Transfer Pricing

Key developments from 2020

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Although 2020 is a year that most of us would prefer to keep in our rearview mirror, it is important to look back before we move forward – especially when considering transfer pricing ("TP"). The fundamental principles of TP have been expanded upon but have remained basically unchanged for the last 85 years.[1] TP has also historically been one of the few aspects of taxation to garner general agreement from countries across the globe. However, 2020 may mark the end of this relative stability, which is why a review of last year's TP news and developments is critical.

Preparing complete documentation and providing adequate support for TP positions appear to be major themes from 2020 – and should be drivers of TP behavior in 2021.

The following is a summary of TP headlines from 2020 that may have a significant effect on TP going forward, covering the following areas:

1. Guidance from the Internal Revenue Service ("IRS") on TP documentation, highlighting potential penalty risks
2. OECD work and guidance on (i) taxation of the digital economy and (ii) TP in the global pandemic. These areas may require further consideration when assessing tax risk and the need for thorough TP documentation
3. A range of global court cases considering TP issues ranging from the appropriate evidence to support intragroup pricing, choice of TP method and comparables, and sustained losses. . These cases demonstrate a selection of the issues that may be used to challenge intragroup arrangements in a world where competition for tax revenues is likely to increase.

1. US Guidance – TP Documentation

In April 2020, the IRS issued informal guidance meant to encourage taxpayers to prepare appropriate TP documentation. Presented as a list of Frequently Asked Questions, this guidance describes best practices to follow and common mistakes to avoid when preparing TP documentation. The IRS introduced its recommendations by reminding taxpayers that multiple types of penalties may be applied to an underpayment of tax resulting from a TP adjustment. Further, the IRS notes that the regulations require certain penalties to be assessed in every case2 when TP documentation is not adequate, reasonable and prepared timely.

Lesson: TP documentation will face increased scrutiny from the IRS. When documentation is incomplete or inadequate,

[1] Article 45-1 of United States ("US") Regulations 86 issued in 1934 interpreted Section 45 of the US Revenue Act of 1928 and introduced the term "arm's length standard" to the world. In 1954 these regulations were moved to their current location, Section 482. Following the US's lead, the Organization for Economic Cooperation and Development ("OECD") included the arm's length principle in Article 9 of its 1963 Model Tax Convention. In 1980, this principle was also formally adopted by the United Nations in Article 9 of its Model Double Taxation Convention between Developed and Developing Countries.
[2] In every case where the penalty thresholds are met.

the IRS will likely begin assessing penalties with more regularity.

2. (i) OECD initiative – Taxing the Digital economy

In October 2020, the OECD issued the Pillar 1 and Pillar 2 Blueprint reports in an attempt to create a global framework for taxing digital service businesses. Because the digital economy has been rapidly expanding, many countries[3] have seen this as an opportunity to raise additional tax revenue by targeting this industry. Their argument is that certain multinationals are not paying enough tax in countries where they generate revenue but have a limited physical presence. If countries adopt unilateral tax measures targeting digital service companies, it will likely result in double taxation and added tax uncertainty for these companies as well as retaliatory tax actions between countries. Therefore, reaching global agreement on a tax approach is important. However, the OECD's plan has received mixed reviews.

The OECD's proposed tax revisions under Pillars 1 and 2 will significantly change how countries' taxing rights are determined and how taxable profit is split between multinational group members. The current proposal seems to disregard certain long-established tax standards such as the arm's length principle and permanent establishment, and its framework appears to deviate considerably from the OECD's prior BEPS project proposals. Although global agreement has not yet been achieved, this initiative has been relatively successful in delaying the wide-spread adoption of unilateral digital service tax regimes., However, the number of jurisdictions introducing or planning to introduce such tax rules is now increasing, and, the détente will be short lived if the OECD is not able to produce a more widely accepted plan.

Lesson: The ongoing debate regarding taxation of the digital economy seems to be based on politics rather than sound economic reasoning. Companies which operate in this space should consider the potential effects of a digital service tax given the jurisdictions in which they do business or have customers - and plan their TP strategies accordingly. Once a digital service tax framework is adopted, taxpayers may need to revisit their TP documentation and add additional descriptions/analysis as necessary. As the complexity of global profit allocation rules increases, proper TP documentation will only become more important for taxpayers.

2. (ii) OECD Guidance – TP during the Global Pandemic

In December 2020, the OECD issued guidance regarding TP issues related to the Covid-19 pandemic and the unusual economic conditions that it has created. The guidance acknowledged the challenges taxpayers face when attempting to comply with the arm's length standard and document their results. This guidance specifically addresses four priority issues: (i) comparability analysis, (ii) allocation of losses and the allocation of Covid-19 specific costs, (iii) government assistance programs, and (iv) Advance Pricing Arrangements. The OECD describes various approaches that may be used during the pandemic to follow the arm's length principle and analyse related party transaction results. It also provides advice on the allocation of unusual, pandemic-generated costs between group members and how to account for temporary government assistance programs.

Throughout the document, the OECD notes that TP principles have not changed and that their guidance only expands upon existing TP regulations. Taxpayers are

[3] In June 2020, the U.S. Trade Representative published a notice of its intention to investigate the Digital Services Taxes (DSTs) adopted or under consideration by Austria, Brazil, the Czech Republic, the European Union, India, Indonesia, Italy, Spain, Turkey, and the United Kingdom.

advised to document all facts and circumstances necessary to support their TP position, describe how the pandemic has affected their business, and note any usual steps/data/approaches used to analyse their TP results.

Lesson: Having documentation that thoroughly describes any changes in TP strategy caused by the pandemic and supports the taxpayer's TP analysis/results will be critical.

3. Notable 2020 TP Court Cases

Intimate court case details and expert witness showdowns can be darkly interesting – like a soap opera or a train wreck. However, when trying to gauge the TP environment, knowing which general principles are being discussed/disputed in court can be more enlightening. This information will often provide insight into possible areas of TP risk for taxpayers. Listed below are a few of the TP court cases that occurred in 2020. Please note that these cases are often complex, and only certain aspects of each are highlighted here.

- **Glencore Investment Pty, Federal Court of Australia Full Court**

  The court determined that the third party agreements chosen by the taxpayer to support its change in TP policy were not comparable, and adjustments for comparability were not made. However, the court also noted that these imperfect agreements did provide appropriate "reference points" or illustrations of arm's length transactions. The court's decision was largely based on the testimony of the taxpayer's expert witness (due to his extensive experience in the taxpayer's industry) – which was a somewhat unusual choice by the Court. This expert was able to convince the court that the taxpayer's change in TP policy was commercially reasonable and prudent.

- **Ice Machine Manufacturer A/S, Danish Western High Court**

  The court agreed with the tax administration and determined that the taxpayer had not provided sufficient evidence to support its long-term losses. The court stated that the taxpayer had not presented facts or extraordinary circumstances that justified its losses, had not provided sufficient information to support its entity characterizations, and had not performed a reliable benchmarking analysis.

- **ECCO Sko A/S, Danish Western High Court**

  With an opposite result from the Ice Machine case listed above, the court ruled in favour of the taxpayer. It determined that the taxpayer's documentation provided sufficient explanation to support its lower profit margin when selling products manufactured by related parties compared to those achieved when it sold product produced by unrelated manufacturers.

- **A Oy, Supreme Administrative Court of Finland**

  The court concluded that the taxpayer provided sufficient explanation to support its losses. It also stated that the tax administration could not choose a different tested party without proving that its approach more closely approximated an arm's length return (i.e., more reliable data and/or more comparable benchmarks).

- Toyota Kirloskar Auto Parts Private Limited, Bangalore Income Tax Appellate Tribunal

  The tribunal determined that the tax administration had not provided sufficient evidence of changes in the taxpayer's business to justify changing from the transactional net margin method ("TNMM") to a new method of analysis. It stated that the profit split method (proposed by the tax administration) was not necessary or preferable because the taxpayer did not contribute valuable intangibles or bear risks relevant to the transactions under review. Although the taxpayer engaged in related party transactions with more than one group member, the tribunal also concluded that testing the taxpayer's overall profit margin with the TNMM would provide more reliable results than testing the transactions separately.

- **Federal Mogul Anand Bearing India Ltd., Mumbai Income Tax Appellate Tribunal**
  The court rejected a company added by the tax administration to the taxpayer's set of comparables the court determined the proposed additional company was not sufficiently comparable (in terms of size and number of years in operation) to the tested party. Further, because the tax administration had not explained the process it used to identify this company, the court ruled that the results of its "search" were unreliable.

- **Società Italiana Per L'Oleodotto Transalpino SPA, Italian Court of Cassation**
  The court agreed with the tax administration's application of the profit split method and determined that the taxpayer had not chosen appropriate profit allocation keys. The court ruled that the taxpayer had not fully examined or documented the contribution made by each party during the course of doing business; and therefore, its analysis did not produce an appropriate arm's length return for the related parties.

- **Prime Plastichem Nigeria Limited, Nigerian Tax Appeal Tribunal**
  Although there was confusion regarding some points of this case, the tribunal clearly noted its concern that the taxpayer had changed its TP analysis method even though no changes to its business or circumstances had occurred. It also stated that this change would have been appropriate only if the availability of reliable benchmark data had also changed (the taxpayer did not provide evidence of this).

- **The Coca-Cola Company, US Tax Court**
  The court ruled against the taxpayer's use of a formula-based profit split to calculate the royalties owed by its subsidiaries for the use of its intangibles. Further, the court also rejected the taxpayer's use of the comparable uncontrolled price method to benchmark the royalty because the taxpayer had not presented license agreements that were sufficiently comparable. The court determined that it was more appropriate to use the comparable profits method and benchmark the overall results of the taxpayer's subsidiaries rather than benchmark their royalty payments alone.

  Lesson: The cases listed above demonstrate various TP topics that tax authorities addressed in 2020. Topics highlighted in these cases included: choice of TP method, losses, comparability of companies/agreements used as benchmarks, changing TP methods, and entity characterizations. The fact that tax authorities have shown interest in these topics, should prompt taxpayers to review their documentation and strengthen these areas where needed.

The overarching theme in the above published guidance, proposed guidance, and court case decisions is the importance of appropriate TP documentation. A taxpayer's TP documentation should adequately explain the rationale for any TP positions taken and provide the necessary information to support them. Although many tax authorities temporarily suspended their audit programs during the pandemic, most suspensions have ended, and TP audits are expected to increase. The TP environment is quite different now, and taxpayers should not rely on strategies or documentation simply because they have worked in the past. This is particularly important when a taxpayer's circumstances have changed due to the global pandemic, and the information in prior TP documentation reports is no longer accurate. The best strategy is to be proactive and reduce TP risk by putting solid documentation in place and reviewing this documentation regularly.

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