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Foreword

Dear Readers,

The number of transfer pricing audits across the globe are expected to rise as taxing authorities look for additional revenue after the Covid-19 pandemic. Countries like the United States have provided additional funding to taxing authorities to bolster compliance by multinational enterprises (“MNEs”), targeting investments in data analysis and artificial intelligence to increase transparency.

Transfer pricing controversies are expensive and time consuming. Although entering into an Advance Pricing Agreement ("APA") may prevent litigating transfer pricing matters, and improvements have been made in this area, the number of mutual agreement procedure (“MAP”) requests to competent authorities keeps rising, and more than half of those are transfer pricing requests. Transfer pricing issues introduced in MAP take an average of 35 months to resolve compared to the 18.5-month average resolution time for other cases.[1] If an issue is litigated, resolution may not come for over a decade. Perhaps, greater emphasis needs to made by the international tax community to implement additional dispute resolutions techniques within the MAP process towards its simplicity and efficiency.

In practice, tax controversies concerning related-party transactions that initially were not focused on transfer pricing matters may be resolved and/or settled through transfer pricing adjustments. This has proven to be an effective mechanism to deal with technical tax issues in cases were no mutual understanding exists between the tax authorities and the taxpayer during the audit and administrative appeal stages and before entering into the litigation stage.

Our global transfer pricing team, comprised of lawyers and economists, prepared this Special Report in partnership with Bloomberg Tax & Accounting to share our best practices for transfer pricing controversy with businesses who may soon find themselves defending their valuations. Please feel free to reach out to the authors with any questions.

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[1] *See* OECD 2020 Mutual Agreement Procedure Statistics, available at https://www.oecd.org/tax/dispute/mutual-agreement-procedure-statistics.htm.

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The Global Landscape of Transfer Pricing Controversy: Trends You Can't Afford to Ignore

I. Introduction: Potential Avenues to Resolve a Transfer Pricing Dispute

By Susan Ryba and Ariane Calloud

Global transfer pricing disputes are on the rise. For many multinational companies, transfer pricing has been and continues to be their top audit issue. New transfer pricing issues have surfaced as a result of the transformational changes to the business and operating models made by companies during the Covid-19 pandemic. In this environment, tax departments strive to proactively manage their transfer pricing disputes in a manner that minimizes exposure to potential penalties and double taxation, as well as efficiently resolve disputes with the tax authorities located in multiple jurisdictions. While some transfer pricing disputes are resolved through litigation, many jurisdictions still provide taxpayers with good opportunities to settle transfer pricing issues administratively in a non-public forum.

In the sections below, we discuss how a taxpayer might prevent a transfer pricing dispute in advance using an advance pricing agreement. Then we turn briefly to the possibility of settlement during audit.

We then focus on the mutual agreement procedure, which may prevent double taxation after a domestic transfer pricing determination is made. We then turn to domestic litigation of contested transfer pricing issues. Finally, we end with a discussion of recent trends and developments in Transfer Pricing.

A. Pre-Audit Prevention

Transfer pricing disputes are among the most difficult, time-consuming, and expensive tax controversies that multinational companies can face. Before a transfer pricing audit begins, taxpayers should identify which intercompany transactions are likely to be examined and in which jurisdictions these examinations could occur. This planning will allow taxpayers to evaluate the opportunities available to settle transfer pricing disputes in each jurisdiction and determine which dispute resolution forum the company prefers. While settlement opportunities vary by jurisdiction, in general, taxpayers can look to settle their transfer pricing disputes before, during, and after the audit.

Audit preparation is the key to a successful settlement at any of these time periods. Because transfer pricing cases are won or lost based on the facts, taxpayers must master the factual record. The earlier the taxpayer begins to understand and control the relevant facts, the better the chances of resolving the issues on favorable terms. Accordingly, by the time the transfer pricing audit begins, the taxpayer should consider the following:

- Identify the intercompany transactions likely to be examined and which tax authorities are likely to examine them;
- Review the intercompany agreements and other documentation governing the transactions likely to be examined and confirm that they support the desired structure and intercompany allocation of risks;

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- Determine the taxpayer's theory of the case, and be able to easily articulate why the taxpayer's chosen methodology is the best method and why other methods were not selected;
- Identify individuals who possess relevant facts and documents and consider the best ways to obtain such information; and
- Identify and preserve documents.

A taxpayer's ability to present a strong, consistent position throughout the audit that shows mastery of the facts will increase the likelihood of achieving a favorable settlement during the audit.

1. APAs

Advance Pricing Agreements ("APAs") historically have been an effective tool to resolve transfer pricing issues before an audit begins. Some jurisdictions may provide taxpayers with other opportunities to obtain transfer pricing certainty before an audit begins – especially in the context of compliance programs and regularization mechanisms. In France, for example, taxpayers who are in the "*partenariat fiscal*," an enhanced relationship program with the French tax administration, may obtain certainty on specific transfer pricing questions during the fiscal year at issue. APAs, however, continue to be the leading choice for preventing a transfer pricing dispute.

For a detailed discussion of the APA process and their advantages and disadvantages, please see II., below.

2. ICAP

The International Compliance Assurance Program (ICAP) is a voluntary risk assessment and assurance program designed by the OECD with the objective of facilitating open and cooperative multilateral engagement between MNEs and tax administrations. In contrast to APAs, ICAP does not provide an MNE group with tax certainty. Instead, its objective from a taxpayer perspective is to provide comfort if there is a determination from the tax administrations participating in an MNE group's risk assessment that the risk of the activity/transaction is low. In other words, ICAP does not examine specific amounts that may be in dispute, rather, it examines whether or not the transaction should be considered low risk and, thus, not a good use of audit resources.

At the conclusion of an ICAP risk assessment, an MNE will receive outcome letters from each covered tax administration, containing the results of the tax administration's risk assessment and assurance of the covered risks for the covered periods. The design, content and wording of the letter is determined by each covered tax administration but will typically address: (i) risk ratings; (ii) any agreement reached as part of an issue resolution process, and; (iii) confirmation of the covered risks that are considered to be low risk, with a statement that it is not anticipated that compliance resources will be dedicated to a further review of these risks for a defined period.[2]

In contrast to APAs, ICAP is currently only available in twenty-two jurisdictions.[3]

Notwithstanding, taxpayers have reported that ICAP letters may also provide comfort / lessen risk in other jurisdictions, even those that do not participate in ICAP. Furthermore, while an APAs provide tax certainty whereas ICAP only has the potential to reduce risk, there are certain benefits to ICAP. ICAP is materially less resource intensive than audits or APAs. ICAP is meant to leverage existing information (e.g., CbCR) and a single documentation package for use by all covered tax administrations. Consequently, the timeline is much faster, with outcome letters issued within 24-28 weeks from delivery of the main risk assessment documentation. Another benefit of ICAP is that, in contrast to APAs, it may be well suited to address one-off transactions (provided the taxpayer believes it to be low risk).

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[2] The defined period is generally the covered period/s, plus the following two tax filing periods, provided there are no material changes.

[3] Argentina, Australia, Austria, Belgium, Canada, Chile, Colombia, Denmark, Finland, France, Germany, Ireland, Italy, Japan, Luxembourg, Netherlands, Norway, Poland, Singapore, Spain, the United Kingdom, and the United States.

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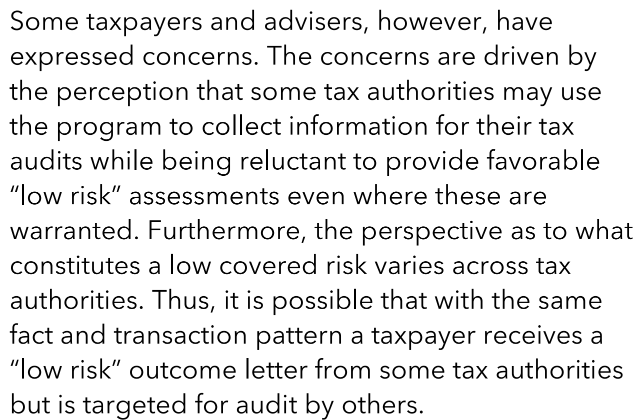

Some taxpayers and advisers, however, have expressed concerns. The concerns are driven by the perception that some tax authorities may use the program to collect information for their tax audits while being reluctant to provide favorable "low risk" assessments even where these are warranted. Furthermore, the perspective as to what constitutes a low covered risk varies across tax authorities. Thus, it is possible that with the same fact and transaction pattern a taxpayer receives a "low risk" outcome letter from some tax authorities but is targeted for audit by others.

As this is a more streamlined process, it is most suitable to less complex issues than those often addressed via APA, such as hard-to-value intangibles and IP migration. But with the right fact pattern and transactions, and if it lives up to the hype, ICAP is arguably the most efficient and accessible multilateral tools available to MNEs. Although it is also possible that a taxpayer does not receive many (or any) "low risk" outcome letters or that ICAP ends up being an additional Information Document Request (IDR) in advance of an audit, the experience of most taxpayers who have been involved in ICAP has generally been positive.

B. Settlement Opportunities During Audit

Some jurisdictions, including the United States, grant settlement authority to the audit team. In the United States, for example, the Exam Team has discretionary settlement authority for transfer pricing issues being audited by the Large Business and International (LB&I) Division. In particular, during an LB&I examination, if a taxpayer previously settled an issue with IRS Appeals, the Exam Team has the authority to settle the issue in the current audit on the same basis.[4] Exam Teams during LB&I examinations also have the ability to settle issues according to written settlement guidelines established by IRS Appeals in certain situations.[5]

Even in jurisdictions that do not have a formal process to settle cases during the audit phase, there still may be an opportunity to reach resolution. In France, for example, the possibility to settle a case with the French tax administration (besides the mere reduction of tax penalties) is not formally provided by French tax law. The litigation phase, however, will not start until various steps have been completed that result in formal exchanges between the taxpayer and the French tax administration. These exchanges can help to narrow the dispute.

Settling transfer pricing issues with the audit team has several advantages. First, it allows the taxpayer to resolve the issue quickly. Litigation and other dispute resolution forums can take many years following the end of the audit, whereas a settlement with the audit team is final by the close of the audit. Second, it is much less expensive than litigation and other dispute resolution forums. Third, the dispute and settlement agreement are not public, which reduces the reputational risk that can sometimes arise in connection with transfer pricing litigation. Fourth, it may mitigate criminal risk in certain circumstances.[6] Finally, reaching a settlement allows the taxpayer to better manage the uncertainty of pursuing litigation, especially when case law is unclear or nonexistent.

Nonetheless, while it is possible to settle transfer pricing issues with the audit team, it may be difficult to reach a settlement on terms acceptable to the taxpayer. For example, settling transfer pricing issues with the audit team may create a disadvantage for the taxpayer. Unlike issues settled using an APA, issues settled during audit may not provide protection on the issue for additional tax years. Further, a determination by the Exam Team may prevent a taxpayer from being able to claim a tax credit in another jurisdiction. In such cases,

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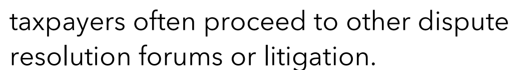
[4] See I.R.S. Deleg. Order 4-24 (Rev. 1), IRM 1.2.2.5.20 (Dec. 3, 2020).

[5] See I.R.S. Deleg. Order 4-25 (Rev. 2), IRM 1.2.2.5.21 (Oct. 18, 2008).

[6] In some jurisdictions, transfer pricing disputes can lead to criminal liability. Some countries have laws that require certain tax disputes to be referred to the Public Prosecutor if no resolution has been reached by the end of the audit. In France, for example, the French tax administration must report to the Public Prosecutor a case that led to the application of certain tax penalties in a tax collection notice at the end of the tax audit phase.



taxpayers often proceed to other dispute resolution forums or litigation.

In some jurisdictions, transfer pricing disputes can lead to criminal liability. Some countries have laws that require certain tax disputes to be referred to the Public Prosecutor if no resolution has been reached by the end of an audit. In France, for example, the French tax administration must report to the Public Prosecutor a case that led to the application of certain tax penalties in a tax collection notice at the end of the tax audit phase. While Italian law generally provides that transfer pricing matters (valuation matters) do not have a direct criminal impact if the taxpayer discloses its transfer pricing policy, criminal ramifications are almost automatic in cases involving deemed permanent establishment challenges because Italian tax authorities must report such cases (omitted tax returns) to the Public Prosecutor. In such jurisdictions, settlement during the audit can mitigate criminal risk. Other jurisdictions, like Spain, require fraudulent intent to trigger criminal liability in transfer pricing cases. Generally, the fraudulent intent requirement cannot be met and, therefore, these cases have no criminal impact.

In some other jurisdictions, the possibility exists to reach out-of-court settlements through alternative dispute resolution mechanisms. In Mexico, taxpayers may file for tax settlements before the Mexican Tax Ombudsman ("Prodecon"). Prodecon acts as a facilitator between the Mexican tax authorities and the taxpayer. This procedure is called "conclusive agreement" and is available for taxpayers only during the audit stage.[7] The ongoing audit is suspended when the taxpayer files the adoption of the conclusive agreement. The conclusive agreement, once executed, cannot be challenged either through the filing of any remedy or through the filing of a MAP in terms of the corresponding double tax convention. Although the procedure does not provide protection for other open years, when the business model remains the same during the following years, audits may be triggered in connection with those years in order to include them in the conclusive agreement procedure, thereby achieving a multi-year settlement.

Finally, the introduction of alternative disputes resolution techniques within the MAP process may be a way to enhance the use of the MAP process. These techniques may expedite the MAP process and make it more efficient and final. Perhaps, the most widely discussed form of these alternative techniques in the tax area is arbitration. However, the decision-making authority granted under arbitration procedures is something that governments in many jurisdictions are not willing to give away because they view the taxing faculty as a sovereign right that cannot be left in the hands of non-government officials.

C. Post-Audit Settlement Opportunities Short of Litigation

If a taxpayer cannot resolve all of its transfer pricing issues during the audit, it must determine whether any post-audit dispute resolution forums are available or whether it must proceed to litigation. The availability of post-audit dispute resolution forums will vary by jurisdiction. In the United States, for example, these post-audit resolution forums are quite developed

In the United States, a common dispute resolution forum to resolve transfer pricing disputes, short of litigation, is IRS Appeals. Appeals is an independent office of the IRS — separate and distinct from the examination function. Appeals seeks to "resolve Federal tax controversies without litigation on a basis which is fair and impartial to both the Government and the taxpayer."[8] Appeals serves a quasi-judicial function by weighing the available evidence in light of the applicable law to negotiate a hazards-of-litigation based settlement. To proceed to Appeals, the taxpayer must request

[7] Taxpayers are entitled to request the adoption of a conclusive agreement at any moment during the audit and within the 20 days following that in which the final audit minute is concluded or the letter of observations is notified, provided that the tax inspector has qualified the corresponding facts and omissions.

[8] IRM 8.6.1.1.1(2) (July 1, 2020).

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consideration by Appeals and, in most cases, file a written protest.[9]

Appeals proceedings are not public, take less time than litigation, and are not subject to the factual discovery that often comes with transfer pricing litigation. Thus, taxpayers often consider taking U.S. transfer pricing disputes to Appeals before deciding to litigate. If a taxpayer tries to settle a transfer pricing case with Appeals, it still has the option to proceed to litigation should the Appeals process fail.[10]

If a taxpayer wants to go to Competent Authority ("CA"), it must do so within 60 days of the conclusion of the Appeals Conference. Accordingly, a taxpayer may consider going directly to a MAP, which may be more efficient although more time consuming.

For most taxpayers, the ultimate goal is a favorable settlement of transfer pricing disputes without having to proceed to litigation. However, for certain transfer pricing issues, a reasonable settlement may be impossible short of trial. In such cases, the taxpayer may choose to skip Appeals and proceed directly to court. In making this determination, taxpayers should consider the following:

- Whether the taxpayer's issue presents a new interpretation of existing transfer pricing law or a similar issue already considered by the courts;
- The likely outcome of pending transfer pricing cases and their impact on the taxpayer's issue;
- The taxpayer's prior experience at Appeals and whether it has been able to successfully negotiate transfer pricing settlements;
- An assessment of the climate at Appeals based on the experience of other taxpayers in the same industry or region with similar transfer pricing issues;
- Whether the taxpayer prefers to keep its dispute in a non-public forum; and
- To the extent the taxpayer's transfer pricing issue continues for multiple years, the impact of facts in later years on the current case. Are the facts in later years more or less favorable?

Other jurisdictions also offer an administrative appeals option but may require that the tax be paid in advance. For example, in Spain, once the STA issues the tax assessment and the taxpayer signs it in disconformity, the resulting tax needs to be paid or suspended through provision of a bank guarantee. Then two possibilities appear prior to litigation:

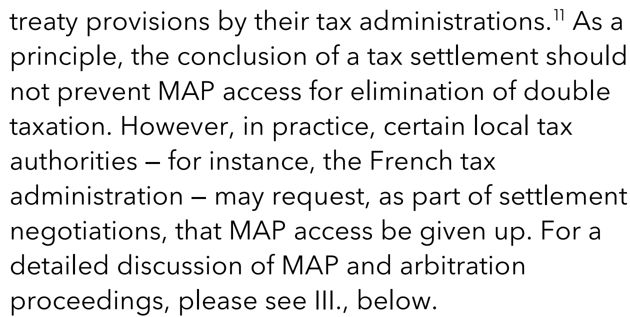
- Appeal before the Central/Regional Administrative Court: This is an Economic-Administrative procedure, which ends with a resolution and not with a judgement. If the taxpayer's position is not accepted, the litigation process can continue through the courts.
- Starting a MAP (if applicable): This suspends the administrative proceeding until the MAP is concluded.

D. Competent Authority

At the end of an audit, the transfer pricing adjustment imposed by the local tax authority may also have tax consequences in a treaty jurisdiction that could result in double taxation. In such circumstances, the taxpayer may seek to have the issue settled through a MAP. Most income tax treaties contain an article that provides for a MAP and arbitration access. The MAP article authorizes designated officials of the treaty partner governments (the "CA") to resolve any cases of double taxation or other disputes arising from differing interpretations or applications of the

[9] Reg. §601.106(a)(1)(iii); IRM 8.1.1.3(6) (Apr. 4, 2014). All section references herein are to the Internal Revenue Code of 1986, as amended (the "Code"), or the Treasury regulations promulgated thereunder, unless otherwise indicated.

[10] Historically, Appeals Conferences were ex parte. Now the IRS has encouraged the audit team to participate in the settlement negotiations. The taxpayer must consider the past relationship with the audit team to determine if it makes sense to participate.



treaty provisions by their tax administrations.[11] As a principle, the conclusion of a tax settlement should not prevent MAP access for elimination of double taxation. However, in practice, certain local tax authorities – for instance, the French tax administration – may request, as part of settlement negotiations, that MAP access be given up. For a detailed discussion of MAP and arbitration proceedings, please see III., below.

E. Transfer Pricing Litigation

Taxpayers use the settlement options above (see I.B. and I.D.) to avoid litigation. While some taxpayers choose to litigate transfer pricing issues, other taxpayers are forced into litigation as the only available option to resolve a transfer pricing dispute. Regardless of jurisdiction, transfer pricing litigation has several common themes. First, the filings and proceedings are public in most jurisdictions. In today's environment, transfer pricing cases may be followed not only in the tax press, but also by the mainstream press and non-governmental organizations focused on tax issues. This publicity can create significant reputational risk with both the public at large as well as other tax authorities. Second, litigation is expensive. Transfer pricing litigation is factually intensive and complicated. Finally, litigation takes a long time. In many jurisdictions, it can be several years after a case is filed before it actually proceeds to trial, and after trial, it can take a few more years before the taxpayer receives the court's decision. Even after receiving the trial court's decision, there can be several more years of appeals before a final decision is reached.

In transfer pricing litigation, taxpayers usually have a key advantage compared to the tax authority because the taxpayer possesses the facts (subject to application of retention rules to be carefully managed), as well as extensive internal and external resources. Historically, the tax authority has been at an information and resource disadvantage. Tax authorities attempt to combat this information disadvantage through various means now at their disposal, including exchange of information, CbCR, information gathered from third parties, and even tax raids in certain jurisdictions. In some jurisdictions, the tax authority has an advantage because taxpayers bear the burden of proof. In the U.S. Tax Court, for example, taxpayers must prove that the IRS's transfer pricing adjustment is arbitrary, capricious, and unreasonable. Once this threshold is satisfied, as a practical matter, the taxpayer must demonstrate that its existing pricing or an alternative pricing arrangement satisfies the arm's-length standard and produces a more reliable result than the IRS's determination. Rules governing burden of proof, however, vary by jurisdiction. For instance, in France, the French tax administration must demonstrate the existence of an undue benefit to a foreign affiliate and to assess it. If, however, such indirect transfer of profits has been characterized, the burden of proof then shifts, and the taxpayer must demonstrate that the transaction was arm's length.

Before initiating litigation, the taxpayer should choose the appropriate forum, if possible. While many jurisdictions, including France, do not allow the taxpayer to choose the litigation forum, others do. In the United States, for example, taxpayers can litigate federal civil tax cases in the Tax Court, federal district court, or the Court of Federal Claims.

F. Forum Selection Considerations

Where taxpayers have the opportunity to select a litigation forum, there are several factors taxpayers should consider to inform this decision. First, does the forum require the taxpayer to first pay the proposed tax deficiency or can the taxpayer litigate without making a payment? In the United States, the Tax Court is the only forum in which a taxpayer does not have to pay the proposed tax deficiency before docketing the case. In contrast, the taxpayer must fully pay the tax and then file a refund claim to litigate a transfer pricing dispute in federal district court or the Court of Federal Claims.[12]

Taxpayers should also understand how and when interest is calculated. If the taxpayer can litigate its transfer pricing dispute in U.S. Tax Court or a non-

[11] In the United States, taxpayers can skip Appeals and go directly to the CA through MAP.

[12] See §7422(a); see also §6511, §6532.

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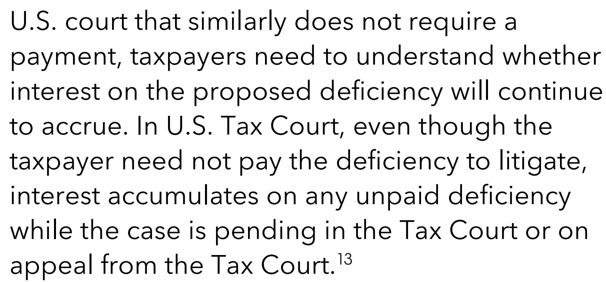

U.S. court that similarly does not require a payment, taxpayers need to understand whether interest on the proposed deficiency will continue to accrue. In U.S. Tax Court, even though the taxpayer need not pay the deficiency to litigate, interest accumulates on any unpaid deficiency while the case is pending in the Tax Court or on appeal from the Tax Court.[13]

Another important consideration in forum selection is the existence of favorable or unfavorable precedent. Taxpayers should examine all cases potentially relevant to their transfer pricing dispute to determine the optimal forum. Taxpayers should also consider the impact of no precedent in their forum selection decisions.

The location of the trial can be another strategic consideration. In U.S. Tax Court, taxpayers have some flexibility to choose the city in which the trial will occur.[14] Taxpayers may be able to use this flexibility strategically. A district court trial offers less flexibility and generally takes place in the district in which the corporate taxpayer has its principal office or place of business.[15]

The decision maker and their technical expertise is a final consideration. Some courts allow for both jury trials and bench trials while others are limited to bench trials. In the United States, there are no jury trials in Tax Court or the Court of Federal Claims, but a district court has both jury and bench trials. Tax Court judges handle only tax cases and tend to have considerable experience handling complex tax issues. Judges in the Court of Federal Claims and district court, however, hear a variety of cases and may have limited experience with tax cases. Depending on the nature of the taxpayer's transfer pricing dispute, the taxpayer may prefer a decision maker with more or less substantive tax experience.

[13] See §6601, §6621.

[14] See Tax Ct. R. 140(a).

[15] See 28 U.S.C. § 1402.

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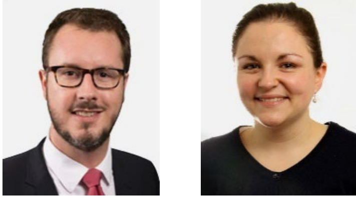
II. APAs: A Practical Way to Prevent Transfer Pricing Disputes

By Eric Torrey and Jessica Eden



While many in the field of transfer pricing are familiar with the concept of APAs, the pace of developments in the area has been swift. Given the nature and scope of change in this field, it is worth revisiting the area and weighing the recent developments because many are yielding (or are expected to yield) favorable improvements to the process of obtaining an APA.

A. Overview of APAs

An **APA** is the outcome of a process that taxpayers pursue voluntarily with one or more tax authorities. The APA that results from such a process ultimately gives taxpayers and tax administrations advance certainty related to the transfer pricing matters covered by the APA. More specifically, an APA determines the transfer pricing, in advance of the relevant covered transactions, through an agreed set of criteria (e.g., method, comparables, critical assumptions), over a fixed period of time.[16]

There are three forms of **APA**s:

- Unilateral APAs, which are APAs involving a taxpayer and a single jurisdiction solely under domestic law and, only provide transfer pricing certainty in a single jurisdiction (and then only if the jurisdiction of a counterparty does not raise any transfer pricing adjustments pertaining to the covered transactions).
- Bilateral APAs ("BAPAs"), which are APAs involving two jurisdictions that are party to an applicable bilateral tax treaty and provide transfer pricing certainty in both jurisdictions pertaining to the covered transactions. BAPAs are typically negotiated between the two countries' CAs and are generally implemented domestically through an agreement between the relevant taxpayers and each CA.
- Multilateral APAs, which are APAs involving more than two jurisdictions and provide transfer pricing certainty in each of the jurisdictions involved in the process. However, multilateral APAs typically require significantly more coordination, resources, and time compared to unilateral or BAPAs.

B. Trends in APAs

Transfer pricing disputes are among the most difficult, time-consuming, and expensive controversies that arise in tax. With the growing complexity of the global tax environment and a rapid increase in global transfer pricing controversy, APAs are becoming more popular among taxpayers and tax administrations as an effective tool for dispute resolution and prevention. For example, according to the 2021 APA Annual Report from the U.S. Internal Revenue Service ("IRS") Advance Pricing and Mutual Agreement ("APMA") Program, the number of APA applications increased by about 20% from 2020 to 2021. Of this total application pool, about 83% were bilateral applications. In 2021, APMA's staff also increased by about 21% in order to handle the increasing number of transfer pricing cases. In a March 2022 statement, the acting director for APMA, Nicole Welch, stated that the IRS would prioritize hiring additional employees for the transfer pricing program and ramp up engagements with U.S. bilateral tax treaty partners in person that were suspended as result of the Covid-19 pandemic. Similarly, according to the European Commission's Statistics on APAs in the EU, the total number of APAs in force increased from 1,041 (intra-EU) and 593 (EU/non-EU) in 2019 to 1,312 (intra-EU) and 839 (EU/non-EU) in 2020, representing growth rates of 26% and 41%, respectively.

The comparable profits method/transactional net margin method ("CPM/TNMM") remained the

[16] Para 4.134 TPG 2022

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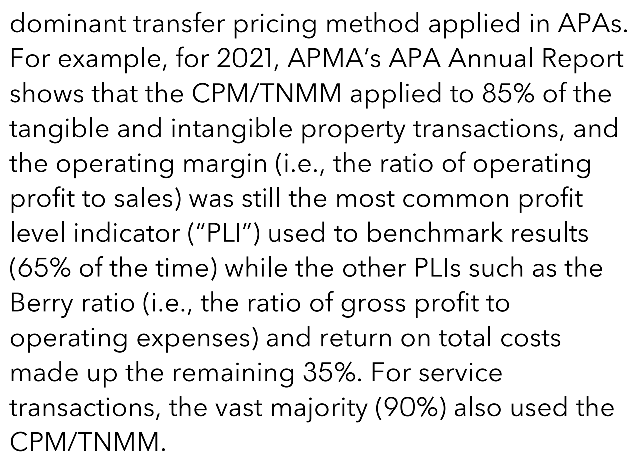

dominant transfer pricing method applied in APAs. For example, for 2021, APMA's APA Annual Report shows that the CPM/TNMM applied to 85% of the tangible and intangible property transactions, and the operating margin (i.e., the ratio of operating profit to sales) was still the most common profit level indicator ("PLI") used to benchmark results (65% of the time) while the other PLIs such as the Berry ratio (i.e., the ratio of gross profit to operating expenses) and return on total costs made up the remaining 35%. For service transactions, the vast majority (90%) also used the CPM/TNMM.

On September 28, 2022, the OECD released the first ever Bilateral Advance Pricing Arrangement Manual ("BAPA Manual"), which was a follow-up to the inaugural Tax Certainty Day discussions where all stakeholders (tax policy makers, tax administrations, business representatives and other stakeholders) agreed that APAs were an effective tool for providing advance transfer pricing certainty. The BAPA Manual reiterates the best practice from the BEPS Action 14 Final Report that jurisdictions without BAPA programs should implement these as soon as they have the capacity to do so because BAPAs provide a greater level of certainty for both treaty partner jurisdictions, lessen the likelihood of double taxation, and may prevent transfer pricing disputes. The BAPA Manual recognizes that stakeholders have identified obstacles that prevent an optimal use of BAPAs, which leads to these being underutilized in many jurisdictions. Accordingly, the BAPA Manual was developed as a guide for streamlining the BAPA process, providing tax administrations and taxpayers with information on the operation of BAPAs, and identifying 29 best practices for an effective and streamlined BAPA process, with an aim to reduce the average time to complete a new BAPA to 24 months for simpler cases and 30 months for more complex cases.

As tax administrations and the OECD continue to invest in APA programs by increasing staffing and other resources, and as global transfer pricing controversy continues to rise, APAs continue to be an excellent forum for preventing and resolving transfer pricing issues (particularly the more challenging ones) and provide tax certainty to taxpayers.

C. APAs Versus Alternative Dispute Resolution Mechanisms

APAs can be a useful tool to prevent transfer pricing disputes. As the OECD Transfer Pricing Guidelines ("OECD TPG") notes "APAs are intended to supplement the traditional administrative, judicial and treaty mechanisms for resolving transfer pricing issues. They may be most useful when traditional mechanisms fail or are difficult to apply …. APAs provide a greater level of certainty in both treaty partner jurisdictions, lessen the likelihood of double taxation and may proactively prevent transfer pricing disputes."[17]

A key benefit of the APA process as compared to the traditional administrative inquiry process is the taxpayer's ability to control the development of the factual and technical narrative. The APA process provides greater ability for the taxpayer to focus the attention of the tax authorities on the most critical issues to reach resolution. By contrast, factual and technical development in Tax Authority-led inquiry processes often digresses into areas that are ultimately determined to be of little significance in resolving the matter. This is also a benefit of APAs over MAP processes, discussed in III., below, which tend to follow tax authority-led inquiry processes and so can suffer from the same convolution of the facts and key technical issues.

BAPA processes with two CAs also hold a significant advantage, as compared to unilateral APA processes involving only one tax authority, of the natural hedge created by the interests of the respective tax authorities in a bilateral process. Where the views of one authority are aligned with those of the taxpayer, the weight of another Tax Authority's interpretation can be beneficial in pushing back on more unusual views on the guidelines or case interpretation. By contrast, unilateral APAs are not binding on the other state tax authority and so have limited benefit in removing double taxation if the authorities have

[17] Para 4.134 TPG 2022.

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differing views on the appropriate level of reward in each state.

While APA processes require upfront investment and can sometimes take a number of years to negotiate, ultimately a negotiated outcome should be achievable far in advance of a transfer pricing dispute resolved through normal administrative inquiry processes, which may potentially lead to a MAP or even litigation. Reducing the time taken to resolve differences in views invariably reduces the cost, both in monetary and resourcing terms, to resolve the dispute.

D. Benefits of APAs

In most jurisdictions, an APA will cover a multi-year prospective period. However, as it can often take several years to negotiate an APA (particularly on a bilateral or multilateral basis), the APA agreement will typically also cover several past years in addition to the multi-year prospective period.

Once an APA has been signed, subject to meeting the critical assumptions for the APA to remain valid and in place, it will provide certainty on the prospective transfer pricing and avoid future audits on the covered issues for the term of the agreement. If facts and circumstances remain substantially the same, taxpayers could typically apply for an APA renewal to cover additional future years through an expedited, less costly, process.

Importantly, as part of the process of agreeing to an APA, the taxpayer will have a proactive role in presenting both the facts and proposed transfer pricing. This can be a significant advantage over MAPs which take place after an audit process and in which the taxpayer's involvement can be much more limited depending on the jurisdictions involved. The APA application process is the key opportunity for the taxpayer to ensure both authorities understand the factual narrative and technical issues involved.

Where, as is often the case, an APA involves a novel transaction or difficult analysis, the BAPA process ensures that both Tax Authorities are required to consider the position from the other’s viewpoint, providing greater opportunity for a balanced outcome even in the most complex of cases.

Agreeing to an APA may avoid the need for comprehensive transfer pricing documentation for the APA term. The OECD Transfer Pricing Guidelines recognize that the existence of an APA should reduce documentation requirements for the term of the APA. This can provide an administrative cost saving. However, the existence of this benefit will depend on the specific documentation rules in the relevant local jurisdiction. For example, the United Kingdom is in the process of introducing minimum transfer pricing documentation requirements to include the Masterfile, local files, and Summary Audit Trail (SAT) report. There has been no suggestion to date that these new documentation requirements will be overridden by the existence of an APA.

Finally, it is worth noting that the process of agreeing to a BAPA requires open and transparent engagement that can ultimately help in strengthening the relationship between the taxpayer and relevant Tax Authorities involved. This can be useful not only in other dealings with those authorities, but also from a public relations perspective, in demonstrating the significance the taxpayer places on cooperative compliance.

E. Is an APA Right for Your Fact Pattern?

As with most things in life, there is no single answer that is right for everyone and the same is true when it comes to deciding whether pursuing an APA is right for your organization. Every organization is unique in some way and has its own facts and circumstances that have to be weighed individually when making such a decision, however, there are a number of factors common to many organizations that we will consider here.

One of the most frequently considered factors is whether the transactions and/or entities are the subject of frequent and recurring transfer pricing audits and disputes. In cases where controversy is a certainty (or a near certainty), there is a lot to be gained from pursuing an APA because it will allow the resolution to be applied to a much greater number of taxable years, including future years, where audit and MAP resolutions are likely to address only the cycle in question. Additional filed years may also be addressed if the treaty partners in question allow for an accelerated CA procedure

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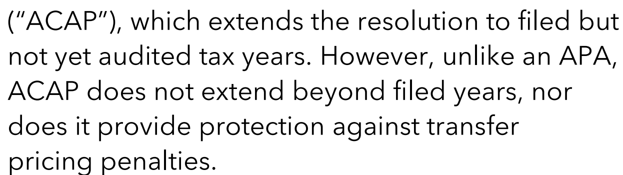

("ACAP"), which extends the resolution to filed but not yet audited tax years. However, unlike an APA, ACAP does not extend beyond filed years, nor does it provide protection against transfer pricing penalties.

Other circumstances where an APA is frequently beneficial is where the transaction is expected to be scrutinized and challenged under audit (e.g., hard-to-value intangibles). For some jurisdictions, even relatively routine transactions are challenged (e.g., routine distribution) on the basis that there is some form of local intangible that warrants greater compensation than what is set out in the transfer pricing documentation.

It is important for taxpayers to approach the APA process with the right mindset. The APA process is normally a voluntary process offered at the discretion of the tax authorities involved. Tax authorities often expect that taxpayers seeking an APA do so for the purposes of resolving or avoiding double taxation and achieving certainty, and that they will be more forthcoming with information and more collaborative than they might otherwise be in an audit context. Inflexible taxpayers motivated purely by tax minimization are less likely to be accepted into the process and, if they are accepted, less likely to be pleased with the outcome.

Not all transactions are suitable for APAs. While different tax authorities have different criteria for determining whether a taxpayer and/or transaction is suitable for consideration, there are some more common factors suggesting that an APA may not be ideal. These include simple or easily-benchmarkable transactions where there is little or no risk of controversy, one-off transactions (e.g., sales of machinery and equipment for use in a manufacturing process), transactions that are of a nature where resolution through an APA or MAP process is unlikely (e.g., cases where litigation may be a preferable means for resolving controversy should the transaction be challenged), or where a particular tax authority's views are inconsistent with the OECD's guidance, which could lead to an inability to reach a resolution.

Other factors to consider include the time and cost for both internal resources and external advisors to support the taxpayer through an audit/MAP process as compared to the time and cost associated with an APA. While pursuing an APA could be as resource intensive as one audit/MAP cycle, the APA process is often more time and cost effective than dealing with repeated audit cycles. APAs are generally also less contentious and more collaborative than audits and, as previously stated, should reduce the compliance burden for the remaining term of the APA.

F. Best Practices for a Successful APA

An **APA** — particularly a **BAPA**[18] — can be a very powerful tool to address recent, unaudited years, and to provide tax certainty for several years into the future. However, as previously discussed, it can also be an expensive, resource-intensive, and-time consuming endeavor. Fortunately, there are certain best practices that can mitigate some of these pitfalls while also maximizing the likelihood of success. To introduce what we consider to be best practices for an APA, it is helpful to first define a successful APA.

A successful BAPA is one in which the CAs reach a resolution on all of the proposed covered transactions. This provides tax certainty, guaranteeing that there will be no double taxation. But from the taxpayer's perspective, the most successful APAs share other attributes: they are negotiated quickly, provide a reasonably long term, and reach a resolution that closely adheres to what is proposed in the APA request. An APA request should aim to increase the likelihood of these objectives

An APA request is a taxpayer's opportunity to explain its business and its transactions to an unfamiliar but savvy audience. In contrast to the audit team, in most jurisdictions the CA will have no prior experience with, and therefore no expectations of or biases towards, the taxpayer.

[18] Multilateral APAs can be even more powerful than BAPAs. While the multilateral APAs are gaining more prominence, they still comprise a fraction of BAPAs given the complexity of adding a third (or more) CAs. Accordingly, this discussion will focus on BAPAs.

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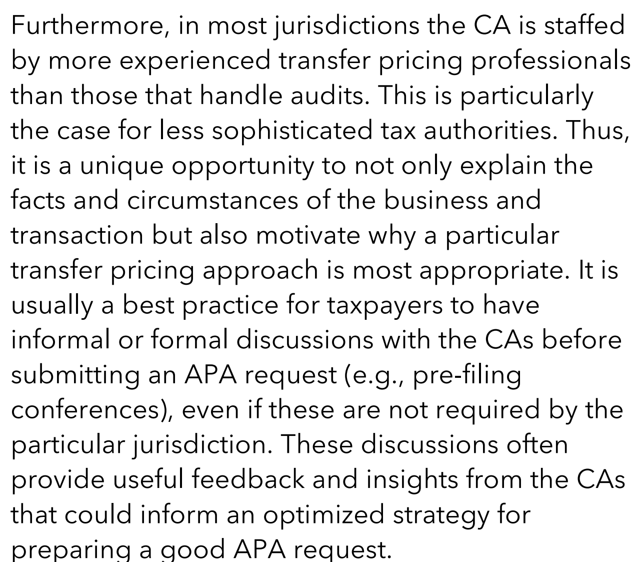

Furthermore, in most jurisdictions the CA is staffed by more experienced transfer pricing professionals than those that handle audits. This is particularly the case for less sophisticated tax authorities. Thus, it is a unique opportunity to not only explain the facts and circumstances of the business and transaction but also motivate why a particular transfer pricing approach is most appropriate. It is usually a best practice for taxpayers to have informal or formal discussions with the CAs before submitting an APA request (e.g., pre-filing conferences), even if these are not required by the particular jurisdiction. These discussions often provide useful feedback and insights from the CAs that could inform an optimized strategy for preparing a good APA request.

A good APA request is one which describes the relevant industry, the particular business, and the corresponding transactions in a clear and concise way. The language should avoid insider jargon; on the contrary, the drafting should reflect that the reader will be a layperson. Consistent with the BEPS project and the OECD TPG, the APA request should inform the reader as to the full supply and value chains, with particular emphasis on the corresponding role of the parties to the subject transactions. A well-written functional and industry analysis will not only provide sufficient context and foundation to understand and evaluate the covered transactions, it should also provide a compelling motivation for why the proposed transfer pricing methodology is most appropriate. In this regard, there should be sufficient information in the APA request to inform the key inflection points for the selection of the most appropriate transfer pricing method.

A seasoned transfer pricing practitioner could read the prior paragraph and conclude that these best practices also apply to transfer pricing documentation prepared for compliance. There is some truth to this. A good transfer pricing report is not one that merely provides the bare minimum to satisfy local requirements and/or provide penalty protection. A good transfer pricing report is a proactive audit defense document, a document that marshals facts in support of the taxpayer's as-filed position with the aim to avoid being audited in the first place. That said, there are still certain differences between good compliance documentation and a good APA request. For example, in compliance documentation it may be tactically advantageous to not fully discredit alternate transfer pricing approaches and, instead, focus more on why the proposed transfer pricing methodology is most appropriate. This provides the taxpayer with greater latitude in defending its as-filed position under audit. In an APA, however, it may be advantageous to offer full-throated arguments both in support of the proposed methodology and against the alternatives. After all, in contrast to recurring audits or to MAPs, neither tax authority has pre-existing views of the specific transactions for this taxpayer, much less a position they may feel compelled to defend. The APA request will not only provide the information on which the CAs establish their view, it also provides a compelling argument supporting the proposed agreement. If done right, the proposed agreement will anchor the negotiation.

A high-quality APA request may require a greater up-front investment. However, this investment should pay dividends. The better the APA request, the less additional information should be required by the CAs. Naturally, the fewer (and less onerous) information requests, the less post-request effort required. In other words, a greater up-front investment could be more than offset by lower post-request costs. But arguably, the more important benefit is a shorter negotiation period (i.e., a shorter period of uncertainty). This may also result in a greater prospective term.

To streamline and expedite the APA process, it is very important for the taxpayers and/or their advisors to be in regular contact with the CAs in order to facilitate the review, due diligence, negotiation, finalization, and implementation of the APA. Taxpayers should also try to work with the CAs to agree on a project plan outlining the timelines for each stage of the process.

If the taxpayer has other affiliates with similar transactions and fact patterns the value of an APA can be further compounded. For example, consider an MNE that owns unique, very valuable manufacturing technology. This technology allows it to command significant market share and generate premium profits. It licenses this technology to subsidiaries around the world who manufacture and sell to third parties. This fact pattern strongly benefits from an APA (e.g., hard-

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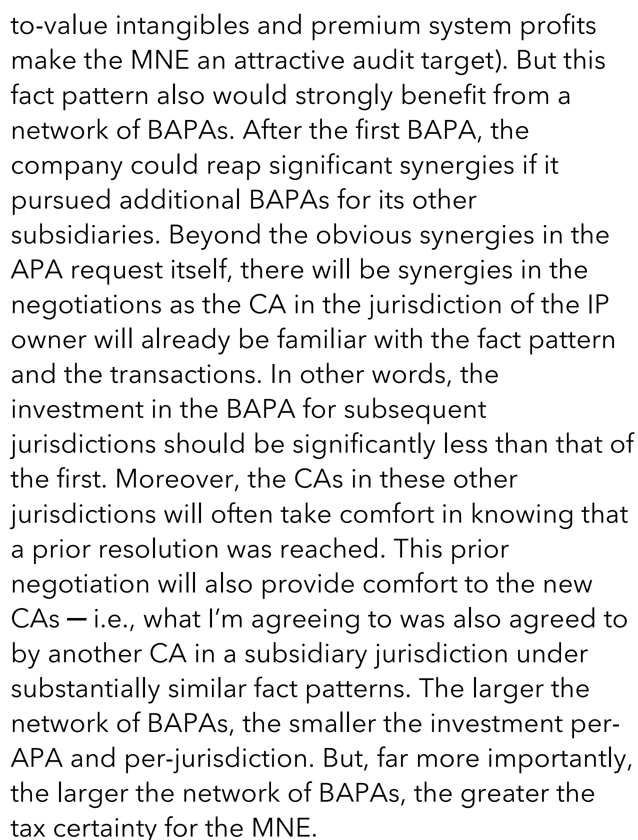

to-value intangibles and premium system profits make the MNE an attractive audit target). But this fact pattern also would strongly benefit from a network of BAPAs. After the first BAPA, the company could reap significant synergies if it pursued additional BAPAs for its other subsidiaries. Beyond the obvious synergies in the APA request itself, there will be synergies in the negotiations as the CA in the jurisdiction of the IP owner will already be familiar with the fact pattern and the transactions. In other words, the investment in the BAPA for subsequent jurisdictions should be significantly less than that of the first. Moreover, the CAs in these other jurisdictions will often take comfort in knowing that a prior resolution was reached. This prior negotiation will also provide comfort to the new CAs — i.e., what I'm agreeing to was also agreed to by another CA in a subsidiary jurisdiction under substantially similar fact patterns. The larger the network of BAPAs, the smaller the investment per-APA and per-jurisdiction. But, far more importantly, the larger the network of BAPAs, the greater the tax certainty for the MNE.

G. Key Questions — Survey of Jurisdictions

The discussion below addresses certain important questions from the perspective of various jurisdictions.[19] The below synthesizes a survey of seasoned, on-the-ground transfer pricing advisers.

1. What is the Risk that an APA Application Could Lead to an Audit?

In an APA process, tax authorities expect that taxpayers will be collaborative and transparent, sharing detailed information about their businesses and transactions. After all, this is a taxpayer-initiated procedure. In light of this, taxpayers may be concerned that the information shared could be used to either initiate audits where none would have otherwise taken place, or to better identify exposures in ongoing audits. In general, an APA application alone should not increase the risk of audit. This makes sense as it would seem to be a poor policy for tax authorities to disincentivize APA applications in this way. However, an exception could be an increased risk of audits for recent years that are not within the proposed APA term. This is why it is generally recommended that an APA request propose roll-backs for any open years that have not been audited, although the availability of this coverage varies from jurisdiction to jurisdiction.

APAs provide protection against audits insofar as the guidelines in most jurisdictions[20] prohibit the tax authority from initiating audits for years that are within the proposed APA term. However, in the event that the CAs are not able to reach resolution on some or all the covered transactions, or should the taxpayer reject the outcome or withdraw from the process, there may be an increased risk of audit. For example, in the United States, APMA is required to inform the taxpayer's audit team if either the proposed APA does not reach resolution or if they identify an exposure that the APA does not remedy. While certain jurisdictions bar the tax authority from sharing information gleaned from an APA procedure with the audit team (e.g., France, Spain, Japan), others make clear that any information provided during an APA process can be used in an audit (e.g., Canada). The United States makes a clear distinction that factual information can be used as evidence in any administrative or judicial proceeding (including in an audit), though non-factual information (if identified as such) shared in the APA process cannot be used as evidence in any administrative or judicial proceeding.

It is worth noting that in certain circumstances, APAs can be shared with the audit functionto manage or mitigate existing audits. As noted above, an APA could be used to prevent an expected audit from taking place. Moreover, it is sometimes possible to suspend audits through an

[19] Australia, Canada, China, France, Germany, Italy, Japan, Mexico, the Netherlands, Spain, Switzerland, the United Kingdom, and the United States.

[20] France is a notable exception of a jurisdiction where an ongoing APA negotiation does not preclude the initiating of an audit for a year within the proposed APA term. Similarly, CA proceedings in Switzerland are generally conducted independently from the activities of both the federal and cantonal tax administrations (although there is a certain amount of coordination taking place in practice).

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APA. This possibility depends on the jurisdiction and sometimes is at the discretion of the tax authority. In general, the likelihood of suspending an audit is greater if the APA request is filed before the audit has made significant progress.

2. How Robust Are the Specific Rules and Guidance for an APA?

As discussed throughout this Special Report, APAs in general and BAPAs in particular have proliferated. In this regard it is perhaps not surprising that many key jurisdictions provide rather robust rules or guidance for BAPAs. This is the case for the vast majority of jurisdictions surveyed. Notable exceptions are Australia (for unilateral APAs), Mexico and Spain (comprehensive rules but no guidance), and Switzerland (no specific legal framework for APAs which are governed on the basis of the mutual agreement provisions contained in tax treaties). It is worth noting that a few jurisdictions have either recently provided robust rules or guidance for the first time, or have updated their guidance (e.g., Germany, the Netherlands). Furthermore, other jurisdictions are expected to provide updated guidance in the near future (e.g., Canada, the U.S.).

3. Ease of Acceptance into the APA Program

For many of the jurisdictions surveyed, acceptance into the APA program is relatively easy as long as the procedural and substantive requirements are met. However, several jurisdictions have additional barriers to admittance. Some, for example, appear to reject APA requests that involve transactions that are either viewed as having a clear tax minimization purpose or are otherwise problematic (e.g., Australia, Canada).[21] Conversely, other jurisdictions may have a dim view of APA requests if they believe that the transaction is either low risk or not significant enough (in currency terms) to warrant an APA (e.g., the U.K.). In this instance, tax authorities are generally fielding an increasingly greater volume of APA requests and, sensibly, they want to obtain the greatest value from their APA program.

Other jurisdictions may decline admittance into their APA program when, for example, they deem the taxpayer has not been sufficiently collaborative and transparent, they deem the primary objective of the transaction is tax avoidance, or one of the parties is in a listed, low-tax jurisdiction (e.g., Australia, Canada, China, Germany, Japan, the Netherlands).

It is worth noting that being accepted into a BAPA process by both jurisdictions does not necessarily guarantee that the CAs will reach an agreement. But there are instances where acceptance does guarantee an agreement. For example, the U.S. - Germany tax treaty calls for mandatory arbitration should the CAs fail to reach a resolution after two years after the commencement date of the case, which is defined as the earlier of i) the date on which the CAs have exchanged position papers setting forth their initial negotiating positions, or ii) two years from the earliest date on which the information necessary to undertake substantive consideration for a mutual agreement has been received by CAs.

4. How Complex is the APA Application Process?

In general, the APA application process is relatively straightforward. However, straightforward applications can still be relatively onerous in terms of the information required by the taxing authorities to accept and process the case. In certain jurisdictions, the taxpayer is in practice required to participate in a pre-file conference and, in some instances, provide additional information or participate in additional pre-file conferences to address the CA's due diligence concerns before being invited to apply for an APA (e.g., Australia, Canada, China, Germany). One benefit of the recent Covid-19 pandemic is that some tax

[21] In the United States, APMA recently publicly stated that it is reevaluating its acceptance criteria and considering being more selective in their acceptance process. See, Erin Slowey, "IRS Reevaluating Advance Pricing Agreement Selection" Bloomberg Daily Tax Report, (Oct. 6, 2022), https://news.bloombergtax.com/daily-tax-report/irs-continues-to-reevaluate-advance-pricing-agreement-selection.

authorities now accept digital submissions (e.g., the United States).

5. Negotiation Process: Are the Information Requests Significant and Onerous? How Rigorous is the Technical Analysis?

In our experience, BAPA processes require significant information and likely will involve technical, rigorous analysis. Furthermore, it is not uncommon for CAs to examine other intercompany transactions outside of the proposed scope of the APA to get a better sense of the overall impact from controlled transactions on the relevant entity. For example, both Canada and the United States may request that the scope of the APA be expanded to cover other transactions where they are interrelated and are most reliably evaluated together. Some CAs will also examine considerations beyond income tax (e.g., withholding tax, permanent establishment, anti-avoidance provisions, characterization of payments).

Notwithstanding the foregoing, information requests via the APA program are arguably less onerous and the process less contentious than would be faced under audit. Furthermore, and as discussed in the best practices section, II.F., above, the scale and breadth of information requests can be mitigated through a high-quality APA request. In contrast to audits, APA processes generally involve more skilled professionals at the tax authority, which is beneficial to complex, nuanced fact patterns and transactions, and the counterweight of another CA that may take a more sympathetic view of the transaction. During the APA process, authorities also take into account OECD guidelines and do not just rely on domestic laws in the review.

6. Tax Authorities' Views of Unilateral vs. Bilateral APAs

Just over half of the jurisdictions surveyed noted a strong preference for bilateral or even multilateral APAs over unilateral APAs. This reflects a hesitation or even unwillingness to commit the time and resources for a unilateral APA only to have to revisit the matter under MAP. Likewise, certain CAs (e.g., the United States) have a strong preference against a unilateral APA where a tax treaty is in place because the unilateral APA process prevents bilateral discourse and negotiation on the covered issues; in such cases, the treaty partner that is not a party to the unilateral APA may not agree to providing any needed correlative relief via MAP (where required) if they were not a party to those unilateral discussions and agreement. In these jurisdictions, the basis for requesting a unilateral APA often needs to be justified in order to gain acceptance (e.g., when there is no tax treaty).

The remaining jurisdictions are more receptive of unilateral APAs. These include China (where unilateral APAs have been heavily promoted over the last few years), Italy, Japan, Mexico, Spain, and Switzerland.

7. What is the Typical Term of an APA?

Many countries have a five-year term (inclusive of jurisdictions that propose terms of three to five years). Some jurisdictions are more flexible. For example, while Canada typically limits the term to five years at the time of request, given the time needed to negotiate and conclude APAs, the Canada Review Agency ("CRA") will generally offer to extend the term so that there are at least two to three prospective years. The United States likewise prefers that an APA request be filed early enough so that the proposed APA term covers at least five prospective years and, like Canada, would seek to extend the APA term beyond five years in the case of protracted negotiations to ensure that the APA continues to offer prospective application. Other jurisdictions could allow for a term greater than five years but these are not common (e.g., Netherlands - in exceptional cases thereby requiring a mid-term review).

The availability of rollback years varies. Some jurisdictions exclude rollbacks altogether (e.g., France) or notes that they are at the discretion of the tax authority (e.g., Germany). China is an outlier in potentially accepting rollbacks for as many as 10 years. In Japan, rollbacks are not allowed for unilateral APAs, but can be applicable to bilateral and multilateral APAs. Canada is the same in that unilateral APAs are effective as of the first unfiled tax year at the time the APA is signed and no rollback to any filed years is permitted. Even years that are filed while the unilateral APA is under negotiation are not eligible for coverage under the unilateral APA.

8. What is the Likelihood that an APA will be Revoked or Otherwise Canceled?

There is almost universal certainty in that APAs cannot be revoked or otherwise canceled provided the critical assumptions and other terms of the APA are met, as well as the monitoring and reporting requirements. One exception is if the taxpayer does not act in good faith (e.g., purposely withholding or misrepresenting information relevant to the APA).

In the U.S., there is very recent case law limiting the IRS's discretion to cancel an APA. In late August of this year, the Sixth Circuit held in *Eaton Corp. & Subs. v. Commissioner*[22] that the IRS had the burden of proving that there were grounds to cancel the APAs under generally applicable contract-law principles and the IRS failed to meet that burden.

H. Key Takeaway

As tax administrations and the OECD continue to invest in APA programs by increasing staffing and other resources, and as global transfer pricing controversy continues to increase, APAs, and BAPAs in particular, continue to be an excellent option for preventing and resolving transfer pricing issues (particularly the more challenging ones) and provide transfer pricing certainty to taxpayers vis-à-vis the covered transactions.

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[22] *Eaton Corp. & Subs. v. Commissioner*, 47 F.4th 434 (6th Cir. 2022) (reversing the U.S. Tax Court's determinations that APAs are administrative determinations that are not subject to review under contract principles and that an arbitrary and capricious standard of review applies).

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III. Avoiding Double Taxation – International Remedies

By Laura Nguyen-Lapierre

A. Overview of MAP and Arbitration

From a treaty perspective, there are two types of double taxation that may arise:

- Juridical double taxation arises where the same profit or income is subject to tax in the hands of the same legal entity for the same time period by two different countries. Examples of juridical double taxation arise in the event of a conflict of residence, or from an adjustment regarding the attribution of profits to a permanent establishment (PE) dealing with its head office.
- Economic double taxation arises where two countries tax the same profit or income in the hands of two legally distinct entities. It can result from a transfer pricing adjustment between two associated enterprises situated in two jurisdictions.

Both juridical and economic double taxation can be eligible to MAP provided by the applicable bilateral tax treaty. MAP is provided under Article 25 of the 2017 OECD Model Tax Convention[23] and Article 25 of the 2021 UN Model.[24]

In the event of economic double taxation resulting from a transfer pricing adjustment, Article 9-2 of the OECD Model Tax Convention (where included in the applicable bilateral treaty) can provide the possibility for the Contracting States to eliminate double taxation unilaterally, without the need to open a MAP (a similar provision is provided by the 2021 UN Model).

According to available MAP data (OECD statistics[25]), a total of 6,478 MAP cases were pending as of the end of 2020, out of which 3,503 were transfer pricing cases.

Among the 2378 cases closed in 2020, 51% were concluded with a full elimination of double taxation or resolution of taxation not in accordance with the treaty. In 16% of cases, a unilateral relief was granted and in 7% of cases they were resolved via domestic remedy.

The average time for transfer pricing cases is 35 months (versus 18.5 months for other cases). As it is an average, there are disparities among countries, some being closer to a 2-year time line (e.g., Australia, Belgium, Canada, Korea, Netherlands, Switzerland…) while other have far longer time line (e.g., 47 months for China, 63 months for India, 41 months for Japan, 59 months for South Africa, 47 months for the US…).

B. Procedural Aspects

Bilateral tax treaties generally provide for the resolution of disagreements or questions regarding the interpretation or application of the treaty, in line with Article 25 of the 2017 OECD Model or of the 2021 UN Model.[26] In the below discussion, we will focus on the MAP and arbitration procedure as provided by the OECD Model, unless otherwise specified.[27]

1. MAP Under Bilateral Tax Treaties

The deadline for the submission of MAP requests under treaties is generally three years from the date of the "first notification" of the action resulting

[23] Model Tax Convention on Income and on Capital 2017 (Full Version), OECD Publishing, Paris.

[24] United Nations Model Double Taxation Convention Between Developed and Developing Countries 2021.

[25] See OECD 2020 Mutual Agreement Procedure Statistics, https://www.oecd.org/tax/dispute/mutual-agreement-procedure-statistics.htm (last accessed on Sept. 22, 2022).

[26] Guidance on MAP under the UN Model is developed in Part 2 of the 2021 "Handbook on Avoidance and Resolution of Tax Disputes."

[27] Particular bilateral treaties may depart from the OECD Model in certain respects, so the applicable treaty provisions should always be reviewed carefully. In addition, some countries supplement the general guidance provided by the OECD with national guidance.

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in taxation not in accordance with the provisions of the Convention.

Although it is inconsistent with BEPS Action 14, a few countries have argued that their domestic statutes of limitations may be applied to preclude CA consideration even prior to the deadline set by the treaty. More commonly, countries may take the position that their domestic statutes of limitations limit the application of a CA agreement if the treaty is silent on the matter of deadlines. Others maintain that this approach is barred by the standard treaty language providing that, "any agreement reached shall be implemented notwithstanding any time limits in the domestic law of the Contracting States." Given the variety of interpretations applied, the positions of the relevant CAs should be confirmed on a case-by-case basis as early as possible.

Most treaties, in line with the prior OECD Model (2014), require that the CA process be initiated in the Contracting State where the person requesting consideration is a resident, while the 2017 OECD Model provides that the MAP request must be presented to the CA of either Contracting State. This change in the 2017 version was made to reinforce the general principle that access to MAP should be as widely available as possible and to provide flexibility.

As a practical matter, a common practice is to file the MAP request simultaneously in both States (some countries require or strongly encourage this approach).

The MAP is divided into two stages:

- An internal phase, during which the procedure takes place exclusively between the taxpayer and the CAs of the State to which the case was presented. The CAs make a preliminary assessment of the taxpayer's objection and may resolve the issue without moving beyond the first (unilateral) stage of the MAP.
- A bilateral phase, which is initiated when the CA initially seized considers whether the taxation complained of is due, wholly or in part, to a measure taken in the other State.

Although the CAs are not required by treaty to reach a mutual agreement, and treaties do not set a deadline for the conclusion of such agreements per se, the BEPS Action 14 Final Report specifies an average time frame of 24 months as a minimum standard for the resolution of MAP cases. Statistics (see III.A., above) show that this time frame is not the standard for transfer pricing cases in practice but given the MAP Forum peer review process (see below, III.D.), it could be hoped that CAs will strive to reach a resolution within this period, all the more where mandatory arbitration applies as described below, in III.B.3.

2. MAP Under the European Directive

On October 10, 2017, the EU adopted a directive (2017/1852) on tax dispute resolution mechanisms ("**European Directive**"), as part of the EU Action Plan for A Fair and Efficient Corporate Tax System in the European Union.[28]

The European Directive introduces an effective and efficient framework for the resolution of tax disputes concerning the interpretation and application of tax treaties and conventions. It builds on existing systems in the EU, including the European convention of July 23, 1990[29] ("**Arbitration Convention**"). However, the scope of the European Directive is broader than the one of the Arbitration Convention because it covers disputes concerning the interpretation and application of bilateral tax treaties among Member States and is not restricted to transfer pricing disputes and adjustments in connection with the allocation of profits to a PE. Furthermore, the legal nature of the European Directive makes it a more powerful legal instrument than the Arbitration Convention.

The European Directive applies to any complaint, submitted from July 1, 2019, onward, regarding

[28] See the Communication from the Commission to the European Parliament and the Council: A Fair and Efficient Corporate Tax System in the European Union: 5 Key Areas for Action (June 17, 2015).

[29] Convention on the Elimination of Double Taxation in Connection with the Adjustment of Profits of Associated Enterprises (90/436/EEC).

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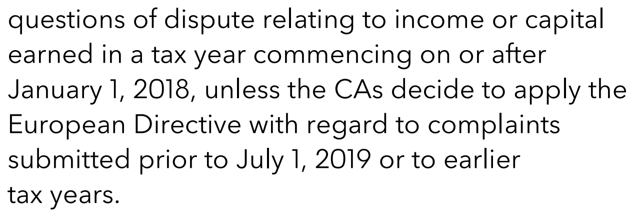

questions of dispute relating to income or capital earned in a tax year commencing on or after January 1, 2018, unless the CAs decide to apply the European Directive with regard to complaints submitted prior to July 1, 2019 or to earlier tax years.

Overview of Procedure

The complaint must be submitted by the taxpayer within three years from the receipt of the first notification of the action resulting in, or that will result in, the question in dispute.

The taxpayer has to simultaneously submit the complaint with the same information to each CA and has to indicate in the complaint which other Member States are concerned.

The European Directive provides for a detailed time frame for each step of the procedure. Each CA shall acknowledge receipt of the complaint within two months from the receipt of the complaint. Each CA shall also inform the CAs of the other Member States concerned of the receipt of the complaint within two months of the receipt. The CAs of each of the Member States concerned shall make a decision on the acceptance or rejection of the complaint within six months of the receipt thereof or within six months of the receipt of the additional information, whichever is later. The CAs shall inform the affected person and the CAs of the other Member States of their decision immediately. Within a period of six months from the receipt of a complaint, or within six months of the receipt of the additional information, whichever is later, a CA may decide to resolve the question in dispute on a unilateral basis, without involving the other CAs of the Member States concerned.

Where the CAs of the Member States concerned accept a complaint, they must endeavor to resolve the question in dispute by mutual agreement within two years, starting from the last notification of a decision of one of the Member States on the acceptance of the complaint. The period of two years may be extended by up to one year at the request of a CA of a Member State concerned to all of the other CAs of the Member States concerned, if the requesting CA provides written justification.

Double taxation is regarded as eliminated if the profits are included in the computation of taxable profits in one State only, or if the tax chargeable to those profits in one State is reduced by an amount equal to the tax chargeable on them in the other.

Parallel Recourse Under Bilateral Treaties

The submission of a complaint puts an end to any other ongoing proceedings under the MAP or dispute resolution procedure under an agreement or convention that is being interpreted or applied in relation to the relevant question in dispute. Other ongoing proceedings concerning the relevant question in dispute shall end with effect from the date of the first receipt of the complaint by any of the CAs of the Member States concerned.

Denial of Access

A taxpayer may be denied access to the dispute resolution procedure provided by the European Directive where penalties were imposed in that Member State in relation to the adjusted income or capital for tax fraud, willful default and gross negligence. Where the commencement of judicial or administrative proceedings could potentially lead to such penalties, and if these proceedings were being conducted simultaneously with any of the proceedings referred to in the European Directive, a CA may stay the proceedings under the European Directive, as of the complaint's date of acceptance until the date of the final outcome of those proceedings.

Member States may deny access to the dispute resolution procedure on a case-by-case basis, where a question in dispute does not involve double taxation. In this case, the CA of said Member State has to inform the taxpayer and the CAs of the other Member States concerned without delay.

Articulation with the Arbitration Convention

By effect of the amendment by the protocol adopted in 1999, the Arbitration Convention has been automatically extended every five years since December 31, 2004, unless contracting states decide otherwise. The European Directive requires that other MAPs or dispute resolution procedures, if any, are terminated to benefit from the European Directive's application. This would exclude parallel

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submissions under the Arbitration Convention and the European Directive, although there is no specific provision as of today as to the articulation between the Arbitration Convention and the European Directive.

3. Arbitration Under Bilateral Tax Treaties

33 countries[30] opted in for the introduction of a mandatory arbitration provision into their applicable tax treaties through the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting ("MLI").[31]

Under the MLI, the mandatory binding arbitration rules will apply only if both parties to a treaty have opted in and agree on the procedures to be implemented.

Irrespective of (and prior to) the application of the MLI, some bilateral tax treaties also include an arbitration clause in the event of unresolved taxation by the CAs under a MAP.[32] Examples of such treaties include those between:

- the United States and Belgium,[33]
- the United States and Canada,[34]
- the United States and France,[35]
- the United States and Germany,[36]
- the United States and Spain,[37]
- the United States and Switzerland,[38]
- France and Germany,[39]
- France and the UK, and[40]
- the Netherlands and the UK.[41]

Where the CAs are unable to reach an agreement under the MAP phase within two years,[42] the unresolved issues can be solved through an arbitration process, at the request of the person who presented the case.[43]

The OECD Commentary on Article 25 specifies that recourse to arbitration is "not automatic; the person who presented the case may prefer to wait beyond the end of the two-year period (for example, to allow the CAs more time to resolve the case under paragraph 2) or simply not to pursue the case."

[30] Based on the OECD Arbitration Profiles as of September 16, 2022: Andorra, Australia, Austria, Barbados, Belgium, Canada, Curaçao, Fiji, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Japan, Lesotho, Liechtenstein, Luxembourg, Malta, Mauritius, the Netherlands, New Zealand, Papua New Guinea, Portugal, Singapore, Slovenia, Spain, Sweden, Switzerland and the UK. Although not included in the OECD Arbitration Profiles, Denmark and Namibia chose to apply Part VI (Arbitration) of the MLI.

[31] The MLI is the result of the work conducted under and further to the OECD/G20 Base Erosion and Profit Shifting Action 15. Pursuant to the MLI, if two countries opted in for the mandatory arbitration clause, this clause will be introduced in the bilateral convention in force between these two countries. The text of the MLI is available here: https://www.oecd.org/tax/treaties/beps-mli-signatories-and-parties.pdf (accessed on Sept. 22, 2022).

[32] This clause was introduced in the OECD Model by the 2008 update.

[33] Article 24.7 of the USA/Belgium double taxation convention ("DTC") signed on Nov. 27, 2006.

[34] Article 26.6 of the USA/Canada DTC signed on Sept. 26, 1980, as amended by protocols through 2007.

[35] Article 26.5 of the USA/France DTC signed on Aug. 31, 1994, as amended by the protocols signed on Dec. 8, 2004, and Jan. 13, 2009.

[36] Article 25.5 of the USA/Germany DTC signed on August 29, 1989, as amended by the protocol signed on June 1, 2006.

[37] Article 26.5 of the USA/Spain DTC signed on February 22, 1990, as amended by the 2013 protocol signed on Jan. 14, 2013.

[38] Article 25.6 of the USA/Switzerland DTC signed on Oct. 2, 1996, as amended by the protocol signed on Sept. 23, 2009.

[39] Article 25.5 of the Germany/France DTC signed on July 21, 1959, as amended by the MLI.

[40] Article 26.5 of the UK/France DTC signed on June 19, 2008, as amended by the MLI.

[41] Article 25.5 of the UK/Netherlands DTC signed on Sept. 26, 2008, as amended by the protocol signed on June 12, 2013.

[42] In contrast, the 2021 UN Model provides for a three-year deadline.

[43] In contrast, the 2021 UN Model provides that arbitration should be requested by the CA of one of the Contracting States.

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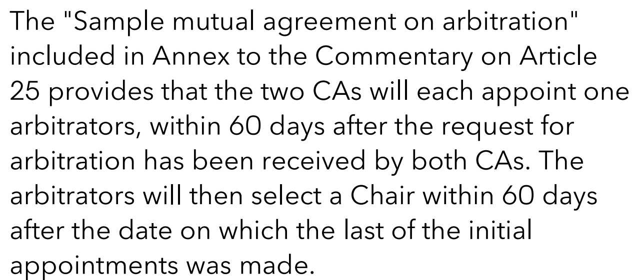
The "Sample mutual agreement on arbitration" included in Annex to the Commentary on Article 25 provides that the two CAs will each appoint one arbitrators, within 60 days after the request for arbitration has been received by both CAs. The arbitrators will then select a Chair within 60 days after the date on which the last of the initial appointments was made.

The OECD Model leaves the mode of application of the arbitration process to be settled by mutual agreement. The "Sample mutual agreement on arbitration" takes as its starting point the “last best offer” approach, i.e., each CAs is required to give to the arbitration panel a proposed resolution of the issue involved and the arbitration panel chooses between the two proposals which were presented to it, without including a rationale or any other explanation of the decision.

In recognition of the fact that in some cases, especially those which involve complex legal questions, the CAs may prefer to receive a more elaborate decision, the "Sample mutual agreement on arbitration" also provides for an alternative “independent opinion” process, i.e. the arbitrators are presented with the facts and arguments by the parties based on the applicable law, and then reach their own independent decision which is based on a written, reasoned analysis of the facts involved and applicable legal sources. CAs can agree to use that independent opinion process on a case-by-case basis.

CAs may adopt a combined approach, adopt the independent opinion approach as the generally applicable process with the last best offer approach as an option or limit themselves to only one of the two approaches.

As part of the “last best offer” approach, the "Sample mutual agreement on arbitration" recommends the following time frame:

- Within 60 days of the appointment of the Chair, each CA must submit to the arbitrators a proposed resolution, which may be supported by a position paper.
- Each CA may also submit within 120 days after the appointment of the Chair a reply submission with respect to the proposed resolution and supporting position paper submitted by the other CA.
- The arbitration decision has to be delivered within 60 days after the reception by the arbitrators of the last reply submission or, if no reply submission has been submitted, within 150 days after the appointment of the Chair.

In case of an alternative “independent opinion” process, the recommended time frame is as follows:

- Each CA must provide to the arbitration panel and to the other CA any information that it considers necessary for the panel to reach its decision, within 120 days after the election for the alternative process.
- Contrary to the "last best offer" approach, it is expected that one or more meetings of the arbitration panel and both CAs can be necessary to discuss the case, and the person requesting arbitration is entitled to present a written submission of its position to the arbitrators and, if the CAs and arbitrators all agree, to make an oral presentation during a meeting of the arbitrators.
- It belongs to the arbitrators to develop the procedural rules on an ad hoc basis that govern the “independent opinion” arbitration process.
- The decision of the arbitration panel has to be delivered to the CAs in writing within 365 days after the date of the appointment of the Chair.

The “Sample mutual agreement on arbitration” suggests that the mutual agreement that incorporates the solution arrived at should be completed and presented to the taxpayer within 180 days after the date of the communication of the arbitration decision.

4. Arbitration Under the European Directive

Where the CAs of the Member States concerned have not reached an agreement on how to resolve the question in dispute within the two-year period (possibly extended by one year), the

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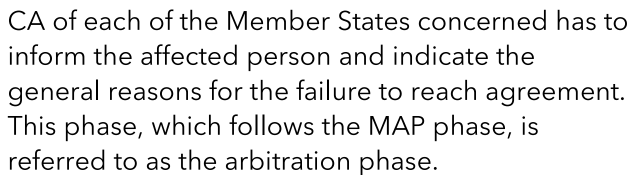

CA of each of the Member States concerned has to inform the affected person and indicate the general reasons for the failure to reach agreement. This phase, which follows the MAP phase, is referred to as the arbitration phase.

The arbitration phase is divided into three periods:

- The CAs must constitute an Advisory Commission (consisting of representatives of both tax authorities concerned and independent persons of standing) or an Alternative Dispute Resolution Commission (providing flexibility in the choice of dispute resolution methods);
- The latter has to render its opinion; and
- The CAs must reach a final decision.

The Advisory Commission or the Alternative Dispute Resolution Commission has to deliver its opinion to the CAs of the Member States concerned no later than six months after the date on which it was set up; this period may be extended by three months.

The dispute resolution process applied by the Advisory Commission is the "independent opinion" process. As an alternative to the process applied by the Advisory Commission, any other type of dispute resolution process, including the "final offer" arbitration process (otherwise known as "last best offer" arbitration), can be agreed by the CAs of the Member States concerned and applied by the Alternative Dispute Resolution Commission.

The CAs concerned have to agree on how to resolve the question in dispute within six months of the notification of the opinion of the Advisory Commission or Alternative Dispute Resolution Commission. The CAs may make a decision that deviates from the opinion of the Advisory Commission or Alternative Dispute Resolution Commission. However, if they fail to reach an agreement as to how to resolve the question in dispute, they shall be bound by that opinion.

It should be noted that some countries (e.g., France, Germany, Spain) have reserved their rights, under the MLI reservations, to exclude from mandatory arbitration pursuant to the MLI any case that falls within the scope of application of an arbitration procedure established by the EU, such as the Arbitration Convention, or the European Directive, or any subsequent regulation.

C. Articulation with Domestic Litigation

The possibility of resorting to MAP must be anticipated because it needs to be articulated with the strategy adopted within the framework of the management of the transfer pricing dispute in order to be fully effective.

For example, although it is not in accordance with stated OECD principles, tax authorities still may request that the taxpayer renounces the right to MAP within the framework of a tax settlement; it will therefore be necessary for the taxpayer to be able to determine the cost/benefit balance of a tax settlement with regard to double taxation which would not be eliminated.

Moreover, "serious penalties" applied as part of the tax audit that have become definitive may prevent access to the MAP.

Finally, a MAP is, in theory, completely compatible with judicial proceedings. Nevertheless, it is essential to coordinate the timing of the two procedures, depending on the objective sought. For example, the implementation of a MAP may require the taxpayer to withdraw from the litigation or waive the benefit of res judicata; or, on the contrary, the existence of a judicial proceedings may delay the processing of the MAP, or even block access to arbitration in the event of a judicial decision becoming final.

In effect, the submission of the question in dispute to procedures covered by the European Directive for instance does not prevent a Member State from initiating or continuing judicial proceedings or proceedings for administrative and criminal penalties in relation to the same matters. Similarly, the taxpayers may have recourse to the remedies available to them under the national law of the Member States concerned. However, where the affected person has commenced proceedings to seek such a remedy, the terms of the six-month period (under which the CAs have to make a decision on the acceptance or rejection of a complaint) and the two-year period (under which the CAs have to endeavor to resolve the question in dispute) respectively shall commence from the

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date on which a judgment delivered in those proceedings has become final or on which those proceedings have otherwise been definitively concluded or where the proceedings have been suspended.

For the application of the European Directive, where a decision on a question in dispute has been rendered by the relevant court or other judicial body of a Member State, and the national law of that Member State does not allow it to derogate from the decision, that Member State may provide that:

- Before an agreement has been reached by the CAs under the MAP on that question in dispute, the CA of that Member State is to notify the CAs of the Member States concerned of the decision of the relevant court or other judicial body, and that procedure is to be terminated as from the date of such notification.
- Before the affected person has made a request for an Advisory Commission to be set up, the provisions relating to the resolution by an Advisory Commission do not apply if the question in dispute had remained unresolved during the whole of the MAP. In this case, the CA of that Member State is to inform the CAs of the Member States concerned of the effect of the decision of the relevant court or other judicial body.
- The dispute resolution process with the Advisory Commission is to be terminated if the decision of the relevant court or other judicial body was rendered at any time after an affected person made a request to set up an Advisory Commission but before the Advisory Commission or the Alternative Dispute Resolution Commission has delivered its opinion to the CAs of the Member States concerned. In this case, the CA of the relevant Member State concerned is to inform the other CAs of the Member States concerned and the Advisory Commission or the Alternative Dispute Resolution Commission of the effect of the decision of the relevant court or other judicial body.
- A careful review of the applicable treaty/EU provisions and national regulations is therefore key to ensure an efficient articulation of international remedies (bilateral or EU) and domestic procedures.

D. Peer Review Information

The BEPS Inclusive Framework members agreed on:

- a peer review process to evaluate the implementation of this standard and
- to report MAP statistics under a newly developed reporting framework.

The peer review process was launched at the end of 2016, with 82 jurisdictions to be reviewed in 10 batches and is now completed:

- In stage 1, jurisdictions' implementation of the Action 14 Minimum Standard was evaluated and recommendations were made where jurisdictions had to improve in order to be fully compliant with the requirements under this standard. In February 2021, the final batch of stage 1 peer review reports were published: based on OECD data, "Of the more than 1750 recommendations made, about 66% (+/- 1150) relate to deficiencies in tax treaties with respect to the MAP article. Around 34% (+/- 600) of the recommendations relate to MAP practices and policies that are not in line with the minimum standard."[44]
- The follow-up of the recommendations was measured in stage 2 of the process. Stage 2 reports for the 82 jurisdictions that were peer reviewed in batches 1-10 have been published from August 2019 until September 2022. Based on OECD data, "For the 82 jurisdictions reviewed in stage

[44] Action 14 - OECD BEPS, https://www.oecd.org/tax/beps/beps-actions/action14/ (accessed on Sept. 22, 2022).

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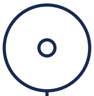

2, many have improved their performance with respect to the prevention of disputes, the availability of and access to MAP, the resolution of MAP cases and the implementation of MAP agreements."

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IV. Global Trends and Developments in Transfer Pricing Controversy

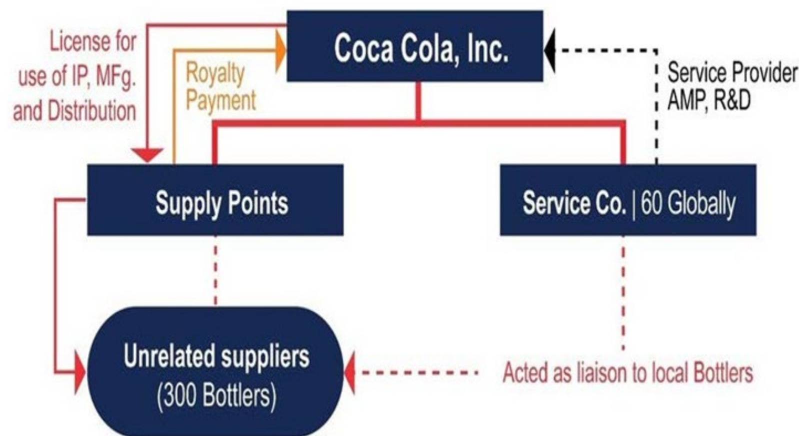
A. Coca Cola—U.S. Controversy

By Marc Levey [46]

The recently-decided Coca Cola case provides an important model for transfer pricing globally. Not only does the decision follow OECD principles, but it lays out, in detail, how to analyze a transfer pricing matter, prepare transfer pricing documentation, analyze marketing intangibles, ensure important legal agreements are properly executed, and ultimately defend against a transfer pricing case.

On November 18, 2020, the U.S. Tax Court ruled that the IRS had not abused its discretion under §482 when it reallocated more than USD 9 billion in income for tax years 2007 to 2009 to petitioner Coca-Cola from its foreign manufacturing affiliates.[47]

The case is factually straightforward. Below, we illustrate the relationships among the U.S. parent company (Coca-Cola), its foreign manufacturing affiliates (known as "Supply Points"), its local foreign service companies ("ServCos"), its independent foreign bottlers, and its "extremely valuable" intangible assets, including trademarks, logos, patents, secret formulas, and "the best-known brand in the world."



[46] This section and the discussions of Altera, Medtronic, and Facebook, below, are adapted from a chapter authored by Marc Levey in Transfer Pricing Developments Around the World 2022 (2022), 77-83, with permission of Kluwer Law International.

[47] Coca-Cola Co. & Subsidiaries v. Commissioner, 115 T.C. 145 (2020).

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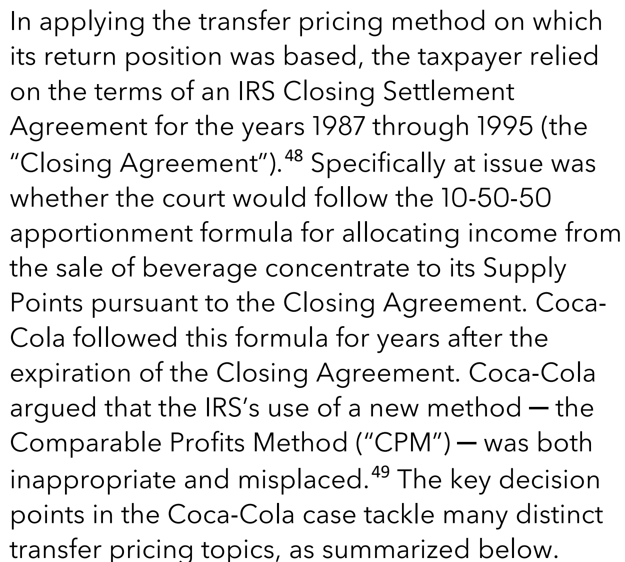

In applying the transfer pricing method on which its return position was based, the taxpayer relied on the terms of an IRS Closing Settlement Agreement for the years 1987 through 1995 (the "Closing Agreement").[48] Specifically at issue was whether the court would follow the 10-50-50 apportionment formula for allocating income from the sale of beverage concentrate to its Supply Points pursuant to the Closing Agreement. Coca-Cola followed this formula for years after the expiration of the Closing Agreement. Coca-Cola argued that the IRS's use of a new method — the Comparable Profits Method ("CPM") — was both inappropriate and misplaced.[49] The key decision points in the Coca-Cola case tackle many distinct transfer pricing topics, as summarized below.

1. Most Appropriate Method

The court determined that the CPM was an appropriate, reliable, and conservative transfer pricing method for determining the amounts that the Supply Points should have paid Coca-Cola for using its intellectual property. The Tax Court found that Coca-Cola's Supply Points were essentially "wholly-owned contract manufacturers" executing steps in the beverage-production process, and that Coca-Cola, rather than its Supply Points, owned "virtually all the intangible assets needed to produce and sell" the company's beverages. In light of these findings, the court concluded that the CPM was "ideally suited" to determine Coca-Cola's compensation for the use of its intellectual property because the CPM was capable of determining an arm's-length profit for the Supply Points without reverting to the value of Coca-Cola's particular valuable intangible assets. The court went into extraordinary detail in analyzing the Supply Points' Profit and Loss Statement, noting that its return on assets dramatically exceeded both the comparable firms reviewed and their returns on assets by five to seven times their returns. The court agreed with the IRS that Coca-Cola's appropriate comparable parties for the CPM analysis were the unrelated bottlers because they operated in the same industry, with similar relationships to Coca-Cola, using its items of intangible property to perform similar functions. Ultimately, the court found the IRS's CPM analysis conservative because the bottlers generally were entitled to a higher rate of return than the Supply Points, had less restricted rights, and could be terminated at will.

The court considered the theories proposed by Coca-Cola to establish that the Supply Points owned valuable marketing intangibles, namely, legal ownership and economic, beneficial ownership.[50] The court reviewed the trademark registrations and found that the Supply Points were not the legal owners of the trademarks nor marketing intangibles, citing the lack of adequate contractual terms. Specifically, the court reviewed the taxpayer's legal agreements to determine if the marketing intangibles were conveyed by contract, whether the contracts granted specific rights of ownership interest to the Supply Points or the contracts made clear that any marketing intangibles were the property of Coca-Cola. The court found the contracts provided that the long-term licenses were terminable at will and did not grant territorial exclusivity, nor guarantee a supply of production.

Key points to note here are:

- marketing intangibles to be asserted by a taxpayer must be established by contract;
- the non-exclusivity and termination at will of the licenses would not constitute a "sale" or conveyance under intellectual property law;

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[48] Taxpayer would have sought CA relief but had been turned away by the IRS in anticipation of litigation.

[49] The Tax Court had concluded in an earlier decision that the taxes were creditable because the taxpayer met both prongs of the compulsory test. See Coca-Cola Co. & Subsidiaries v. Commissioner, 149 T.C. 446 (2017).

[50] The court also considered the secondary argument that the Supply Points owned intangible assets in the form of "long term licenses." Citing former Reg. §1.482–4T(f)(a)(i)(A), which provided in part that the "legal owner of an intangible pursuant to intellectual property law of the relevant jurisdiction … or contract terms … will be considered the sole owner of the respective intangible unless such ownership is inconsistent with the economic substance of the underlying transactions."

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- taxpayers cannot affirmatively use the economic substance doctrine to assert marketing intangibles;
- pure advertising is an annual expense and likely would not constitute brand building or "non- routine" expenses; and
- the agreements were not economically sustainable as noted above.

Applying the CPM during audit, the IRS determined that the ratio of operating profit to operating assets ("ROA") for six of Coca-Cola's seven Supply Points during the years 2007 to 2009 was between 21.5% and 94%. The interquartile range of ROAs of Coca-Cola's independent bottlers was 7.4% and 3.8%. After the IRS reallocation of income from the Supply Points to Coca-Cola, the ROAs of the six Supply Points were between 34.3% and 20.9%. The Tax Court noted that these ROAs remained higher than almost 80% of the manufacturers analyzed by the IRS, which included Pepsi, Nestle, and other prominent beverage firms.

2. Three Alternatives Rejected

Coca-Cola proposed three alternative transfer pricing methods to support its contention that, in arm's-length transactions, Coca-Cola's foreign Supply Points would receive most of the income that Coca-Cola derives from foreign markets. The Tax Court rejected all three, as follows:

Comparable Uncontrolled Transaction ("CUT") method found "aggressive" and "mathematically and economically unsound:" This method generally compared Coca-Cola's Supply Points to fast-food master franchisers such as McDonald's. The court identified several flaws in this comparison, including that beverages and fast-food products are not similar products nor in the same general industry or market. Further, the Tax Court observed that Coca-Cola's Supply Points did not have similar long-term contracts, territorial exclusivity, nor management responsibilities of fast-food master franchisers. Also, because Coca-Cola's analysis did not include data from unrelated party transactions involving the transfers of trademarks, secret formulas, and other intangible property used in producing branded beverage products, the court concluded that the CUT method's reliability was questionable.

Residual Profit Split Method ("RPSM") found "wholly unreliable:" The proposed RPSM involved estimating a value for non-routine intangibles that Coca-Cola asserted were the property of the Supply Points. This estimate was based on capitalized advertising costs less amortization, rather than on external market benchmarks nor brand building expenditures. The court found this estimation method unreliable for two basic reasons: (1) the lack of consensus about whether the costs of advertising can be capitalized into intangible assets, particularly as these expenditures were annual expenses and not typically susceptible to capitalization; and (2) these assets would have no value to an unrelated party because an unrelated party could not use the asset without infringing Coca-Cola's trademarks.

The court also identified several other flaws in the proposed RPSM. For example, it determined that the Supply Points were the relevant controlled taxpayers under the §482 regulations, rather than a combination of Coca-Cola's Supply Points and local foreign service companies. The court also found that Coca-Cola, not its Supply Points, was the owner of the intangible assets involved in the transactions at issue. Regardless, the court found that it would not be appropriate to exclude the value of Coca-Cola's own intangible property determinations of the relative value of non-routine intangible property in the RPSM.

Coca-Cola's unspecified method: Coca-Cola based this method on the fee structure typically used to compensate hedge fund managers. The court determined that the method "does not remotely resemble any of the 'specified methods' for valuing intangibles under the §482 regulations" because it compensated Coca-Cola only for asset management services, and not for the use of the intangible assets.

3. Blocked Income Ruling Reserved

The Tax Court reserved ruling on Coca-Cola's argument that Brazilian law would have prevented Coca-Cola's Brazilian Supply Points from paying more than a small fraction of the hundreds of millions of dollars of additional income that the IRS determined should be reallocated from the Brazilian Supply Points to Coca-Cola. The IRS asserted that under Reg. §1.482(h)(2), the "blocked income" regulations, the provisions in Brazilian law

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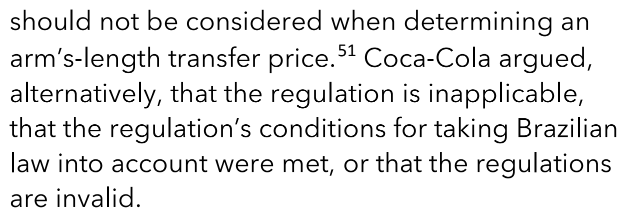

should not be considered when determining an arm's-length transfer price.[51] Coca-Cola argued, alternatively, that the regulation is inapplicable, that the regulation's conditions for taking Brazilian law into account were met, or that the regulations are invalid.

Because the validity of the blocked income regulation is currently before the Tax Court in 3M Co. & Subs. v. Commissioner, the Court in the Coca-Cola case decided not to rule on these arguments until an opinion is issued in the 3M Case. The 3M Case was fully briefed in 2016 and is awaiting decision.

Interestingly, these cases will challenge the validity of the IRS Treasury regulations issued in 1994 which made standards for challenging blocked income rigorous, if not practically unachievable. The two pending cases each involve licensing of intangibles by a U.S. corporation to its Brazilian affiliates. IRS concedes that Brazilian law limited the royalties that could be paid, but argues that these affiliates could pay dividends, which they could have reported as a royalty increase.

4. Collateral Adjustments Allowed

The Tax Court also allowed two types of collateral adjustments for the years 2007 to 2009:

- the IRS's adjustment of Coca-Cola's losses under §987 for its Mexico Supply Points after the IRS reallocated income from the Mexico Supply Points to Coca-Cola,[52] and
- reductions or offsets of the royalty amounts owed by Supply Points to Coca-Cola as a result of the adjustments, equal to the amount of dividends these Supply Points had previously remitted to Coca-Cola to satisfy their royalty obligations.

For the dividend offsets, the Tax Court rejected the IRS's argument that any offset was barred by Coca-Cola's failure to file the explanatory statements required for taxpayers electing dividend offset treatment for taxpayer-initiated §482 adjustments. This was the only taxpayer win in the case. The Tax Court instead found that Coca-Cola substantially complied with this requirement in the "peculiar circumstances of this case," where the explanatory statements "would have added nothing to the IRS's sum of knowledge" about Coca-Cola's adjustments and offsets.

5. The Appeal

The day after the opinion was published, Coca-Cola stated that it was "disappointed with the outcome," is considering "potential grounds for its appeal," and "intend[s] to continue to vigorously defend our position." Accordingly, the next step is to the Sixth Circuit Court of Appeals. Considering that Appellate courts typically address errors in the application of the law or a misrepresentation of the factual record,[53] it will be interesting to see the approach by the Appellant Coca-Cola.

6. Conclusion

What does the Coca Cola case say about the future of transfer pricing? Of course, any transfer pricing case is highly fact specific, but there is always a message to be learned. The Coca-Cola case highlights the importance of legal agreements. The starting point to assert that Coca-Cola's affiliates possess economically beneficial marketing intangibles starts with the legal relationship by and between the respective parties. The court painstakingly reviewed the Distribution and/or License Agreements and found that Coca-Cola's legal agreements did not support its argument that the Supply Points possessed non-routine marketing intangibles.[54]

[51] Changes to the Brazilian financial regulations effective 2023 will make the blocked income argument ineffective.

[52] The court rejected Coca-Cola's arguments and found that it had jurisdiction to review the adjustment, that the computation of the adjustment was neither premature nor dependent on Mexican law, and that the re-computation was a necessary part of "produc[ing] the same result that would have occurred if [Coca-Cola] and its Mexican branch had reported income consistently with the arm's-length standard from the outset."

[53] One factual issue is the court's statement that the Supply Points did not have similar non-routine intangibles. One would think this may be different than what was represented to the IRS in the "old" APA.

[54] This section was prepared with contributions from 17 Baker McKenzie offices.

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Further, the court thoroughly reviewed the Supply Points' Profit and Loss Statements. This is typically done because the easiest way to understand a party's functional and risk profile is to understand how they spend their money. This was most relevant in the court's consideration of the marketing intangible issue.

The clear message here is to pay close attention to your legal agreements and whether your transfer pricing policy is closely aligned with them. OECD Action Items 8 to 10 also make this point clear.

B. Global Transfer Pricing Cases

By Caroline Silberztein and Jetlira Kurtaliqi[55]

Transfer pricing controversies are increasing in number, complexity and amounts at stake, all over the globe. Several factors contribute to this phenomenon. First, the global transfer pricing framework has become more sophisticated with detailed OECD and domestic guidance being issued on topics such as business restructuring, intangibles, and financial transactions. Second, tax authorities have increased capabilities including access to tools and databases. In many countries, dedicated audit teams that are specifically trained in transfer pricing and international tax matters have been set up. Further, fiscal pressure and governments' need for extra revenues, combined with the perception of transfer pricing being an area of aggressive tax optimization, lead to closer scrutiny and more in-depth assessments.

Many tax administrations start challenging transfer pricing methods by focusing on controversies involving the burden of proof, the selection of reliable comparables, management fees and royalties. As they become more sophisticated, they tend to challenge the functional analysis presented by the taxpayer and the resulting selection of the most appropriate method, with possible structural effects on the taxpayer's business model in cases where they disregard the identification of the risk taker or entrepreneur. They also tend to tackle issues on business restructurings, intangibles valuation and financial transactions.

With the media and political attention on the BEPS project and the perception of transfer pricing as being an area of aggressive tax optimization, controversies emerge from the interaction between transfer pricing and anti-abuse measures. In several countries, transfer pricing cases can have criminal ramifications.[56] Further, new stakeholders appear, as transfer pricing challenges may result not only from tax audits, but also from complaints lodged by employee representatives[57] or even by competitors or the civil society (as the latter can bring alleged non-adherence to the OECD TPG before National Contact Points under the OECD Guidelines for Multinational Enterprises).

This section focuses on transfer pricing controversies that have been brought before tax courts in recent years. The majority of transfer pricing controversies are still settled at the pre-litigation level, although the proportion varies from country to country. For instance, in China, cases

[55] This section was prepared with contributions from 17 Baker McKenzie offices.

[56] For instance, in France, a transfer pricing case will be automatically denounced to the public prosecutor where the total amount of reassessed taxes exceeds EUR 100,000 and one of the following penalties is applied: the 100% penalty for opposing a tax audit, the 80% penalty for abuse of law, hidden activity, fraudulent manoeuvres, undisclosed accounts and profits derived from criminal offences; or the 40% penalty for wilful neglect and abuse of law when at any time during a six-year period the taxpayer has already been subject to a 40%, 80% or 100% penalty.

[57] As an example, in 2016, McDonald's France employee representatives filed a complaint for "organized tax fraud laundering" that related to the group's transfer pricing policy regarding royalties paid by McDonald's France to a Luxembourg associated entity. The procedure ended on June 16, 2022, when the Paris Judicial Court validated a CJIP (judicial public interest agreement) signed between the French Financial Public Prosecutor and several French companies of the McDonald's group for which the sum of the duties and penalties due under the global settlement and the public interest fine amounted to more than EUR 1 billion.

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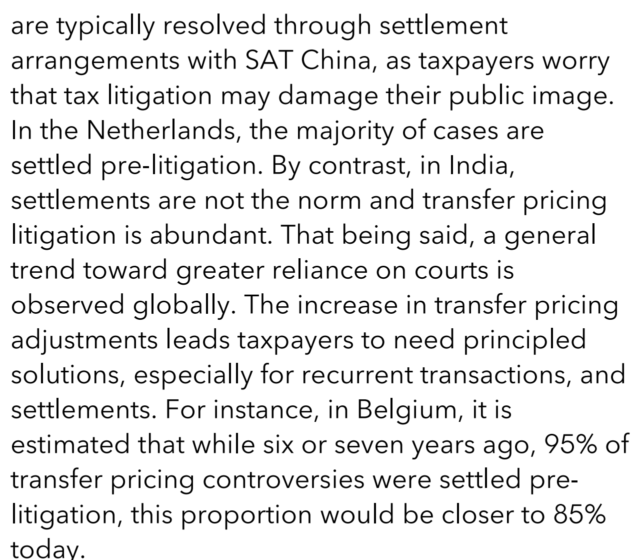

are typically resolved through settlement arrangements with SAT China, as taxpayers worry that tax litigation may damage their public image. In the Netherlands, the majority of cases are settled pre-litigation. By contrast, in India, settlements are not the norm and transfer pricing litigation is abundant. That being said, a general trend toward greater reliance on courts is observed globally. The increase in transfer pricing adjustments leads taxpayers to need principled solutions, especially for recurrent transactions, and settlements. For instance, in Belgium, it is estimated that while six or seven years ago, 95% of transfer pricing controversies were settled pre-litigation, this proportion would be closer to 85% today.

1. Scope of Transfer Pricing Litigation

Recently, the Polish and Spanish courts have addressed the question of when transfer pricing analysis applies.

The Polish Provincial Administrative Court in Poznań [58]characterized the free-of-charge redemption of shares as a transaction subject to transfer pricing regulations and documentation requirements. In justification of its position, the court referred to a broad definition of the controlled transaction concept covering all economic activities. According to the court, the introduction of a relatively broad definition of a controlled transaction is intended to include arrangements that may not be considered transactions in the common sense of the word, such as restructurings, cost sharing agreements, partnership agreements, cooperation agreements, or liquidity management agreements, among others.

The Polish Supreme Administrative Court [59]also ruled that a free-of-charge guarantee is a transaction subject to transfer pricing regulations and documentation requirements, confirming that a broad definition of the controlled transaction concept should be adopted, covering all economic activities.

In Spain, other legal principles, such as tax fraud, may supersede transfer pricing rules. The Supreme Court of Spain illustrated this approach in its Sara Lee Southern Europe SL decision[60] Sara Lee Southern Europe SL acquired from a French related entity some shares of various loss-making related companies through intragroup loans to finance these acquisitions. Consequently, the Spanish taxpayer deducted the financial expenses of the loans received and the impairment losses of the shares acquired. In this case, the arm's length price of the relevant transactions was not discussed, but rather the economic substance of the shares acquisition. The Spanish Tax Authorities concluded that the shares acquisition lacked substance having only a tax avoidance purpose, and therefore applied the anti-abuse clause of fraud of law to eliminate the effects of the transaction carried out. The Supreme Court of Spain ruled in favor of the Spanish Tax Authorities pointing out that the regularization of transactions through the application of article 9.1 of double tax treaties can be carried out without the need to resort to the transfer pricing methods if internal general anti-abuse clauses are applied.

2. Delineation of Transactions/Recharacterization of Transactions

The circumstances in which a tax administration may recharacterize or disregard the transaction structured by the taxpayer has been addressed in the OECD TPG since 1995.[61] Further, a new paradigm based on control over risk, financial capacity and **DEMPE**[62] functions was established in the 2017 OECD TPG with the new guidance on the accurate delineation of actual transactions.[63] The cases below illustrate how different courts have addressed these issues.

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[58] Provincial Administrative Court in Poznań, Case No. I SA/Po 454/20 (Nov. 17, 2020).

[59] Supreme Administrative Court, Case No. II FSK 1475/19 (Feb. 3, 2022)

[60] Sara Lee Southern Europe SL, Supreme Court of Spain, Case No. 3730/2020 (Nov. 3, 2020).

[61] Paragraphs 1.36 1.41 of the 1995 OECD TPG.

[62] DEMPE *means development, enhancement, maintenance, protection and exploitation*.

[63] Paragraphs 1.139 to 1.148 of the 2022 OECD TPG.

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Recharacterization of Transactions/Sham Transactions

The Canadian **Cameco case** [64] is an important decision on the recharacterization issue. Cameco was a Canadian headquartered uranium producer, refiner, and processor. The Russian and United States governments executed an agreement in 1993 to allow Russia to sell uranium from its nuclear weapons arsenal. Cameco led a consortium of companies to negotiate purchase agreements for the Russian uranium (and over time uranium from other suppliers). While the initial contracts were negotiated by Cameco, Cameco designated what would become its Swiss subsidiary as the signatory to the contracts. At the time, the market price of uranium had been stable for decades and the contracts were not expected to be profitable. However, an unexpected jump in the price of uranium resulted in significant profits being realized by Cameco's Swiss subsidiary. The CRA argued that all of the profit should be recognized and taxed in Canada.

The Crown advanced three arguments: (1) the transaction was a sham, (2) the transaction should be recharacterized under 247(2)(b) and (d) of the Canadian Income Tax Act ("Act"), or (3) the transaction should be repriced under 247(2)(a) and (c) of the Act. The Tax Court rejected all three arguments. The Crown appealed (dropping the sham argument from its appeal).

The Canadian Federal Court of Appeal upheld the Tax Court finding and noted the following about the recharacterization power in 247(2)(b) and (d):

- the test is whether hypothetical arm's-length parties would enter into the transaction or series, and not whether the specific taxpayer would do so; and
- the provision does not contemplate replacing a transaction with anything that would result in the separate existence of the Swiss subsidiary being ignored or effectively being amalgamated.

The Canadian Federal Court of Appeal also noted that the Crown did not challenge the factual findings of the Tax Court on appeal, and as such, no change to the decision regarding the applicability of 247(a) and (c) of the Act was warranted or possible. The important takeaway from this case is that 247(2)(b) and (d) of the Act do not allow the CRA to simply disregard the separate existence of a foreign subsidiary and tax an entity as if the subsidiary does not exist.

The Tax Court of Canada reaffirmed the limits to recharacterization set out in Cameco in the *Agracity*[65] decision.

Control over Risk and Financial Capacity to Bear the Risk

In the Swedish **Pandox case**[66], the Swedish tax authorities (STA) attempted a recharacterization based on the control over risk and financial capacity requirements to support risk allocation. In this case, the STA placed greater importance on where the value was produced within the group. According to the STA, an important value driver was the investment strategy developed by the Swedish parent company. Further, the STA claimed that the risk control was very low in the subsidiaries and the subsidiaries should therefore only retain a residual reflecting a risk-free investment. The Swedish company claimed, however, that the management was passive during the holding period and there were no actual transactions; hence, no transaction could be priced incorrectly, as Swedish law does not allow for reclassification of transactions unless Swedish law supports it (ergo not solely via the guidelines). The court ruled that the parent company's involvement in the subsidiaries, after the initial investment, was low and therefore the risk control could not be attributed the way the STA claimed. The question of whether a reclassification had occurred and if Swedish law allowed for such reclassification was not assessed by the court.

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[64] *Her Majesty the Queen v. Cameco Corporation, Canadian Federal Court of Appeal, Case No. 2020 FCA 112* (June 2020).

[65] Agracity Ltd. v. The Queen, Tax Court, Case No. 2020 TCC 91, August 2020.

[66] Pandox, Case No. 13265-20, February 25, 2022.

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Would a Transaction Have Happened at Arm's Length?

In the **Blackrock case**,[67] the English Upper Tribunal (UT) ruled on the economically relevant characteristics of transactions, both actual and hypothesized. The Blackrock Group acquired the Barclays Global Investors business in December 2009. During the course of the acquisition, Blackrock Holdco 5 LLC ("LLC5") incurred debits in respect of interest and other expenses relating to USD 4 billion worth of loan notes ("Loans") issued in return for the loan it received from its parent, BlackRock Holdco 4 LLC. On the issue of whether the Loans would have been made in an arm's length relationship, the UT noted that the hypothetical transaction entered into by an independent enterprise must be sufficiently comparable with the actual transaction for the purpose of testing it. Accordingly, the UT determined that the first-tier tribunal erred in law by inferring third party covenants that were absent because, for a comparison to be useful, the economically relevant characteristics of the situations being compared must be sufficiently comparable.

Because no loan for USD 4 billion would have been made on an arm's length basis, the proper application of the transfer pricing rules resulted in the entirety of LLC5's interest deductions being disallowed.

On the issue of whether the debits were wholly attributable to an unallowable purpose, the UT found "ample evidence" that securing a tax advantage for the group was a main purpose of the creation of LLC5. The UT accepted that LLC5 had both commercial and tax advantage purposes, but for the tax advantage purpose there would have been no commercial purpose. All the debits were apportioned to the unallowable purpose and disallowed.

This decision can be appealed.

3. Selecting the Most Appropriate Transfer Pricing Method

Tax authorities no longer hesitate to challenge the selection and implementation of the most appropriate method. In particular, a trend toward profit split discussions has been observed.

Comparable Uncontrolled Price Method and Commodities

The 2017 OECD TPG contains specific guidance on the application of a Comparable Uncontrolled Price ("CUP") method for commodities transactions.[68]

A recent **Argentinian decision**[69] is a leading case for the whole industry of Argentine exporters of commodities. In this decision, the Federal Tax Authority ("Federal TA") adjusted the export prices of commodities transferred by ADM Argentina and assessed income tax. The Federal Tax Court revoked the tax assessment and confirmed ADM Argentina's tax position. The court concluded that:

- the Federal TA's adjustments were not reasonable but were arbitrary because adjustments and assessment were made only with respect to certain export operations where the official price at the time the export transaction was agreed upon was lower than the official price when the goods were loaded; and
- the export transactions of third-party companies used as external comparables were not valid for transfer pricing purposes because they have significant irregularities and deficiencies. The Court of Appeal confirmed the Federal Tax Court decision and ADM Argentina's tax position. The Supreme Court of Justice dismissed the complaint appeal filed by the Federal TA, and the ruling issued by the Federal Tax

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[67] The Commissioners For HMRC and Blackrock Holdco 5, LLC, Upper Tribunal, Case No. [2022] UKUT 00199 (TCC), July 19, 2022.

[68] See Paras 2.18 through 2.22 of the 2022 OECD TPG.

[69] Favorable decision of the Federal Tax Court in ADM Argentina SA s/Appeal, June 5, 2016; Favorable decision of the Court of Appeals in ADM Argentina S.A. v. Dirección General Impositiva s/ recurso directo de organismo externo (Aug. 29, 2017); and Favorable decision of the Supreme Court in ADM Argentina S.A. v. Dirección General Impositiva s/ recurso directo de organismo externo (Oct. 28, 2021).

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Court in favor of ADM cannot be further challenged.

Cost Plus Method

Philips France SAS,[70] a French taxpayer, provided contract R&D services to its Dutch parent for which it was remunerated at cost +10%. For its R&D activity, the taxpayer received government subsidies from 2003 to 2007. Philips France SAS deducted from the cost base of the contract R&D services the amount of the subsidies and research tax credit it received. The French Tax Administration (FTA) denied the deduction of the subsidies and research tax credit and thus applied the 10% mark-up on the full cost base.

The French Supreme Court ruled against the FTA because the deduction of subsidies from the cost base did not constitute a "transfer of profits abroad" and allowed the reduced cost base for calculation of the arm's length remuneration.[71]

Profit Split Method

In the **Engie case**,[72] the Administrative Tribunal of Montreuil reviewed the FTA's substitution of the Profit Split method (PSM) for the method applied by the taxpayer. The French company Engie was engaged in the liquefied natural gas (LNG) business with two Luxembourg and U.S. subsidiaries. Engie carried out operations on the spot market, under an intercompany service agreement. The subsidiaries entrusted their cargoes to Engie, which found customers on the spot market and sold the excess LNG. Engie was compensated with a cost +10% remuneration. The FTA recharacterized Engie as a co-entrepreneur instead of a service provider, notably because:

- The functions performed by Engie went beyond those of a simple service provider, insofar as Engie can carry out sales on the spot market without receiving instructions from its subsidiaries during the solicitation and approval procedure.
- Engie bore almost all the risks related to the spot activity and has a high value-added intangible asset through the master sale and purchase agreement ("MSPA") signed with the customers.

The FTA considered the most appropriate transfer pricing method to be a 50/50 PSM between Engie and its subsidiaries. The Administrative Tribunal of Montreuil decided in favor of the FTA. The taxpayer has appealed the decision.[73] Despite being a low-level tribunal decision, it may have a significant impact on the FTA's ability to substitute the transfer pricing method selected by the taxpayer.

Conversely, in a case where a Ukrainian taxpayer applied the PSM, the selection of this method was challenged by the Ukrainian tax administration. The **Ukrainian Supreme Court**[74] established a new precedent on the application of the PSM in favor of the tax administration. The case relates to a joint venture engaged in the extraction and sale of oil. Three controlled transactions were in place: the purchase of technology services, the sale of oil, and the sale of fixed assets. For the purchase of services, the parties applied a PSM, arguing that joint knowhow and development of valuable technology was involved. The Tax Office applied the cost plus method relying on BvD Ruslana comparables.

The significance of the OECD TPG (which are not part of Ukrainian domestic law) was reconfirmed by the appeals court. The Supreme Court confirmed that a PSM may be applied if (i) the operations are highly integrated or (ii) the parties contribute valuable intangibles. Further, it clarified the burden of proof rules in transfer pricing cases, stating that while the burden of proof rests with the Tax Office, including the burden to prove the wrongfulness of

[70] Philips, Supreme Court of France, Case No. 405779 (Sept. 19, 2018).

[71] For the question of whether to include stock-based compensation in the cost base, see specific developments in the context of cost-sharing arrangements, notably in the **Altera decision** (See IV.B.5., below).

[72] Société Engie, Administrative Tribunal of Montreuil (1st chamber), Case No. 1812789 (Jan. 14, 2021).

[73] Appeal No. 21PA01277.

[74] The Sixth Appeal Administrative Court decision on Case No. 620/1767/19 (Dec. 22, 2021).

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the method selected, the taxpayer is required to substantiate its method. In this case, the taxpayer failed to (i) justify the relevant profit allocation, (ii) provide evidence of the use of knowhow, and (iii) comment on the rejection of traditional methods. Accordingly, the tax administration prevailed.

In a 2020 decision,[75] **the Italian Supreme Court** did not challenge the selection of the PSM but instead its practical determinations, accepting the position of the Tax Office that an additional allocation key (resulting in a higher allocation of profits to the Italian taxpayer) was appropriate. The allocation key added by the Tax Office (besides the two original ones selected by the taxpayer, i.e., the quantities of oil transported and distance in kilometers of the pipeline) related to the maintenance costs incurred by the three companies participating in the PSM.

The application of the Residual PSM was disputed three times by Japanese courts. In the **NGK case**,[76]

a Japanese resident entity engaged primarily in the manufacture of ceramic products. NGK licensed patent and manufacturing knowhow to its Polish subsidiary ("Sub A"). Sub A manufactured particulate removal devices (DPF) for diesel engine cars and sold DPF to automobile manufacturers in Europe through another affiliated entity in Germany. Shortly before the establishment of Sub A, the European Commission (EC) introduced a series of regulations for exhaust gas emissions. The regulations targeted black particles caused by incomplete combustion of fossil fuels, which particularly affected diesel vehicles. NGK's DPF was effective in reducing the amount of black particle emission. As a result of demand driven by the regulations as well as improvements in manufacturing techniques at Sub A leading to higher yields, Sub A's profitability significantly increased.

The tax authorities concluded that royalty income from Sub A was below the arm's length price established based on the Residual PSM. A key issue of contention was how the residual profit split factor was to be calculated. The tax authority's position was that contributions of each party to the development of important intangible assets should be factored into the profit split (i.e., DPF R&D expenses for NGK and expenses relating to manufacturing improvement for Sub A). NGK argued that the depreciation expenses of Sub A should also be included because their large capital investment significantly contributed to their high profit.

The courts held that the contribution factor is not necessarily limited to intangible assets, and that other interrelated factors contributed to the high profit. It was therefore appropriate to include residual depreciation expense (excess over the normal level of depreciation expense obtained from the comparable companies for routine return) in the split factor for Sub A. In terms of other factors, the courts considered: 1) scale profit and 2) NGK's decision to make a large-scale investment in Poland ahead of competitors. The scale profit was attained by reduced manufacturing costs per unit as a result of a substantial sales increase. The courts recognized Sub A's contribution to the scale profit and held that Sub A's excess depreciation expense should be included in the split factor. In contrast, the courts rejected the tax authority's argument that NGK's decision regarding the upfront investment should be included in the split factor for NGK, on the grounds that such a decision by a parent company on a large investment in its subsidiary should generally be recouped by dividends, and it is not considered appropriate to take it into account when it comes to determining a residual profit split factor.

Unlike previous cases, the NGK case is unique because the court acknowledges for the first time that there is a factor other than those relating to important intangible assets (i.e., scale profit) that can be included in the split factor under the PSM, and that the factor can be split among associated companies relevant to the transaction in the same manner as those related to important intangible assets. This decision could require the Japanese tax authority to change their way of applying the Residual PSM in a transfer pricing audit going forward.

[75] Supreme Court of Cassation, Case No. 11387 (Feb. 25, 2020).

[76] The Tokyo High Court (appellate court), NGK case (NGK Insulators, Ltd.) (Mar. 10, 2022).

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4. Comparability Analysis

Taxpayer's Functional Analysis and Loss-Making Situation

In a **French case**[77] where the French taxpayer sold products to intragroup distribution companies abroad, the FTA challenged the loss-making situation of the taxpayer, arguing that the latter was not a principal and, as such, should not bear any losses. The French Supreme Court ruled in favor of the French taxpayer. In the case at hand, the taxpayer notably set the subsidiaries' sales prices to end customers and had a functional profile allowing it to bear economic losses related to the operation of its business.

Sufficiently Reliable Comparables

Courts commonly rule on the requirements for comparables to be sufficiently reliable. See, for instance, a **Polish decision**[78] in which the tax authorities had not taken into account the specific contractual terms of the transaction carried out by the taxpayer (limitation of risks, exclusion of liability for defects in the goods, lack of necessity to store the goods) and Turkish decisions on the need to adjust comparables for market differences. Another **Italian decision**[79] indicated that courts should take into consideration all the weaknesses of certain comparables presented by the Italian Tax Office.

Government and Other Local Constraints

In a **Bluestar decision**,[80] a French taxpayer did not invoice management fees to its Chinese and Brazilian affiliates, unlike its English and Italian affiliates. The FTA considered that the uncharged management fees consisted in a transfer of profits by the French taxpayer to the Chinese and Brazilian entities. The Administrative Court of Appeal of Versailles ruled against the taxpayer, considering that it had not demonstrated "in particular in the absence of a formal refusal by the Chinese and Brazilian authorities, that the legislation of each of these countries would prohibit the payment of management fees by resident companies to French companies."

In a **Bureau Veritas decision**,[81] the Administrative Court of Appeal of Versailles recognized that local constraints must be considered when determining the level of an arm's length royalty. In this decision, the taxpayer entered into franchise agreements with its subsidiaries giving them access to its technical and administrative services, remunerated by a royalty fee. For its Brazilian and Indian subsidiaries, the taxpayer applied lower royalty rates due to constraints resulting from Brazilian and Indian "legal, exchange control and criminal" legislations. Noting that the subsidiaries benefited from the same services as the other subsidiaries of the group, the FTA considered this practice as a renouncement of royalties at the usual rates and proceeded to reassessments.

The Administrative Court of Appeal of Versailles censured the FTA's position by recognizing that local constraints, other than tax, place the subsidiaries in a different situation from the independent comparables retained in the taxpayer's panel, justifying the use of lower royalty rates with the subsidiaries. The court emphasized that the cap on royalties in Brazil and India "does not derive from their tax legislation but from measures of broad general scope, mainly economic, aimed at protecting the internal market." In the case at hand, it is important to note that the taxpayer succeeded in producing "amply documented and detailed" analyses. By contrast, the same court determined that the elements

The Administrative Court of Appeal of Versailles censured the FTA's position by recognizing that local constraints, other than tax, place the subsidiaries in a different situation from the independent comparables retained in the taxpayer's panel, justifying the use of lower royalty rates with the subsidiaries. The court emphasized

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[77] SAS SKF Holding France, French Supreme Court, Case No. 44313 (Oct. 4, 2021).

[78] Judgment of the Provincial Administrative Court in Szczecin, Case No. I SA/Sz 604/20 (Dec. 2, 2020).

[79] Italian Supreme Court of Cassation, Case No. 15668 (May 17, 2022).

[80] Bluestar Silicones France, Administrative Court of Appeal of Versailles, Case No. 16VE00352 (Feb. 9, 2021).

[81] SA Bureau Veritas, Administrative court of appeal of Versailles, Case No. 19VE01727 (Nov.18, 2021).

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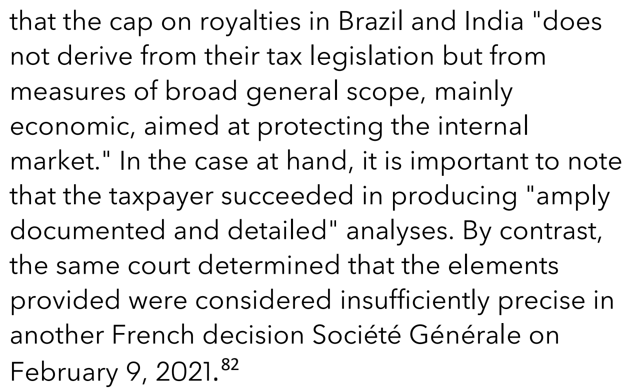

that the cap on royalties in Brazil and India "does not derive from their tax legislation but from measures of broad general scope, mainly economic, aimed at protecting the internal market." In the case at hand, it is important to note that the taxpayer succeeded in producing "amply documented and detailed" analyses. By contrast, the same court determined that the elements provided were considered insufficiently precise in another French decision Société Générale on February 9, 2021.[82]

5. Intangibles

Development, Enhancement, Maintenance, Protection and Exploitation (DEMPE) functions were introduced in the 2017 OECD TPG as a key component of the analytical framework for transactions involving intangibles.

The **Ghent Court of Appeal**[83] ruled on the temporal application of this new concept in Belgium. Referring to the 2017 OECD TPG, the Belgian tax authorities claimed that an abnormal or benevolent advantage was provided by the taxpayer to another group entity, because the taxpayer exercised the DEMPE functions with respect to the IP and incurred all risks for which the taxpayer was not remunerated. The taxpayer argued that DEMPE as a new concept was not present in the 1995 OECD TPG and that therefore one should consider the OECD TPG that were available at that time. According to the Ghent Court of Appeal, only the OECD TPG and legal framework known at the time of the transactions should be taken into account. A more recent version of the OECD TPG may only be used to the extent that it provides clarifications to older OECD TPG without extending the scope of the latter. To date, we are not aware of any appeal that has been filed regarding this decision.

Selection of a CUT/ CUP or CPM/ TNMM Method: Major U.S. Decisions

In a 2016 U.S. Tax Court case, Medtronic, provided in a matter that centered around which transfer pricing list reflected the contributions from the company's Puerto Rican subsidiary when calculating the arm's-length royalty rates for an intercompany licensing transaction. In refuting the IRS USD 1.36 billion tax deficiency, the court rejected the IRS's use of the CPM, which considered the level of profit made by a company in a controlled transaction. Instead, the court used an uncontrolled transaction method (CUT) that relied upon transactions by and between unrelated parties to benchmark the related party intercompany transaction. The court also disagreed with aspects of the taxpayer's CUT analysis, noting that it failed to make adjustments to account for significant differences between the license of devices and leads to Medtronic Puerto Rico and the third-party (Pacesetter) agreement, which arose from a litigation settlement. Thus, the court favored an outcome that it believed was arm's length with certain adjustments to arrive at an arm's length royalty rate.

In 2018, a three-judge panel disregarded the court's opinion requiring a more extensive determination that Medtronic could use a settlement with another supplier. Notably, the Eighth Circuit found that the court did not make "a specific finding as to what amount of risk and product liability expense was properly attributable to Medtronic Puerto Rico." Accordingly, the Eighth Circuit vacated and remanded the Tax Court's decision finding that the lack of certain factual findings prevented it from evaluating whether the CUT method was the best method, and whether proper adjustments were made.

The decision led to a second Tax Court decision that addressed those issues. The second trial began in June 2021, and it has since concluded. This second trial focused on the selection of the most reliable transfer pricing method, as well as the determination of any necessary adjustments to the results of applying the CUT method. In the second trial, Medtronic and its experts continued to assert that the CUT method was the most reliable method to price the instant licensing agreement, while the IRS and its experts continued to assert that the CPM was the best method. More

[82] Société Générale, Administrative court of appeal of Versailles, Case No. 18VE04115 and 19VE00405 (Feb.9, 2021).

[83] Court of Appeal Ghent (5th chamber) Case No. 2016/AR/455 (June 8, 2021).

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particularly, the IRS asserted that the differences between the third-party agreement and the instant royalty transaction were too significant to be resolved through adjustment and that the CPM determined profit that more accurately reflected an arm's length result.

At the conclusion of this second trial, the trial judge suggested the use of the CUT method as the best method. The trial judge did, however, observe that it may be possible to use the third-party agreement as an unspecified method.

This case highlights the most important transfer pricing concepts, namely, concepts that involve what functions were performed, what risks were assumed and what assets were employed more specifically; the trial judge did not identify the risk in the comparable transaction. One can posit that the IRS is moving away from basic arm's length principles in a manner that simply justifies its position and gets the best answer for it.

On August 18, 2022, the Tax Court issued its recent opinion in *Medtronic v. Commissioner*,[84] holding that only a new, unspecified method could adequately calculate the appropriate §482 royalty rate. This alternative method used a three-step approach based on Medtronic's proposed analysis making adjustments in the third stage, thus, resulting in a largely 2-1 profit split between Medtronic and its Puerto Rican subsidiary. In rejecting the IRS's position, the Tax Court determined that Medtronic's position was an appropriate measure of the intercompany royalty by and between Medtronic and its subsidiary and thus increasing the income allocated to the U.S. tax by Medtronic. While the tax years at issue for Medtronic were 2005 and 2006, the consequences for future years could be significant. Based on Medtronic's Form 10-Q, Medtronic anticipates that tax and interest could give rise to amounts owing of up to USD 2 billion.[85] Note that this case was remanded by the Eighth Circuit, which noted the Tax Court's failure to properly scrutinize the comparability of Medtronic's use of the CUT method. The IRS set its position based on the CPM, which has gained greater use and acceptance by the Tax Court, despite the recent **Coca Cola Company case**, discussed above, at IV.A.

The decision has not yet been finalized so the time is running for Medtronic to either file for reconsideration or appeal.

The **Amgen, Inc. case** is similar to Medtronic. According to the petition filed with the U.S. Tax Court, the IRS asserted a USD 3.6 billion plus interest tax deficiency for the taxable years 2010 to 2012. Proposed tax adjustments for taxable years 2013 to 2015 have also been issued. It appears the issues center around the Company's Puerto Rican manufacturing facility and how profits are allocated between the U.S. company and these Puerto Rican manufacturing operations. The answer to the petition filed on August 2021 was filed in November 2021; thus, the case has been joined. While this case is just getting underway, it will prove interesting to follow in the wave of transfer pricing cases currently being pursued by the IRS.

Hard-to-Value Intangibles

In the **Facebook case** the U.S. Tax Court will decide whether the taxpayer correctly valued its intangible property, e.g., trademarks and copyrights, regarding its licensing transaction with its Irish affiliate. The IRS assessed a value of USD 13.6 billion rather than the USD 6.5 billion cited by the taxpayer. The case was a battle of experts concerning the appropriate value of the intellectual property at the time of the transfer. The key issue for the court is whether the taxpayer paid what an unrelated company would have paid for Facebook's September 2010 platform technology.

The trial started in early 2020 when dozens of current and former Facebook employees testified. Following a 16-month delay due to the COVID-19 pandemic, the trial resumed in person on October 11, 2021. As the case continued, the court heard vast amounts of testimony from researchers and consultants on matters of accountancy, digital marketing and monetization efforts.

[84] T.C. Memo 2022-84.

[85] See "Medtronic Decision Might Trigger Up to $2 Billion Tax Liability," Tax Notes (Sept. 2, 2022).

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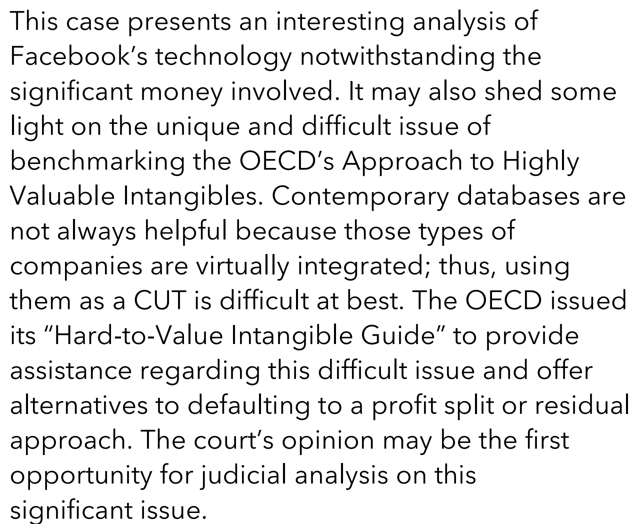

This case presents an interesting analysis of Facebook's technology notwithstanding the significant money involved. It may also shed some light on the unique and difficult issue of benchmarking the OECD's Approach to Highly Valuable Intangibles. Contemporary databases are not always helpful because those types of companies are virtually integrated; thus, using them as a CUT is difficult at best. The OECD issued its "Hard-to-Value Intangible Guide" to provide assistance regarding this difficult issue and offer alternatives to defaulting to a profit split or residual approach. The court's opinion may be the first opportunity for judicial analysis on this significant issue.

Cost-Sharing Arrangements

On July 27, 2015, the U.S. Tax Court unanimously ruled in favor of the taxpayer in **Altera Corporation & Subsidiaries v. Commissioner**[86] and invalidated a Treasury Regulation promulgated under §482. Reg. §1.482-7(d)(2) (2003) ("Final Rule"), which required controlled participants in a qualified cost-sharing arrangement ("QCSA") to include amounts attributable to stock-based compensation in their cost pool.

The case arose because the IRS exercised its discretion under §482 to allocate income from Altera International to Altera U.S. by increasing Altera International's cost-sharing payments by an amount relating to stock-based compensation. The sole purpose of the adjustments was to bring Altera into compliance with the Final Rule, and the Final Rule was the sole basis for such adjustments.

On June 7, 2019, the U.S. Court of Appeals for the 9th Circuit, in a split 2-1 decision overturned the July 2015 Tax Court decision. Generally, the 9th Circuit held that companies in cost-sharing agreements ("CSAs") should share the cost of employee stock-based compensation in the cost pool of their CSAs. The 9th Circuit focused on the development of the Tax Code, the perceived intent by Congress and the Tax Reform Act of 1986 that led to the addition of the "commensurate with income standard." In short, the 9th Circuit decision held that Treasury's requirement that stock-based expenses be shared under a CSA was reasonable despite any empirical evidence that showed that unrelated parties dealing under a similar arrangement would not share such an expense. The Tax Court further found Treasury's adherence to the APA Act met the act's intent and further that the public comments were not particularly helpful.

On February 10, 2020, Altera filed a petition for a writ of certiorari asking the U.S. Supreme Court to review the 9th Circuit's decision. The Supreme Court denied Altera's petition for certiorari, so the 9th Circuit stands, at least if and until another circuit hears the case and there is split among the circuits.

In July 2021, the IRS Office of Chief Counsel released AM 2021-004, a memorandum regarding "Non-SBC CSAs" and "reverse clawback" provisions triggered by, e.g., *Altera v. Commissioner*.[87] Specifically, AM

2021-004 provided guidance on the timing of IRS adjustments related to the non-stock-based compensation ("SBC") CSAs and on double-counting issues related to such adjustments. AM 2021-004 also signals the IRS's confidence that it can hold taxpayers to their reverse clawback provisions, despite the statute of limitations being closed for years in which the taxpayers incurred the SBCs at issue.

In AM 2021-004, the IRS first addressed the appropriate year for a §482 adjustment to include SBCs for Non-SBC CSAs that contained a reverse clawback provision. Some taxpayers drafted their CSAs to allow for the possibility that any adjustment for SBCs would be taken into account in the year of the triggering event. AM 2021-004 states that the IRS should make adjustments to any open year in which the SBCs were incurred. Because Taxpayers in Non-SBC CSAs have "IDC shares that are not equal to their RAB shares… the IRS has the authority to correct this imbalance by, for instance, adjusting the results of a CST [cost sharing transaction] in the year in which the IDCs or intangible development costs, were incurred" (AM 2021-004 at 5 (citing Reg. Paragraph 1.482-

[86] *Altera Corp v. Commissioner,* 145 T.C. No. 3 (July 27, 2015).

[87] 926 F.3d 1061 (9th Cir. 2019), rev'g 145 T.C. 91 (2015), cert. denied, 141 S. Ct. 131 (2020).

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7(i)(2))). The IRS authority to make allocations clearly "exists regardless of the existence or lack of a reverse clawback provision ..." [88]Accordingly, the IRS concluded that an adjustment to an open year (as described above) would reduce the amount of the true-up due in the year in which the triggering event occurred (again, regardless of what the reverse clawback stated (or did not state)). This prevented double-counting of SBCs.[89]

AM 2021-004 also addressed where the IRS could make adjustments, even if the year in which IDCs incurred was closed, clarifying that it could make allocations "in an appropriate year" under Reg. §1.482-7(i)(5) (allocations when cost-sharing transactions are consistently and materially disproportionate to RAB shares)—i.e., in closed years as well.[90] For example, if taxpayers disregarded their reverse clawbacks and failed to include the true-up payments due in their income, despite the triggering event, the IRS could use the tax benefit rule to make adjustments for the unshared SBCs in the year of the triggering event. Also, if taxpayers tried to remove or modify the reverse clawbacks, the IRS could make "appropriate adjustments" to reflect the unmodified contract or otherwise ensure the results are consistent with arm's length principles.[91]

In conclusion, AM 2021-004 makes clear that the IRS should make adjustments to include SBCs to open years in which the IDCs were incurred. The IRS further emphasizes that the IRS can hold taxpayers to their reverse clawbacks to pursue adjustments, where the SBCs were incurred in closed years.

Marketing Intangibles

The French Supreme Court[92] ruled that flagship expenses incurred by Ferragamo France SAS, a French distributor contributing to the value of the brand owned by its foreign parent, may in certain cases constitute an indirect transfer of profits abroad. The taxpayer purchased products from its Italian parent company and distributed them in its stores in France. It reported a gross margin higher than comparables it had identified (explained by an additional 25% discount granted by its parent company) but suffered operating losses between 1996 and 2009.

The FTA observed that the salary costs and certain expenses (particularly rent) borne by the taxpayer were "noticeably higher" than those incurred by the comparables identified by the taxpayer. Thus, the FTA considered that the surplus of expenses borne by the taxpayer was an advantage granted to its Italian parent company, owner of the trademark, and that this surplus was not compensated by the higher gross margin granted to it.

The French Supreme Court ruled against the taxpayer, stating the following:

"Supporting additional expenses of salaries and rents compared to independent companies was aimed at increasing the value of the Italian brand in a strategic market in the luxury goods sector."

The taxpayer did not prove that it had received any consideration for the advantage in question by merely asserting that it was profitable between 2010 and 2015.

Substantiating an Arm's Length Royalty

In the case of an Italian taxpayer paying royalties to its Swiss parent company, the Italian Supreme Court of Cassation[93] confirmed the position of the Tax Office, stating that the Italian taxpayer had not substantiated its position and did not rebut the reassessment performed by the Tax Office that entailed the following:

- Exclusion of intercompany sales from the royalty base

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[88] AM 2021-004 at 5.

[89] See AM 2021-004 at 5-6.

[90] AM 2021-004 at 6.

[91] AM 2021-004 at 7.

[92] Ferragamo France, French Supreme Court, Case No. 425577 (Nov. 23, 2020), confirmed by the Administrative Court of Paris on June 30, 2022, which judged the case after referral from the French Supreme Court.

[93] Supreme Court of Cassation, Case No. 9615 (Apr. 5, 2019)

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- Application of the lower percentage mentioned in a 1980 circular letter that provided a specific safe harbor rule on royalties, with no comparable search or alternative analyses

In another **Italian case**[94] where the Italian taxpayer charged royalties to foreign associated licensees based on their profitability, the Italian Supreme Court of Cassation considered the royalty rate to be too low in light of the results (measured applying the resale price method) reached by the foreign entities. Further, in contrast to the above decision, the Italian Supreme Court of Cassation decided in favor of the inclusion of intercompany sales in the royalty base.

6. Business Restructurings

Conversion of a Distributor into a Commercial Agent

Confirming a well-established trend in French case law, the French Supreme Court, in a Piaggio decision,[95] affirmed that the conversion of a distributor into a commercial agent entails a transfer of clientele. In this case, the taxpayer was converted from an exclusive distributor of vehicles of the "Piaggio" brand in France to a commercial agent for its Italian parent company. The French Supreme Court considered that the taxpayer had created its own customer base – independently from the strong reputation of the Italian brand in France – through a network of retailers, notably for the following reasons:

- It had developed its independent strategy for the French market; and
- It had established and managed a vast network of retailers for which it determined the volumes and models to buy as well as its own commercial policy in terms of pricing and after-sales services.

Conversion of a Manufacturer into a Consignment Manufacturer

The **Dutch Court of Appeals issued a decision**[96] concerning the conversion of a Dutch industrial zinc production facility into a consignment manufacturer, operating on behalf of a regional principal located in Switzerland. The taxpayer took into account a conversion fee of EUR 28 million as compensation for the restructuring on the basis that an existing agreement was terminated with one year's notice.

The Dutch tax authorities (DTA) increased the tax assessment to EUR 188 million on the basis that either the conversion fee should have been calculated as compensation for the transfer of an ongoing concern, or on the basis that the Dutch entity had not effectively been converted to a routine service provider. The taxpayer prevailed at the district court level, as the court found that the taxpayer did not perform non-routine functions on the year of the tax assessment. As such, the DTA had not met its burden of proof to claim higher compensation for a transfer of value, or the non-recognition of the conversion. During the court of appeals procedure, the taxpayer and the DTA agreed on a settlement, whereby the taxpayer agrees to apply a PSM to recognize the contributions of the Dutch entity. The settlement resulted in an adjusted taxable profit of EUR 122 million.

Post-Acquisition Transfer of Functions, Assets and Risks (FAR)

The Tel Aviv District Court held in favor of the taxpayer in the **Medingo decision**[97] regarding a deemed transfer of FAR. In 2010, the Roche group acquired the full share capital of an Israeli company. Six months after the acquisition, four intragroup agreements were entered into, with

[94] Supreme Court of Cassation, Case No. 1232 (Jan. 21, 2021).

[95] Piaggio, Supreme Court of France, Case No. 418817 (Oct. 4, 2019)

[96] Dutch Court of Appeals, Case No. ECLI:NL:GHSHE:2020:968 (Mar. 13, 2020).

[97] District Court, Israel v. Medingo Ltd, Case No 53528-01-16 (May 8, 2022).

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retroactive effect, all of which were set to expire by the end of 2013:

- an R&D agreement pursuant to which the taxpayer provided R&D services with a remuneration at cost +5% (All the IP developed was wholly and exclusively owned by Roche);
- a support services agreement pursuant to which the taxpayer provided services in the areas of marketing, technical support and management as well as support advice regarding the use of patents in exchange for a cost +5% remuneration;
- a manufacturing agreement pursuant to which the taxpayer provided Roche with manufacturing and packaging services with a remuneration at cost +5%; and
- a license agreement pursuant to which the taxpayer granted Roche the right to use the IP developed up to that point (Roche shall manufacture, use, sell, exploit commercially, continue to develop related products and grant sub-licenses to related entities in the Roche Group.).

In January 2012, the taxpayer's employees were notified that the operations in Israel would be terminated, no later than on December 31, 2013. On November 1, 2013, an agreement was signed between the taxpayer and a number of companies from the Roche group for the sale of the taxpayer's old IP for approximately USD 45 million. The Israel tax authority (ITA) classified all the transactions as a single scheme aiming at the transfer of the main FAR of the taxpayer to the Roche group. The ITA considered that such a transfer occurred immediately following the taxpayer's acquisition in 2010. As such, considering that this transfer constituted a capital transaction liable to tax, the ITA considered that the value of the FAR transferred and subject to taxation was the 2010 acquisition price, i.e., USD 160 million (with certain adjustments). The court concluded that the transfer of the taxpayer's FAR occurred in 2013 (date of the actual transfer) and not on the taxpayer acquisition date as supported by the ITA. This decision is consistent with the Israeli precedent (especially the Broadcom ruling, cited repeatedly in the decision).

7. Management Fees

The **National Court of Spain**[98] denied the deductibility of fees for strategic management services provided to a Spanish entity by its Portuguese related party because of insufficient supporting documentation provided by the taxpayer. The National Court considered that the invoices provided were too generic and the description of services in the invoices referred to an intragroup agreement that had not been provided. Additionally, the court considered that the internal correspondence provided as proof of services rendered would only support the existence of habitual and ordinary relationships between the staff of the Spanish and Portuguese entities. Based on the above arguments, the National Court concluded that the requirements set out in the Spanish legislation to support the deductibility of the management services (i.e., actual provision, benefit, and utility to the recipient) had not been met. This judgment can still be appealed.

The **Administrative Court of Appeal of Versailles** issued a similar decision,[99] considering that simple invoices, without any other material evidence, are not sufficient to evidence the performance of services. The Court observed that no proof was provided by the taxpayer to corroborate the effective performance of the invoiced services (such as agendas, minutes of meetings or any other document detailing the nature of the services provided).

The Italian Supreme Court of Cassation[100] ruled against a taxpayer, considering that the mere existence of an intercompany agreement regulating the services received is not sufficient to prove the effectiveness of such services and their

[98] *Sierra Spain Shopping Centers Services SLU, National Court of Spain, Case No*. 151/2022 (Jan. 25, 2022).

[99] *SAS Groupe LAGASSE EUROPE, Administrative Court of Appeal of Versailles, Cases No*. 18VE00059 and 18VE02329 (Jan. 28, 2020).

[100] *Italian Supreme Court of Cassation*, Decision No. 13085 (June 30, 2020).

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benefit for the Italian entity. It also pointed out that, although an indirect charge methodology can be accepted, if the allocation keys used are not clear, the identification of the benefit received can become more challenging, making the position of the recipient entity harder to support.

For information regarding whether or not to take into account local constraints that restrict the ability to charge management fees to Brazil and China, see IV.B.4., above.

8. Financial transactions

In February 2020, the OECD issued, for the first time, guidance on the transfer pricing aspects of financial transactions. The aim was to "contribute to consistency in application of transfer pricing and help avoid transfer pricing disputes and double taxation."[101]

The **French Supreme Court**[102] provided some useful clarifications regarding the types of evidence that a taxpayer may provide to establish that the interest rate of an intragroup loan is at arm's length. To demonstrate that this rate was equal to the rate that financial institutions or organizations would have granted – considering its own characteristics and, in particular, its risk profile – the borrowing company provided economic analyses. The Administrative Court of Appeal of Paris dismissed the analyses provided by the taxpayer, stating that the credit rating was not determined on the basis of the borrowing company's own situation to the extent that the consolidated financial statements of the subgroup – formed by the borrowing company and its subsidiaries and sub-subsidiaries – were taken into account. Ruling in favor of the taxpayer, the French Supreme Court ruled that the risk profile of the borrowing company should be assessed with regard to the consolidated economic and financial situation of the company and its subsidiaries.

The French Tax Supreme Court further stated that a benchmarking study based on rating systems developed by rating agencies could be used irrespective of the fact that the taxpayer did not prove that the companies used as benchmarks had the same level of risk as the borrowing entity, due to their heterogeneous business sectors. In effect, such rating systems are commonly used to compare the credit risks of the rated companies after considering their sector of activity.

Recent **German case law**[103] brings up interesting elements regarding loan write-off and the deductibility of write-off expenses. In 2010, a German limited partnership ("KG") granted a loan to its wholly owned Turkish subsidiary ("T"). The loan was interest bearing with 6% p.a., but unsecured. In 2011, KG decided to liquidate T. Thus, KG wrote off its loan and interest receivable against T and declared the write-off expense as tax deductible. The German tax authorities denied the deduction because the loan was unsecured. The Federal Tax Court held that refraining from stipulating a collateral for a shareholder loan may not be at arm's length. Such deviation from the arm's length principle may cause a write-off of the loan receivable and, thus, lead to a reduction in income. This reduction in income can be reversed based on Section 1 of the German Foreign Tax Act ("GFTA"). Article 9 OECD-MC does not prohibit such income adjustment. It should be noted that the local tax court had determined that a third party would not have granted the loan to T without a security. This finding was binding for the Federal Tax Court.

Another German decision[104] was issued with similar facts. As of 2004, a Belgian entity ("B NV") had a settlement account with its German parent company ("A GmbH"). Loan receivables of A GmbH against B NV under this settlement account were interest bearing with 6% p.a., but unsecured. In September 2005, A GmbH waived its loan receivable claim against B NV to the extent the loan was seen as unrecoverable. A GmbH wrote off its loan and interest receivable against B NV and declared the write-off expense as tax deductible. The German tax authorities denied the deduction based on Section 1, paragraph 1 of the GFTA

[101] *See* Executive Summary of Transfer Pricing Guidance on Financial Transactions (Feb. 2020).

[102] *Apex Tool Group, French Supreme Court*, Case No. 441357 (Dec. 29, 2021).

[103] Federal Tax Court of Germany, Case No. I R 19/17, February 19, 2020, Federal Tax Gazette II 2021, 223.

[104] Federal Constitutional Court of Germany, Case No. 2 BvR 1161/19, IStR 2021, 363 (March 4, 2021).

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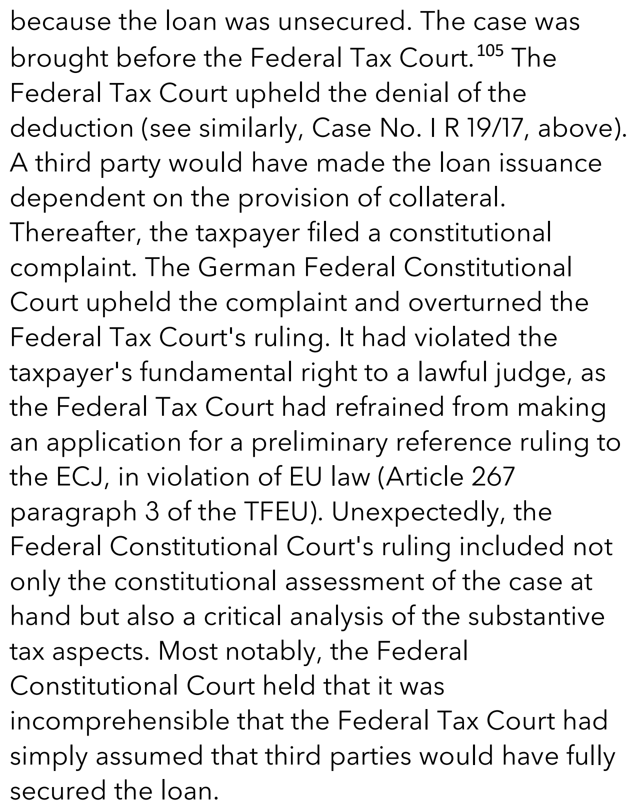

because the loan was unsecured. The case was brought before the Federal Tax Court.[105] The Federal Tax Court upheld the denial of the deduction (see similarly, Case No. I R 19/17, above). A third party would have made the loan issuance dependent on the provision of collateral. Thereafter, the taxpayer filed a constitutional complaint. The German Federal Constitutional Court upheld the complaint and overturned the Federal Tax Court's ruling. It had violated the taxpayer's fundamental right to a lawful judge, as the Federal Tax Court had refrained from making an application for a preliminary reference ruling to the ECJ, in violation of EU law (Article 267 paragraph 3 of the TFEU). Unexpectedly, the Federal Constitutional Court's ruling included not only the constitutional assessment of the case at hand but also a critical analysis of the substantive tax aspects. Most notably, the Federal Constitutional Court held that it was incomprehensible that the Federal Tax Court had simply assumed that third parties would have fully secured the loan.

In Case No. I R 32/17,[106] the German Federal Tax Court again dealt with an income adjustment due to the write-off of an unsecured intercompany loan receivable. At first, the Federal Tax Court confirmed its case law according to which Section 1, paragraph 1 of the GFTA allows for an income adjustment in case of a write-off of an unsecured loan receivable. However, in its ruling, the court took a more differentiated view on the arm's length principle in an intercompany finance context. In contrast to previous decisions, it found that the lack of loan collateralization does not per se render the loan incompatible with the arm's length principle. Rather, an overall assessment must be made as to whether a third party would have granted such a loan under the same conditions. In that regard, arm's length behavior can be evidenced by reference to not only third-party banks, but any other creditor if there is a market for such (unsecured) finance transaction. If a loan is unsecured and there is a market for such loan where third parties would have agreed on a higher interest rate to compensate for the risk due to the lack of collateral, an adjustment of the interest income shall have priority over the non-recognition of the write-off of the receivable.

In Luxembourg, for the first time, a court ruled on the subject of profit participating loans (PPL) in the **Blackstone decision.**[107] The Luxembourg administrative tribunal overturned an assessment made by the Luxembourg tax authorities (LTA) that recharacterized a portion of the profit-linked variable interest on a PPL, issued by a Luxembourg company ("LuxCo"), as dividends subject to 15% withholding tax. Previously, the LTA had entered into a tax ruling with LuxCo that provided that the profit-linked interest would be accepted to the extent that such interest was at arm's length and in line with transfer pricing principles. However, the LTA recharacterized a portion of the variable profits as a hidden dividend subject to a 15% withholding tax. LuxCo provided a fixed interest rate benchmark study ("TP Study") demonstrating that the applied annual variable interest rate was still within the TP Study's ranges and thus aligned with the terms and conditions of the ruling. The court sided with the Luxembourg taxpayer that the PPL's profit-linked interest payments were still within the range of the TP Study and thus compliant with the terms and conditions of the Luxembourg tax ruling.

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[105] Case No. I R 73/16 (Feb. 27, 2019).

[106] Federal Tax Court of Germany, Case No. I R 32/17, BFH/NV 2022, 49 (June 9, 2021).

[107] Blackstone/GSO Debt Funds Europe S.à.r.l., Administrative Tribunal of Luxembourg, Case No. 43264 (July 13, 2021).

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V. Final Remarks

With exacerbated transfer pricing audits occurring across the globe, taxpayers may employ alternative mechanisms to properly manage their transfer pricing disputes and possibly prevent important tax assessments, penalties, and double taxation.

APAs, in their different modalities, offer an excellent option to prevent and resolve transfer pricing disputes and provide transfer pricing certainty to taxpayers vis-à-vis the covered transactions. When a dispute arises during an audit, however, taxpayers may seek to resolve disputed issues with the tax authorities in one or multiple jurisdictions before going into litigation. Some of these alternatives allow for resolution during the audit, through a direct interaction with the relevant audit authorities. In other cases, the taxpayer may use alternative dispute resolution mechanisms involving official facilitators.

These alternatives range from the initial discussion of the merits of the potential transfer pricing adjustments, the clarification of the taxpayers' positions, the formal rebuttal of the positions put forward by the tax administration still at the administrative stage, MAPs, settlement options and arbitration procedures. Taxpayers resort to the alternatives referred above to avoid litigation, which in most cases is public and can create significant reputational risk in today's environment. Litigation is expensive, factually intensive, complicated and takes a long time, but sometimes it is necessary.

As such, high quality court precedents have marked the global trends and developments in transfer pricing controversy. These court precedents derived from cases where taxpayers either exhausted all pre-litigation alternatives without any success or in cases where taxpayers decided to litigate.

Well-known cases like the Coca Cola – U.S. case, allow taxpayers and tax authorities to enhance their transfer pricing positions and interpretations by achieving a clearer understanding of what a reasonable transfer pricing policy should stand for.

Cases like the Coca-Cola case, lay out, in a quite impressive detail, how to analyze a transfer pricing matter, prepare transfer pricing documentation, analyze marketing intangibles, ensure important legal agreements are properly executed, and ultimately defend against a transfer pricing case. Any transfer pricing case is highly fact specific, but as we were able to see, there is always a message to be learned. The Coca-Cola case highlights the importance of legal agreements that should be perfectly aligned to the specific transfer pricing policy. The transfer pricing documentation needs to be integrated with the corresponding supporting evidence, chief among which, the legal agreements reflecting the transfer pricing positions in full detail. Taxpayers are recommended to integrate a proper defense file and have it readily available in case a questioning is triggered by the tax authorities.

Reviewing different tax court cases across many jurisdictions sheds light on the future of transfer pricing disputes. Because transfer pricing adjustments generate an important amount of tax revenues, many tax administrations have challenged a wide range of transfer pricing positions; from the mere selection of transfer pricing methodologies and reliable comparables to a more sophisticated questionings related to business restructurings/conversions, hard-to-value intangibles, and financial transactions. Disputes also emerge from the interaction between transfer pricing and anti-abuse measures.

These cases create an important reservoir of information that taxpayers should consider in order to align their transfer pricing policies to current interpretations and act accordingly.

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