Worldwide Trends in Transfer Pricing

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In this article, the authors examine common transfer pricing issues arising in audits across the globe and emphasize the importance of maintaining comprehensive local files to document factual, functional, and economic analyses to ensure compliance and reduce risk.

This article examines common transfer pricing issues that tax authorities across the globe are increasingly focusing on, as informed by our own experiences. International disputes are constantly evolving, and some recent trends we have observed include:

- challenges based on the effect of government incentives;
- heightened scrutiny of local documentation, including a focus on operating expense ratios;
- required substantiation of development, enhancement, maintenance, protection, and exploitation (DEMPE) functions;
- a resurgence of the deductibility and cost allocation challenges that were common in the late 1990s and early 2000s;
- a focus on interest rate issues; and
- increased assertion of penalties.

The case studies below address these common transfer pricing issues in several representative jurisdictions: Canada, Greece, South Korea, the Netherlands, Peru, and the United States.

Canada

In Canada, the Canada Revenue Agency is increasingly focused on transfer pricing adjustments for government incentives. The CRA has a long-standing administrative policy that tax credits associated with government incentives should not be included in cost-based transfer pricing analyses. The CRA takes the position that taxpayers should not reduce their cost base by the

amount of the government incentive received unless there is reliable evidence that arm's-length parties would do the same in similar circumstances. The CRA maintains that taxpayers would be unlikely to pass government incentives received on to unrelated taxpayers.

Over the years, we have seen a rise in CRA transfer pricing audits focused on the reduction of a Canadian taxpayer's cost base by the governmental incentive received. Adjustments are frequently seen for cost-plus service providers and are common in tech, software, gaming, and similar sectors regarding the interactive digital media credit (a credit for corporations that develop interactive digital media products). These issues also arise in manufacturing, specifically regarding COVID-19 relief measures and the Canada Emergency Wage Subsidy (a program designed to help businesses that experienced a drop in revenue retain and pay employees during the COVID-19 pandemic).

The CRA's stated grounds for these audit adjustments are: (1) arm's-length parties should not pass through similar government incentives to their customers; (2) intercompany agreements do not have provisions for dealing with government incentives of this type; and (3) the functional profiles of the service recipients do not justify the passthrough of the incentives.

The rise in CRA transfer pricing adjustments pertaining to government incentives provides taxpayers with a few key takeaways:

- Transfer pricing documentation should include evidence and support for the position that the relevant incentives would flow through to the service recipient at arm's length.
- The CRA's administrative position suggests that a discussion with the field auditor will likely be unproductive given the field auditor's limited discretion.
- Using the competent authority process in the relevant treaty is usually the most effective way of resolving this type of issue if the CRA chooses to make an adjustment. However, taxpayers should look carefully at each legal entity's tax position and tax attributes to ensure that effective correlative relief is available. Further, the best practice is to ensure that notices of objection are filed simultaneously on a protective basis to keep the relevant tax years open under the statute of limitations.
- Taxpayers should be aware of and comply with the notification requirements under the relevant tax treaty. For instance, under the Canada-U.S. treaty, the CRA and IRS must be notified within six years of the end of the relevant tax year to ensure access to competent authority relief in cases of actual or potential double tax.
- To the extent the issue exists in subsequently filed tax years that have not yet been subject to audit, it may be possible to include those years in a competent authority submission under the accelerated competent authority procedure or in an advance pricing agreement with rollback.

We expect this focus on government incentives to continue in both Canada and other global jurisdictions. In the United States, under the Inflation Reduction Act, we anticipate that the government may provide incentives or governmental support similar to what we are seeing in Canada. We think the IRS will be measured in its approach to how relief is provided in these cases. Moreover, as countries around the world encourage clean energy and similar activities, we can look for a continued increase in controversies involving the treatment of government incentives.

Greece

In our recent experiences, Greece's tax authority, the Independent Authority for Public Revenue (IAPR), has taken an aggressive approach toward transfer pricing audits. The IAPR regularly targets companies based on their benchmarking studies. It is thus important that studies are localized for use in Greece and that they strongly support the company's transfer pricing.

In one recent case in which the IAPR closely scrutinized local documentation, it rejected a taxpayer's benchmarking study supporting a routine distributor operating margin for a Greek subsidiary of a U.S. multinational enterprise. The IAPR argued that the three-year testing period used should have commenced one year earlier,

and it rejected the taxpayer's analysis entirely on that basis. The IAPR performed its own benchmarking study, concluded a higher interquartile range for the routine distributor return, and proceeded with an upward adjustment.

The IAPR has also increased focus on the operating expense-turnover ratio of taxpayers compared with benchmarked comparables, making adjustments when the taxpayer's ratio is significantly higher in comparison. The IAPR asserts that this adjustment is required to reflect the additional marketing activity of the taxpayer. For distribution activities, companies should consider conducting a comparison of their operating expense-turnover ratio against benchmarked comparables to understand their potential audit risk.

Similar issues are frequently seen in other jurisdictions, particularly in India, where marketing advertisement promotion comparables are typically less operating expense intensive compared with tested parties. The OECD efforts on OECD pillar 1 amount B, which look to similar operating assets-sales ratios, have also intensified the focus on the pricing of marketing and distribution activity.

South Korea

Operating expenses have also been under increased scrutiny by tax authorities in South Korea and China. In one example, a South Korean MNE with a Chinese subsidiary filed an APA request in 2017 for tax years 2017-2022. During the proposed APA years, the Chinese subsidiary's operating margin exceeded the upper quartile of the benchmarked arm's-length range. As a result, the State Taxation Administration (STA) of China would owe the Chinese subsidiary a refund under the terms of the APA. However, the STA is not generally permitted to give a refund during a pending APA or mutual agreement procedure case.

During the same period, the National Tax Service (NTS) of South Korea initiated an audit and made a transfer pricing adjustment for tax years 2017-2019. In response to the adjustments, the Korean company filed a MAP application.

With a MAP and APA pending at the same time, the company proposed that the best way to settle the APA and MAP discussion would be: (1) for the STA to accept the Chinese entity's profits and losses for past years on an as filed basis; and (2) for the NTS to cancel the transfer pricing adjustment for 2017-2019.

The company requested a multiyear term test rather than annual testing to properly reflect the significant fluctuation in the Chinese entity's profitability during the covered period. The Chinese entity initially recorded high profits during the APA period, but profitability dropped significantly after 2020. As further support for its position, the company noted that marketing expenses for the Chinese subsidiary increased significantly during the years of operating losses, indicating that the fluctuation in profitability was in large part unrelated to transfer pricing factors.

In response to the company's arguments, the NTS audit team canceled the adjustment and agreed with the STA to an APA with a term test, accepting the years as filed. Although term tests are somewhat common in South Korea-U.S. APAs, they are rarely agreed to in South Korea. This is especially true regarding APAs with the STA in situations in which there are high profits in China in early APA years. Although generally uncommon, a term test under an APA is a good way to manage fluctuations in profitability. Using a term test could be a viable option for companies affected by COVID-19 that saw fluctuations in profits (in either direction).

The Netherlands

In recent years, we have seen an increase in tax audits in Europe. This has been especially true in the Netherlands. Most of these audits focus on intellectual property centers: IP transfers, IP royalties, and DEMPE functions, as detailed in the OECD guidelines. To manage risk in light of this increase in audits, it is essential to consider the transfer pricing aspects of IP and maintain proper transfer pricing documentation in case an audit arises. These examinations are factually driven, and local documentation can carry great weight for their outcome.

There are several key factors to keep in mind when preparing local documentation in the Netherlands. First, the facts around roles and responsibilities must be analyzed under DEMPE concepts to determine economic ownership. The

documentation should include robust support for the factual and economic analyses. The local and formal aspects of the documentation can have a significant effect on audit outcomes.

In another recent case, the Netherlands Tax Administration (NTA) audited a Dutch entity that was paying royalties to a related Luxembourg entity for the use of IP. The NTA challenged the substance of the IP center and argued that the entity only carried out routine activities while DEMPE functions were located at the company's headquarters in the Netherlands. Since the IP center had been out of existence for a few years by the time of the audit, the company struggled to counter the NTA's arguments. Although the company's transfer pricing documentation for the years at issue did not include a detailed discussion of DEMPE functions, the taxpayer and the NTA were able to settle the case at an IP sale favorable to the taxpayer through a bilateral APA with advance pricing and mutual agreement.

The main takeaway of the cases we are seeing in the Netherlands is that a company can safeguard itself from a DEMPE-related audit by creating robust contemporaneous documentation for its local files.

Peru

There has recently been an increase in audits on intragroup services in Latin America following the release of the OECD base erosion and profit-shifting project action plan. In Latin America and specifically Peru, tax authorities are focusing more on costs in recent legislation. Changes were introduced in the legislation to ensure that cost bases are accurate and well supported. As a result of these legislative changes, taxpayers must comply with a series of conditions for intragroup charges coming from abroad to be deductible.

In one recent case, a Peruvian electricity generation company was under a transfer pricing audit focused on intragroup charges from the group's headquarters in Europe. The audit team imposed stringent requirements for the documentation needed to support the beneficial nature of the services. The Peruvian National Superintendency of Customs and Tax Administration requested copies of personal legal identification documents for the individuals rendering the services, declarations for the persons who received the service, confirmation of services received, and a large number of documents for the deliverables of each service. The individuals involved in the provision of intercompany services included the global CEO and CFO. The Superintendency of Customs and Tax Administration requested proof that these two individuals traveled to Peru and that they had specific calls with, or sent specific emails to, the Peruvian office. This request was challenging for the company to comply with in practice. The Superintendency of Customs and Tax Administration ultimately disallowed the deduction for the intragroup services, and the case is now in litigation.

Given the increased scrutiny of intragroup services and the high bar for the proof required to support the pricing of those services, the disallowance of deductions for intragroup services is becoming significantly more common in Peru.

For companies looking to mitigate risk, it is key to have a strong supporting local file with evidence of the beneficial services being provided. The use of technology can assist in this process. For example, tools exist that can prompt a person rendering services to select from certain descriptive options that are then automatically transferred to a company's documentation files. Having a system in place to contemporaneously capture the benefit of certain costs can help defend the deductibility of those costs in the face of an audit challenge.

United States

In the United States, there has been an increased focus on interest rates for intercompany loans, as well as an increase in the assertion of penalties.

Within the past three years, we have seen increased complexity and controversy concerning interest rate issues in the United States. Tax authorities are focused on protecting national tax revenue as interest rates are high and are expected to remain elevated. Although interest rate issues may have previously been a lower priority for the IRS, that is likely no longer the case. Companies responding to this increased attention to intercompany loans not only should be focused

on controversy but should also renew their focus on transfer pricing planning and documentation.

Many countries have set principles on the characterization of a loan as debt versus equity. When this question arises in the United States, the IRS often proposes two alternative arguments to address the characterization or pricing of a loan: (1) the loan should not be considered debt but rather equity, in which case a dividend withholding would have been required; or (2) a transfer pricing adjustment is required because of technical issues, such as the models being used to determine a synthetic credit rating when considering the credit rating of the borrower.

Another more frequently seen issue concerning interest rates involves the U.S. safe harbor interest rate. The IRS has recently proposed use of the safe harbor interest rate as an alternative arm's-length interest rate. The IRS has asserted this use of the applicable federal rate as the arm's-length rate in several cases, and it appears the agency may continue to do so. If a taxpayer faces this argument in an examination, it is advisable to take the matter to IRS Appeals, where the chances of success against this argument appear relatively high.

Our experience is that other countries may also use a safe harbor as a basis for a proposed adjustment. Switzerland has a similar safe harbor and has recently used it in at least one instance to propose an adjustment. We may see this issue arise more frequently as the OECD's amount B is implemented and tax authorities begin making adjustments based on the amount B analysis. The IRS's APMA program has also indicated that amount B will be directly relevant in an APA context in the United States. As with the approach to reducing exposure to many of the other transfer pricing risks recently observed, it is important to maintain robust documentation supporting interest rates as arm's length.

The IRS is also increasingly imposing transfer pricing penalties or economic substance penalties, which have historically been rarely assessed. Penalties are still seen in only a relatively small percentage of cases, particularly when there is robust documentation in place, but there has been a significant year-over-year increase in the assertion of penalties during the last five years. To reduce potential exposure to penalties, strong transfer pricing documentation is key.

Conclusion

As shown in the examples above, businesses using government incentive credits and thereby potentially lowering their cost base should be aware of the risk of increased scrutiny from tax authorities. Intragroup services and IP should be well documented, as global tax authorities are increasingly scrutinizing local files and supporting evidence. We are also seeing tax authorities, including the IRS, focus more on intercompany interest rates. There has also been an uptick in deductibility and cost allocation challenges and in the assertion of penalties. We can expect attention on these areas to continue or increase, so it is essential for companies to understand these areas of scrutiny and build robust transfer pricing documentation accordingly. For companies wanting to ensure global compliance and reduce risk, maintaining comprehensive local files to document factual, functional, and economic analyses is paramount. ■