Editors: Anuschka Bakker
and Marc M. Levey

Transfer Pricing and Dispute Resolution

Aligning strategy and execution

IBFD

Transfer Pricing and Dispute Resolution

Why this book?

Transfer Pricing and Dispute Resolution addresses the complexity, valuation and administrative nuances, and cultural impacts of resolving this significant cross-border issue when tax disputes arise.

This book sets out in detail not only the general laws in each tax jurisdiction impacted by the multinational companies' transfer pricing practices, but also the ancillary concerns of how the issue is interpreted locally as well as related to the OECD Guidelines; the varied approaches to administrative resolution of these issues, including specific alternative dispute resolution mechanisms and the effective uses of Advance Pricing Agreements; correlative adjustment procedures in the event of transfer pricing adjustments; cross-border exchange of information concerns; and how to proceed to litigation if all else fails administratively.

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Table of contents

Chapter 2

Dispute Channels

Suzan Arendsen*

This chapter is based on information available up to 1 October 2010.

1. Overview of common dispute process

Authorities worldwide increasingly consider transfer pricing as an area to focus on. As a result, tax authorities are increasing the resources that they can bring to bear on transfer pricing issues, and are improving their knowledge in this area.

According to a global transfer pricing survey, the majority of tax authorities focus on the following aspects of transfer pricing:[1]

– transactions with perceived tax havens and "blacklisted countries";
– service transactions;
– financial transactions; and
– intangibles.

On the other hand, in the current economic climate, taxpayers are faced with reduced profits or (substantial) losses and have decreased budget and resources to meet tax requirements.

As a consequence of this increasing focus on transfer pricing and the current economic climate, taxpayers have been more likely to be the subject of tax audits. Events mentioned by authorities as the most common reasons for launching an audit are:[2]

– a sudden reduction in taxable profits;
– business restructuring; and
– indirect tax challenges.

* Tax Director Europe, Nike.
1. Ernst & Young, 2009, Global Transfer Pricing survey, available at www.ey.com/GL/en/Services/Tax/2009-Global-Transfer-Pricing-survey---Survey-findings-by-country.
2. Ernst & Young, 2009, Global Transfer Pricing survey, at 8.

For example, the Australian Tax Office published a booklet in which they present a checklist of issues that will attract the attention of the ATO.[3]

This chapter considers the following options for resolution of transfer pricing disputes:
- audit;
- appeals and litigation;
- mutual agreement procedure (MAP) and arbitration; and
- advance pricing agreements (APAs).

The advantages and disadvantages of each procedure are considered, and commentary is provided on discussions and negotiations with tax authorities.

2. Description of procedures

2.1. Audit

Tax audits can be a useful tool for the raising of revenues. For example, in Germany, in 2009 approximately 26% of total tax revenues were collected through tax audits.[4] In most countries, during audits the tax authorities show an increased focus on transfer pricing .

A tax or transfer pricing audit can be triggered by several circumstances. Circumstances external to the taxpayer may include the fact that some tax authorities perform audits on a regular basis (e.g. every 5 years), or information received by the tax authorities through a (spontaneous) exchange of information between tax authorities of different countries. However, audits can also be triggered by a taxpayer's internal changes, such as a change in profits, implementation of a royalty structure or a reorganization or restructuring.

The approach taken by the tax authorities in an audit may differ from one country to the next. Some countries take a legalistic approach (e.g. Germany, Italy and France), while others take a more economic approach (e.g. the United States).

Transfer pricing audits are governed by domestic procedures and legislation. The discussion here therefore deals only with some common

3. Australian Tax Office, Large Business and Compliance, at 7, available at www.ato.gov.au/content/downloads/bus33802nat8675092010.pdf.
4. Deloitte, EMEA Dbrief (27 October 2010).

denominators in the process and does not deal with any specific country issues.

Transfer pricing audits are very fact-intensive and may include difficult assessments of comparability, judgement of industry, market and financial information, analysis of intangible property ownership and interpretation of intercompany agreements. As a consequence, transfer pricing audits and disputes may become very complex and, as transfer pricing is not a science, somewhat subjective.

During an audit, it is therefore essential for a taxpayer to maintain control of the critical facts underlying each transaction. Central points to achieve this include the following:

- as audits can take place years after the fact, it is necessary that the knowledge regarding transfer prices not be dependent on only one or a few persons. In this regard, the taxpayer should ensure that it has documentation available. Documentation may consist of agreements, transfer pricing documentation, economic studies, policies, invoices, etc.;
- the taxpayer should consider appointing one person or a distinct team of persons to manage the audit process. Only this person or team should answer questions from the tax authorities, in order to avoid providing contradicting or incorrect information. All interviews, plant tours and company information given to the tax authorities must be carefully planned and choreographed;
- it is important to make sure management is involved. Mostly, the timeframe in which questions must be answered is short, so management support is essential. A large part of the information requested will be available within the company, but people in the company should be able to properly prioritize the information requests and be able to free up time to dig up the information needed; and
- the taxpayer should establish an audit plan, both internally and, if possible, with the tax authorities, for the audit procedure, including what protocol to follow and who the contact person(s) is/are.

When the tax auditors present their findings and proposed adjustment (if any) following the audit, it is time to settle the audit. This can be done by negotiation through whatever administrative vehicles may exist or, ultimately, through litigation and arbitration. The latter two are discussed in depth at 2.2. and 2.3.

However, the first step – negotiations – is a critical step in the audit process. One of the main things to keep in mind at this stage, is a clear understanding of the financial risks of reaching or not reaching an agreement. It is in this regard, it is also critical to have a strategy at hand regarding the issues at stake, and on which issues to compromise and on which to stand firm.

Also, the timeline must be considered. In most countries litigation can take years, which would mean an uncertain position for several years regarding the outstanding issue(s).

If one comes to an agreement during the negotiation stage, it is important to plan for the implications of the agreement for the relevant parties in the other countries; the impact on prior years (if they are not yet closed) and future years; and any consequences for indirect taxes. Most important is ensuring that the statutory limits are held open so that correlative adjustments can be made to avoid issues of double taxation.

Accepting the adjustment of taxable profit in one country (the primary adjustment) may have the following consequences:

- *a secondary adjustment*. A secondary adjustment is an adjustment on a secondary transaction relating to the primary transaction. Consider the following example: Company *A*, resident in Country *A*, bought goods from Company *B*, resident in Country *B*. The tax authorities in Country *A* make an adjustment by increasing the taxable profits of Company *A*. Therefore, Company *B*, the seller of the goods, should have received less income according to this adjustment. Because generally no real payments take place in accordance with the adjustment made in Country *A*, Company *B* still holds the (higher amount of) money received from the transaction. This money can subsequently be considered to be transferred by way of a loan, dividend distribution or (informal) capital contribution, depending on the relationship between the companies. The related secondary adjustment can take the form of additional interest charges or withholding taxes; and
- *double taxation*. A part of the profits (amounting to the adjusted profit) is taxed in both countries where the relevant parties are established, provided that no corresponding adjustment can be made. Corresponding adjustments are not mandatory, and therefore a corresponding adjustment will be made only when the tax authorities in the counterparty's country agree to the adjustment. The possibility to make a corresponding adjustment is provided for under Art. 9(2) of the OECD Model Tax Convention on Income and on Capital (OECD Model Convention).

If the taxpayer cannot come to an agreement with the tax authorities, the next step would be litigation, mediation and/or arbitration.

2.2. Appeals and litigation

The chances of success in court can vary widely from one country to the next. Also, judgements sometimes seem to reflect certain trends and attitudes (e.g. public concern around multinationals that appear to shift profits from high-tax jurisdictions to low-tax jurisdictions). Therefore, taxpayers should consider the risks and benefits of litigation carefully. One significant risk is the cost of litigation. Expert witnesses, forensic costs, document production and depositions and interviews lead to significant costs, besides the substantial costs of counsel.

The allocation of the burden of proof is a noteworthy factor to consider. The burden of proof is generally allocated according to domestic legislation. The OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines) mention that the burden of proof is generally initially borne by the tax authorities.[5] If the taxpayer does not fulfil certain requirements (e.g. making available transfer pricing documentation), the burden of proof will be reversed and shifted to the taxpayer. However, in some countries the burden of proof is initially borne by the taxpayer. In the United States, for example, one must prove that the assessment by the US tax authorities is unreasonable, arbitrary and capricious before the burden of proof is shifted from the taxpayer to the tax authorities.

The following table gives a global indication of the burden of proof for transfer pricing issues in the various countries:[6]

Country	Party bearing burden of proof	Comments
Argentina	taxpayer	
Australia	taxpayer	at all stages, taxpayer must prove arm's length price
Austria	party claiming an advantageous position	for deductions claimed, the taxpayer; for increase of profits, the tax authorities
Argentina	taxpayer	
Belgium	tax authorities	
Canada	taxpayer	

5. OECD Transfer Pricing Guidelines, Para. 4.11.
6. IBFD online, available at http://online.ibfd.org/highlight/collections/tp.

Country	Party bearing burden of proof	Comments
China (People's Rep.)	taxpayer	tax authorities may use secret comparables
Denmark	tax authorities, in first instance	supporting transfer pricing taxpayer must provide documentation
France	tax authorities	in practice, the taxpayer must prove arm's length nature of transactions
Germany	party claiming an advantageous position	taxpayer must provide documentation
Greece	taxpayer	taxpayer in case of cross-border transactions; tax authorities in domestic transactions
Hungary	tax authorities	
Israel	tax authorities	documentation must be provided by taxpayer, also from foreign related party
Italy	tax authorities	documentation strongly advised
Japan	tax authorities	taxpayer must provide documentation
Luxembourg	party claiming an advantageous position	
Netherlands	party claiming an advantageous position	taxpayer must provide documentation
Poland	tax authorities	
Portugal	tax authorities	taxpayer must provide documentation
Russia	tax authorities	
Spain	taxpayer	taxpayer must provide documentation
Sweden	tax authorities	taxpayer must provide documentation
Switzerland	tax authorities	
Taiwan	taxpayer	
United Kingdom	taxpayer	if position is reasonable and well documented, burden of proof shifts to tax authorities

Country	Party bearing burden of proof	Comments
United States	taxpayer	documentation is required and allows taxpayer to avoid certain penalties
Vietnam	taxpayer	documentation is advised

2.3. Mutual agreement procedure and arbitration

An alternative means of resolving tax disputes can be found in the MAP, provided for under Art. 25 of the OECD Model Convention[7] or the mutual agreement and arbitration procedure under the EU Arbitration Convention.[8]

The MAP under Art. 25 of the OECD Model Convention is placed outside domestic law, so that the usual legal remedies remain available to the taxpayer and may be invoked for the elimination of economic[9] and/or juridical[10] double taxation not in accordance with the applicable treaty. Generally, in practice the MAP process is used in cases to resolve disputes on withholding tax issues, the attribution of profits to a permanent establishment, transfer pricing or dual residency.

In 2008, Para. 5 was added to Art. 25, affording the opportunity to submit any unresolved issues to arbitration.

Arbitration had already been in place within the European Union since 1 January 1995 for an initial period of 5 years through the EU Arbitration Convention. Several months before expiration of the first period, the Council adopted a Protocol to the Convention, which provides for an automatic extension by periods of 5 years, unless a contracting state objects.

The EU Arbitration Convention generally is used only to address transfer pricing adjustments.

7. OECD Model Tax Convention on Income and on Capital (2008).
8. Convention 90/436/EEC of 23 July 1990 on the Elimination of Double Taxation in Connection with the Adjustment of Profits of Associated Enterprises (Arbitration Convention).
9. Economic double taxation means the inclusion of the same income in the tax base of different taxpayers.
10. Juridical double taxation means the imposition of income taxes in two (or more) states on the same taxpayer and on the same income.

In 2004, the European Council adopted a communication on the work of the EU Joint Transfer Pricing Forum (JTPF) on a proposal for a Code of Conduct for the effective implementation of the EU Arbitration Convention.[11] On 22 December 2009, the EU Council adopted a revised Code of Conduct.[12] For further details, see Chapter 3 (International Developments).

2.3.1. Mutual agreement procedure

The discussion of the MAP is based on its definition in Art. 25 of the OECD Model Convention. Taxpayers should revert to the text of the MAP article of the applicable tax treaty in order to determine the applicability of the following discussion.

The OECD has published helpful guidance on how the MAP should ideally work – the "Manual on Effective Mutual Agreement Procedures" (MEMAP). The latest available version was issued in February 2007, i.e. before the release of the updated 2008 Model Convention.

Initiation of the mutual agreement procedure

The initiative to commence a MAP rests with the taxpayer, which may submit a request to the competent authority. The period to initiate a MAP is limited: within 3 years from the first notification of the action resulting in taxation not in accordance with the applicable treaty. In most cases, the first notification is clear in the form of an assessment or an official demand for collection or levy of tax. If the tax is levied by deduction at source, the 3-year period commences at the moment the income is paid, unless the taxpayer can prove that it learned of this deduction only later.

The Commentary on Art. 25 notes that the request may also be submitted by the taxpayer even before the tax has been charged or even notified to the taxpayer.[13] Therefore, a MAP request may already be submitted where the taxpayer assumes it is probable that an issue will result in taxation not in accordance with the applicable treaty.

The person or entity to which the request may be addressed is defined in Art. 25 as the "competent authority of the Contracting State of which [the taxpayer] is a resident or, ... of which [the taxpayer] is a national". For transfer pricing adjustments, which have an effect on related parties in two (or more)

11. Official Journal C 176 of 28 July 2006, at 8.
12. Official Journal C 322 of 30 December 2009.
13. OECD Commentary on Art. 25, Paras. 14 and 15.

jurisdictions, the MEMAP recommends the submission of separate requests to the competent authorities of all relevant countries by the taxpayers involved.

The competent authority is typically defined in the Definitions article of the applicable treaty. In addition, the OECD publishes country profiles that indicate who the competent authority is for a certain country.

The OECD country profiles on MAPs also include guidance on how to make a MAP request. For cases where no such guidance is provided, the MEMAP indicates the relevant information that should be provided by the taxpayer.[14] The recommended relevant information includes:

- tax treaty article(s) that are claimed not to be applied correctly and the taxpayer's interpretation of the application of those articles;
- the relationship, situation and structure of the transactions or related parties involved;
- a summary of the facts and analysis of the issues;
- documentation as described in domestic law of the taxpayer's home country;
- a copy of any other relevant competent authority requests and related documents filed;
- a schedule of the statutes of limitations in each jurisdiction in respect of the years under review; and
- a statement as to whether the taxpayer has filed a notice of objection, notice of appeal, refund claim or something comparable in the relevant jurisdictions.

Obviously, the provision of complete, accurate and timely information to the competent authorities should facilitate the process.

Role of the competent authorities

After receipt of the MAP request, the competent authority to which the request was submitted will consider the request's acceptability. Aspects that may be considered by the competent authorities are (1) whether the issue or transaction is covered by the applicable treaty, (2) whether the request is submitted within the time limits specified and (3) whether the issue or objections seem to be justified.

14. OECD, Manual on Effective Mutual Agreement Procedures (MEMAP) (February 2007), at 14.

The competent authority should in first instance try to resolve the issue unilaterally. If this is not possible, the competent authority will engage the other competent authority and the second phase of the MAP commences. At this point, the MAP foremost concerns dealings at the level of both states, with no or very limited interaction with the taxpayer. As the competent authorities may communicate directly and in different ways (e.g. by telephone or in-person meetings), it is not necessary to go through diplomatic channels.

The MEMAP describes in the Annex the ideal timeline and procedure for a typical MAP process. For example, it recommends for a timely procedure that the competent authority to which the request was filed, issue a position paper within 4–6 months after it was agreed by the two competent authorities to enter into a MAP. The other competent authority should then review and respond to the position paper within 6 months after receipt thereof. In the following 12 months, a solution should be sought for the issues at hand. Although the competent authorities should use their best efforts to come to a solution, they are not obliged to come to a result.

Arbitration

The MAP does not guarantee that an agreement will be reached. However, due to the addition of the new Para. 5 of Art. 25, it is now possible to submit unresolved issues of the case to arbitration, if so requested by the taxpayer. Para. 5 also provides the period when this is possible, namely 2 years after the case is presented to the competent authority of the other state.

The addition of Para. 5 is a major improvement on the previous Art. 25, as it specifies a deadline for the MAP (i.e. 2 years after the case has been presented to the competent authorities), and it provides the taxpayer an opportunity to obtain a solution for unsolved issues by arbitration and consequently a mutual agreement, whereas a mutual agreement was not an evident outcome before the implementation of Para. 5.

In some countries, the arbitration procedure as described in Art. 25(5) is not allowed or is restricted to certain cases due to national law or policy or administrative considerations.[15] Also, in the United States, arbitration is available only under its tax treaties with Canada and Germany, and has seldom been used.

The arbitration process is not dependent upon a prior authorization by the competent authorities and is an extension of the MAP (and not an alter-

15. OECD Model Convention, Commentary on Art. 25, Paras. 65 and 66.

native or additional recourse).[16] It focuses only on particular unresolved issues that stand in the way of a mutual agreement and is not an automatic process. The latter means that it is also possible for the taxpayer to wait until after the end of the 2-year period or not to pursue arbitration at all.

Art. 25(5) does not indicate who the arbitrators should be; this is to be defined in mutual agreement between the countries involved. The OECD provides in a Sample Mutual Agreement on Arbitration (which is taken up as an annex to the Commentary on Art. 25) a suggested basis for a mutual agreement to implement the arbitration process. According to this Sample Agreement, the competent authorities must each appoint one arbitrator. Two months later, the two arbitrators will appoint a third one who will function as chair.[17]

The arbitration decision should be considered and communicated within 6 months after the chair has informed the relevant parties that he or she has received all required information. The Sample Mutual Agreement on Arbitration also foresees a simplified, alternative process which would only take 3 months after appointment of the arbitrator – the “Streamlined Arbitration Process”.[18]

The decisions taken on the particular issues submitted to arbitration, whether under the Streamlined Arbitration Process or otherwise, are binding, unless the person directly affected does not accept the mutual agreement that implements the arbitration decision.[19]

EU Member States must coordinate the scope of Para. 5 of the OECD Model Convention with the obligations under the EU Arbitration Convention, as discussed below.

Domestic law

To avoid conflicting positions on the same (unresolved) issues, it is recommended in the OECD Commentary not to pursue domestic legal remedies and a MAP at the same time.[20]

16. OECD Model Convention, Commentary on Art. 25, Para. 63.
17. Sample Mutual Agreement on Arbitration, point 5.
18. Sample Mutual Agreement on Arbitration, point 6.
19. OECD Model Convention, Commentary on Art. 25, Para. 81.
20. OECD Model Convention, Commentary on Art. 25, Para. 76.

Notes

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