to identify not only the conditions of the transaction that would be set by independent entities, but also the most appropriate pricing method.

Regarding pricing methods, to verify whether the conditions of transactions between related parties are consistent with market conditions, transfer pricing regulations define five pricing methods that may be used by tax authorities, 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);<sup>7</sup>

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6 The comparability analysis requirements are regulated in the Regulation of the Minister of Finance of 21 December 2018 on transfer prices in corporate income tax and in the Regulation of the Minister of Finance of 21 December 2018 on transfer prices in personal income tax.

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

- b* the resale price method – most often used in the case of distributors, who are inclined to further market goods without improvements;<sup>8</sup>
- c* the cost-plus method – most often used in the case of manufacturers or service providers selling goods or services in a standardised and routine manner;<sup>9</sup>
- d* the transactional net-margin method – most often used in the case of distribution business transactions;<sup>10</sup> or
- e* the profit split method.

Transfer prices should be verified using the method that is most appropriate under given circumstances. Where it is impossible to use the methods referred to above, another method that is most appropriate under given circumstances, including valuation techniques, may be used. In determining the most appropriate method under given circumstances the availability of information necessary for the correct use of the method, and any specific criteria for the use of the method should be taken into account.

In 2019, Poland introduced safe harbours for loans and certain categories of low value-adding intra-group services. If the criteria for application of the safe harbours are met, the transfer price established by a taxpayer may not be subject to reassessment by the tax authorities.

## **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 CbCRs were also applied from 1 January 2016, imposing a tax obligation to submit information about the group within 12 months of the end of the taxpayer's fiscal year. The requirements of content and structure of the CbCR were introduced in the Regulation of the Minister of Development and Finance,<sup>11</sup> which is consistent with the forms recommended by the OECD in the 2015 Final Report on Action 13 of the OECD Base Erosion and Profit Shifting Action Plan. 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.

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

9 Kosieradzki Tomasz, Piekarczyk 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 See the Regulation of the Minister of Development and Finance on the detailed scope of data transferred information about a group of entities that will be passed in the CbCR dated 13 June 2017, in Polish: 'Rozporządzenie Ministra Rozwoju i Finansów w sprawie szczegółowego zakresu danych przekazywanych w informacji o grupie podmiotów oraz sposobu jej wypełniania'.

## IV INTANGIBLE ASSETS

Polish transfer pricing regulations introduced in 2019 include specific provisions governing comparability analysis of hard-to-value intangibles (HTVIs). When carrying out the comparability analysis of HTVIs, the tax authorities are expected to take into account principles regarding the development, enhancement, maintenance, protection and exploitation (DEMPE) of intangibles, as well as determining whether independent entities in comparable circumstances would have adopted price adjustment clauses or contingent pricing arrangements, and whether the related entities took into account any foreseeable and predictable developments at the time of entering into the transaction.

In practice, the tax authorities had been scrutinising the substance behind transactions involving HTVIs and applying DEMPE principles even before the 2019 amendments to the law; this had been the case ever since the July 2017 update of the OECD Transfer Pricing Guidelines (the OECD Guidelines).

## V SETTLEMENTS

APAs were introduced into the Polish tax system from 1 January 2006. They are issued by the central authority overseeing tax administration – the head of the National Fiscal Administration (NFA).

The procedure to issue an APA decision starts with a domestic entity's request, indicating the proposal of the pricing or cost distribution methodology; the reasoning for this method; and the 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 include transactions completed before the date of the submission of the request or transactions started before that date that are already subject to tax audits before the tax authorities or administrative courts. However, the APA decision may cover the whole tax year in which the request is submitted.

The regulations distinguish three categories of APA decisions: one-sided, bilateral and multilateral. One-sided APA proceedings are carried out by the Polish tax authorities. The bilateral APA decision is in turn concluded between domestic and foreign entities and requires the approval from a tax authority of the given foreign country. If an arrangement concerns entities from more than one foreign country, the approval of each foreign tax authority is necessary to be able to conclude the applicable multilateral APA decision.

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. 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. However, in practice, these terms may be extended.

The APA decision issued may be valid for no longer than five years, and may be renewed for subsequent periods, albeit no longer than five years, upon the request of a domestic entity filed no later than six months after the lapse of the previous period of validity. The renewal, which is also issued in the form of a decision, is possible if the elements of the decision have not changed in any significant manner.

The APA decision may be amended or declared expired before the end of its validity period only in the case of a change of economic relations that results in the agreed terms of

transaction being grossly inadequate. The APA decision may also be declared expired *ex officio* by the NFA when the related parties do not apply the transaction price or the conditions defined in the decision.

APAs were not particularly popular in the past, but this situation changed dramatically with the introduction in 2018 of provisions limiting deductibility of costs of certain categories of intra-group services above 5 per cent of tax-EBITDA (see Section I). This limitation does not apply to transactions covered by an APA, therefore many MNEs incurring substantial costs for such services have submitted applications for APAs.

## VI INVESTIGATIONS

Tax authorities are entitled to investigate taxpayers to assess whether transactions or other events between related parties were performed in accordance with transfer pricing regulations. Therefore, the subject of the transfer pricing investigation usually concerns:

- a* CIT or PIT grounds – whether the related parties have set the transaction's conditions differently than independent entities would agree on; or
- b* VAT grounds – whether the remuneration for goods or services set by related parties (a customer and a person supplying the goods or the supplier itself) was at the market-value level.

The transfer pricing investigation may then state that the pricing of the transaction or other event between related parties was in line with conditions that would be set by independent parties, or it may indicate some irregularities arising from the relationship between the parties. In the second case, the tax authorities have the right to determine the taxpayer's taxable amount and tax due (see Section VIII).

The investigation may be initiated if the taxpayer's tax liability expires. As a rule, the limitation period is five years beginning at the end of the calendar year in which the time limit to pay tax ended. That means that, owing to the effluxion of time, the tax liability expires by law and the tax authority cannot effectively demand payment of the tax due, 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 has been identified for investigation and what kind of tax authority is going to perform the 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 delivery of the notification. In certain circumstances, a tax audit may be conducted without prior notification being given (e.g., a fiscal or commercial offence has been committed).

The tax audit ends with the delivery of the tax authority protocol. The protocol consists of a description of the facts of the case and a legal assessment, but it does not constitute the taxpayer's liability. If the tax audit indicates some irregularities, after the delivery of the protocol, the taxpayer may agree with the tax authority and correct its tax settlements and tax return; or make reservations and clarifications to the protocol within 14 days of its delivery. The tax authority is then obliged to review these within the next 14 days. A tax audit that has ended in a dispute between the tax authority and the taxpayer usually continues in the form of tax proceedings.

## **ii Tax proceedings**

The main aim of a tax proceeding 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.

Tax proceedings should be settled without undue delay. When evidentiary hearings are required, limits are longer and are set at a month or, in particularly complicated cases, two months from the day proceedings begin. In practice, these limits are not adhered to and tax authorities extend them according to the case's complexity.

Tax proceedings are a two-instance procedure. The first ends with a decision that may be subject to appeal by the taxpayer. The taxpayer's appeal must be submitted within 14 days of the date of the delivery of the initial decision. In the event of an appeal, 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 of the submission of the appeal and, in cases where a trial was conducted, at the latest within three months. These time limits are often extended by the tax authorities.

The decision of the upper instance is final and enforceable. However, this decision still may be challenged by lodging a complaint with the voivodeship administrative court (see Section VII).

## **iii Customs and fiscal audit**

The customs and fiscal audit was introduced into the Polish tax system as of 1 March 2017, and it replaced the fiscal audit procedure. The tax authorities that may initiate such an audit 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. As in other investigative procedures, the tax authorities may also extend the length of the investigation in these cases.

The customs and fiscal audit ends with the delivery of the audit's findings. Similarly to the tax audit, the taxpayer has the right to correct its tax settlements and tax returns within 14 days of the audit's delivery. If irregularities were indicated during the audit and the taxpayer did not correct its tax settlements and tax returns, the audit investigation transforms into tax proceedings. The tax proceedings are then continued by customs and fiscal offices in line with the scheme described in Section VI.ii.



## VII LITIGATION

### i Procedure

Transfer pricing cases may be the subject of a dispute before administrative courts only when the taxpayer lodges a complaint against the tax authority's decision. The complaint must fulfil formal requirements (e.g., be submitted within 30 days of the delivery of the decision via the tax authority that issued the decision). When a complaint is lodged, the administrative authority is under an obligation to turn it over to the court with the relevant files and to prepare a response within 30 days of the date the complaint was submitted. It must be emphasised that the complaint process is not particularly formalised since the only requirement is for 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 Act on Proceedings before Administrative Courts<sup>12</sup> allow evidence to be taken from documents, in practice, courts reject parties' applications to submit evidence. This includes expert witness evidence.

The administrative courts may dismiss the complaint or overturn a decision 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 of the date of judgment and the delivery of its justification. The cassation appeal may only be based on strictly defined grounds, namely a violation of substantive law – on account of an erroneous interpretation or incorrect application of law, or the breach of procedural regulations where the breach could have seriously affected the outcome of a particular case. It is also more formalised than a complaint to the administrative court (e.g., the cassation appeal has to be prepared and submitted by professional proxy (advocate, attorney at law or tax adviser)).

As a rule, a case before the administrative court should be completed as soon as possible. However, the reality is slightly different as the waiting time for the first hearing can take up to 18 months.<sup>13</sup> A taxpayer lodging a complaint at the voivodeship administrative court in Warsaw or Krakow will likely wait for approximately one year before the case is considered. A backlog of cases in the Supreme Administrative Court (as it is the only upper administrative court in Poland) causes long delays in obtaining a hearing date, up to 18 months.<sup>14</sup>

### ii Recent cases

As of 1 January 2019, transfer pricing regulations have changed significantly. For this reason, the new regulations have not yet been subject to extensive juridical interpretation. Nevertheless, recent judgments may continue to be relevant.

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12 Act of 30 August 2002.

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

14 *ibid.*

### ***Transfer pricing documentation***

*Judgment of the Voivodeship Administrative Court in Wrocław, Ref No. I SA/Wr 861/19, 9 January 2020*

This case regarded the exemption from local TP documentation applying to transactions between related entities being Polish tax residents, which did not incur tax loss. There are two sources of revenues, and accordingly two sources of potential tax loss (from capital gains and from other sources). The question was whether the exemption may still apply when tax loss is incurred in only one of these sources. According to the judgment, conditions of exemption are met only when there is no tax loss in both sources of revenues.

*Judgment of the Voivodeship Administrative Court in Wrocław, Ref No. I SA/Wr 900/19, 6 February 2020*

New TP regulations introduced in 2019 oblige taxpayers to prepare local TP documentation for controlled transactions of a homogeneous nature, the value of which exceeds set thresholds. Such value, according to the Court, is determined irrespective of the number of accounting documents, made or received payments and affiliated entities with which the controlled transaction is concluded. In the case a credit or a loan is a controlled transaction, the value corresponds to the capital amount and not the interest amount.

*Judgment of the Voivodeship Administrative Court in Szczecin, Ref No. I SA/Sz 904/17, 15 December 2017*

This case concerned a question of how a controlled transaction of a homogeneous nature should be understood, especially how to treat two separate lease agreements concerning two distinct production halls. The Court accepted the view of the tax authority that such agreements constitute one transaction of a homogenous nature. In fact, the value of those agreements should be calculated together to determine whether they exceed TP documentation thresholds.

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

This case regarded the obligation to prepare transfer pricing documentation for transactions between related treasury companies. The transactions concerned shares and stock contributions to the related company. The Supreme Administrative Court stated that the transfer pricing regulations and resulting taxpayer's obligations also apply to transactions involving the transfer of goods, money and other things of value, regardless of whether an economic operation triggers any income tax to be paid. Therefore, transfer pricing documentation is also required in the case of tax-neutral transactions.

### ***Transfer pricing assessment***

*Judgment of the Voivodeship Administrative Court in Warsaw, Ref No. III SA/Wa 2116/18, 5 September 2019*

This case concerns a taxpayer who financed an investment in a shopping centre through a loan granted by a related entity. The interest rate was questioned by the tax authority, taking into account, for example, the average level of bank loan interest granted to an unspecified debtor. The Court ruled that the price established by a taxpayer may be questioned by the tax authorities only if a proper comparability analysis is carried out by the tax authorities. The comparability analysis should take into account all factors resulting from Ministry of Finance

regulation, as well as include successive, logical stages. The Court pointed out that the tax authority had not carried out such an analysis, as it had not taken into account risks incurred in connection with the purchase of a shopping centre, the specifics of a given property and its nature and economic potential.

*Judgment of the Voivodeship Administrative Court in Warsaw, RefNo. III SA/Wa 504/18, 13 February 2019*

This case concerned a taxpayer that received a true-up adjustment of the expenses related to intra-group services (increasing the incurred expenses). The Court accepted the view of the tax authorities that such a true-up adjustment is not a tax deductible cost, regardless of the circumstances. The practical consequence is that whatever transfer pricing method is used by a taxpayer, it may not be based on year-end adjustments.

*Judgment of the Supreme Administrative Court, RefNo. II FSK 1665/16, 20 June 2018*

In this case the Supreme Administrative Court confirmed that the comparability analysis carried out by the tax office may not be based on information that is not publicly available. In the past, the tax authorities often used confidential information obtained in tax proceedings as evidence against the transfer pricing method applied by another taxpayer.

*Judgment of the Voivodeship Administrative Court in Białystok, RefNo. I SA/Bk 978/16, 1 February 2017*

The Voivodeship Administrative Court agreed with the tax authority on the correct application of the income assessment procedure because of the non-arm's-length pricing of the transaction. The following facts weighed against the taxpayer's pricing: sales of finished products concluded below the costs of their production (as a result of the increase in raw material prices); uneven distribution of risks between the parties; and payments made over an extended payment period.

## **VIII SECONDARY ADJUSTMENT AND PENALTIES**

### **Tax penalties**

#### ***Income corrections***

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.

#### ***Additional sanctions***

If income tax is reassessed, the tax authorities apply an additional sanction in a range of between 10 per cent and 30 per cent of the reassessed income or loss.

#### ***VAT obligations correction***

The tax authorities have the right to determine the VAT taxable amount and VAT due if the remuneration established between associated enterprises does not satisfy the arm's-length principle, but only in the following cases:

- a where the remuneration is lower than the market value and the customer of the goods or services does not enjoy a full right to reduce the input VAT;
- b where remuneration is lower than the market value and a person supplying goods or services does not enjoy a full right to reduce the input tax amount, and a supply of goods or services is exempt from VAT; or
- c where remuneration is higher than the market value and a person supplying goods or services does not enjoy a full right to reduce input VAT.

### ***Interest on tax arrears***

The taxpayer also has to pay penalty interest on tax arrears. As from 1 January 2017, the interest rate for tax arrears incurred is 8 per cent. It must also be underlined that the interest rate may be applied at a higher 12 per cent rate when VAT arrears have their source via understating a tax liability, or overstating a tax overpayment or a refund amount that was subsequently discovered by the tax authority during a tax investigation.

### ***Fiscal penal liability***

If a taxpayer fails to comply with tax obligations, it may result in fiscal penal liability. According to the Fiscal Penal Code,<sup>15</sup> only individuals may bear fiscal penal liability even if a tax obligation is imposed on a legal entity. Therefore, the liability for fiscal offences rests with an individual who, under the provisions of law, a decision of the relevant authority, an agreement or actual execution, conducts the economic and, in particular, financial affairs of the legal person. Furthermore, a fiscal offence is committed only by an individual to whom guilt may be attributed in the course of an act; however, this does include the awareness of the misconduct along with acceptance thereof. From this perspective, the risk of fiscal penal liability rests in particular with the management board's members and finance or tax director. Non-compliance with transfer pricing regulations may cover several criminal acts, for example, failure to disclose the object of taxation or tax base, tax fraud, obstruction of a tax audit or a customs and fiscal audit, and accounting procedure infringements.

Committing a fiscal criminal act may result in the imposition of a pecuniary fine or even imprisonment. In practice, imprisonment is a theoretical possibility rather than a likely prospect, except in cases of very serious economic crime; however, criminal courts very often hand out pecuniary fines, which may be of an amount up to the equivalent of 720 daily wage rates. In 2020, one daily wage rate may vary from approximately 87 zlotys to 35,000 zlotys. Therefore, the potential maximum fine may be approximately 25 million zlotys (again, in practice, the criminal courts impose much lower fines).

## **IX BROADER TAXATION ISSUES**

### **i Double taxation**

All double taxation treaties (DTTs) concluded by Poland provide the possibility to evoke the mutual agreements procedure (MAP). The MAP was implemented into Polish domestic law in the Minister of Finance's Regulations.<sup>16</sup>

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15 Act dated 10 September 1999.

16 *ibid.*, 5.

According to those rules, a person may present its case to the Minister of Finance to start the MAP under the Convention of 23 July 1990 on the elimination of double taxation in connection with the adjustment of profits of associated enterprises or on the basis of a DTT with Poland. The MAP procedure may be used when formal requirements are met and within the limit of a three-year term. This term is counted from the date of the delivery to the taxpayer or its related party of the tax audit protocol or tax decision that leads or may lead to double taxation. Polish regulations provide that the MAP is required to be finalised within two years. Moreover, there is also the possibility of a trilateral MAP. The MAP cannot be used as a premise to suspend an ongoing tax proceeding. However, when the MAP has been successfully finalised, it may constitute a premise to revision.

## **ii Consequential impact for other taxes**

### ***VAT***

See Sections I.ii and VIII.i, ‘VAT obligations correction’.

### ***Import and customs duties***

The customs aspect of transfer pricing remains unnoticed – at least in Poland – both by doctrine and the customs and tax authorities. However, there are binding customs system regulations covering transfer pricing (e.g., the Union Customs Code, which defines the obligations and duties in this matter).

## **X OUTLOOK AND CONCLUSIONS**

Since 2015, the main policy aim of the Minister of Finance has been to ‘seal the tax system’. New tools and tax obligations have been introduced to fulfil this goal. One such tool is the extension of transfer pricing obligations and their effective enforcement by tax authorities. The number of tax investigations focusing on these matters has increased in recent years.<sup>17</sup> These investigations are not only being performed more often, but are also more likely to result in the imposition of tax liabilities. We believe this trend will continue over the coming years, until the frequency of investigations reaches the levels seen internationally. The newly introduced MDR regime should also help the tax authorities to better identify problem areas and make the inspections more effective.

On the other hand, the Minister of Finance is also seeking to help taxpayers deal with their compliance obligations. The Minister regularly organises public consultations and TP forums during which both current regulations and future legislation are thoroughly discussed with taxpayers. Recently, as a result of such discussions, official guidelines concerning benchmarking analyses have been published, giving considerable support for taxpayers. As regards the most recent international developments (Inclusive Framework Pillar One and Two), the approach of the Minister of Finance is rather reserved. The tax authorities await the final conclusions reached by the OECD forum.

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17 [www.podatkiwbiznesie.pl/tp-kontrola-us-cen-transferowych-w-2016-r](http://www.podatkiwbiznesie.pl/tp-kontrola-us-cen-transferowych-w-2016-r).

# PORTUGAL

*Susana Estêvão Gonçalves*<sup>1</sup>

## I OVERVIEW

The Portuguese transfer pricing regime is currently laid down in Article 63<sup>2</sup> of the Corporate Income Tax (CIT) Code and regulated by Ministerial Order No. 1446-C/2001, 21 December 2001 (Order 1446-C/2001),<sup>3</sup> without prejudice to other legal provisions regulating specific matters.

This regime is based on the Organisation for Economic Co-operation and Development Transfer Pricing Guidelines (the OECD Guidelines), reflecting the arm's-length principle. In addition, the preamble of Order 1446-C/2001 also mentions that the OECD Guidelines should be followed in cases of greater technical complexity or in the absence of internal rules. Thus, OECD Guidelines (as updated from time to time) should be used as an interpretative tool and a source of guidance by taxpayers, tax authorities and courts.

The CIT Code establishes that all transactions between a taxpayer and another entity with which it has special relations (i.e., controlled transactions), must be carried out as if both were independent entities conducting comparable transactions.

The CIT Code defines transactions for the purposes of application of the transfer pricing rules as:

- a* any commercial transactions, including transactions or series of transactions related to tangible or intangible assets, rights or services, even where concluded under an agreement, namely a cost-sharing arrangement or an intra-group services agreement;
- b* financial transactions; and
- c* restructuring and reorganisation transactions involving changing the current business, ending or renegotiating the existing contracts, particularly when involving the transfer of tangible and intangible assets, of rights over intangibles, or compensation for damages or loss of earnings.

Under the CIT Code, two entities are deemed related for transfer pricing purposes if one entity has, directly or indirectly, a significant influence over the management of the other entity; such a significant influence is deemed to exist in the following cases:

- a* where the entities concerned are a shareholder holding, directly or indirectly, at least 20 per cent of the share capital or voting rights of an entity (or their respective spouses, ascendants or descendants) and that entity;

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2 As recently amended by Law No. 119/2019, 18 September 2019.

3 It is expected that Order 1446-C/2001 will be amended soon, in order to reflect the amendments recently introduced in Article 63 of the CIT Code by Law No. 119/2019, 18 September 2019.

- b* where the same shareholders, their spouses, ascendants or descendants hold, directly or indirectly, at least 20 per cent of the share capital or voting rights of the two entities concerned;
- c* where the entities concerned are the members of the corporate bodies (or the management, governing or supervisory bodies) of an entity and that entity;
- d* where the majority of the corporate bodies or the management, governing or supervisory bodies of the entities concerned are the same or are their spouses, ascendants or descendants;
- e* where the entities concerned are linked by a subordination agreement, joint group agreement or other agreement of equivalent effect;
- f* where the entities concerned are in a control relationship as defined in the Commercial Companies Code; and
- g* where the entities concerned are a Portuguese resident entity or a Portuguese permanent establishment (PE) of a non-resident entity and an entity resident in a country, territory or region listed as a tax haven on the Portuguese Ministry of Finance blacklist.<sup>4</sup>

If a taxpayer fails to comply with the transfer pricing rules, the Portuguese tax authorities may make positive adjustments to the taxpayer's taxable profit (primary adjustment) and consequently issue additional assessments, plus interest and penalties.

The transfer pricing legislation applies not only to transactions between Portuguese taxpayers, but also to transactions between Portuguese companies and related non-resident entities, including transactions between PEs and their head offices or between PEs of the same head office, provided that one of them is resident or established in Portugal.

In the case of controlled transactions carried out with non-resident entities not compliant with the arm's-length principle, the Portuguese taxpayer should indicate in its tax return the positive adjustment corresponding to the tax effects resulting from this deviation. If the positive adjustment is not made voluntarily by the taxpayer or is deemed insufficient, the Portuguese tax authorities may also proceed with a primary adjustment to the taxable profit of the resident entity, and consequently issue additional assessments, plus interest and penalties.

An adjustment made to the taxable profit of a taxpayer in a controlled transaction should, in principle, be reflected by an offsetting adjustment to the taxable profit for CIT purposes or the taxable income for personal income tax (PIT) purposes of the related entity (correlative adjustment). Where a primary adjustment is made to the taxable profit of a foreign related entity, the Portuguese tax authorities may make a correlative adjustment to the taxable profit of the resident entity in the terms allowed by applicable international instruments, if any (see Section IX.ii).

The Portuguese transfer pricing rules are mainly addressed to corporate entities (i.e., CIT taxpayers, without prejudice to correlative adjustments to other individuals or entities with which the taxpayers have entered into transactions).

Although the CIT Code mentions adjustments to taxable income for PIT purposes and Order 1446-C/2001 (implementing Article 63 of the CIT Code) states that transfer pricing rules should apply to any transactions involving taxpayers of CIT or PIT and any other entities, as the PIT Code does not have any rules on transfer pricing, it may be considered that transfer pricing rules should not apply to PIT taxpayers directly (i.e., by means of primary adjustments).

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<sup>4</sup> Ministerial Order No. 150/2004, 15 February 2004.

This notwithstanding, when it comes to PIT taxpayers who obtain a business or professional income (Category B) and are subject to taxation on their profits (i.e. outside a simplified regime based on coefficients), as there is a generic reference to CIT rules for determining their taxable income, it may be argued that transfer pricing rules, including primary adjustments (as established in the CIT Code), should apply.

Further to the transfer pricing rules, Portuguese law also provides for a general anti-avoidance rule and specific anti-avoidance provisions (such as a controlled foreign companies rule), which may apply in similar contexts but with different approaches.

As a general rule, if a transaction is not compliant with the arm's-length principle, there are no specific corporate law or accounting implications. Transfer pricing adjustments work as deviations from the accounting records (the prices charged and recorded for accounting purposes are replaced by the market value only for tax purposes), having an impact only at the level of the CIT return or CIT assessment, and not in the accounting records.

## II FILING REQUIREMENTS

Under Portuguese law, there are three main filing and documentation obligations related to transfer pricing, as follows.

### i Annual accounting and tax return

Each taxpayer must declare in its annual accounting and tax return (IES) any transactions carried out with related entities during the relevant tax period, including the following information:

- a* identification of the parties involved in the transactions;
- b* identification of the amount and nature of the transactions performed with each related party;
- c* identification of the transfer pricing methods adopted and any changes of methods;
- d* identification of the amount of transfer pricing adjustments made due to lack of compliance with the arm's-length principle; and
- e* a statement confirming that transfer pricing documentation has been prepared on a timely basis and is available.

The IES should be filed by the 15th day of the seventh month following the end of each tax year.

### ii Transfer pricing tax file

In addition, taxpayers with a turnover of €3 million or more in the previous year should maintain in a prepared condition their documentation regarding the transfer pricing policy adopted (i.e., the transfer pricing tax file).

According to the CIT Code, the transfer pricing tax file should include: (1) its instructions or directives; (2) the agreements entered into with related parties and corresponding amendments; (3) information regarding the related parties; (4) information regarding any entities, goods or services used as a comparable; (5) functional and financial analyses; and (6) data and any other information supporting the terms and conditions agreed and the methods adopted.



The list of information required for the transfer pricing tax file is more detailed and is specified in Order 1446-C/2001, with specific information and documentation related to cost-sharing agreements and intra-group service agreements also being required.

With the transfer pricing tax file, the taxpayer should be in a position to prove (1) the market parity of the terms and conditions agreed with related parties, and (2) that the selection and application of the methods was the most appropriate.

As a general rule, the transfer pricing tax file is not required to be automatically transferred to the Portuguese tax authorities; the taxpayer should keep the transfer pricing tax file and be able to provide it to the Portuguese tax authorities (at their request) for a period of 10 years. However, CIT taxpayers deemed to be large taxpayers by Order No. 130/2016 of 10 May 2016<sup>5</sup> and, therefore, included in the Large Taxpayers Unit (LTU), as well as entities subject to taxation under the tax consolidation regime, are required to submit the transfer pricing tax file within the deadline applicable to the annual accounting and tax return (IES) – namely, by the end of the 15th day of the seventh month following the end of each tax year.

Portuguese law has not (yet) introduced the documentation format recommended by Action 13 of the OECD Base Erosion and Profit Shifting (BEPS) Action Plan and, therefore, rules regarding master and local files are not applicable in Portugal. This notwithstanding, the transfer pricing tax file required by Portuguese law addresses the most relevant items of both master and local files and, to the extent of our knowledge, the Portuguese tax authorities have been accepting transfer pricing files prepared in accordance with master and local file formats.

### **iii Country-by-country reporting**

In 2016, Article 121-A was introduced into the CIT Code, establishing country-by-country reporting for multinational groups, as recommended by the OECD in BEPS Action 13.

The Portuguese reporting rules follow the general terms recommended in BEPS Action 13, including on the information to be reported.

According to Article 121-A of the CIT Code, a Portuguese resident entity is required to file a country-by-country report (CbCR) with financial and tax information by country or fiscal jurisdiction, whenever the Portuguese resident entity:

- a* is required to prepare consolidated financial statements;
- b* has consolidated income equal to or higher than €750 million; and
- c* holds or controls one or more entities or PEs in other countries or jurisdictions, and is not held by another entity or entities in a country or jurisdiction where such entities would be similarly obliged to submit a CbCR, which would be exchanged with Portugal (i.e., when the Portuguese resident company is deemed to be a parent company).

A Portuguese resident entity that is not the parent company of the multinational group may also be required to file a CbCR, if one of the following conditions is met:

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<sup>5</sup> The list of large taxpayers includes the following: (1) taxpayers subject to supervision by the Bank of Portugal or the Insurance Authority or collective investment undertakings subject to supervision of the Portuguese Securities Market Commission; (2) taxpayers with a turnover higher than €200 million; (3) taxpayers qualified as holding companies with an income higher than €200 million; (4) taxpayers with a total amount of taxes paid higher than €20 million; (5) taxpayers that are considered significant, even if the above-mentioned criteria are not met (namely, because of their relationships with entities that comply with one of the above-mentioned criteria); and (6) taxpayers included in a tax group, to the extent that one of the group's companies complies with the above-mentioned criteria.

- a* the entity was designated as the reporting company of the group by the parent company;
- b* the entity is held or controlled by non-resident entities not required to submit a CbCR; or
- c* the entity is held or controlled by entities resident in countries or jurisdictions with which Portugal does not have a relevant exchange-of-information agreement in force, or those entities systematically infringe a relevant exchange-of-information agreement such that the Portuguese tax authorities have to notify any of the multinational group's entities.

The CbCR should be electronically filed by the end of the 12th month following the end of each tax year to which the report refers. However, any Portuguese tax resident or Portuguese PE included in a multinational group that qualifies for country-by-country reporting should communicate to the Portuguese tax authorities the identification and jurisdiction of the reporting entity by the end of the fifth month following the end of each tax year to which the report refers.

### III PRESENTING THE CASE

#### **i Pricing methods**

The transfer pricing methods, as well as the comparable factors adopted by the Portuguese legislation are closely based on the OECD Guidelines.

Indeed, according to the CIT Code, the methods to be adopted to decide the terms and conditions that would normally be agreed, accepted and applied between independent entities, should be as follows:

- a* the comparable uncontrolled price method, the resale price method, the cost-plus method, the profit split method or the transactional net margin method; or
- b* other methods, techniques or models of economic assets' evaluation – in the event that the methods referred to at (*a*) above cannot be applied due to the unique characteristics of the relevant transactions or the lack of information or reliable comparable data related to similar transactions between independent parties, especially when the transactions refer to real estate, unlisted shareholdings, credit rights or intangible assets.

Portuguese law has adopted the best-method rule, meaning that the taxpayer should adopt the most adequate method. The most adequate method is defined in Order 1446-C/2001 as the method that is most likely to ensure the highest degree of comparability between a controlled transaction and transactions between independent entities (uncontrolled transactions).

The transfer pricing tax file must include an explanation of the method or methods used to determine an arm's-length price for each transaction and the rationale for the selection.

Order 1446-C/2001 details each method and provides examples of situations where each method may be deemed appropriate.

Where comparable factors are concerned, Order 1446-C/2001 provides some indications regarding the selection of potential comparable uncontrolled transactions.

For instance, and as a general rule, internal comparable transactions (i.e., transactions between a party to the controlled transaction and an independent party) are preferable to external comparable transactions (i.e., transactions between two independent parties).

The transfer pricing tax file must also include information about the comparable data used, including research records, and sensitivity and statistical analyses.

Finally, it should be noted that special rules are provided for cost-sharing agreements and intra-group services agreements, which follow the principles of the OECD Guidelines, as updated by BEPS Actions 8–10.

## **ii Authority scrutiny and evidence gathering**

As a general rule, taxpayers' transfer pricing policy may be analysed and challenged by the Portuguese tax authorities during tax audits (i.e., procedures for the control and investigation of tax matters, verification of taxpayers' fulfilment of their tax obligations and prevention and detection of tax infringements).

During a tax audit, the Portuguese tax authorities are allowed to ask a taxpayer or a third party for any type of information related to the taxpayer's activity. The Portuguese tax authorities may also ask to exchange information with tax authorities of other jurisdictions, using the available international instruments for the exchange of information (e.g., EU instruments, double-tax treaties (DTTs) and exchange-of-information agreements).

Under a general principle of collaboration, during tax audits, taxpayers may offer further information, documentation or even expert analysis to the Portuguese tax authorities.

Any taxpayer may be audited by the tax authorities. However, as a general rule, the chances of a taxpayer being audited vary depending on the type and amount of income obtained, the type of transactions entered into (for transfer pricing purposes, the relevance and nature of controlled transactions) and the type and amount of tax deductions claimed in the taxpayer's tax return.

In this regard, it should be taken into account that the CbCR, in addition to the IES (and the transfer pricing tax file, in particular, in the case of large taxpayers and entities subject to taxation under the tax consolidation regime, which should submit it annually), provides the Portuguese tax authorities with much more information on controlled transactions, allowing them to identify more easily any possible infringements of transfer pricing rules.

In addition, it should be noted that large taxpayers (as defined by Order No. 130/2016 of 10 May 2016) – generally found in multinational groups – are subject to permanent monitoring, auditing and supervision by the Portuguese tax authorities through the LTU. According to the applicable law, one of the statutory duties of the LTU, together with the tax auditors and the large taxpayers, is to promote the due application of the transfer pricing rules.

Transfer pricing matters are increasingly becoming one of the key concerns of the Portuguese tax authorities when looking at taxpayers' tax situation.

## **IV INTANGIBLE ASSETS**

Portuguese transfer pricing legislation does not establish any specific rules for intangible property. However, in accordance with the general reference to the OECD Guidelines established in Portuguese law, the general rules on transfer pricing should be interpreted and complemented by Chapter VI of the OECD Guidelines, as updated by the BEPS Actions 8–10.

Because of the express reference in law to the OECD Guidelines, substance principles (mostly regarding the ownership of intangible assets in relation to their development, enhancement, maintenance, protection and exploitation (DEMPE)) should be deemed to have been assimilated by the Portuguese framework on the transfer pricing of intangibles.

Indeed, in this regard, the OECD recommends the application of a substance principle to the creation of intangible value (value creation), to ensure that income or losses from intangibles are attributed to the entities that carry out or control the DEMPE functions, irrespective of the legal owner of the intangible asset.

Based on the DEMPE principles, the intangible outcomes should be aligned with the value creation of intangible assets (the functions performed, the assets used and the risks assumed), avoiding profit shifting achieved through artificial structures.

Note that substance principles regarding intangible property had previously been introduced into Portuguese law but this was done through an amendment to the Portuguese patent box regime. The amendment was made in line with the modified nexus approach developed as part of the BEPS Action 5, which requires that the benefits received be aligned with the actual activities performed by the taxpayer claiming the benefits.

Based on the above, it is expected that the Portuguese tax authorities will increase their scrutiny for substance under transfer pricing analyses related to intangible property.

However, it is not yet clear how, in practice, the application of these principles will materialise in transfer pricing adjustments in Portugal. In this regard, it should be noted that, although Portuguese tax authorities have already tried to apply substance principles and requalify transactions under the transfer pricing rules, it has been argued by taxpayers that the requalification of transactions can only be made under the general anti-avoidance rule and only where the conditions of the anti-avoidance rule apply.

## V SETTLEMENTS

Portuguese legislation, in Article 138 of the CIT Code and Ministerial Order 620-A/2008 of 16 July 2008, provides for a system of advance pricing agreements (APAs), in line with the OECD Guidelines.

APAs are intended to provide legal certainty to taxpayers through prior consensus with the tax authorities regarding the transfer pricing methods used to determine arm's-length conditions of controlled transactions covered by the APA (as the tax authorities agree not to seek transfer pricing adjustments for such transactions while the APA is in force).

An APA may be classified as (1) unilateral, if entered into by the Portuguese tax authorities and Portuguese taxpayers; or (2) bilateral or multilateral, if entered into by taxpayers, the Portuguese tax authorities and one or more foreign tax authorities.

Bilateral and multilateral APAs can only be entered into with states with which Portugal has entered into a DTT, as the corresponding procedure comprises a phase of consultations between the tax authorities of the jurisdictions involved, in accordance with the mutual agreement procedure (MAP) established in the applicable DTT (based on Article 25, No. 3 of the OECD Model Convention).

The procedure should be initiated by the taxpayer and involves:

- a* a preliminary phase, for an initial evaluation of the terms and conditions of the agreement and its effects, which should be concluded within 60 days; and
- b* a submission phase, for the analysis and negotiation of the APA proposal, which should take no longer than 180 days in the case of unilateral agreements, and 360 days in the case of bilateral and multilateral agreements.

During the procedure, taxpayers should provide the tax authorities with detailed information or documentation regarding their transfer pricing policy, and they cannot refuse to share any information or documentation required by law or requested by the Portuguese tax authorities.

APAs should be settled for a period no longer than four taxable years, but they can be renewed at a taxpayer's request, if the legal conditions are met.

## VI INVESTIGATIONS

As previously mentioned, taxpayers' transfer pricing policies may be investigated and challenged by the Portuguese tax authorities during tax audits.

Tax audits are classified as (1) internal, if they are conducted in the Portuguese tax authorities' facilities and based on documentation held or obtained by them, or (2) external, if they are conducted at the facilities of the taxpayer or relevant third parties or any other place to which the Portuguese tax authorities do not have access.

Depending on its classification, the tax audit may follow a specific procedure; however, in both cases:

- a* it should be initiated prior to the end of the statute of limitations period for tax assessment, which, as a general rule, is four years;
- b* it should be based on a general principle of collaboration (both ways);
- c* after the end of the acts of inspection, a preliminary report should be notified to the relevant taxpayer, which will have the right to a prior hearing; and
- d* the tax audit should be concluded (with the issuance and notification of a final audit report)<sup>6</sup> within six months, which can be extended for two more three-month periods if certain legal conditions are met.

The statute of limitations period for tax assessment (which, as noted above, is generally four years) is suspended if an external tax audit is initiated; however, this suspension does not apply if the tax audit is not concluded within six months.

As a general rule, the result of a tax audit (i.e., the final audit report) cannot itself be challenged. If, as a result of the tax audit, the Portuguese tax authorities issue an additional assessment, the tax assessment can be challenged by the taxpayer through an administrative claim or, directly, through a judicial claim filed with the judicial court or the arbitration court (see Section VII.i).

If the taxpayer decides to challenge a tax assessment by way of an administrative claim, a petition should be submitted within 120 days of the deadline for payment of the tax assessment.

If the administrative claim is partially or totally overruled, the taxpayer may (1) appeal to the Ministry of Finance, within 30 days of the date of notification of the administrative claim decision, or (2) submit a judicial claim directly with the judicial court or the arbitration court (see Section VII.i).

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<sup>6</sup> As for transfer pricing corrections performed by the Portuguese tax authorities, Article 77 of the Portuguese General Tax Law establishes justification standards higher than the regular ones.

## VII LITIGATION

### i Procedure

Taxpayers may choose to challenge tax assessments before the court (1) directly (i.e., immediately after the issuance of the tax assessment), or (2) after the overruling of an administrative claim or appeal.

In this regard, the following solutions are available:

- a Judicial courts: the claim must be submitted within three months of the deadline for payment of the tax assessment or, if an administrative claim or appeal is rejected, within three months of the date the taxpayer was notified of it.
- b Arbitration courts (operating within the framework of the Centre for Administrative Arbitration): the claim must be submitted within 90 days of the events referred to at (a) above for judicial courts.

In both solutions (judicial and arbitration), taxpayers may provide to the relevant court any kind of evidence by any lawful means (including expert analysis and testimonial evidence, which are quite common in transfer pricing litigation).

The arbitration solution is only available if the value of the dispute is not higher than €10 million. Arbitration courts must rule in accordance with the law and are barred from ruling *ex aequo et bono* (i.e., they cannot decide on the basis of fairness).

Generally, arbitration provides for a fast and high-quality decision-making process. In fact, from the date the arbitration challenge is presented, the arbitration court should not take more than 12 months to issue a decision, while judicial courts may take several years to issue a decision.

However, in the event of a final unfavourable decision from an arbitration court it is rarely possible to appeal (because of the limited legal framework for appeals against the arbitration decisions rendered).

On the other hand, judicial court decisions may be appealed to a higher court – to the second instance (the Central Administrative Court) if there are factual and legal grounds for an appeal, or directly to the third instance (the Administrative Supreme Court) if the appeal is based solely on legal grounds – within 10 days of the date of notification to the taxpayer.

### ii Recent cases

The most recent case law on transfer pricing focuses mainly on financing transactions and intra-group services (cost allocation). There have also been several disputes related to the sale and purchase of goods and shares and IP transactions (payments of royalties).

The main subjects of disagreement on transfer pricing (giving rise to litigation) between the Portuguese tax authorities and taxpayers have been (1) the level of comparability between controlled and uncontrolled transactions, (2) the choice of transfer pricing methods, (3) the verification of the legal conditions for the application of the transfer pricing regime, and (4) the burden of proof.

It is noteworthy that, under transfer pricing disputes, Portuguese (judicial and arbitration) courts have been particularly focused on burden of proof matters, taking into consideration that (1) the burden of proof of lack of compliance with the arm's-length principle lies with the Portuguese tax authorities, and (2) the Portuguese tax authorities are subject to a special obligation of justification (the special duty to state reasons) in case of transfer pricing corrections, as established in Article 77 of the Portuguese General Tax Law.

## VIII SECONDARY ADJUSTMENT AND PENALTIES

### i Secondary adjustments

In Portugal, there are no specific provisions for secondary adjustments and, therefore, in accordance with the principles of legality in tax matters, such adjustments are not allowed.

Furthermore, in practice, taxpayers and the Portuguese tax authorities do not perform these kinds of adjustments.

### ii Penalties

Transfer pricing adjustments made by the Portuguese tax authorities may translate into additional income tax assessments, with corresponding interest and penalties, as follows:

- a compensatory interest at an annual rate of 4 per cent on the additional income tax due; and
- b a general penalty for an incomplete or inaccurate tax return of between €750 and €45,000.

The following penalties may also apply for inaccurate compliance or failure to comply with transfer pricing ancillary obligations:

- a failure to (1) submit the transfer pricing file (when due or requested), (2) identify the reporting entity for CbCR purposes, or (3) submit the CbCR, is punished with a penalty of between €500 and €10,000, plus an additional 5 per cent per day of delay; and
- b an incomplete or inaccurate (1) transfer pricing file, (2) identification of the reporting entity for CbCR purposes, or (3) CbCR, is punished with a penalty of between €750 and €45,000.

Taxpayers are allowed to challenge penalties before the Portuguese tax authorities or the judicial courts.

## IX BROADER TAXATION ISSUES

### i Diverted profits tax and other supplementary measures

In Portugal, there is no diverted profits tax or other tax measures supplementing transfer pricing rules.

### ii Double taxation

Portugal has an extensive network of DTTs, which, as a general rule, follow the OECD Model Convention, allowing for (1) correlative adjustments in the state of residence of a related entity when a primary adjustment is made in the state of residence of the other related entity, to avoid potential double taxation (in line with Article 9 of the OECD Model Convention); and (2) the application of the mutual agreement procedure (MAP) (in line with Article 25 of the OECD Model Convention).

When a DTT provides a MAP clause, one of the related entities may ask the corresponding tax authorities to initiate the corresponding MAP to reach an agreement with the other relevant tax authorities. However, if this fails and no agreement is concluded, the double taxation remains.

Alternatively, when the related entities are both resident in EU Member States, the taxpayers may apply for the procedure provided in the EU Arbitration Convention<sup>7</sup> to settle a situation of double taxation arising from a transfer pricing adjustment. Under this procedure:

- a* the competent tax authorities should first try to reach an agreement on the transfer pricing adjustments; or
- b* if they fail to reach agreement within two years, they must set up an advisory commission that will decide.

Therefore, as the mechanism provided in the EU Arbitration Convention is more effective than a MAP, it is recommended that, when possible, taxpayers apply for the EU Arbitration Convention procedure.

However, it should be noted that Portugal signed, ratified, approved and deposited the multilateral instrument (MLI) introduced by BEPS Action 15 and chose to introduce mandatory binding arbitration (as defined in Part IV of the MLI). Therefore, DTTs entered into with signatory countries of the MLI that have chosen to introduce arbitration provisions will provide that disputes unresolved under a MAP should be submitted to an arbitral panel, whose decision is binding. The MLI will enter into force for Portuguese DTTs covered by the MLI from 1 June 2020, where the other signatory country has already ratified the MLI and it has entered into force for that country.

### **iii Consequential impact for other taxes**

Transfer pricing adjustments are preferably a matter of income tax (CIT or even PIT) and, as a general rule, they do not trigger any impact on other taxes.

This notwithstanding, transfer pricing adjustments may have customs or value added tax (VAT) implications, which should be carefully analysed on a case-by-case basis.

Where customs duties are concerned, it is established in Articles 70 et seq. of the Union Customs Code that, when transactions are carried out between related parties (as defined for customs purposes) and the relationship influences the price, the value of goods for customs purposes should not be based on the transaction price but determined in accordance with certain legal criteria based on transactions with identical or similar goods.

Considering that valuation regimes for customs duties and transfer pricing are different, it is possible for different values to be attributed to the same transaction for customs and transfer pricing purposes. Thus, it may be argued that in the event of a transfer pricing adjustment in the import country (having been considered, for transfer pricing purposes, an amount lower than the customs value), the taxpayer can ask for a refund of the customs duties paid in excess, under Article 116 of the Union Customs Code. The application for the refund should in any case be submitted within three years of the date of notification of the customs debt.

As for VAT, the corresponding correction as a result of transfer pricing adjustments would depend on the issue of a corrective invoice.

However, considering VAT neutrality (because of the right to deduct input VAT), as a general rule, there is no need for price adjustments for VAT purposes as a result of transfer pricing adjustments.

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<sup>7</sup> Convention on the elimination of double taxation in connection with the adjustment of profits of associated enterprises (90/436/EEC Official Journal L 225 of 20 August 1990).



This notwithstanding, the VAT Code provides for a VAT-specific transfer pricing rule<sup>8</sup> applicable when a transaction is carried out between related entities (as defined in the CIT Code, but including relationships between employers and employees, their family or other closely connected people) when one of the entities does not have a full right to a VAT deduction.

The VAT transfer pricing rule applies automatically whenever one of the following situations verifies:

- a* the consideration is lower than the open market value and the recipient of the supply does not have a full right to a VAT deduction;
- b* the consideration is lower than the open market value and the supplier does not have a full right to a VAT deduction and the supply is subject to an internal exemption; or
- c* the consideration is higher than the open market value and the supplier does not have a full right to a VAT deduction.

In these cases, the corresponding taxable amount for VAT purposes should be the open market value (as defined in Article 16, No. 4 of the VAT Code), with the value of the consideration being disregarded.

## X OUTLOOK AND CONCLUSIONS

Portuguese legislation has already implemented some of the recent OECD recommendations, namely, the hierarchy of transfer pricing methods has been removed (OECD Guidelines 2017) and country-by-country reporting has been introduced (BEPS Action 13). However, specific progress concerning BEPS Actions 8–10 and the documentation format (master and local files) recommended by BEPS Action 13 are still expected.

In practical terms, new concepts and principles (such as value creation and substance principles) introduced by the OECD through the BEPS Actions 8, 9, 10 and 13 have been gradually adopted and implemented by Portuguese taxpayers and the Portuguese tax authorities. However, without prejudice to the use of OECD Guidelines (as updated by the BEPS project) as an interpretative instrument, in compliance with the constitutional principle of tax legality and for clarity's sake, those new concepts and principles are expected to be reflected in Portuguese tax legislation in the near future.

Additionally, in the context of the international impetus for taxing the digital economy, structural changes on transfer pricing principles are expected before long. In particular, under the Programme of Work for Addressing the Tax Challenges of the Digitalisation of the Economy, the OECD/G20 Inclusive Framework on BEPS is currently working to reach a consensus on the relevant proposals, grouped into two pillars: (1) the unified approach on new profit allocation and nexus rules (pillar one); and (2) the Global Anti-Base Erosion (GloBE) proposals for the adoption of a minimum corporate income tax for taxing multinationals (pillar two).

Although Portugal has not yet adopted any relevant measures to address the tax challenges of digitalisation, some developments in this regard are also expected, at least when a consensus is reached by the OECD/G20 Inclusive Framework on BEPS.

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<sup>8</sup> See Article 16, Nos. 10 to 12 of the VAT Code, which transposed Council Directive No. 2006/69/EC of 24 July 2006, with effect as of 1 January 2012.

In addition to the expected law changes, the Portuguese tax authorities are particularly focused on transfer pricing issues, and consequently have been increasing the number of tax inspections and becoming more sophisticated in these matters (training tax inspectors on transfer pricing issues and looking to international practices for inspiration).

On the other hand, the covid-19 outbreak will introduce new challenges at the level of transfer pricing policies adopted by taxpayers (in particular by multinational groups), namely, in terms of liquidity, supply chains, control functions and business strategy. As a result of the new economic scenario created by the pandemic, companies may need to review their transfer pricing policies and arrangements and prepare themselves for an expected increase in scrutiny by the tax authorities in the coming years (in particular, through the preparation of detailed and consistent supporting documentation justifying any review of transfer pricing policies).

All this, combined with the strengthening of mechanisms of exchange of information and country-by-country reporting, translates into new challenges for taxpayers entering into transactions with related entities, as well as an increase in the legal and economic complexity of transfer pricing matters.

In summary, we expect to witness an increase in the importance of transfer pricing matters (and even structural changes to the principles underlying transfer pricing) in the coming years, namely, through: (1) issuance of new OECD recommendations, addressing the challenges of digitalisation of the economy, by the OECD/G20 Inclusive Framework on BEPS; (2) internal legislative changes adopting OECD instructions (not only the existing ones but also the expected ones); (3) an increase in tax inspections and litigation; (4) a massive review of transfer pricing policies adopted by taxpayers as a result of the covid-19 outbreak, which may lead to increased scrutiny by the tax authorities; and (5) an increase in the expenditure of time and financial resources by taxpayers to comply with transfer pricing requirements.

# SPAIN

*Raúl Salas Lúcia and Pilar Vacas Barreda<sup>1</sup>*

## I OVERVIEW

On 30 November 2006, Act 36/2006 of 29 November on Tax Fraud Prevention Measures was published in the Spanish Official Gazette, which provided for the obligation to value on an arm's-length basis transactions carried out between related entities or persons.

As is stated in the preamble to the Act, this reform is in line with the recommendations of the EU Joint Transfer Pricing Forum and the principles laid down by the Organisation for Economic Co-operation and Development Transfer Pricing Guidelines (the OECD Guidelines), in light of which this legislation should be interpreted. When this Act was published, the 1995 version of the OECD Guidelines was in force; however, tax authorities and courts can refer to current versions of the OECD Guidelines to help determine whether transactions predating those Guidelines were arm's length.

In addition, on 28 November 2014, Act 27/2014 of 27 November on Corporate Income Tax (the CIT Act) was published in the Spanish Official Gazette, repealing Royal Legislative Decree 4/2004 of 5 March, which enacted the former Corporation Tax Act, as amended.

The transfer pricing rules included in the CIT Act covers both companies and individuals. It must be noted that Spanish legislation does not recognise the existence of trusts in Spain. In this regard, transfer pricing rules apply to CIT, personal income tax and non-resident tax.

Additionally, and in line with Spanish accounting principles, the CIT Act clearly specifies that controlled transactions carried out by related parties must be valued on an arm's-length basis. In this sense, the burden of proof falls upon the taxpayer, which must provide documentary proof to the tax authority showing that the values applied in transactions with related parties meet the principle of valuation at fair market value or on an arm's-length basis.

The CIT Act establishes the obligation to make available to the tax authority the documentation that is determined by law. The documentation requirements are categorised on the basis of the concepts of 'country-by-country information', 'specific group documentation' and 'specific taxpayer documentation' (see Section II).

One significant point on which the Spanish transfer pricing regulations differ from the OECD Guidelines, and which gives them more relevance, is their broader parameters

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for related or associated parties, and which require the preparation of documentation and application of transfer pricing principles to operations that would not be regarded as related operations in other countries.

The CIT Act establishes that ‘associated/related persons or enterprises’ shall mean:

- a* an enterprise and its shareholders or participants;
- b* an enterprise and its directors or administrators (although the remuneration received by directors or administrators solely for the exercise of their functions is excluded from consideration as a related transaction);
- c* an enterprise and the spouses or persons united by kinship relations, in direct or collateral line, by consanguinity or affinity up to the third degree of the shareholders or participants, directors or administrators;
- d* two enterprises that belong to a group;
- e* an enterprise and the directors or administrators of another enterprise, when both enterprises belong to a group;
- f* an enterprise and another enterprise in which the former has an indirect shareholding of at least 25 per cent of the share capital or equity;
- g* two enterprises in which the same shareholders, participants or their spouses, or persons united by kinship relations, in direct or collateral line, by consanguinity or affinity up to the third degree, participate, directly or indirectly, in at least 25 per cent of the share capital or own funds; and
- h* an enterprise resident in Spanish territory and its permanent establishments abroad.

In those cases in which the association is defined on the basis of the relationship between the shareholders or participants and the enterprise, the participation must be equal to or greater than 25 per cent. The reference to administrators will include both *de jure* and *de facto* administrators.

The CIT Act establishes that there is a group when an enterprise holds or can hold control of another or others according to the criteria established in Article 42 of the Commercial Code (e.g., 51 per cent of voting rights), regardless of its place of residence and the obligation to file consolidated annual accounts.

However, it must be noted that the CIT Act stipulates certain exceptions from the application of the transfer pricing rules, such as:

- a* the remuneration paid by an entity to its directors in the performance of their functions;
- b* shareholder transactions such as dividends and capital contributions, as the CIT Act stipulates a specific valuation rule for those transactions; and
- c* the following entities, which are excluded from the list of related parties:
  - an entity and the shareholders or participants of another entity when both entities form part of a tax unity or tax group;
  - a non-resident entity and its permanent establishment in Spain (however, the transactions between a permanent establishment and its head office or between permanent establishments are considered related operations under the non-resident income tax regime); and
  - companies taxed under the cooperatives tax regime.

Spanish legislation expressly recognises the application of secondary adjustments and where a transfer pricing adjustment is made to the arm’s-length price, the CIT Act establishes a secondary adjustment regime whereby the difference that arises between a non-arm’s-length

transaction and its market value will receive the tax treatment that corresponds to the true nature of the income disclosed by the existence of the difference (usually either a dividend distribution or equity contribution).

The secondary adjustment will not apply if the related counterparty refunds the relevant amount of the difference between the fair market value and the challenged applied price.

## II FILING REQUIREMENTS

Section 18.3 of the CIT Act establishes the obligation to make available to the tax authority the documentation determined by law.

This documentation is not required for those transactions carried out between entities that are taxed on a consolidated basis for corporation tax or those transactions carried out between the members of economic interest groups or temporary consortiums, as well as those carried out within the context of takeover bids or public offerings.

Moreover, transfer pricing documentation is not required for those transactions carried out with the same associated enterprise if the amount of the consideration for the transactions as a whole does not exceed €250,000 on the basis of the fair market value.

The documentation must be available to the tax authority from the end of the voluntary payment period, generally on 25 July of each year.

The transfer pricing documentation must be prepared in accordance with Spanish legislation, in compliance with the OECD Guidelines in their current wording, and with the recommendations of the EU Joint Transfer Pricing Forum.

The Corporation Tax Regulations, enacted in Royal Decree 634/2015 of 10 July, set out the required content for transfer pricing documentation. As noted above, the documentation is categorised on the basis of the concepts of country-by-country information, specific group documentation, and specific taxpayer documentation, as follows.

### i Country-by-country information

The following documentation (defined as country-by-country information by Section 14 of the Corporation Tax Regulations) is required for entities with a combined net group turnover of at least €750 million in the 12 months preceding the start of the tax period.

#### *Master file (specific group documentation)*

The following documentation is required for the master file (defined as group documentation by Section 15 of the Corporation Tax Regulations):

- a Information relating to the structure and organisation of the group:
  - a general description of the group's organisational, legal and operational structure, as well as any relevant change therein; and
  - identification of the various entities forming the group.
- b Information relating to the group's activities:
  - the main activities of the group, as well as a description of the main geographic markets in which the group operates, main sources of profits and chain of supply of those goods and services that represent at least 10 per cent of the group's net turnover, for the tax period;
  - a description of the functions performed and the risks assumed and main assets used by the various entities of the group, including changes with respect to the previous tax period;

- a description of the group's transfer pricing policy, including the method or methods adopted by the group to establish prices;
  - a list and brief description of the cost-sharing agreements and agreements for relevant services between entities of the group; and
  - a description of the restructuring transactions and transactions for the acquisition or assignment of relevant assets, carried out during the tax period.
- c* Information relating to the group's intangible assets:
- a general description of the group's global strategy in relation to the development, ownership and operation of intangible assets, including the location and the address of the main premises where research and development activities are carried out;
  - a list of the group's relevant intangible assets for the purposes of transfer pricing, indicating the entities owning those assets, as well as a general description of the group's transfer pricing policy in relation to the assets;
  - the amount of the considerations for the group's controlled transactions, arising from the use of the intangible assets, identifying the entities of the group concerned and their territories of tax residency;
  - a list of agreements between entities of the group in relation to intangible assets, including cost-sharing agreements, the main research service agreements and licence agreements; and
  - a general description of any relevant transfer of intangible assets carried out in the tax period, including the entities, countries and amounts.
- d* Information relating to financial activity:
- a general description of the group's means of financing, including the main financing agreements entered into with persons or entities unrelated to the group.
  - identification of the entities of the group that carry out the group's main financing functions, as well as their country of incorporation and the country of their place of effective management; and
  - a general description of the transfer pricing policy in relation to financing agreements between entities of the group.
- e* The group's financial and tax position:
- the group's consolidated annual financial statements, when they are mandatory for the group or are prepared voluntarily; and
  - a list and brief description of the applicable prior valuation agreements and any other agreement with any tax authority that may affect the distribution of the group's profits between countries.

***Local file (specific taxpayer documentation)***

The documentation stipulated in this section will not apply to those groups whose net turnover is less than €45 million. In addition, this documentation must indicate the tax period in which the taxpayer has carried out the transactions with its associated enterprises. When the documentation prepared is applicable in future years, it will not be necessary for it to be prepared again, irrespective of any necessary adaptations.

In the case of entities regarded as small and medium-sized enterprises (those belonging to a group with a turnover below €10 million) these obligations are partially mitigated (except for transactions carried out with entities resident in a tax haven).

The following local documentation is required (defined as taxpayer documentation by Section 16 of the Corporation Tax Regulations):

- a* The taxpayer's information:
- the management structure, structural chart and persons or entities receiving reports on the taxpayer's business activities, indicating the countries or territories in which those persons or entities are tax-resident;
  - a description of the taxpayer's business activities, business strategy and, where applicable, participation in restructuring transactions or transactions for the assignment or transfer of intangible assets in the tax period; and
  - the taxpayer's main competitors.
- b* Information regarding controlled transactions:
- a detailed description of the nature, characteristics and amount of the controlled transactions;
  - the names and surnames or full company name, tax address and tax identification number of the taxpayer and the related persons or entities with whom the transaction is carried out;
  - a detailed comparability analysis,<sup>2</sup> as stipulated in Section 17 of the Corporation Tax Regulations;
  - an explanation of the valuation method chosen, including a description of the reasons that justified choosing the method, as well as the way in which it has been applied, the comparables obtained and the specification of the value or value range arising from the method;
  - where applicable, the basis for cost sharing as services provided jointly to various related persons or entities, as well as the relevant agreements, if any, and the cost-sharing agreements referred to in Section 18 of the Corporation Tax Regulations;
  - a copy of the applicable prior valuation agreements and any other agreements with any tax authority related to the controlled transactions indicated above; and
  - any other relevant information that has been used by the taxpayer to determine the value of the controlled transactions.
- c* The taxpayer's economic and financial information:
- the taxpayer's annual financial statements;
  - the reconciliation between the data used to apply the transfer pricing methods and the annual financial statements, where appropriate and relevant; and
  - the financial data of the comparables used and their source.

### III PRESENTING THE CASE

#### i Pricing methods

The five transfer pricing methods accepted by the OECD have been adopted in Spanish legislation. As of fiscal year 2015, the CIT Act does not state a priority in the application of transfer pricing methods. The selection of a transfer pricing method shall take into account,

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<sup>2</sup> The new Section 17 of the Corporation Tax Regulations includes the circumstances to be taken into consideration to determine whether two or more transactions are comparable for these purposes, such as the characteristics of the goods and services involved, the functions and risks assumed by the parties, the contractual terms agreed, and the economic circumstances or the business strategies.

among other circumstances, the nature of the controlled transaction, the availability of reliable information and the degree of comparability between controlled and uncontrolled transactions. In situations where it is not possible to apply these five methods, any other generally accepted method and valuation techniques that respect the arm's-length principle shall be applicable.

The following are the definitions of the five prescribed methods as listed in Article 18 of the CIT Act.

***Comparable uncontrolled price method***

In this method, the price of the product or service in a transaction between associated persons or enterprises is compared with the price of an identical product or service or one with similar characteristics in a transaction between independent persons or enterprises in comparable circumstances. Where applicable, the necessary adjustments should be made to obtain an equivalent and to take into account the specific nature of the transaction.

***Cost-plus method***

In this method, the mark-up normal in identical or similar transactions with independent persons or enterprises is added to the purchase price or cost of production of the product or service, or, failing this, the mark-up applied by independent persons or enterprises to comparable transactions. Where applicable, the necessary adjustments should be made to obtain an equivalent and to take into account the specific nature of the transaction.

***Resale price method***

In this method, the mark-up applied by the reseller itself in identical or similar transactions with independent persons or enterprises is subtracted from the sale price of a product or service, or, failing this, the mark-up applied by independent persons or enterprises to comparable transactions. Where applicable, the necessary adjustments should be made to obtain an equivalent and to take into account the specific nature of the transaction.

***Profit split method***

In this method, each associated person or enterprise carrying out jointly one or more transactions is allotted part of the common profits resulting from the transaction or transactions, provided that this reflects what independent persons or enterprises would have done in the same circumstances.

***Transactional net margin method***

In this method, the net profits are allotted to the transactions carried out with an associated person or enterprise, calculated based on the most appropriate base (costs, sales or assets) depending on the characteristics of the transactions, which the taxpayer or third parties would have obtained in identical or similar transactions carried out between independent parties. Where applicable, the necessary adjustments should be made to obtain an equivalent and to take into account the specific nature of the transaction.



## **ii Authority scrutiny and evidence gathering**

The State Tax Administration Agency (AEAT, or the Tax Agency) publishes its General Guidelines for the Tax and Customs Control Plan every year. In recent years, the Tax Control Plan has included transfer pricing as one of the essential points for attention in the review of multinational groups, especially operations carried out with high-value intangibles, intra-group services, corporate restructurings and intra-group financing operations.

In Spain, tax authorities usually examine transfer prices during the normal course of CIT tax audits, rather than conducting special transfer pricing audits.

These CIT tax audits are mainly oriented towards understanding the role of the Spanish companies under scrutiny in the group's value chain, to check the consistency of the transfer pricing methods applied and the results of the benchmark analyses. These audits are also oriented to the detection and regularisation of permanent establishments of non-resident entities, which may arise in certain operating structures of multinational groups, such as contracts for the provision of marketing, agencies, commissionaires, and similar services. Therefore, the review of transfer pricing policies not only covers the quantification of operations, but also the structure of the operations, and their different tax effects.

With respect to related transactions between a natural person and a company, the actions of the Spanish tax authorities are currently aimed at avoiding the abusive use of companies to channel income from natural persons in a way that reduces the effective tax rate. In practice, these tax audits result in adjustments to the valuation of the related operations (made or presumed) between the individual and the company.

For confidentiality reasons, audit results are not published in Spain.

## **IV INTANGIBLE ASSETS**

Spain has traditionally been an intangible importer rather than exporter; Spanish taxpayers, therefore, are usually scrutinised about royalties paid and whether the relevant fee matches the benefit obtained from the intellectual property (IP) received.

Spanish legislation has declared directly applicable all OECD criteria regarding transfer pricing, so there is no need for any implementation exercise by the Spanish authorities.

It is worth noting that the Spanish transfer pricing regulations introduced the option for application of the discounted cash flow method when it is considered the method that most correctly applies the arm's-length principle. This option has mainly been used in relation to IP and goodwill.

That said, there are no specific regulations or legislation dealing with the valuation of intangibles.

As mentioned above, the transfer pricing documentation requires an in-depth description of intangibles belonging to multinationals.

## **V SETTLEMENTS**

The only settlements with the tax authorities covered by Spanish legislation are advance pricing agreements (APAs).

These agreements have advantages both for taxpayers (they have the legal certainty that the valuation of their operations will not be subject to modification by the Tax Agency in a subsequent verification of the settlements) and for the Tax Agency itself (avoiding the complexity of verifying the market value of these operations after they have been carried out).

APAs may be unilateral (when there is an agreement between the taxpayer and the Tax Agency) or bilateral (when an agreement is reached with other countries' administrations, linking both related companies resident in different states and their administrations).

To start this procedure, taxpayers who wish to conclude an APA with the Tax Agency should initiate it by a formal proposal, identifying the persons or entities that will carry out the transactions and describing the transactions and the basic elements of the valuation proposal that are the subject of the agreement. The application must be accompanied by the specific documentation for the group to which the taxpayer belongs, as well as the specific taxpayer documentation.

The APA must be set out in a document that includes the place and date of its formalisation, the identification of the taxpayers to whom the proposal refers, the taxpayers' conformity with the content of the agreement, the description of the operations to which the proposal refers, the essential elements of the valuation method, the tax periods to which the agreement will be applicable, and its date of entry into force and the critical assumptions whose existence determines the applicability of the agreement under the terms contained therein.

According to Section 25(4) of the Corporation Tax Regulations, the procedure subsequent to the formulated proposal must be completed within six months of the date on which the application is entered in any of the registers of the administrative body competent for the resolution of the matter.

Should the six-month period elapse without the Tax Agency having expressly settled the procedure, the proposal is understood to have been rejected.

These can be unilateral agreements, concluded solely with the Tax Agency, or bilateral agreements, between the Tax Agency and a foreign administration.

The APA shall take effect in respect of operations carried out after the date on which it is approved, and shall be valid for the tax periods specified in the agreement itself, but may not exceed four tax periods following the date on which it is approved. However, the APA can be also applied to operations from previous tax periods provided that the right of the Tax Agency to determine the tax debt by means of the appropriate liquidation has not expired.

## **VI INVESTIGATIONS**

In Spain, the general statute of limitations period is four years for tax purposes. This period has been extended to 10 years under the new CIT Act with respect to the right of the tax authorities to audit in cases of tax loss carry-forward. As of fiscal year 2015, the General Tax Act has also been amended to extend this 10-year statute of limitations period to the right to conduct an administrative review of tax.

The General Tax Act also establishes that the interruption of the statute of limitations period for the collection of a tax will imply the interruption of related tax obligations.

During a tax inspection, it is normal for the tax authorities and the taxpayer to hold meetings to discuss and, when possible, resolve important and useful points for the inspection. These agreements will be very important for the outcome of the tax audit when the authorities are preparing their final conclusions.

When the tax inspectors have obtained all relevant information and documentation necessary to proceed with the verification and, to the extent possible, have issued an

assessment, a period is granted for the taxpayer to review all the documents incorporated in the tax inspection records, and to submit any relevant additional documents to strengthen the taxpayer's standing or raise any matters it deems appropriate.

Finally, there could be some negotiations between the inspector and the taxpayer in complex tax inspections, although there is no legal basis for it.

For example, in cases where theoretical elements are unclear (indeterminate concepts) and where both parties accept the technical arguments presented by the other party on different issues arising in the course of the inspection, the inspection may conclude with a record (or certificate) of agreement, or one of conformity, to avoid an appearance before the courts of justice to resolve controversial technical issues.

At the end of the submissions period, the tax inspector will issue a proposal for an evaluation.<sup>3</sup> There are three different types of evaluation document: agreement, conformity and disagreement.

The tax audit procedure will be extended to 18 months, and to 27 months if the taxpayer has to audit its financial statements or it forms part of a tax consolidation group. This period was formerly 12 months, extendable to 24 months under certain circumstances.

## VII LITIGATION

### i Procedure

The conflict resolution procedure in Spain is not very simple and it has many stages, in administrative (tax) courts and courts of justice. Tax courts tend to agree with the tax authorities in a higher percentage of cases; therefore, it is necessary to appeal to the courts of justice, sometimes delaying and extending the duration of the judicial process up to as much as 10 years from the time the taxpayer started the procedure before the tax courts.

As previously mentioned, at the end of the submissions period, the tax inspector will issue a proposal for an evaluation. Of the three different types of evaluation document, an agreement reflects a settlement proposal agreed between the tax auditors and the taxpayer; an evaluation indicating conformity means the taxpayer fully accepts the regularisation proposal; and when the taxpayer does not agree with the facts considered by the inspectors and, in general, disagrees with the valuation proposal, the evaluation will indicate disagreement.

If taxpayers do not agree with the tax authorities' proposed settlement, two different appeal options are available. The taxpayer can appeal directly to the tax courts (an economic-administrative claim) or to the tax authorities themselves (an appeal for reversal). Regardless of the choice, either of the two actions must be filed within one month of the date of notification of the assessment. There are two types of tax courts: regional tax courts (TEARs) and the Central Economic-Administrative Court (TEAC).

If these tax courts reject the economic-administrative appeal, the taxpayer may file a contentious-administrative appeal before a court of justice within two months of the notification of the tax tribunal's decision (or within six months if one year has elapsed since the filing of the economic-administrative appeal without an express decision being issued by the tax court within one year).

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3 Known as an *acta*.

The Spanish courts competent in tax matters are the National High Court, which, in general terms, hears appeals against the decisions of the TEAC; and the regional courts of justice, which, in general terms, hear appeals against the decisions of TEARs.

Finally, an adverse ruling by the National High Court may be appealed before the Supreme Court by means of an appeal in cassation within 30 days of the notification of the adverse ruling to the taxpayer.

Until 2016, cassation made the Supreme Court a second or third instance. However, as from that year, the system, based on three forms of cassation (common or ordinary cassation; cassation for the unification of doctrine; and cassation in the interest of law), has been changed into a single appeal process. Under the new system, the principal question to be addressed is whether the case is of sufficient interest for the Supreme Court to pronounce upon, and if it does so, it creates case law that will serve as a basis for future similar cases.

## II RECENT CASES

The most recent case regarding transfer pricing is the National High Court judgment dated 6 March 2019. According to the Court, multi-year analysis may be valid for conducting a comparability study, but comparison must be to the taxpayer's results for each year under review. However, as regards the value to be used in the valuation adjustment of the result, the Court accepts the company's claim and concludes that in order to use the median, there must be 'comparability defects' in the subject's sample.

On 15 October 2018 the Spanish Supreme Court published a ruling regarding the different penalty regimes that can be applicable to related-party transactions. In particular, the Supreme Court established that where the taxpayer has no obligation to prepare transfer pricing documentation, the specific transfer pricing penalties will not apply, but the general penalties regime will come into force. It must be noted that the general penalties regime has higher penalties for the taxpayer than the specific transfer pricing penalties regime.

The General Directorate for Taxation has stated in several rulings<sup>4</sup> the value that must be taken into account for the purposes of determining whether a loan must be included in the transfer pricing documentation.

According to the General Directorate for Taxation, the value to take into account must be the market value of the interest corresponding to the loans, without including the amount of the principal nor the amounts reimbursed during the financial year.

Therefore, only the market value of the total consideration of the related operation should be taken into account, namely the market value of the total interest corresponding to the specific loan.

The National High Court has ruled<sup>5</sup> on intra-group services rendered between related parties on several occasions. The CIT Act requires that intra-group services must produce, or be likely to produce, an advantage or utility for the Spanish recipient. Spanish courts, therefore, have mainly focused on the taxpayer being able to demonstrate such an advantage or utility.

However, it is very rare for the Spanish Courts to have to issue a ruling on the valuation of such services as the taxpayers usually fail to demonstrate an advantage or utility.

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4 Tax rulings of the General Directorate for Taxation Nos. V0767-11, V1263-11, V1341-12 and V1238-13.

5 Rulings of 1 December 2011, 19 January 2012 and 10 October 2012.

The TEAC, in its rulings of 5 September and 3 October 2013, rejected the application of a 'secret comparable' to determine the market value of a transaction. The TEAC stated that the use of secret comparables renders the taxpayer powerless to sustain a legal defence against the valuation determined by the tax authorities.

Regarding the transfer of non-listed businesses or shares, in its ruling of 27 September 2013, the Spanish Supreme Court stated that the underlying book value of the company can be considered its market value.

## **VIII SECONDARY ADJUSTMENT AND PENALTIES**

In Spain, tax authorities are entitled to impose secondary adjustments to reflect the consequences of a non-arm's-length transaction. The CIT Act establishes that the difference arising between a non-arm's-length transaction and its market value will receive the tax treatment corresponding to the true nature of the income disclosed by the existence of the difference.

### **i Secondary adjustments between related parties**

In particular, when the difference between a non-arm's-length transaction and its market value arises between an entity and its partners or participants, the CIT Act establishes the following two possibilities.

#### ***Differences in favour of the partner***

Where the difference is determined as being in favour of the partner, the difference must be considered as dividends for the partner and as a redistribution of own funds for the entity, in the proportion corresponding to the percentage of participation.

The part of the income that does not correspond to the percentage of participation is considered to be redistribution funds for the entity and to be a conditional utility for the partner. Therefore, the secondary adjustment gives rise to a non-deductible expense in the entity since the income is considered in its entirety as remuneration of own funds.

As far as the partner is concerned, although all the income must be included in its tax base, for the part of the income attributable to the percentage of participation, the double taxation exemption may be applied.

#### ***Differences in favour of the entity***

However, if the difference is determined as being in favour of the entity, the difference must be considered a contribution to the entity's funds made by the partner. Consequently, for the partner, the difference will result in an increase in the acquisition value of its participation.

The part of the income that does not correspond to the partner's percentage of participation in the entity is considered to be income. This income will have to be included in the entity's taxable base and will be considered a non-deductible liability for the partner.

### **ii Secondary adjustments to transactions between other related parties**

Although not specifically regulated in the CIT Act, secondary adjustments will also be applicable to transactions carried out between other related parties (an entity and its directors, an entity and parties related to the partners, sister entities, etc.).

The application of the secondary adjustment rule may be excluded when the funds corresponding to the primary adjustment are restored between the related parties involved in the transaction.

### **iii Penalties imposed for non-arm's-length transactions**

Regarding the penalties that the tax authorities might impose on a taxpayer for non-arm's-length transactions, the CIT Act provides for the following two scenarios.

#### ***No value adjustments***

Where the tax assessment does not find it necessary to make value adjustments in the transfer pricing used by the taxpayer, the penalty will consist of a fixed monetary fine of €1,000 for each item of data and €10,000 for a set of data, omitted or false, relating to each of the documentation obligations established by law for the group or for each person or entity in its capacity as taxpayer.

The maximum limit of this penalty will be the smaller of the following two amounts:

- a* 10 per cent of the aggregate amount of the transactions subject to this tax, personal income tax or non-resident income tax carried out in the tax period; or
- b* 1 per cent of net turnover.

#### ***Value adjustments***

Where the assessment finds that the taxpayer has not applied the values stated in the documentation, value adjustments will be made in respect of the value given to the transaction by the taxpayer (on account of there being differences between the value stated by the taxpayer and the fair market value of the transaction), and the penalty will consist of a proportional fine of 15 per cent of the sum of the amounts resulting from the adjustments for each transaction.

## **IX BROADER TAXATION ISSUES**

### **i Diverted profits tax and other supplementary measures**

A diverted profits tax is not applicable under Spanish domestic tax law.

### **ii Double taxation**

Adjustments resulting from the application of transfer pricing rules by tax authorities can lead to double taxation of income. Sometimes, this double taxation cannot be solved unilaterally by tax authorities. In these cases, the use of bilateral procedures involving both states are required.

Spanish law provides two different applicable procedures to resolve double-taxation conflicts:

- a* the Mutual Agreement Procedure (MAP), provided in the double-tax treaties (DTTs) signed by Spain with other states. In Spanish domestic law, the MAP has been implemented in the First Additional Provision of the Non-Resident Income Tax Act, and developed in the Regulations on Mutual Agreement Procedures (RPAs); and
- b* the EU Arbitration Convention.<sup>6</sup>

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<sup>6</sup> Convention 907436/EEC of 23 July 1990 on the elimination of double taxation in connection with the adjustment of profits of associated enterprises.

### **MAP**

The RPAs only apply to the MAP provided for in Section 25(1) and (2) of DTTs signed by Spain (i.e., those initiated at the request of the interested party). The competent Spanish body is the General Directorate for Taxation of the Ministry of Finance; however, for specific transfer pricing cases the competent authority is the Tax Agency.

The RPAs envisage the possibility of terminating the procedure because of lack of cooperation by the taxpayer. The agreement reached by the tax administrations of both DTT signatory states may not be appealed by the interested party.

Typically, interest arises on late payments of taxes; however, no interest will be accrued in cases where the Tax Agency makes an adjustment on the basis of the agreement reached in a MAP.

Spanish law incorporates the possibility of suspending the debt once the MAP has been initiated, without having to go to the Spanish courts; however, if court procedures have been initiated, the court should be the one to grant the suspension.

Once the tax administrations reach an agreement, it is applied by means of an exchange of letters, which must be expressly accepted by the interested party. If this does not happen, the authorities may terminate the procedure without eliminating double taxation.

There is no stated maximum duration for the procedure, but the average duration has decreased over the past few years thanks to the better functioning of the tax administrations and by the interested parties having a better knowledge of the instrument.

### **EU Arbitration Convention**

At the European level, transfer pricing adjustment cases can also be resolved through the mechanism of the EU Arbitration Convention, which is a multilateral convention that follows a scheme similar to the one for the Mutual Agreement Procedure.

There is a first phase of dialogue between tax administrations over a period of two years. If no agreement is reached at this stage, the interested party may request to go to the arbitration stage.

Affected companies may apply for the Arbitration Convention procedure in their state of residence and, in addition, permanent establishments may apply to commence the procedure in the state in which they are located or in the state of their parent company.

Unlike the MAP, the EU Arbitration Convention, in accordance with its Code of Conduct, has developed very precise guidelines for the operation of the arbitration commission to ensure its proper functioning.

### **iii Consequential impact for other taxes**

In Spain, there is no specific legislation regarding the consequential impact of transfer pricing adjustments on other taxes. In this respect, as stated by the VAT Expert Group of the European Commission, transfer pricing adjustments should be considered ‘outside the scope of VAT’ where both parties have a full right to recover VAT. It is only when one of the traders does not have a full right of recovery that transfer pricing adjustments might require a VAT adjustment, if there is a sufficiently direct link between any payments resulting from an adjustment and specific supplies. Transfer pricing adjustments resulting from a tax audit should always be treated as being outside the scope of VAT unless the parties agree to change the consideration accordingly.

The VAT treatment of the transfer pricing adjustment varies if it is an adjustment of a previous taxable transaction and therefore constitutes additional consideration for the same taxable transaction or if there is no consideration as such, because there is no taxable transaction.

When the transfer pricing adjustment can be linked to the initial supply, the VAT treatment of the adjustment is the same as for the initial supply. If there is no direct link with the initial supply and no contractual obligation to make a transfer pricing adjustment payment, the assumption is that the adjusting payment aims to reach an agreed profit margin, which is not a taxable transaction or taxable consideration, and as such is outside the scope of VAT.

The transfer pricing adjustment would not constitute a consideration if the profit margin is not correctly applied where goods or services are invoiced on a cost-plus basis. Typically, the taxable basis of the person under audit is increased while there is no corresponding decrease in the taxable basis of the counterparty.

## **X OUTLOOK AND CONCLUSIONS**

When the current transfer pricing legislation was approved in 2006, the capabilities and knowledge of the Spanish tax authorities and tax professionals were not sufficiently developed to be able to apply the law properly. Now, however, more than 10 years later, things have changed significantly and transfer pricing is now a significant matter for the attention of companies and other economic operators (such as funds, venture capital firms and start-ups).

Also, tax authorities have become used to dealing with transfer pricing matters to the extent that it has gone from being a rarely considered area to one that is now omnipresent, featuring in every single tax audit.

Now it is not merely a question of documentation, which is obviously a starting point, but mainly it is a matter of having robust transfer pricing criteria that duly and realistically reflect the actual risks and functions assumed by the parties.

Tax authorities' weakness is usually lack of consistency when reviewing companies from the same sector and with the same profile in terms of risk and functions, since their reviews are aimed at tax collection rather than technical correctness, which provides taxpayers with an extremely useful resource when litigating.

Tax disputes over transfer prices are becoming more and more frequent, involving international competent authority procedures and arbitration procedures, which is something Spanish taxpayers should be prepared for.



# SWITZERLAND

*Jean-Blaise Eckert and Jenny Benoit-Gonin*<sup>1</sup>

## I OVERVIEW

Switzerland is a federal democracy. As such, the Swiss Federal Constitution grants both the federal government and the cantons the power to levy direct taxes. Federal income tax and corporate income tax are levied in accordance with the Federal Income Tax Act (FITA) of 14 December 1990. The cantons enact their own laws concerning cantonal income tax, wealth tax, corporate income tax and capital tax, but these laws must conform to the Federal Tax Harmonisation Act (FTHA) of 14 December 1990.

Taxes are levied by the Federal Tax Administration and the cantonal tax authorities.

As a member of the Organisation for Economic Co-operation and Development (OECD), Switzerland has accepted the Transfer Pricing Guidelines developed by the OECD and is actively implementing the recommendations of the OECD's Base Erosion and Profit Shifting (BEPS) project.

Switzerland relies heavily on the Transfer Pricing Guidelines as it has no specific transfer pricing regulations. Accordingly, the Federal Tax Administration has instructed cantonal tax administrations to apply directly the OECD Transfer Pricing Guidelines for all questions related to transfer pricing.<sup>2</sup>

Transfer price adjustment in Switzerland is based on the principle of the prohibition of harmful profit shifting between related parties. According to settled case law of the Swiss Federal Supreme Court,<sup>3</sup> a transfer price can be adjusted when all the following conditions are met:

- a* a company provides a benefit without receiving an adequate consideration in return;
- b* the benefit was provided to a shareholder or related party;
- c* the benefit would not have been granted to a third party; and
- d* the disproportion between the benefit and the consideration was recognisable for the company.

If these conditions are met, the tax authorities will consider that harmful profit shifting has occurred; there is no need to prove that it was the parties' intention to evade paying taxes.

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1 Jean-Blaise Eckert is a partner and Jenny Benoit-Gonin is an associate at Lenz & Staehelin.

2 Federal Tax Administration, Circular Letter of 4 March 1997; renewed by Circular No. 4 of 19 March 2004.

3 ATF 115 Ib 274, consid. 9b.

As previously mentioned, Switzerland does not have a specific piece of legislation defining and addressing transfer pricing. However, certain<sup>4</sup> Swiss federal and cantonal tax laws address related issues, such as the arm's-length principle and hidden equity.

Legal bases for transfer price adjustment are, however, contained in most Swiss tax Acts governing income tax and corporate income tax,<sup>5</sup> withholding tax<sup>6</sup> and value added tax<sup>7</sup> (VAT).

Article 58 FITA forbids the deduction of unjustified expenses, meaning that all dealings with shareholders and related parties must be conducted at arm's length. For tax purposes, these unjustified expenses may be reintegrated into the company's taxable profits and profits realised due to insufficient transfer prices may be requalified as constructive dividends. Shareholders will be subject to income tax or corporate income tax on any constructive dividends.

Further, if the company is found to have distributed constructive dividends, these dividends will be subject to withholding tax of 35 per cent (in accordance with Article 4, Paragraph 1, Letter (b) of the Withholding Tax Act of 13 October 1965); if the withholding tax is not borne by the beneficiary, then the withholding tax is levied at the gross-up rate of 54 per cent. Beneficiaries of the constructive dividends may nevertheless request a total or partial reimbursement based on Swiss internal law (Article 24, Paragraph 1 of the Withholding Tax Act of 13 October 1965) or an applicable double tax agreement. A notification procedure to notify instead of paying the withholding tax may also be available under certain conditions. In the event of a hidden capital contribution, the capital contribution may be subject to stamp duty tax of 1 per cent (Article 5, Paragraph 2, Letter (a) of the Stamp Tax Act of 27 June 1973).

The Federal Tax Administration also issues directives in the form of circulars and circular letters that provide guidance on transfer pricing and related topics. These cover safe harbour rules (thin-capitalisation and interest rates),<sup>8</sup> service companies<sup>9</sup> and restructuring.<sup>10</sup>

The VAT Act of 12 June 2009 is the only legislation that explicitly refers to the requirement that transactions between related parties be at arm's length. It also defines the notion of 'related parties' for VAT purposes as:<sup>11</sup>

- a* the owners of at least 20 per cent of the nominal or basic capital of a business or of an equivalent participation in a partnership, or persons associated with them; or
- b* foundations and associations where there exists a particularly close economic, contractual or personal relationship. Pension schemes are not regarded as concerning closely related persons.

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4 e.g., Article 58 FITA and Article 24 the Federal Tax Harmonisation Act.

5 Article 58 FITA for corporate income tax at the federal level; Article 24 FTTHA for corporate income tax at cantonal and municipal level.

6 Article 4, Paragraph 1 of the Withholding Tax Act and Article 20, Paragraph 1 of the Withholding Tax Ordinance for the taxation of constructive dividends.

7 Article 24, Paragraph 2 of the VAT Act.

8 Circular No. 6/1997.

9 Circular No. 4/2004.

10 Circular No. 5/2004.

11 Article 3, Letter (h) of the VAT Act.

The Swiss Federal Supreme Court has defined the notion of ‘related parties’ as entities or persons with a close commercial or personal relationship,<sup>12</sup> which it interprets very broadly. In particular, the Court considers that the granting of a service under unusual terms or conditions that do not reflect the market is an indication that there is a relationship between the parties.<sup>13</sup> It is vital to know whether the transaction was conducted under these conditions because of a relationship between the parties, or if it could have occurred under the same conditions between independent parties.

## II FILING REQUIREMENTS

There is no explicit list of documents concerning transfer pricing that must be included in the tax filing. However, tax authorities may dispute certain transfer prices, and the taxpayer must demonstrate that the prices used in the transaction with a related party conform with the arm’s-length principle and be able to provide commercial justification.

Since 1 December 2017, Swiss tax law requires multinational companies to submit a country-by-country report that complies with the requirements of Annex III to Chapter V of the OECD Transfer Pricing Guidelines. These will not be published and there is no initiative from lawmakers suggesting future publication.

Tax returns must be filed in one of the official languages of Switzerland (French, German and Italian).

## III PRESENTING THE CASE

### i Pricing methods

Switzerland relies on the OECD Transfer Pricing Guidelines concerning pricing methods.

Taxpayers may select the appropriate OECD-compliant pricing method to determine the arm’s-length price. These include traditional transaction methods, such as the comparable uncontrolled price method (CUP method), the resale price method and the cost plus method. Also acceptable are transactional profit methods, such as the transactional net margin method and the transactional profit split method. The global formulary apportionment method is not considered OECD-compliant.

There is no hierarchy between the methods. The comparable uncontrolled price method is the preferred method and the transactional net margin method is the most common method.<sup>14</sup>

### ii Authority scrutiny and evidence gathering

The cantonal tax authorities are responsible for assessing direct federal and cantonal taxes and the Federal Tax Administration plays a supervisory role. Further, tax authorities may audit taxpayers. Accordingly, taxpayers should retain all documents necessary to prove that transfer prices were made in accordance with the arm’s-length principle. The burden of proof lies

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12 Federal Supreme Court 2C\_177/2016, 30 January 2017, Section 4.3.

13 *ibid.*

14 Greter M, Häni M, Streule F and Dietschi M, ‘Transfer Pricing in Switzerland: Overview’ (Thomson Reuters *Practical Law*) [https://uk.practicallaw.thomsonreuters.com/w-007-3885?transitionType=Default&contextData=\(sc.Default\)&firstPage=true&bhcp=1](https://uk.practicallaw.thomsonreuters.com/w-007-3885?transitionType=Default&contextData=(sc.Default)&firstPage=true&bhcp=1), accessed 26 May 2020.

with the taxpayer for the justification of the expenses, and with the tax authorities regarding adjustments which increase the taxpayer's taxable income. In recent years, there has been an increase in the number of audits performed by Swiss tax authorities.

Decisions may be challenged before cantonal courts (for decisions made by cantonal authorities) and before the Swiss Federal Administrative Court (for decisions made by federal tax authorities). Decisions can be appealed to the Swiss Federal Supreme Court.

#### IV INTANGIBLE ASSETS

Swiss tax legislation does not contain specific provisions relating to transfer pricing of intangible assets or hard-to-value intangible assets. Switzerland follows the OECD Transfer Pricing Guidelines for transactions involving intangible assets.

#### V SETTLEMENTS

Tax rulings are a common practice in Switzerland and Advance Pricing Agreements (APAs) can be concluded with the tax authorities even though domestic tax law does not contain specific provisions. Taxpayers may request advance rulings from the Swiss tax authorities to determine how they will be subject to Swiss taxes and how much they will owe in Swiss taxes.

Bilateral or multilateral APAs are also possible in coordination with the State Secretariat for International Finance.

Since Switzerland is a federal state, often it is necessary to request a minimum of two rulings in transfer pricing cases.<sup>15</sup> A ruling regarding withholding tax or stamp duty (or both) must be requested from the Federal Tax Administration, and a second ruling with regard to corporate income tax must be requested from the competent cantonal tax administration. In general, no fees are charged, but certain cantons levy fees.

The duration of APA procedures varies widely. The time necessary to receive a unilateral APA ranges from a few days to several months, depending on the complexity of the case and the competent tax administration. For bilateral or multilateral agreements, the duration is counted in years. The average duration of mutual agreement procedures concerning APAs closed in 2018 was 29 months.<sup>16</sup> This average has decreased by three months compared to 2017 and 14 months compared to 2016. Although there is currently no OECD requirement for the duration of APAs, Switzerland considers such procedures essential for legal certainty and the attractiveness of Switzerland as a business location.<sup>17</sup> Therefore, Switzerland is striving to speed up APA procedures, while at the same time giving priority to achieving the best possible results in each case.

In addition to providing legal certainty for complex and high-risk transactions and preventing double taxation, the system of advance rulings reduces the number of tax-related disputes that are litigated before the courts. However, it is important to consider the exchange of information aspect before filing a ruling request as Switzerland is part of the international

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15 Bottini P, Schreiber S, Lehmann D and Mühlemann M, 'Transfer Pricing in Switzerland' (Law Business Research, *Lexology*, 29 April 2019).

16 State Secretariat for International Finance (SIF), 'Les procédures amiables fondées sur les conventions contre les doubles impositions conclues par la Suisse – Statistiques 2018', 3 December 2019.

17 *ibid.*

spontaneous exchange of information on tax rulings, even if the ruling itself will not be exchanged. Therefore, the possible consequences of an APA request must be carefully considered.

Mutual agreement procedures and international arbitration may also be used in an international dispute.

## VI INVESTIGATIONS

The Swiss tax authorities do not usually perform transfer pricing investigations. However, based on the ordinary taxation procedure, the assessment authorities shall review the taxpayer declaration and carry out the necessary investigations (Article 130, Paragraph 1 FITA).

In particular, the Swiss tax authorities are allowed to review information submitted by the taxpayer under its yearly tax return and request additional information. This is related to the Swiss tax authorities' obligation to determine all the relevant facts to assess the taxation and to take into consideration only facts they consider as proven.

Swiss taxpayers submit tax returns on a self-assessment basis. In this respect, the Swiss tax authorities can also consider that the tax return is complete and that no further investigation is necessary. Investigations are, therefore, not automatic, including for transfer pricing issues.

Swiss tax authorities can open an investigation following submission of the tax return for the relevant tax period. The time limit for tax authorities to proceed with investigations depends on the tax concerned.

For corporate income tax, this right is generally limited to 10 years and can be extended by up to 15 years by the tax authorities after the close of the relevant tax period. Indeed, the 10-year statute of limitations can be interrupted by various official acts, such as a complaint, an appeal or revision proceedings (Article 120, Paragraph 2 FITA). This includes any official communications from the tax authorities to the taxpayer that aims at interrupting the statute of limitations. In practice, a simple letter announcing the interruption is generally considered sufficient, even in cases where a tax assessment has yet to be issued.

For withholding tax, this right is generally limited to five years after the end of the calendar year in which the tax claim arose. Unlike corporate income tax, there is no absolute statute of limitations. As a result, the tax authorities can interrupt the five-year period by official communications without limitation, unless they act against the general principle of good faith.

Taxpayers can adjust their tax return, once submitted, as long as the tax authorities have not issued a final tax assessment. After receiving the final tax assessment, taxpayers can lodge a written formal complaint against the assessment notice with the assessment authority within 30 days. If the formal complaint is brought against a tax notice that sets out extensive grounds, the formal complaint may, with the consent of the appellant and the other petitioners, be referred directly as an appeal to the Cantonal Tax Appeals Commission (Article 132, Paragraph 2 FITA).

After receiving a written formal complaint, tax authorities may proceed with new tax assessments and may adjust their first decision in favour or in disfavour of the taxpayer. Once the protestation decision (a second decision taken by the tax authorities after the first tax assessment) is notified to the taxpayer, the latter has 30 days to lodge an appeal against this decision to the Cantonal Tax Appeals Commission.

## VII LITIGATION

### i Procedure

From a procedural perspective, the general limitation period of 10 years after the close of the relevant tax period can be extended to 15 years for corporate income tax purposes, following an official act that interrupted the statute of limitations. For withholding tax purposes, the general limitation period of five years after the end of the calendar year in which the tax claim arose does not suffer any limitation if officially interrupted.

A final tax decision can also be revised in favour of the taxpayer, provided certain conditions are fulfilled (e.g., significant facts or decisive evidence is discovered (Article 147, Paragraph 1 FITA)). This procedure must, however, be filed either within 90 days of discovery of the grounds for revision or, at the latest, within 10 years of notification of the final tax decision (Article 148 FITA).

Upon submission of their tax return, taxpayers can generally expect to receive a final tax decision from the tax authorities within one to two years. This timeline mostly depends on the tax authorities' requests for information and the taxpayers' cooperation with tax assessment decisions. If the taxpayer does not agree to the specified taxation and lodges a written appeal with the tax authorities, this procedure can take up to an additional two years. A later appeal to the Cantonal Tax Appeals Commission is generally subject to the same waiting period.

As a result, after receipt of the first tax decision from the tax authorities, a procedural process with the Swiss Federal Supreme Court generally lasts from six to eight years.

The initial process before the tax authorities (submission of the tax return and written formal complaint to the same tax authorities) generally allows taxpayers to disclose all relevant facts and evidence. Even once the procedure goes before the Cantonal Tax Appeals Commission, new evidence is still acceptable as the Commission has powers to review all facts and the law (Article 142, Paragraph 4 FITA). Any other higher jurisdiction where an appeal is lodged (a superior cantonal court or the Swiss Federal Supreme Court) is, however, restricted in its power to review the facts.

### ii Recent cases

Case law involving transfer pricing issues is quite rare in Switzerland. Exceptionally, at the end of 2019, the Swiss Federal Supreme Court rendered two rulings on transfer pricing.

In the first case,<sup>18</sup> the Swiss Federal Supreme Court addressed the question of transfer pricing in cross-border (Switzerland–Seychelles) transactions between companies of the same group. The Swiss Federal Supreme Court restated that in lieu of specific transfer pricing legislation, the OECD Guidelines and the arm's-length principle should be applied. In this case, the Swiss Federal Supreme Court found that an asymmetrical relationship between a company's losses and the services it provides and its expenses, along with insignificant added value to the services provided by the subsidiary, are sufficient evidence that the price of the services provided by the subsidiary was disproportionate. In this case, the burden of proof was reversed and it fell on the company to show that the cost of the services in question was commercially justified. Finally, with regard to the method used, the Swiss Federal Supreme Court emphasised that for the CUP method to be used, the economics of the situations taken into account must be sufficiently comparable. In this respect, five areas of comparability must be examined: the characteristics of the goods or services transferred; the functions performed

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18 Swiss Federal Supreme Court 2C\_343/2019, 27 September 2019.

by the parties (taking into account the assets used and the risks assumed); the contractual clauses; the economic situation of the parties; and their industrial and commercial strategies. If these factors cannot be established, then the determination of the arm's-length price must be carried out using other methods, including the cost plus method.

The second case<sup>19</sup> involved a Swiss company and its subsidiary in Guernsey, a low-tax jurisdiction. In this case, the Swiss parent entity argued that the hidden contribution it had made to its subsidiary was wrongly equated with a hidden profit distribution under Article 58, Paragraph 1, Letter (b) FITA and that the immediate adjustment of its profit by the Geneva tax authorities was erroneous.

Previously, in the case of a parent company that had overpaid its (foreign) subsidiary, the Swiss Federal Supreme Court ruled that the write-backs of the profit of the parent company had to be made. The Court clarified that, since all the conditions for considering the payment as a dividend were met, it was not necessary to examine whether there was a hidden profit distribution or a hidden contribution, since the payment must be included in the parent company's taxable profit in both cases.

In this case, in the opinion of the Swiss Federal Supreme Court, there is no reason why the result should be any different when a parent company receives no, or insufficient, compensation for services provided to its subsidiary. A clawback is already justified under the tax correction provision in Article 58, Paragraph 1, Letter (b) FITA. Several authors also take the view that a clawback is justified in such a case. However, other authors believe that the shareholder is not liable to tax, since the administration cannot require the parent company to make a profit off its own subsidiary. However, this is not compatible with the constant case law of the Swiss Federal Supreme Court, which states that transactions between companies of the same group must be conducted as if they were carried out with third parties in the free market. Even the authors supporting the latter position reserve the possibility of a clawback when there is an abuse of rights, such as when a shareholder provides a service that favours a foreign subsidiary, which then distributes its profits in the form of dividends to the shareholder, who benefits from the application of the Swiss participation exemption. This is precisely what happened in the case before the Swiss Federal Supreme Court: the subsidiary distributed a considerable portion of its profit as a dividend and the parent company was able to benefit from the application of the participation exemption.

## VIII SECONDARY ADJUSTMENT AND PENALTIES

Provided a non-arm's-length transaction is considered by the tax authorities, such as a hidden dividend distribution or interests received against a loan considered as insufficient, a Swiss withholding tax of 35 per cent may be levied. Secondary adjustments (e.g., transfer of an amount representing the adjustment to its foreign parent) are also subject to this 35 per cent withholding tax (or 54 per cent if not paid directly by the transaction's beneficiary) provided it has not been agreed in a mutual agreement procedure.

A partial or full reimbursement of the withholding tax withheld may be claimed in accordance with double tax treaties and Swiss internal law. Late interest fees of 5 per cent may also be applicable without a possibility to claim full or partial reimbursement.

Aside from the penalties for non-compliance with the CbC reporting obligation, there are no specific transfer pricing penalties, but general penalty rules apply. Under the

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19 Swiss Federal Supreme Court 2C\_1073/2018, 20 December 2019.

ordinary tax procedure and provided a non-arm's-length transaction is considered by the tax authorities, penalties do not generally apply in practice and late interest fees are privileged. However, penalties may occur, in particular where tax fraud is considered.

Penalties are generally assessed in view of the taxpayer's fault. It can be challenged during the administrative or criminal procedure by giving relevant evidence or facts, or during later legal proceedings in front of the Swiss courts up to the Swiss Federal Supreme Court.

## **IX BROADER TAXATION ISSUES**

### **i Diverted profits tax and other supplementary measures**

Under Swiss tax law, there is no specific regulation about transfer pricing issues. Tax authorities should, however, follow OECD Transfer Pricing Guidelines as disclosed under Circular No. 4 of the Swiss Federal Tax Administration, dated 1997, revised in 2004. This Circular provides a general application of the arm's-length principle to determinate taxable income of service companies. Those generally applicable principles have not been supplemented by any other regulations.

### **ii Double taxation**

Switzerland has concluded double taxation treaties with over 90 countries. If double taxation occurs with a country Switzerland signed a double taxation treaty with or if there is a risk of double taxation occurring, Swiss resident taxpayers, both individuals and corporations, can ask the Federal Department of Finance in Bern to initiate a mutual agreement procedure.

In accordance with the OECD Model Tax Convention on Income and Capital (OECD MC), taxpayers can initiate a mutual agreement procedure within three years of the first notification of the action resulting in double taxation (Article 25, Paragraph 1 OECD MC). Most double taxation treaties concluded with Switzerland provide this three-year time limit, but each double taxation treaty must first be reviewed.

An arbitration procedure is also available under a number of double taxation treaties concluded with Switzerland. In general and in contradiction with mutual agreement procedures, taxpayers can only file a request for arbitration with one of the competent authorities, for example, if an agreement has not been reached after two years (Article 25, Paragraph 5 OECD MC).

To avoid double taxation, taxpayers can also request a ruling with the Swiss tax authorities before a transfer pricing transaction occurs. Swiss taxpayers generally choose this route; however, provided a foreign country decides to adjust a transfer pricing transaction, double taxation may still occur. In this respect, APAs can also be chosen by Swiss taxpayers to confirm the tax treatment under the relevant double tax treaty, and obtain an agreement between Swiss tax authorities and foreign tax authorities.

### **iii Consequential impact for other taxes**

Even if transfer pricing adjustments are generally analysed from an income tax and withholding tax perspective, VAT consequences have to be considered. Under the Swiss Federal VAT Act, the arm's-length principle also applies for transactions between parties considered as related. Consequently, an adjustment required by the tax authorities may have an impact on the tax levied. Penalties and interest may also apply if an adjustment is discovered during an audit.



## **X OUTLOOK AND CONCLUSIONS**

Switzerland does not have any specific transfer pricing legislation and there is currently no indication that it will in the near future. However, Swiss authorities, including both the administration and the courts, are increasingly influenced by the OECD, which includes, as mentioned, the BEPS project. This means that any taxpayer active in Switzerland should remain extremely cautious when dealing with transfer pricing issues and should always take into account the OECD Transfer Pricing Guidelines.

# UNITED KINGDOM

*Steve Edge, Dominic Robertson and Tom Gilliver<sup>1</sup>*

## 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 these persons was directly or indirectly participating in the management, control or capital of the other, or the same person or persons were directly or indirectly participating in the management or control of the two parties to the provision;
- 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 for the UK rules to apply. While the term 'provision' is not defined in the legislation, Her Majesty's Revenue and Customs (HMRC) guidance suggests that it embraces all the terms and conditions attaching to a transaction or series of transactions and should be given a wide meaning. The guidance also provides that the term is broadly equivalent to the phrase 'conditions made or imposed' in Article 9 of the Organisation for Economic Co-operation and Development (OECD) Model Tax Convention (the Model Convention) and so should be interpreted in line with the OECD Transfer Pricing Guidelines (the OECD Guidelines).<sup>2</sup> The UK's Upper Tribunal has held that a share issue could be treated as a provision for transfer pricing purposes, although the point has been

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1 Steve Edge and Dominic Robertson are partners and Tom Gilliver is an associate at Slaughter and May. The authors wish to thank Sam Cadd for research assistance on this chapter.

2 HMRC International Manual (INTM412050).

appealed to the Court of Appeal.<sup>3</sup> This interpretation suggests that the term is not confined to commercial transactions between companies and that the transfer pricing legislation can also impact shareholder transactions.

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.<sup>4</sup>

'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.<sup>5</sup> 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 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. It is not yet clear whether the rules can apply to a provision between a company and an individual acting in her personal capacity rather than as an 'enterprise', which may be clarified by a First Tier Tribunal decision expected later in 2020.

Both cross-border transactions and domestic transactions fall within the scope of these rules.

Where an adjustment is required by the transfer pricing rules to increase the profits (or reduce the losses) of one party (the advantaged party), the connected UK party (the

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3 *Union Castle Mail Steamship v. HMRC* [2018] UKUT 316 (TCC).

4 Section 1124 of the Corporation Tax Act 2010.

5 Sections 157 to 163 of TIOPA.

disadvantaged party) may, in turn, claim a compensating adjustment to its 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.<sup>6</sup>

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.<sup>7</sup> 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 2017 OECD Guidelines.<sup>8</sup> 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. Although additional transfer pricing guidance on BEPS Actions 4, 8–10 was released by the OECD in February 2020, at the time of writing this guidance had not yet been incorporated into the definition of the OECD Guidelines for the purposes of TIOPA. 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 views the updates as merely clarifications. Therefore, HMRC contends that pre-April 2016 transactions should also be tested under the current, post-BEPS version of the OECD Guidelines.

## **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 have to consider 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.<sup>9</sup>

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

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6 Section 196(2) of TIOPA.

7 HMRC International Manual (INTM412040).

8 Section 164 of TIOPA.

9 HMRC International Manual (INTM483030).

an enquiry into a taxpayer's return. However, where HMRC makes any adjustments to a taxpayer's transfer pricing position in its tax return, HMRC will in practice require some evidence that the company had carefully considered the arm's-length position, to be satisfied that no 'careless error' penalty is due. Traditionally, this would be done by preparing a formal transfer pricing report; however, the company should still verify that the comparables identified in the report are genuinely functionally similar to the company itself.

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.<sup>10</sup>

### 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.

The OECD Guidelines do permit taxpayers to adopt 'other methods' outside 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.

Factors influencing the selection of the most appropriate method include 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. HMRC endorses the OECD's preference for traditional transaction methods over transaction profit methods where both can be applied in an equally reliable manner and, similarly, it is generally accepted that a comparable uncontrolled price (CUP) is the most effective way of assessing the arm's-length price.

#### *Comparability*

HMRC emphasises the importance of carrying out a robust comparability analysis as this may have a considerable impact on the acceptable range of arm's-length pricing. However, it is difficult for a CUP to be entirely robust given that access to information on a third party's actual position is limited. A determination as to whether any given comparable is reliable must be made case by case having regard to the extent to which they satisfy the five comparability factors identified in the OECD Guidelines (i.e., the characteristics of the property or services transferred, the functions performed (taking into account the assets used and risks 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.

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10 HMRC International Manual (INTM483030).

The feasibility of carrying out reasonably accurate comparability adjustments is equally important when performing a comparability analysis. Examples of comparability adjustments include adjustments for accounting consistency and adjustments for differences in functions, assets and risks. However, in line with the OECD Guidelines, the only adjustments that should be made are those for differences that will have a material effect on the comparison 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. HMRC now considers that cost-plus is rarely appropriate for regional headquarter functions.

### ***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 taking recourse to this method.

### ***Cost sharing***

The guidance contained in the OECD Guidelines on cost-sharing arrangements applies in the UK. In applying this guidance, HMRC emphasises that there is no difference in the approach for analysing transfer pricing for cost-sharing arrangements than for any other transactions, and that parties performing activities under similar economic circumstances should receive the same expected return, irrespective of whether those activities are performed within the framework of a cost-sharing arrangement or not.

The BEPS Actions 8–10 Final Reports make clear that contributions made to such an arrangement should not be measured at cost where this is unlikely to provide a reliable basis for determining the value of the relative contributions of the participants. While cost share methods are acceptable in the UK, it is expected that arrangements of this kind will be less commonly used for IP in the future because of 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 is 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 as to the reasonableness of the result from a business and economic perspective.

One sense check that HMRC is particularly keen to examine is the global tax position for multinational groups and the profit share in each jurisdiction in the value chain. 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 diverted profits tax (DPT) (see Section IX, below), HMRC now expects to be provided with information on a group's full value chain, and the profits earned in each entity. Details of 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***

The UK has adopted country-by-country reporting (CbCR). 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 with HMRC. The Finance Act 2016 afforded Her Majesty's Treasury the power to make regulations requiring CbCRs to be included in a group's published tax strategy. The UK government has confirmed that it is keen to achieve an international consensus for a public model of this kind before exercising its powers to make such regulations, and the OECD remains in the process of international public consultation on its CbCR and BEPS Action 13 guidelines.

### ***Evidence gathering***

HMRC's governance process plays a key role in shaping how transfer pricing investigations are conducted. For any settlement to be approved by HMRC's governance process, the HMRC case team must conduct a comprehensive fact-finding exercise.

### ***Interviews***

In addition to carrying out a review of documentary evidence (including email reviews), witness interviews may also be required. Interviews with key business personnel can serve as a useful tool to address any gaps in HMRC's knowledge following a review of the documentary evidence, to verify HMRC's analysis of the material functions and risks in the business, and to assess whether there is any divergence between the related parties' conduct and the terms of the written contracts between them. In addition to speaking with the tax personnel in the business, HMRC is keen to meet with those working at the coalface to get a proper understanding of where they perceive the real value-generating activities of the business to be located. It is fairly unusual for expert witnesses, such as economists, to be engaged by the taxpayer prior to an appeal, but in some cases HMRC may consult its in-house economists.

Depending on the facts and circumstances of a particular enquiry, HMRC may request interviews with third parties outside the taxpayer group, including customers. To avoid any undue business disruption, it is generally accepted that HMRC should try, where practical, to obtain information and documents from the taxpayer concerned before approaching

third parties. That said, third-party witness interviews can enable HMRC to independently check information provided by a taxpayer and to gain a more holistic picture of the business concerned.

In the case of customers, HMRC will liaise in the first instance with the taxpayer concerned to coordinate the interviews. If the taxpayer or the third party refuses to comply with this informal request, HMRC may decide to issue a third-party information notice that would legally require the customer to give HMRC certain information or documents to help it check the relevant taxpayer's position. Before making a decision, HMRC case teams are advised to consider carefully whether they can be satisfied in any way other than by issuing a third-party information notice. In addition, the approval of the tribunal, or taxpayer consent, is required to issue such a third-party information notice. HMRC cannot 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 enquiry is not 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 use these facilities pursuant to a double tax treaty that contains an exchange of information article, the Joint Council of Europe and OECD Convention on Mutual Administrative Assistance in Tax Matters, various EU directives and regulations (during the Brexit transitional period) and exchange of information agreements.

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.<sup>11</sup> While transfer pricing will fall within the scope of most double-tax treaties, this may not be the case for DPT since HMRC views DPT as a tax 'in its own right' and not as corporation tax.<sup>12</sup>

## **IV INTANGIBLE ASSETS**

HMRC recognises that the use and transfer of intangible assets represent a material risk area for transfer pricing, particularly in the context of multinationals.

The BEPS Actions 8–10 Final Reports provide revised guidance specifically tailored to determining arm's-length conditions for intangible asset transactions. The revised guidance provides a framework for determining which members of a multinational group should share in the economic returns generated by those intangibles based on the value they create through functions performed, assets used and risks assumed in their development, enhancement, maintenance, protection and exploitation (DEMPE). In 2018, the OECD issued guidance for tax administrations on hard-to-value intangible assets.

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11 HMRC International Manual (INTM156050).

12 HMRC DPT Guidance (DPT1040).



Based on recent transfer pricing enquiries involving multinationals in the technology area, it is expected that HMRC will 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, so if a member of a multinational group contractually assumes a specific risk but neither exercises control over that risk nor has the financial capacity to assume the risk, the risk should be allocated to another multinational group member that satisfies those requirements. To justify a higher than passive return for a member of a multinational group, it would be necessary to evidence that the member in question has appropriately skilled and qualified employees and resources to manage the economically significant risks associated with the relevant DEMPE functions.

## V SETTLEMENTS

The settlement of a transfer pricing enquiry 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, the 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 as to how the case should be settled and a ‘statement about culpability’.<sup>13</sup> The statement about culpability is intended to assist the relevant panel or board in assessing whether penalties should be imposed.

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 2018–2019, it considered 29 cases (27 in 2017–2018).<sup>14</sup> The Diverted Profits Board similarly makes recommendations to the TDRB on HMRC’s largest and most sensitive cases. In 2018–2019, the Diverted Profits Board considered 41 proposals to resolve DPT issues (16 in 2017–2018).<sup>15</sup>

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 its 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.<sup>16</sup>

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13 HMRC International Manual (INTM481060).

14 Tax Assurance Commissioner’s Report, pages 100–110 of HMRC’s Annual Report and Accounts 2018–2019.

15 *ibid.*

16 Sections 208 and 209 of TIOPA.

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.<sup>17</sup>

In cases where a settlement has resulted in an adjustment to a taxpayer's returned profits, this may be relied upon to inform the future returning position provided there has been no material change in the circumstances of the business or in the market conditions in those future periods. In such cases, HMRC may provide comfort that the enquiry 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 enquiry. Certainty in relation to future years can be obtained only through a formal advance pricing agreement (APA) process.<sup>18</sup> 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 enquiry 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 enquiry itself – though the critical assumptions on which the APA is based can, of course, mean that the APA falls away whenever the critical assumptions are breached.

## VI INVESTIGATIONS

### i Process

The way in which a transfer pricing enquiry is conducted will vary from case to case, although once an enquiry has been opened the process generally involves HMRC: making and agreeing an action plan and timeline with the taxpayer; carrying out a fact-finding exercise; assessing the evidence and engaging in technical discussions with the taxpayer; and resolving the enquiry.

A transfer pricing enquiry is undertaken by Large Business Service or Local Compliance case teams headed by their respective Customer Compliance Managers (CCMs). A transfer pricing specialist is allocated to each enquiry. The CCM is responsible for HMRC's relationship with the customer and for the planning and direction of the work of the case team.<sup>19</sup>

Because of the punitive rate of DPT and for the other reasons outlined in Section IX, below, DPT can represent a strong incentive for taxpayers to be open and cooperative with transfer pricing enquiries.

### ii Time limits

In most cases, HMRC may open an enquiry into a taxpayer's return within 12 months of the date on which a tax return is filed. Once opened, there is no specified time limit for completing the enquiry, although HMRC's 'Review of Links with Large Business' commits HMRC to resolving transfer pricing enquiries within 18 months for the large majority of

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17 HMRC International Manual (INTM483070).

18 HMRC International Manual (INTM483130).

19 HMRC International Manual (INTM481080).

cases, and 36 months for those that are particularly complex and high risk. In its guidance, HMRC comments that a transfer pricing enquiry 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 enquiry if there appears to be an unnecessary delay by HMRC in progressing the case.<sup>20</sup>

Where the 12-month period within which an enquiry 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).<sup>21</sup> The 12-year time limit for assessing offshore cases does not apply to corporate tax.

To conclude a formal enquiry, HMRC must issue a closure notice either confirming that no amendment is required or requiring the taxpayer to amend its return.<sup>22</sup> 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.<sup>23</sup> Such a determination has effect for enforcement purposes as if it were a self-assessment by the taxpayer.<sup>24</sup>

An appeal may be brought against any closure notice or assessment by giving notice in writing within 30 days of the notice or assessment being issued.<sup>25</sup>

### **iii Profit Diversion Compliance Facility**

In January 2019, HMRC launched a Profit Diversion Compliance Facility (PDCF) intended to enable multinational enterprises to correct transfer pricing irregularities. The PDCF is targeted at situations in which a multinational enterprise has adopted cross-border pricing arrangements that might trigger a DPT investigation because the arrangements either do not reflect what is happening on the ground or are inconsistent with the OECD Guidelines. An enterprise wishing to use the PDCF must submit a detailed disclosure report of its transfer pricing affairs, including a proposal for the amount of tax, interest and penalties payable to remedy the identified irregularities. By using the PDCF, an enterprise may obtain more control over its interactions with HMRC regarding transfer pricing, avert a future DPT investigation or benefit from lower penalties for profit diversion that has already occurred. HMRC will aim to respond to proposals submitted through the PDCF on an accelerated three-month timescale, though this may be optimistic given the time taken to investigate and resolve recent transfer pricing cases in the UK.<sup>26</sup>

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20 Paragraph 33 of Schedule 18 to the Finance Act 1998.

21 Paragraph 46, *ibid.*

22 Paragraph 32, *ibid.*

23 Paragraph 36, *ibid.*

24 Paragraph 39, *ibid.*

25 Paragraph 48, *ibid.*

26 HMRC Profit Diversion Compliance Facility Guidance dated 10 January 2019.

## VII LITIGATION

### i Procedure

If a transfer pricing enquiry cannot be resolved by agreement, the taxpayer may appeal any final decision by HMRC to the UK's First Tier Tribunal (FTT). The time limit for taxpayers to make an appeal is generally 30 days from the date of such a 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 exceptionally be heard by the Upper Tribunal at first instance. Decisions by the FTT may be appealed to the Upper Tribunal on a point of law. Upper Tribunal decisions create legally binding precedents.

As a public body, a taxpayer may seek judicial review of the decision of an HMRC officer if certain requirements are satisfied. A taxpayer may seek this avenue of redress if, for example, it believes an HMRC officer has failed to properly carry out his or her duties or misdirected the taxpayer, and in consequence the taxpayer has suffered a disadvantage. The FTT cannot hear judicial review claims. In *R (Glencore Energy UK Ltd) v. HMRC*,<sup>27</sup> the taxpayer received a DPT charging notice and sought judicial review of the notice, arguing that the statutory appeal process was 'slow, inappropriate and ineffective'. Unsurprisingly, given the very high threshold required for a judicial review case to succeed, the High Court refused this application and the Court of Appeal reached the same conclusion, going on to determine that none of taxpayer's grounds for judicial review would have succeeded in any event.

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. Economists or businesspeople may give expert evidence, though there is little established practice in this regard due to the dearth of transfer pricing cases in the UK (see below).

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 those wider grounds.

### ii Recent cases

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

*DSG Retail Ltd v. HMRC*<sup>28</sup> is one of the few substantive transfer pricing cases to have reached the tribunal. This case concerned a UK company that sold electrical goods. 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

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27 [2017] EWHC 1476 (Admin); [2017] EWCA Civ 1716.

28 SpC [2009] SSCD 397.

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.

More recently, several cases, especially *Union Castle Mail Steamship v. HMRC*, have considered whether shareholder transactions such as bonus issues are subject to adjustment on transfer pricing groups (see Section I.i, above).

## 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. These proposals have not been taken forward, though no response to the consultation has ever been published.

### ii Penalties

HMRC may impose penalties if an incorrect return is made and a taxpayer has been careless or negligent in establishing an arm's-length basis for the return; or a taxpayer does not maintain adequate records.<sup>29</sup> Penalties may also apply where a taxpayer fails to comply with information requests made by HMRC in the conduct of an enquiry.<sup>30</sup>

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 will depend on a number of factors, including, among others, whether the underlying behaviour that gave rise to the inaccuracy was careless, deliberate, or deliberate and concealed; whether the disclosure was prompted or unprompted; and the quality of disclosure.

Given that transfer pricing is more of an art than a science and identifying 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.<sup>31</sup>

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29 HMRC International Manual (INTM483110).

30 Part 7 of Schedule 36 to the Finance Act 2008.

31 HMRC International Manual (INTM483120).

## IX BROADER TAXATION ISSUES

### i Diverted profits tax and other supplementary measures

DPT was introduced from 2015 to tax profits of multinational businesses that have been diverted from the UK tax net through contrived arrangements.<sup>32</sup> It is intended to provide the transfer pricing legislation with a little more steel to support HMRC enquiries 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 enquiries.

Broadly speaking, a DPT charge can arise in two scenarios: first, where a UK subsidiary or permanent establishment enters into arrangements with a related person where that person or the arrangements lack economic substance, resulting in a reduction in taxable profits; or second, where a person carries on an activity in the UK connected to the supply of goods, services or other property made by a non-UK resident company in the course of its trade in a way that avoids creating a UK permanent establishment. The amount of DPT payable is 25 per cent of the amount of 'taxable diverted profits'.<sup>33</sup> (An error in the DPT legislation meaning that both DPT and corporation tax were technically payable on the amount of taxable diverted profits was corrected in 2019, such that profits charged to DPT are excluded from corporation tax to avoid double taxation.)

In most cases, any DPT charge can be franked by making appropriate transfer pricing adjustments. DPT can accelerate resolution of a transfer pricing enquiry for the following reasons: the DPT rate is considerably higher than the UK corporation tax rate; it is not possible to postpone any DPT payment once a charging notice has been issued; and DPT gives credit for transfer pricing adjustments only if they are made before DPT is assessed.

In 2018–2019, HMRC issued 203 DPT preliminary notices to 11 businesses and 204 DPT charging notices to 13 businesses. HMRC reported that the amount raised from DPT charging notices themselves during the 2018–2019 financial year was only £12 million, though most of the DPT revenue impact comes through transfer pricing adjustments and changes in taxpayer behaviour.<sup>34</sup>

### ii Double taxation

Most of the UK's tax treaties have effective mutual agreement procedures (MAPs). These provisions typically permit HMRC to engage in MAP but do not require the case in question to be resolved. Consequently, there is no guarantee of relief from double taxation under MAP. That said, the UK is generally seen as having a good track record in obtaining relief from double taxation in cases involving transfer pricing adjustments. HMRC resolved 95 MAP cases in the 2018–2019 financial year.<sup>35</sup>

EU Convention 90/436/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. 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

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32 HMRC DPT Guidance (DPT1000).

33 Section 79 of the Finance Act 2015.

34 Transfer Pricing and Diverted Profits Tax Statistics, to 2018–2019.

35 *ibid.*

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 end of the Brexit transitional period. Until then, however, the UK continues to implement EU arbitration provisions, implementing the Double Taxation Dispute Resolution (EU) Regulations in February 2020. It is not clear what (if any) new arrangements the UK will seek to put in place with the EU27 post-Brexit.

MAP is not an alternative to the normal transfer pricing enquiry process. An enquiry will not be conducted as part of MAP and, equally, MAP will not suspend or replace an enquiry. A taxpayer cannot pursue domestic legal remedies and MAP concurrently. If a case is accepted for MAP while domestic legal remedies remain available, HMRC will generally require the taxpayer to agree to suspend these remedies or delay MAP until these remedies are exhausted.<sup>36</sup>

Part VI of the OECD multilateral instrument enables countries to include mandatory binding arbitration (MBA) in their double tax treaties. MBA applies only between countries that expressly choose to apply it to their double tax treaties. Twenty countries (including the UK) have committed to adopt and implement MBA. These provisions will provide taxpayers with certainty that a case submitted to MAP will be resolved.

HMRC is of the view that DPT is a separate, stand-alone charge on diverted profits and is not income tax, capital gains tax or corporation tax. Consequently, HMRC would not make it the subject of a bilateral APA or enter into MAP discussions concerning it. This is another reason why it is important to agree transfer pricing disputes before disputing DPT.

### **iii Consequential impact for other taxes**

#### ***VAT***

Where a business records its transactions with related parties on arm's-length terms, no transfer pricing issues should typically arise in respect of those transactions for VAT purposes. Further, HMRC is of the view that balancing payments do not in themselves create taxable supplies for VAT purposes. However, the existence of a transfer pricing adjustment or the payment or receipt of a balancing payment may indicate that the value of a previous VATable supply has been understated so that a VAT correction may be required.<sup>37</sup>

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.<sup>38</sup>

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.<sup>39</sup>

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36 HMRC Statement of Practice 1/2018.

37 HMRC VAT Valuation Manual (VATVAL 15700).

38 *ibid.*

39 HMRC VAT Valuation Manual (VATVAL 15800).

### ***Import and customs duties***

Similar issues arise in relation to the interaction of the transfer pricing rules with import and customs duties. Balancing payments may have 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 required.<sup>40</sup>

#### **iv Income tax in respect of intangible property**

With effect from April 2019, income tax is charged on income from intangible property received by non-UK residents in low-tax jurisdictions which do not have tax treaties with the UK, to the extent that such income is referable to the sale of goods or services in the UK.<sup>41</sup> Tax is charged on the gross amount of income, rather than on profits.

If the non-UK resident subject to the income tax charge fails to pay, the tax will be recoverable from other entities in the same corporate group (whether or not the other entity is resident or taxable in the UK).<sup>42</sup>

This new income tax charge does not include any arm's-length concept, and applies even if the income is subject to a CFC or GILTI charge higher up the corporate structure. In practice, it is intended to encourage businesses to move intangible property out of low-tax jurisdictions – as most of these countries have recently adopted 'economic substance' requirements, this shift was largely happening anyway.

While this new income tax charge does not fall directly within the scope of the BEPS project, it provides another mechanism to counter circumstances in which multinational enterprises generate significant income from intangible assets through activities in the UK but receive that income in low-tax jurisdictions.

#### **v Digital services tax**

From April 2020, the UK has levied a digital services tax on large search engines, social media platforms and online marketplaces. The tax is levied at 2 per cent of the gross revenues attributable to UK users. The Government has said that this will be a temporary measure, which will be removed if and when international agreement is reached on reforming transfer pricing principles to reflect the growing digitalisation of the economy.

## **X OUTLOOK AND CONCLUSIONS**

The chilly atmosphere that seems to have pervaded many UK transfer pricing disputes lately can be attributed to the spectre of DPT, which has emboldened HMRC to adopt an increasingly assertive approach to policing the transfer pricing of what might be considered commercially conventional licencing arrangements or above-market functions, even in cases which taxpayers and advisers (and perhaps also HMRC) would not have imagined to fall within the intended scope of DPT at the time when it was being designed and consulted upon. In transfer pricing enquiries where DPT is arguably at issue, taxpayers will generally aim to achieve resolution on the basis of a transfer pricing adjustment that eliminates any potential charge to DPT, though such an adjustment is still subject to approval by the

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40 HMRC VAT Valuation Manual (VATVAL 15900).

41 Chapter 2A of Part 5 of the Income Tax (Trading and Other Income) Act 2005.

42 Sections 608O–608V of the above Act.



Diverted Profits Board. If (or when) any cases of this kind come before the courts, the judicial approach to interpreting and applying the DPT rules, which is not a straightforward task, will be closely watched.

Taking a wider view, the UK transfer pricing landscape continues to be reshaped by international tax reform efforts led by the OECD. The original BEPS project increased focus on the functional analysis in applying the transfer pricing rules in the UK, to ensure that transfer pricing outcomes are aligned with the individuals involved in value creation. The much-anticipated OECD Transfer Pricing Guidance on Financial Transactions, published in February 2020, may influence HMRC's approach in subtler ways.

More profound change is potentially around the corner, in the form of the OECD's Pillar One and Pillar Two proposals. It is already clear that the challenge of integrating the conceptual and practical framework of Pillar One (and, to a lesser extent, Pillar Two) with conventional approaches to transfer pricing, and navigating the areas of overlap, will open up new perspectives on fundamental tenets of transfer pricing, in the UK no less than elsewhere.

# UNITED STATES

*Edward Froelich and Jessica Stern*<sup>1</sup>

## I OVERVIEW

### Transfer pricing generally

Given the historically high corporate tax rate in the United States, transfer pricing has been an area of particular concern to the Internal Revenue Service (IRS).<sup>2</sup> Accordingly, the United States has developed a comprehensive regulatory regime to ensure that related taxpayers engaging in cross-border transactions do so at arm's length.

Section 482 of the Internal Revenue Code (the Code or IRC) is the main statutory tool provided to the IRS to combat inappropriate transfer pricing. This statute gives the IRS broad authority to allocate gross income, deductions, credits and other allowances between two or more organisations, trades or businesses owned or controlled by the same interests whenever 'necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses'.<sup>3</sup> 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'.<sup>4</sup> True taxable income is determined by judging transactions between controlled taxpayers against comparable transactions between unrelated persons dealing at arm's length.<sup>5</sup> 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'.<sup>6</sup>

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

1 Edward Froelich is of counsel and Jessica Stern is an associate at Morrison & Foerster LLP.

2 Profit shifting between multinational companies has cost the US government between US\$77 billion and US\$111 billion in corporate tax revenue between 1987 and 2012. Kimberly A Clausing, 'The Effects of Profit Shifting on the Corporate Tax Base in the United States and Beyond', 69 *National Tax J.* 905 (17 June 2016). Not all of this profit shifting arises from transfer pricing abuses, but a significant portion may. However, with the enactment of substantial corporate tax rate cuts and certain cross-border tax legislation effective 1 January 2018, there may be less incentive for multinational US companies to engage in transfer pricing as a tax avoidance vehicle.

3 IRC Section 482.

4 Treas. Reg. Section 1.482-1(a)(1).

5 Treas. Reg. Section 1.482-1(b)(1).

6 IRC Section 482.

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 IRS to undertake a study of the operation of transfer pricing mechanisms, particularly with respect to the exploitation of intangible property, which resulted in the issuance of the Section 482 White Paper in 1988.<sup>7</sup> The Section 482 White Paper led to a series of proposed regulations that were amended repeatedly before being issued in final form in 1994 through 1996. These regulations implemented the commensurate with income standard and introduced new procedural rules and pricing methods for intangible property. They also included new rules for cost-sharing arrangements. In 2009, the IRS proposed an entirely new set of regulations on cost-sharing arrangements, effective for transactions after 4 January 2009, which were adopted in final form in 2012.<sup>8</sup>

### Statutory requirements of Section 482

There are three prerequisites for a reallocation under Section 482. First, there must be ‘two or more organizations, trades, or businesses’. Second, these 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’.<sup>9</sup> 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.<sup>10</sup> 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.<sup>11</sup> 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.<sup>12</sup>

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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., *Dolse 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).

The requirements for ownership or control are similarly broad. Ownership may be direct or indirect. Control may be any kind of control, whether direct or indirect, legally enforceable or not. Control for the purpose of Section 482 also exists where two or more taxpayers are acting in concert or with a common goal or purpose.<sup>13</sup> The regulations make it clear that the reality of the control is what is 'decisive, not its form or the mode of its exercise'.<sup>14</sup> An arbitrary shifting of income or deduction raises a presumption of control. This broad definition of control allows Section 482 to be applied to enterprises owned by different members of the same family or in different proportions by a group of persons.

The final requirement, namely that the IRS make a determination that the allocation is necessary to prevent tax evasion or to clearly reflect the income of any member of the controlled group, is practically meaningless as a prerequisite. If the IRS determines the transfer price adopted by the group is erroneous then, by definition, certain group members' income is not clearly reflected. Allocations affecting taxable income can be made to income, deductions, credits and allowances. The courts have generally upheld a reallocation by the IRS unless the taxpayer is able to prove that the IRS abused its discretion by engaging in conduct that was arbitrary, capricious or unreasonable.<sup>15</sup>

## 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, Treasury Regulation Section 1.482-7(k) requires that cost-sharing agreements 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);<sup>16</sup>
- 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;

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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 F.3d 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.

- i* a description or summary of any relevant data obtained after the close of the tax year but before filing the tax return; and
- 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 obliged to update and maintain the CSA documentation.<sup>17</sup>

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 Treasury Regulation 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.<sup>18</sup>

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 the 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').<sup>19</sup> In general, for tangible property, the CUP, resale price, cost-plus, comparable profits method (CPM), profit split and unspecified methods are all acceptable. For intangible property, the IRS accepts the comparable uncontrolled transaction (CUT), CPM, profit split and unspecified methods. With respect to services, the IRS accepts the services cost, comparable uncontrolled services price, gross services margin, cost of services plus, CPM, profit split and unspecified methods. For CSA buy-ins, technically called platform contribution transactions or PCTs, the IRS accepts the CUT, income, acquisition price, market capitalisation, residual profit split and unspecified methods. The IRS has shown a clear preference for the income method in determining an appropriate buy-in valuation.

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17 Treas. Reg. Section 1.482-7(k)(2).

18 Treas. Reg. Section 1.482-7(k)(4)(iii)(B). If a controlled participant does not file a US income tax return that participant must ensure that the same information is attached to Schedule M of any Form 5471 'Information Return of a Foreign Owned Corporation' or the equivalent foreign partnership form.

19 Treas. Reg. Section 1.482-1(c).

**ii Authority scrutiny and evidence gathering**

In scrutinising a taxpayer's return position, the IRS may request to interview key personnel. The IRS has broad authority under Section 7602 of the Code to examine the books and records of the taxpayer and this can include interviews. Section 7603 empowers the IRS to issue an administrative summons to require a taxpayer to provide information and to submit to an interview; however, a taxpayer can oppose such a summons in court on various grounds such as privilege or administrative defects in the issuance of the summons. Further, the IRS is not limited to seeking information from the taxpayer. The IRS can and does seek relevant information from third parties such as accounting firms who may have advised the taxpayer, outside financial auditors, banks or other parties. Section 7609 of the Code authorises the IRS to issue summons to third parties. In no event is a taxpayer required to create new documentation as the authority of the IRS is limited to an examination of the books and records supporting the filing position.

Interviews are not a routine audit practice. For the most part, a taxpayer will satisfy the IRS information needs through a combination of documents and written responses to questions, called information document requests or IDRs. It can also be helpful to both the IRS examiner and the taxpayer for the taxpayer to make a presentation to the IRS regarding the transfer pricing transactions and supporting economic analysis. Such presentations can feature the key taxpayer personnel who took part in the implementation of the transactions.

Apart from information exchange agreements and treaty provisions, the IRS is generally limited in its authority to obtain information outside the jurisdiction of the United States.

On 30 June 2016 the Treasury Department published final country-by-country reporting rules.<sup>20</sup> The Treasury explained the reasons for adopting these rules in the preamble:

*U.S. MNE groups will be subject to CbC filing obligations in other countries in which they do business if the United States does not implement CbC reporting. Thus, a decision by the Treasury Department and the IRS not to implement CbC reporting will result in no compliance cost savings to U.S. MNE groups. In fact, failure to adopt CbC reporting requirements in the United States may increase compliance costs because U.S. MNE groups may be subject to CbC filing obligations in multiple foreign tax jurisdictions.*

*In addition, CbC reports filed with the IRS and exchanged pursuant to a competent authority arrangement benefit from the confidentiality requirements, data safeguards, and appropriate use restrictions in the competent authority arrangement. If a foreign tax jurisdiction fails to meet the confidentiality requirements, data safeguards, and appropriate use restrictions set forth in the competent authority arrangement, the United States will pause exchanges of all reports with that tax jurisdiction. Moreover, if such tax jurisdiction has adopted CbC reporting rules that are consistent with the 2015 Final Report for Action 13 (Transfer Pricing Documentation and Country-by-Country Reporting) of the Organization for Economic Co-operation and Development (OECD) and Group of Twenty (G20) Base Erosion and Profit Shifting (BEPS) Project (Final BEPS Report), the tax jurisdiction will not be able to require any constituent entity of the U.S. MNE group in the tax jurisdiction to file a CbC report. The ability of the United States to pause exchange creates an additional incentive for foreign tax jurisdictions to uphold the confidentiality requirements, data safeguards, and appropriate use restrictions in the competent authority arrangement.*

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20 Treas. Reg. Section 1.6038-4.

The IRS and 32 foreign tax agencies have entered into competent-authority agreements to exchange taxpayers' global tax and profit reports with foreign jurisdictions. Nine more foreign agencies are in negotiations with the IRS to execute such agreements.

These bilateral agreements would allow US multinationals to file their global tax and profit reports with the IRS instead of with foreign jurisdictions.

#### IV INTANGIBLE ASSETS

The Treasury regulations define the term 'intangible' to include all property that both has 'substantial value independent of the services of any individual' and fits within any of six classes:

- a* patents, inventions, formulae, processes, designs, patterns or know-how;
- b* copyrights and literary, musical or artistic compositions;
- c* trademarks, trade names or brand names;
- d* franchises, licences or contracts;
- e* methods, programmes, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists or technical data; and
- f* other similar items.

For the purposes of Section 482, an item is considered similar to those listed in Paragraph (b)(1) to (5) of this Section (corresponding to the items at (a) to (f) above) if it derives its value not from its physical attributes but from its intellectual content or other intangible properties.<sup>21</sup>

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.<sup>22</sup> 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.<sup>23</sup> 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).<sup>24</sup> Additionally, because of the language in Section 482 requiring that in the case of any transfer or licence of intangible property, 'the income with respect to such transfer or licence shall be commensurate with the income attributable to the intangible', the transfer or licence should be periodically re-examined and potentially adjusted, even if the licence or other agreement provides for no such adjustment.<sup>25</sup>

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21 Treas. Reg. Section 1.482-4(b). The 2018 tax reform legislation changed the definition of intangible to include 'goodwill, going concern, workforce in place, and any other item the value or potential value of which is not attributable to tangible property or the services of any individual'. As noted in the *Amazon* case, this may have a substantial impact on the determination of CSA valuations going forward.

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

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

24 We discuss 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).

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.<sup>26</sup> There is one method that is unique to determining transfer pricing for licences and other transfers of intangible property – the CUT method.<sup>27</sup> As in the case of the determination of tangible property transfer pricing, the CPM and profit split method may be used for intangible property transfers.<sup>28</sup> 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.<sup>29</sup> 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 Independent Office of Appeals. IRS Appeals is engaged only after the taxpayer and the IRS examiners cannot agree on an adjustment.<sup>30</sup> 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.<sup>31</sup> A third method of settlement is through the competent authority process. The competent authority process can be initiated during the examination phase or after an initial settlement conference with IRS Appeals.

Appeals is the official settlement arm of the IRS for disputes arising from audits.<sup>32</sup> It is staffed by appeals officers located in various 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

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

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

28 *id.*

29 Treas. Reg. Section 1.482-4(d).

30 IRS examiners do not have authority to settle cases based on litigation hazards. However, if the examiners and the taxpayers can agree on a particular valuation, for example by agreeing to a discount rate, a transfer pricing dispute can be resolved at the examination level. Examiners will need to have a non-hazards basis on which to agree to such a resolution.

31 In 2006, the Internal Revenue Service settled its transfer pricing dispute with Glaxo SmithKline Holdings (Americas) Inc & Subsidiaries (GSK). At the time this case was being litigated in the US Tax Court it was the largest tax dispute on record. Under the settlement agreement, GSK paid the IRS approximately US\$3.4 billion, and abandoned its claim to a refund of US\$1.8 billion in overpaid income taxes. The Tax Court dispute involved intercompany transactions between GSK and certain of its foreign affiliates relating to various GSK 'heritage' pharmaceutical products. The IRS questioned the amount of US profits reported by GSK after making intercompany payments that took into account product intangibles developed by and trademarks owned by its UK parent, and other activities outside the United States, and the value of GSK's marketing and other contributions in the United States.

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).



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 this analysis with its protest. The IRS audit team then forwards the protest letter to the appropriate appeals office, along with the audit team's written rebuttal to the protest letter. It is possible that the IRS audit team, upon review of the protest letter, may change its legal analysis to respond to the taxpayer's argument, or may in fact be persuaded to concede.

Appeals' review is an informal consideration of the contrasting positions. There is no testimony or formal hearing process. Instead, the appeals officer will convene a series of meetings to assist the officer in evaluating the litigation risks for both sides. It is typical for Appeals to include transfer pricing experts on its team in dealing with these disputes. They may also consult with a staff economist. The first (pre-conference) meeting allows the IRS audit team to explain its position on the various adjustments that it proposes. IRS legal counsel is likely to assist in that presentation. Because an appeals officer may not have *ex parte* communications with the audit team, a taxpayer must be allowed to attend this meeting.

If, after settlement discussions, the taxpayer and the appeals officer agree on a resolution, Appeals will prepare an internal memorandum to record the analysis of the case, and for approval by his or her supervisor. The appeals officer will then prepare either a Form 870-AD or a closing agreement for the taxpayer that contractually binds the taxpayer and the IRS to the terms of the settlement.<sup>33</sup> If no settlement is reached, the appeals officer will prepare either a statutory notice of deficiency, giving the taxpayer the opportunity to seek relief in the US Tax Court, or a Form 870, which obtains the taxpayer's consent to the immediate assessment and collection of any tax due. Most taxpayers will elect to receive a statutory notice of deficiency. However, some may wish to pursue their case in court after payment of taxes, and so will request a Form 870, pay the tax due and begin proceedings for filing a tax refund action in federal district court or the US Court of Federal Claims.

## VI INVESTIGATIONS

As with any IRS examination, the first step of an audit is the delivery of a notice of audit letter, sometimes called an appointment letter. This is a standardised letter that is sent to the taxpayer's address on file and, along with identifying the year or years under audit, includes a request for certain general business information and proposes a time for a meeting. What precedes the selection of a taxpayer for audit is a process of risk analysis. The IRS reviews income tax returns and, through a combination of algorithms and review of disclosure forms, decides which taxpayers present the highest compliance risk. Schedule UTP<sup>34</sup> 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. It has adopted what is called a

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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.

34 Uncertain Tax Position.

‘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 of the time of filing of the return. The IRS can request the taxpayer to agree to extend the assessment period. This is usually in the taxpayer’s interest because otherwise the IRS will be forced to make a protective assessment, which will always be an inflated amount.

## VII LITIGATION

### i Procedure

If efforts to resolve an issue within the administrative apparatus of the IRS have failed, a taxpayer has the option to file suit in federal court. A taxpayer thus is able to have its ‘day in court’ on the tax issue that the IRS has raised. As a matter of jurisdiction, there are four potential judicial venues in which to raise a federal tax claim: the US Tax Court, the US Court of Federal Claims, a federal district court or a bankruptcy court.

With the exception of the Tax Court, the above-mentioned courts hear tax cases just as they hear any other dispute that comes before them. They follow the Federal Rules of Civil Procedure (or similar versions of those rules) and apply the Federal Rules of Evidence at trial. They allow for a full range of discovery of the IRS, dispositive motions, oral arguments, motions *in limine* and trial, as well as all post-trial procedures, including appeal rights to a federal appellate court, and thereafter the ability to petition the court of last resort, the US Supreme Court.<sup>35</sup>

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

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<sup>35</sup> 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.

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 the choice of forum.

## ii Recent cases

Several major companies are disputing proposed IRS adjustments, including Coca-Cola, Inc, which is disputing in the Tax Court a US\$9 billion proposed transfer pricing adjustment, Facebook, Inc, Western Digital Corp, Microsoft Corp, and the 3M Company. Recent court decisions include *Amazon v. Commissioner*, *Medtronic v. Commissioner*, and *Altera v. Commissioner*.

### *Amazon*

Amazon's dispute is indicative of current IRS enforcement practices in the transfer pricing area. Like many multinational companies, Amazon entered into cost-sharing agreements with its foreign subsidiaries. Pursuant to the applicable Treasury regulations, those subsidiaries were required to make 'buy-in' payments to reflect the value of pre-existing intangibles provided by Amazon for the development of the operations of its foreign subsidiaries. Among other issues, the IRS in audit focused on the value of the buy-in payment. To that end, the IRS audit team engaged outside economists to analyse and opine on the value of the pre-existing intangibles. The economists issued a report that concluded that the value of the intangibles was more than 10 times higher than the value used to determine the buy-in payment. The economists used a specific valuation method, the discounted cash-flow method and collected three sets of data (future cash-flow estimates, cash-flow timing and a discount rate) in the application of that method. In its petition to the Tax Court, Amazon attacked the discounted cash-flow method and compared it to the method used by the IRS in *Veritas Software v. Commissioner*, in which the Tax Court found that the IRS's determination was arbitrary, capricious and unreasonable.<sup>36</sup> Amazon prevailed in the Tax Court. On 23 March 2017, in a reviewed decision of the Tax Court, Judge Lauber rejected the IRS's US\$3 billion proposed transfer pricing adjustment against the online retail giant. Because of the IRS's unreasonable disregard of certain critical facts, the Tax Court determined that the IRS had abused its discretion and threw out the proposed deficiency. The Tax Court then considered Amazon's specific transfer pricing determinations and agreed with some and disagreed with others and came to a final ruling largely upholding Amazon's tax return position. The Ninth Circuit affirmed the Tax Court on the sole ground that the IRS erroneously interpreted the regulatory definition of intangibles to include 'residual business assets' such as going concern value and goodwill and thereby erroneously inflated the value of the intangibles that were transferred by Amazon to its foreign subsidiaries.<sup>37</sup>

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

37 *Amazon.com, Inc & Subsidiaries v. Commissioner*, 934 F.3d 976 (9th Cir. 2019). The Ninth Circuit did note that the expanded definition of intangibles introduced by the 2018 tax reform legislation includes such residual assets, however that definition did not apply to the tax years at issue in the case. Moreover, it is still a question whether, where a transfer would not, at arm's length, include such residual assets, the IRS can

### **Medtronic**

In August 2018, the US Court of Appeals for the Eighth Circuit vacated and remanded a 2016 decision of the US Tax Court. The US Tax Court had ruled that the IRS had abused its discretion in determining its proposed transfer pricing adjustment, but also did not completely accept the taxpayer's methodology. Instead, the Tax Court fashioned its own solution in the US\$1.36 billion tax dispute. Medtronic, a Minnesota corporation, is a leading medical technology company, servicing clients around the world. Medtronic has an affiliate in Puerto Rico called MPROC that manufactures cardiac rhythm disease management and neurological devices and leads. In 2002, the IRS audited Medtronic. The Commissioner was concerned that Medtronic was shifting too much money to its affiliate, MPROC. Medtronic, in turn, agreed to lower the amount being shifted to the Puerto Rican affiliate. The agreement specified that the royalty rates for MPROC would be 44 per cent for devices and 26 per cent for leads. This agreement was memorialised in a memorandum of understanding (MOU). The Commissioner reviewed Medtronic's tax returns for 2003 and 2004 and agreed with how the MOU was being applied.

In 2007, the IRS again audited Medtronic and determined that Medtronic owed an additional US\$84 million because of a revision under the MOU. In 2009, the Commissioner determined that MPROC's royalty payments should be increased by another US\$455 million. Medtronic appealed this and in 2010, it was sent back to the Commissioner for re-examination at his request. In December 2010, after consulting with an expert, the Commissioner issued Medtronic a notice of deficiency for approximately US\$1 billion for 2005 and 2006. In July 2014, the Commissioner adjusted the deficiencies up to US\$1.36 billion.

The Tax Court had to determine whether the IRS had abused its discretion in proposing the deficiency. In its analysis there were two main considerations: whether the Commissioner abandoned a prior position; and whether the Commissioner's adjustments were unreasonable because they did not give enough credit to the work MPROC does. The Court found that because the Commissioner was not bound by positions taken in a previous year, the Commissioner had not abandoned the position taken. However, the Court sided with Medtronic in finding that the Commissioner's allocations were arbitrary, capricious and unreasonable, because the expert report that the Commissioner relied on to determine the allocations did not give the appropriate weight to MPROC's role in the production process. The IRS had determined that MPROC was merely a routine manufacturer and thus shifted 90 per cent of the income back to Medtronic. On the contrary, the Court determined that MPROC had significant independent responsibility, particularly with regard to quality control. This was especially important considering that the products being manufactured were medical technologies used in life or death situations. Thus, concluded the Tax Court, MPROC was far from an average manufacturer and the profits should not be allocated to the US parent as asserted by the IRS. However, the Tax Court did not accept the taxpayer's transfer pricing methodology and proceeded to evaluate the evidence before it to determine a different transfer price. Among other things, the Tax Court looked to the pricing of similar medical devices that the taxpayer and a third party agreed to in settlement of litigation.

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require valuation of such transfers to include a valuation of residual business assets. See 'Amazon Prevails in Ninth Circuit – Government Opportunism Rejected', by Edward L Froelich, 16 September 2019, at [www.mofo.com/resources/insights/190916-amazon-prevails-ninth-circuit.html](http://www.mofo.com/resources/insights/190916-amazon-prevails-ninth-circuit.html).

The Court of Appeals vacated and remanded the case to the Tax Court. It held that the Tax Court did not adequately support its adoption of its methodology in light of the applicable Treasury regulations. It instructed the Tax Court to apply specific regulations, such as Treasury Regulation Section 1.482-1(d)(3)(ii)(A)(1), which requires a determination of comparability between the transaction at issue and the proposed comparable uncontrolled transaction. On remand, the Tax Court has considered retaining its own expert to assist it in developing its analysis and the parties are preparing for trial.

### ***Altera***

In this case, the US Tax Court invalidated final cost-sharing regulations which required parties to include stock-based compensation costs as costs to be shared in a CSA. In 2019, the Ninth Circuit, in a 2–1 panel decision, ultimately determined that the regulations were valid and satisfied certain statutory procedural requirements. While the issue was settled in the Ninth Circuit (barring a reversal by the Supreme Court), taxpayers residing in other circuits can continue to rely upon the Tax Court decision. The matter is currently pending before the Supreme Court, where the taxpayer has filed a petition for *certiorari*.

## **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 a review of IRS appeals and settlement of any such penalty and can also dispute penalties in court.

## **IX BROADER TAXATION ISSUES**

### **i Diverted profits tax and other supplementary measures**

The United States does not impose a diverted profits tax (DPT). It is unclear whether payment of such a 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.

Other measures have been adopted that could substantially affect transfer pricing structures, specifically significant tax-reform legislation effective on 1 January 2018. The legislation reduced the corporate tax rate from 35 per cent to 21 per cent. This reduction alone will cause many US multinationals to reassess their foreign structures and their transfer pricing arrangements. Given the competitive US rate, some multinationals may seek to locate income in the US by way of revised transfer pricing agreements. In addition to the rate reduction, the legislation introduced two new cross-border taxes: the base erosion and anti-abuse tax (BEAT) and the global intangible low-taxed income tax (GILTI). Both were created to combat base erosion conduct of US multinationals. In light of these taxes, US taxpayers will re-evaluate their foreign structures and intercompany agreements to minimise their exposure. Finally, a taxpayer-favourable tax change, the foreign-derived intangible income (FDII) provision encourages US taxpayers to keep IP in the United States. FDII reduces the tax rate on export income involving IP owned by the US corporation.

## **ii Double taxation**

Taxpayers can request the assistance of the US competent authority when the taxpayer believes that the actions of the United States or a treaty country result or will result in taxation in violation of treaty provisions. The US competent authority can assist taxpayers under the mutual agreement procedure articles of US tax treaties through consultations with the applicable foreign competent authorities but may also unilaterally act. The grant of the authority by the mutual agreement procedure articles of US tax treaties is separate from and in addition to the authority under the mutual agreement procedure articles for the US competent authority to consult generally with foreign competent authorities to resolve difficulties or doubts regarding treaty interpretation or application, irrespective of whether the consultation relates to a current matter involving a specific taxpayer.

There are two offices within the US competent authority: the Advance Pricing and Mutual Agreement (APMA) programme office, and the Treaty Assistance and Interpretation Team (TAIT) office. APMA handles issues relating to the business profits and associated enterprises articles of US tax treaties and will handle double taxation issues that arise as a result of an allocation made by the IRS under Section 482 or by a foreign tax authority under its own version of Section 482. TAIT handles issues arising under other articles of US tax treaties.

## **iii Consequential impact for other taxes**

The United States does not impose value added tax or goods and services tax.

Transfer pricing adjustments proposed by the IRS typically propose a decrease in the value of the imported goods (which would result in a refund of duties to the importer). This is the opposite of what the customs agency, US Customs and Border Protection (CPB), typically proposes (i.e., higher import prices and therefore duties). In general, CPB will accept adjustments resulting in a refund of duties to the importer if certain criteria are met; for example, that a written transfer pricing determination policy has been adopted prior to importation and the policy takes into account Section 482 of the Code. CPB also encourages importers to report adjustments using its reconciliation programme, which allows for initial pricing to be provided to CPB with the understanding that it may be subject to change.

## **X OUTLOOK AND CONCLUSIONS**

Cross-border transactions in general will remain a high priority for scrutiny and tax enforcement in the United States. Transfer pricing is probably the highest-priority issue within this general category of transactions. The IRS has already identified one type of transfer pricing transaction (inbound distributors) as a formal campaign audit issue but has also indicated that transfer pricing generally is a top enforcement issue.<sup>38</sup> The IRS Commissioner has publicly stated his desire to keep fighting taxpayers in what the IRS perceives to be abusive transfer pricing cases.

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38 As further evidence of this, on 12 January 2018, the Commissioner of the IRS Large Business and International Division (LB&I) issued memoranda with instructions on transfer pricing selection, including instructing examiners to suspend examination of new stock-based compensation issues in cost sharing arrangements and to obtain supervisory approval before changing taxpayers' selection of best transfer pricing method. The IRS is clearly focused on ensuring appropriate cases are brought to court.

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 to implement tax reform. Further, guidance to IRS examining agents shows that the IRS plans to increase imposition of transfer pricing penalties under Section 6662(e).<sup>39</sup> Also, the US participation in the BEPS project will continue to form the landscape for transfer pricing, though the US has noted opposition to proposed digital taxation schemes.

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39 IRS Directive LB&I-04-0118-003, 'Instructions for Examiners on Transfer Pricing Issue Examination Scope – Appropriate Application of IRC Section 6662(e) Penalties', instructs examining agents to actively consider imposing the penalty where the taxpayer has failed to provide adequate, contemporaneous documentation on time.

# VENEZUELA

*Alberto Benshimol, Humberto Romero-Muci and José Valcillos<sup>1</sup>*

## I OVERVIEW

The Venezuelan Income Tax Law sets out 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 Organisation for Economic Co-operation and Development Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the OECD Guidelines), which are applicable on a supplementary basis provided that they are congruent with the Venezuelan Income Tax Law and international treaties signed by Venezuela. The OECD Guidelines are commonly applied in Venezuela and certain tax courts have used them as a source for interpreting the Venezuelan transfer pricing rules.

Venezuelan transfer pricing rules apply to transactions between Venezuelan taxpayers and related parties, and they cover both income and capital transactions. Following the OECD Model Tax Convention, the Venezuelan transfer pricing rules define related parties as any enterprise that participates directly or indirectly in the management, control or capital of another enterprise, or when the same persons participate directly or indirectly in the management, control or capital of both enterprises. In addition, companies incorporated in low-tax jurisdictions for Venezuelan tax purposes conducting transactions with Venezuelan taxpayers are presumed to be related parties.

The Venezuelan tax authorities may adjust the profits reported by Venezuelan taxpayers by imputing income or reducing or denying deductions if transactions have been entered into between related parties on non-arm's-length terms. Transfer pricing adjustments only generate income tax consequences and do not have any other legal implications.

The accounting treatment given by a Venezuelan taxpayer to a related-party transaction does not affect the technical position taken by the taxpayer for Venezuelan income tax purposes or its risk of challenge if the 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 of the end of the fiscal year.

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The reportable information about related-party transactions carried out during the fiscal year includes, among other items:

- a* the related parties involved;
- 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 or methods used to set the transfer prices, indicating the criteria and objective elements considered to determine that the method used is the most adequate;
- 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 out the following pricing methods as being 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 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, may be deemed appropriate if the Venezuelan taxpayer can prove that the transactions are very interrelated and that they cannot be evaluated on a separate basis.

In certain audits, the tax authorities have challenged the use of a pricing method other than the CUP method. In *Veneasistencia, CA v. República de Venezuela*<sup>2</sup> 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, the tax authorities sometimes ask whether any of the affiliated companies have 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 these 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 those two 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,

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2 Venezuelan Supreme Court, 27 November 2012.

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 substantive development, support or exploitation of the intangible asset is based to justify a higher than passive return; however, these issues are not exempt from consideration and the tax authorities could try to raise them during an audit based on the OECD Guidelines.

The development, enhancement, maintenance, protection and exploitation functions (known as 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 this 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 out in the Venezuelan Tax Code, the tax authorities have six years after the closing of a fiscal year in which to audit that fiscal year. The six-year limit applies to the extent that the taxpayer has filed the applicable tax returns. If the taxpayer has failed to file the applicable tax returns, the period is extended to 10 years.

After a transfer pricing audit has commenced, the tax authorities are limited by the general statute of limitations period to close the audit. Typically, the investigation period in a

transfer pricing audit before the tax authorities issue an assessment ranges from six months to two years. The assessments must be based on factual findings and Venezuelan law. Once the tax authorities issue an assessment and make a transfer pricing adjustment the taxpayer has 15 business days to decide whether it accepts the assessment. If the taxpayer decides to challenge the assessment, the taxpayer has five months to file a defence brief and submit evidence to rebut the tax authorities' position.

The tax authorities have one year to issue a final decision regarding the taxpayer's defence brief, and if the tax authorities do not decide within the one-year period the administrative procedure is deemed void. The tax authorities may accept the taxpayer's arguments contained in the defence brief and modify or completely annul the adjustment, or they can also dismiss the defence brief with appropriate legal and technical arguments. If the tax authorities uphold the assessment, the taxpayers have 25 business days to:

- a* accept the decision and pay the assessment, applicable penalties and interest;
- b* file an administrative appeal before a higher tax-authority office; 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 of the tax authorities upholding 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 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 out 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 *Coca-Cola FEMSA de Venezuela SA v. Bolivarian Republic of Venezuela*<sup>3</sup> the tax court annulled two transfer pricing assessments issued by the Venezuelan tax authorities in connection with deductions taken for the purchase of raw materials, fixed assets and the payment of interest to related parties. The tax authorities examined the application of the transactional net margin method (TNMM) and the comparable uncontrolled price method made by Coca-Cola FEMSA to determine its transfer prices, concluding that certain transactions were not at arm's-length terms. Coca-Cola FEMSA appealed the assessments and the Tax Court granted all Coca-Cola FEMSA's claims, making the following rulings:

- a* Application of the OECD Guidelines is mandatory: the court ruled that the OECD Guidelines were an integral part of the Venezuelan legal system, except for when it contradicts international treaties signed by Venezuela, and the Income Tax Law, which, in turn, has mandatory rules that must be applied and followed on matters not expressly regulated by the Income Tax Law.
- b* The principle of annuity for Venezuelan income tax does not apply when comparing related transactions: when comparing transactions between related parties, it is more accurate to use the effective annual interest rate than the nominal interest rate. For this reason, the court ruled that Coca-Cola FEMSA correctly considered all the years implicated in the loan agreement with a related party to determine the effective annual interest rate.
- c* The OECD Guidelines do not prohibit using comparable enterprises with losses: it was concluded that, after analysing the OECD Guidelines, there is no prohibition against using comparables with financial losses, given that a comparable enterprise can realise genuine losses.
- d* It is possible to compare enterprises that commercialise different products: the search for identical products is unnecessary and there is no justification for excluding the comparison of companies with different products. The Tax Court indicated that under the OECD Guidelines and when applying the transactional net margin method, the relevant aspects of the comparable enterprises are:
  - the economic sector in which they operate;
  - their competitiveness;
  - their production capacity;
  - ease of market entry;
  - management efficiency;
  - individual strategy;
  - assumed risks;

<sup>3</sup> 7th Tax Court of Caracas, 14 August 2017.

- variations in the companies' cost structure; and
  - their degree of experience in their field.
- e Multi-year data can be applied to obtain a complete understanding of facts and circumstances surrounding a controlled transaction in a volatile environment: this conclusion was based on the OECD Guidelines Paragraph 3.44 and acknowledged that the volatile economic environment in Venezuela – as evidenced by data of the Venezuelan Central Bank – had affected the financial results of Venezuelan companies during the years concerned with the tax assessments; therefore, Coca-Cola FEMSA correctly adjusted some data when determining if its prices were at arm's length.
- f Profit margin may be adjusted to median point of arm's-length range if the principles of reasonableness and proportionality are met: the Tax Court established that adjusting the profit margin to the median point of the arm's-length range, as performed by the tax authorities in the assessments made to Coca-Cola FEMSA, is not a mandatory adjustment under the Income Tax Law and the OECD Guidelines. However, the Tax Court indicated that, if this adjustment is made, it needs to be sufficiently justified by the tax authorities and meet the principles of reasonableness and proportionality.

The decision by the Tax Court to annul the assessments can be appealed by the tax authorities before the Venezuelan Supreme Tribunal of Justice, which is the court of last resort.

In *Brightstar de Venezuela v. Bolivarian Republic of Venezuela* (5th Tax Court of Caracas 23 February 2017) the tax court annulled a transfer pricing adjustment, holding that the tax authorities did not follow the 2010 OECD Guidelines, which required that the segmented financial information of the audited transaction under the transactional net margin method be taken into account.

In *Sodexo Pass Venezuela v. República Bolivariana de Venezuela*<sup>4</sup> the claimant (Sodexo 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 Sodexo 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, Sodexo Pass Venezuela should have used an active rate such as the prime rate. In this case, the tax court ruled that Sodexo 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*<sup>5</sup> 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 an expert report, and not a

4 8th Tax Court of Caracas, 15 December 2016.

5 9th Tax Court of Caracas, 30 September 2014.

simple expert witness, was the adequate means of proving that the interest rate was established on arm's-length terms. Therefore, the tax court upheld the transfer pricing adjustment on the basis of lack of evidence.

## **VIII SECONDARY ADJUSTMENT AND PENALTIES**

The tax authorities are not entitled to impose secondary adjustments. If the tax authorities have conducted a transfer pricing audit and issued an assessment that has either been accepted by the taxpayer, upheld or revoked by the tax authorities or a tax court, the tax authorities are not allowed under the Venezuelan Tax Code to investigate the same tax, transactions and fiscal years that were subject to the assessment.

Under the Venezuelan Tax Code, the penalties for underpayment of taxes resulting from transfer pricing adjustments are the same as those applicable to the underpayment of taxes resulting from other types of assessment. The penalty for underpayment varies depending on whether the taxpayer has accepted the assessment at an early stage of the audit procedure. If a taxpayer accepts and pays the assessment within 15 days of the issuance of the assessment, the penalty for underpayment is 30 per cent of the amount of the taxes underpaid. If the taxpayer has not accepted the assessment and the tax authorities have upheld the assessment, the penalty for underpayment ranges between 100 per cent and 300 per cent of the amount of the underpayment. Under the general principles set out 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, and file an appeal arguing a mistake of law, but most of the appeals filed are still pending a decision.

## **IX BROADER TAXATION ISSUES**

### **i Diverted profits tax and other supplementary measures**

To supplement transfer pricing rules, in 2007 Venezuela enacted thin capitalisation rules that limit the deduction of interest paid to related parties if a 1:1 debt-to-equity ratio is exceeded. The debt-to-equity ratio and the related-party interest deduction allowed are calculated using the method provided in the Venezuelan Income Tax Law. Additionally, the Venezuelan thin capitalisation rules provide that debts between related parties that are not on arm's-length terms must be recharacterised as equity and, therefore, interest paid on such debts is 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 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 an 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 for other taxes**

Under Venezuelan laws transfer pricing adjustments only have effects for income tax purposes. If the tax authorities have made a transfer pricing adjustment to the taxable profits of a taxpayer, it could be the case that the tax authorities later begin an audit on VAT or import and custom duties matters to determine whether there has been an underpayment of those 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 focused on raising tax revenue through other measures, and the transfer pricing rules have not been further developed. Currently, the tax authorities have been active in conducting transfer pricing audits and the tax courts have begun to rule on certain transfer pricing disputes, but most cases are still pending resolution.

Venezuelan authorities have not published their aim to implement standards provided by the BEPS Action Plan on transfer pricing matters, but it is possible that they will be incorporated in the future under the current transfer pricing rules, which must be revised to adapt them to the new standards for the application of the arm's-length principle.



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Marcos Ribeiro Barbosa has been acting in tax consulting, direct and indirect taxes, M&A and reorganisations for 30 years and he is a member of the boards of several companies. Marcos has a postgraduate degree in taxation from the Pontifical Catholic University of São Paulo (PUC) School of Law and the University of São Paulo (USP); a Bachelor of Laws from the University of San Francisco (USF) Law School in Brazil; and a Bachelor of Accounting from the Santo André Foundation in Brazil. Marcos speaks Portuguese and English.

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Alberto has represented corporate clients such as Bristol-Myers Squibb, Brown Brothers Harriman, Citigroup Private Bank, Henkel, Coca-Cola FEMSA, GE, HSBC, JPMorgan, Procter & Gamble, Mexichem, Rolex, Rosneft and Toshiba in domestic and international tax matters. He has been recognised as a leading Venezuelan tax practitioner in numerous surveys, such as *Chambers*, *Who's Who Legal*, *World Tax*, *Latin Lawyer* and *Practical Law*. Alberto was a member of the Venezuelan team that conducted and completed the negotiations for the US–Venezuela tax treaty in 1998. In 1997, he was an international associate at Wilmer, Cutler & Pickering in Washington, DC.

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Mukesh Butani is the managing partner of BMR Legal Advocates. Specialising in corporate international tax and transfer pricing, he has significant experience in advising Fortune 500 multinationals and large Indian business houses on a wide range of matters relating to FDI policy, business reorganisations, cross-border tax structuring, tax controversy and regulatory policy across a range of sectors.

Mukesh participated in the Kelkar task force (2002) tax reforms and was a member of the Indian Ministry of Finance (MoF) committee (2000) on e-commerce taxation. He is presently representing the International Chamber of Commerce, Paris (ICC) on the MoF Standing Committee on TDS and Foreign Tax Credit.

Mukesh has served as a member of the expert task force on international tax and transfer pricing set up by the MoF in July 2012. He was a member of the tax bureau of OECD-BIAC and the Permanent Scientific Committee of the International Fiscal Association (IFA) (2012–2016) and he is vice chairman of the Taxation Commission of the ICC in Paris (as of 2011).

He served as a member of a focus group on administrative practices on tax disputes under the Tax Administration Reform Commission (TARC) of the MoF. He is also a founder member (2015) of ITRAF, a think tank carrying out research and analysis on international taxation to ensure superior tax policy and effective tax administration in India, and chairman of the India Branch of the IFA.

Mukesh is a commerce graduate from the University of Mumbai and also holds a bachelor's degree in law. He qualified as a chartered accountant in 1985 and enrolled as an advocate in 2010. He is a member of the Bar Council of Delhi and practises in various tribunals, high courts and the Supreme Court of India.

Mukesh is a trustee at the Foundation of International Tax, and Joint Conference Director with IBFD for its annual conference, which is in its 25th year. He is part of the visiting faculty for the LLM in international tax and the advanced transfer pricing programme at the WU Transfer Pricing Center, Institute for Austrian and International Tax Law, Vienna University of Economics and Business, and ADIT committee member at the UK Chartered

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Steve Edge, who qualified with Slaughter and May in 1975, acts for clients across the full range of the firm's practice.

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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. He thus has considerable experience of negotiating and dealing with HMRC at all levels.

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She has developed a broad expertise in the design and implementation of intra-group corporate restructurings, including in post-merger situations, as a result of the outcome of the OECD BEPS project and its impact on related domestic legislation. Elina and her team also frequently advise on the topic of allocation of profits to Greek permanent establishments of foreign enterprises. She is often engaged in the negotiation of bilateral APAs involving the Greek tax authorities, and she has extensive experience in transfer pricing audits and related disputes.

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He has also provided advice to domestic and international legal entities on direct and indirect tax matters and on administrative (tax, customs) and court procedure. His practice

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Humberto has represented clients such as Coca-Cola FEMSA, Brightstar Corporation and Sodexo in important tax and transfer pricing disputes. He also provides tax and legal advice to multinational companies such as Weatherford International, Zurich Insurance, FerroGlobe and Procter & Gamble on corporate tax issues. 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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Raúl Salas Lúcia is the leading tax partner in the tax practice at Roca Junyent in Madrid. With over 20 years of experience, he has participated in some of the most significant M&A and real estate operations in the Spanish and European markets.

Raúl has led the teams advising several large international groups in litigation with the Spanish tax authorities and tax authorities from other European countries. As well as M&A, his areas of specialisation include tax advice for financial institutions, and energy and infrastructure companies.

Raúl has been recognised as one of the leading tax lawyers in Spain by independent directories such as *Chambers* and *The Legal 500*, and also by the prestigious British publisher Euromoney.

Before joining Roca Junyent, he was the leading partner in Baker McKenzie's corporate tax practice, which won Spain Transfer Pricing Firm of the Year, awarded by *International Tax Review*, in 2011, 2013, 2014 and 2017.

He has published numerous articles in specialist magazines and financial newspapers, and has contributed to various publications, and has been a guest speaker in seminars and courses on tax issues.

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João Victor Guedes Santos works with tax and provides corporate advice in general. He is recognised for his expertise in domestic and international tax planning, corporate structures, wealth and estate planning, and taxation of financial instruments. His experience abroad includes a period as foreign associate at Grant, Herrmann, Schwartz & Klinger LLP, in New York, and at Uría Menéndez in Madrid. João has a Master of Laws in tax law from the University of São Paulo (USP); an LLM in international taxation from the University of Florida (LAC scholarship); a specialist qualification in international taxation from the Brazilian Institute of Tax Law (IBDT); a Bachelor of Laws from USP; and a Bachelor of Administration from the Getúlio Vargas Foundation (FGV). João speaks Portuguese, English and Spanish.

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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

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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, Stephan has been admitted to the German tax bar. He holds a German doctoral degree and a master's degree in business administration, as well as a US master's degree in economics. Stephan is a member of the German Association of Tax Advisers and a member of the International Fiscal Association.

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She has published numerous articles in specialist magazines and has contributed to various publications, and she has been a frequent guest speaker at seminars and courses on tax issues.

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He obtained his law degree at the Metropolitan University in 2007 and received his LLM in taxation from Georgetown University Law Center in 2014.

José is currently ranked as a 'next generation lawyer' by *The Legal 500* in the 2018 tax rankings for Venezuela. He is also the Venezuelan representative for the Venezuelan Branch of the International Fiscal Association's Young IFA Network (YIN). He often participates as a speaker in tax forums and has published articles on tax matters such as the Venezuelan taxation of hybrids.

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Heleen assists and manages multiple transfer pricing projects for large and smaller multinational entities, providing tax, transfer pricing and valuation services. Furthermore, she is involved in global transfer pricing design and overall alignment, conversion of business operations and overall transfer pricing documentation. In addition, Heleen assists in the negotiation of APAs and rulings and is involved in assisting companies during transfer pricing audits.

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In 2012, Lisa completed her master's degree, *cum laude*, in corporate tax law at Bocconi University and currently attends the University of Milan Faculty of Law. Her experience includes domestic and international tax matters, IFRS, transfer pricing and the patent box regime. Lisa has attended some advanced transfer pricing classes at IBFD in Amsterdam.

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