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Increasing Importance of Transfer Pricing in M&A Transactions

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Multinational enterprises pursue transformation strategies and grow inorganically through mergers and acquisitions (M&A). Irrespective of the macroeconomic circumstances, this trend will continue. Ensuring that related integrated tax risks and opportunities are managed well is key to its success. In this article, the authors explain the increasing importance of transfer pricing in M&A transactions during the tax due diligence phase through a case study and think ahead on post-closing items to ensure a sustainable transfer pricing model towards the future.

1. Introduction

Mergers and acquisitions (M&A) is not a new phenomenon, but the complexity of transactions has significantly increased over the last decades and more specifically in recent years. Within the international tax landscape, the complexities relating to transfer pricing arose when businesses started expanding their operations across the globe and consequently have been setting up international tax structures, which sometimes include a shift of profit from high(er) to low(er) taxed jurisdictions with questionable substance. Since then, numerous international tax initiatives have been deployed to tackle various types of (potential) tax avoidance schemes, which, as a result, have added an additional layer of complexity in the M&A landscape on transfer pricing. In general, a transfer pricing risk arising ultimately stems from non-compliance with the arm's length principle.[1]

2. Developments in the Transfer Pricing Landscape

Due diligence mainly focuses on financial, commercial, legal and tax considerations, and their impact on a transaction. Among these many considerations – specifically within the international tax landscape –transfer pricing has become a hot topic, which has led to its emerging role in tax due diligence. This is mainly due to several notable international institutions, such as the G20 and Organization of Economic Co-operation and Development (OECD), perceiving base erosion and profit shifting (BEPS) as a major issue in the international tax sphere.[2] The OECD published its first report on this matter in June 2012, which further created awareness on critical transfer pricing issues. This resulted in the release of 15 Actions in July 2013 (in the form of Action Reports) to combat BEPS.[3]

The momentousness of the BEPS Action Reports had not been seen before in the international tax landscape. Firstly, there was concrete guidance aimed at ensuring alignment of operational profits and economic activities in line with value creation. Secondly, guidance on transfer pricing documentation and country-by-country reporting requirements were implemented globally. Thirdly, the increasing transparency on transfer pricing arrangements allowed tax authorities to easier challenge such arrangements, which has led to a rise in disputes (as tax authorities may impose adjustments).

Several factors have been identified as crucial in driving changes to operating models, including the intense competition in a globalized economy, the cost savings from economies of scale, the requirement for specialization, and the desire to enhance efficiency and reduce expenses.[4]The forward-thinking multinational enterprises (MNEs) are embracing the innovative opportunities that arise within the macroeconomic environment. In turn, this also impacts the tax function (including transfer

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1. *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, para. 1.6., Primary Sources IBFD [hereinafter *OECD Guidelines*].
2. OECD, *OECD urges stronger international co-operation on corporate tax* (12 Feb. 2013), available at https://www.oecd.org/newsroom/oecd-urges-stronger-international-co-operation-on-corporate-tax.htm (accessed 26 Mar. 2023).
3. OECD, *BEPS Actions*, available at https://www.oecd.org/tax/beps/beps-actions/ (accessed 26 Mar. 2023).
4. *OECD Guidelines,* para. 9.24.

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pricing) as part of broader business decisions as a response to the ever-changing tax landscape to achieve a sustainable model towards the future. On the flip side, small and medium-sized enterprises (SMEs) operating internationally often struggle with the interaction of transfer pricing with their operating model, which results in non-compliance with global and local transfer pricing regulations and, as a result, in discussions between the taxpayer and local tax authorities or between tax authorities on the allocation of profits to each respective country. This is critical considering the increasing focus on transfer pricing in global tax controversy cases.

Considering the complexity of the transactions and the resulting increase in the audit and dispute landscape, taxpayers may seek advance tax certainty by way of an advance pricing agreement (APA) on the transfer pricing methodology and transfer pricing applied on intercompany transactions. Taxpayers can also apply for bilateral APAs (BAPAs) or multilateral APAs (MAPAs), which involve multiple tax authorities and taxpayers. The unilateral, bilateral and multilateral APAs can simplify tax examinations on transactions, and while there are certain costs and timing elements to consider, within an environment of increasing controversy there can be great value in having certainty on the allocable profits between group entities.

In the Netherlands, a notable development was made in the field of APAs on transparency when the Dutch State Secretary of Finance published the decree "preliminary consultation on rulings with an international character" (hereinafter: APA decree).[5] In general, it is noted that there has been a decline in unilateral APA requests since the APA decree became effective.[6] There has however been an increase in BAPA applications.

The critical changes due to globalization vis-à-vis the changes in the international tax landscape have made transfer pricing imperative and, as such, transfer pricing is considered of great importance in M&A transactions.

3. Impact of Transfer Pricing in M&A Transactions

Prior to pursuing an M&A transaction, thorough tax due diligence is typically conducted by the parties. The aim of the tax due diligence process is conducting an investigation into the target's[7] tax position to identify potential tax exposures (and opportunities) that may impact the transaction metrics. Based on the outcome of the tax due diligence process, the transaction price is determined (amongst other factors taken into consideration). Ultimately, the tax due diligence allows for a "helicopter view'' on the target and the historical risks embedded in the target and, thus, contributes to an informed decision as to whether the target is a strategic fit in the business of the acquiring company.

3.1. Typical risks identified as part of the Tax Due Diligence process

There are numerous transfer pricing risks that are often identified as part of the tax due diligence process. Based on the authors' experience, these may include:

- *Mismatch between legal and economic ownership of intellectual property (IP).* By performing risk control-related development, enhancement, maintenance, protection and exploitation (DEMPE) functions (i.e. the economic owner), an entity in one jurisdiction should receive the residual return derived from an intangible. However, often this residual return is attributed to the jurisdiction of the legal owner, who is merely performing administrative functions, such as maintaining patents/trademarks. This may trigger scrutiny by tax authorities, as the residual return is not allocated to the party performing the key functions and assumes the key risks in relation to the IP.
- *Business restructurings conducted without assessment of the transfer pricing implications.* It may also be the case that business restructurings occur to streamline an MNE's business model without the assessment of any transfer pricing implications. More specifically, taxpayers need to consider (i) reallocation of profit potential, (ii) transfer of something of value and (iii) termination of existing arrangements to ensure this is in line with the arm's length principle. The question arises whether triggers resulting from the business restructuring would be compensated between independent parties in comparable circumstances under chapter IX of the OECD Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines).[8]
- *Misalignment between contractual arrangements and actual conduct of the related parties.* This concept is referred to as substance over form, which implies that the economic reality of a transaction should take precedence over its legal form. In other words, the true nature and economic impact of a transaction should be considered more important than the way it is

5. NL: *Besluit vooroverleg rulings met een internationaal karakter* (Decree preliminary consultation on rulings with an international character), Decree of 19 June 2019, no. 2019/13003, published in the Government Gazette on 28 June 2019 (updated June 2022).
6. K. Lukosz, D. van Haastrecht & S. Volleberg, *The Evolution of the Dutch APA Practice – Analysis of APAs in the Netherlands*, 29 Intl. Transfer Pricing J. 6 (2022), Journal Articles & Opinion Pieces IBFD.
7. The company or companies being acquired are often referred to as "target" or "target companies".
8. Chapter IX describes business restructurings in the context of (i) arm's length compensation for the restructuring itself and (ii) remuneration of post-restructuring controlled transactions.

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legally structured or documented. Applying the substance-over-form concept could result in a different allocation of profits within the group, depending on the actual functions performed, risks assumed and assets deployed by the relevant parties to the transaction and, as a result, a lower or higher effective tax rate (ETR) for the group. This occurs often because local tax authorities may have different views on the "correct" allocation of profits.

- *Lack of substantiation of intercompany financing transactions.* Often, in practice, intercompany financing transactions lack the underlying supporting documents to substantiate the transfer pricing policy applied. In a vast majority of cases, chapter X of the OECD Guidelines has not been considered in this regard. For example, the increased focus on delineation of intercompany financing transactions to ensure the terms and conditions are in line with commercial rationale may not be addressed. Lack of substantiation or support for the interest rate applied may result in tax authorities scrutinizing the arm's length nature of the interest rates and, in turn, impose corrections. It should be noted that quantifying an exposure is inherently difficult without an appropriate benchmark. Provided that merely a review is performed of the intercompany financing position without performing benchmark studies, the quantification of a potential exposure is generally based on business experience.

- *Attribution of profits to permanent establishments (PEs).* It may be the case that, for example, sales representatives are active in jurisdictions in which an entity does not have a legal presence. These sales representatives may perform sales activities on behalf of the group company in those jurisdictions. It may be the case that the sales representatives negotiate and have the power to execute or play a principal role in the conclusion of the relevant contracts, which triggers a PE exposure. As a result, profit should be attributable to this jurisdiction from a transfer pricing perspective, which may result in increased taxes payable (as well as penalties).

- *Misaligned transfer pricing model.* It may be the case that MNEs have not implemented a consistent transfer pricing model, which results in inaccurate allocation of profits among related entities. Based on a misalignment of actual functions performed, risks assumed and assets deployed, this can result in an inaccurate characterization of entities, whereby the allocations of profits among these entities are not in accordance with the arm's length principle. A lack of a consistent transfer pricing model can result in a (cash) ETR that does not reflect the true economic activity of the group, which increases the risk of disputes and penalties. As a result thereof, mismatches could result in ETR impact for the target and, thus, potentially negatively impact the valuation of the target because of increased tax liabilities.

  Lack of –- or non-compliant – transfer pricing documentation. The purpose of transfer pricing documentation is to demonstrate that a company's related-party transactions have been concluded in line with the arm's length principle. Transfer pricing documentation is typically prepared on a contemporaneous basis, usually simultaneously with the preparation of annual tax returns. The transfer pricing documentation should be supported by appropriate supporting documentation (e.g. benchmarking analysis) to demonstrate that the transfer pricing policy applied is in line with third-party behaviour (i.e. in line with the arm's length principle). Lack of – or non-compliant – transfer pricing documentation may result in a shift of the burden of proof and fines/penalty exposures.

The above section has described the most common types of risks observed in practice. Sections3.2. and 3.3. describe the most notable and/or complex risks, which, in the authors' experience, result in the most significant (cash) tax impact if these are assessed not to be in line with the arm's length principle. This will be further demonstrated by means of the following case study.

Product Group BV purchases sneakers from Product Corp and distributes the sneakers through its two subsidiary companies: Distribution & Trading Ltd. located in Ireland and Distribution BV located in the Netherlands. In turn, both Distribution & Trading Ltd. and Distribution BV sell the sneakers to external parties. *See* Figure 1.

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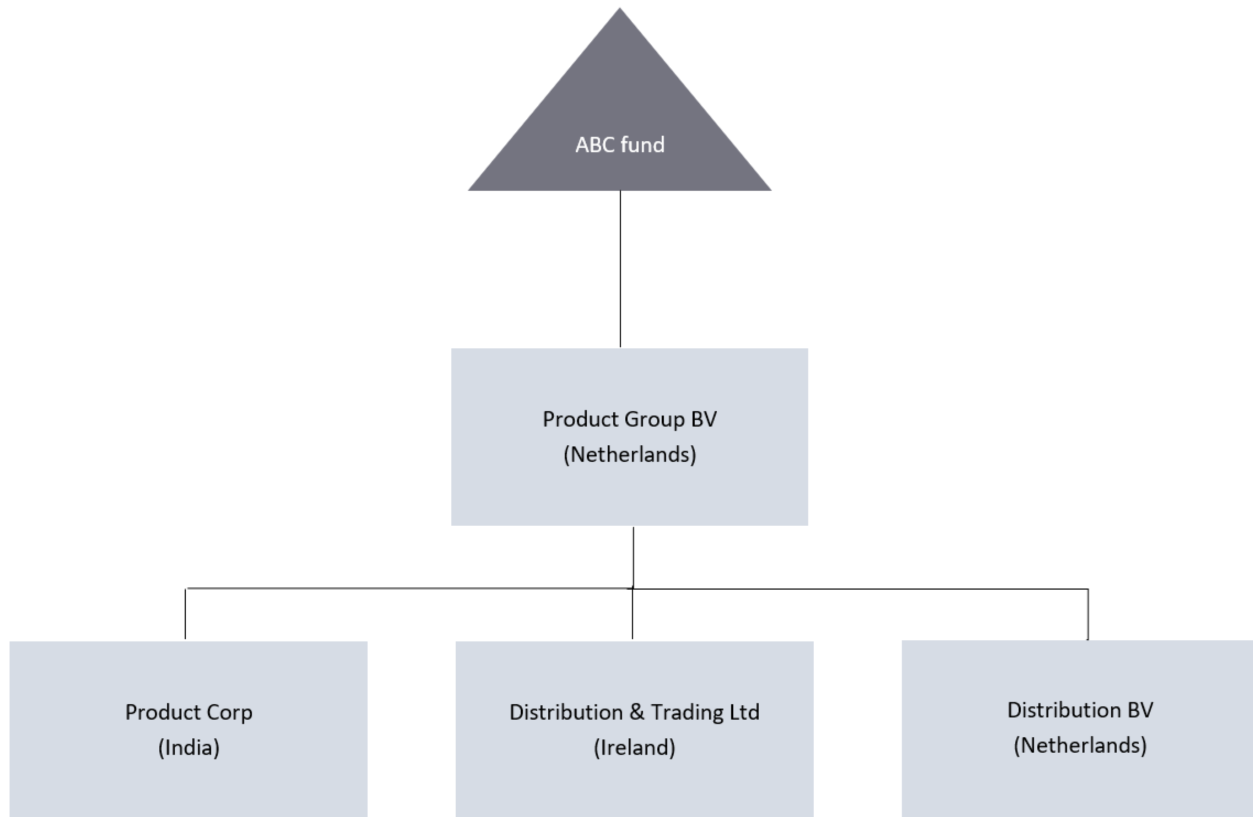
Figure 1. Group structure



3.2. Misaligned Transfer Pricing model

Upon conducting further tax due diligence, it is noted that the target has undergone a centralization of the transfer pricing model, whereby Product Group BV is characterized as the entrepreneur with routine entities (e.g. routine manufacturing and sales, contract R&D and support services) at the local level (i.e. Product Corp, Distribution & Trading Ltd, Distribution BV).

Directly before the implementation of the centralized model, the group was operating fully decentralized with local entrepreneurs, whereby in this old set-up the entrepreneurs accumulated tax losses for the period reviewed.

As part of the centralization process, there has been a build-up of functionality at the level of the entrepreneur Product Group BV in relation to strategic management, steering committees and a tactical layer of key roles on the sales and marketing aspect. However, the exact tipping point of centralization cannot be drawn in terms of the precise year. Furthermore, no robust business restructuring analysis as per chapter IX of the OECD Guidelines is available to support the change in the transfer pricing model.

The tax authorities may scrutinize the entrepreneurial nature of the local entities prior to the centralization of the transfer pricing model, claiming a routine functional profile (i.e. characterization) was already appropriate for historical years. In this regard, a conversion analysis is required to elaborate on tax and legal implications associated with the new transfer pricing model to determine whether the change to existing intercompany relationships within the target would have led to any taxable events.

As a consequence of the above, tax authorities might impose a routine return for the historical years, which may result in double taxation. Despite the access to a corresponding adjustment at the counterparty's jurisdiction, the change from a loss-making position to a profitable position in line with the routine functional profile would mean the following from a transaction perspective:

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(1) With regard to the change from a loss-making position to the break-even point, arguments can be made not to attribute any value to local entities' tax losses due to uncertainty on the transfer pricing position and, therefore, the validity of these tax losses.

(2) The change from a break-even point to the profitable position in line with the routine functionality results in an actual cash tax out, whereby there is solely an increase of the losses at the level of the entrepreneur (i.e. the counterparty to the transaction) This is regardless of whether a corresponding adjustment (as discussed in section 4.) is obtained.

3.3. Misaligned DEMPE functions

Distribution & Trading Ltd. is situated in Ireland and in addition to its distribution function legally owns all IP of the Product Group. Product Group BV performs the DEMPE functions related to the design and branding of its sneakers by means of 100 FTEs that are involved in these processes. Distribution & Trading Ltd. has only a few FTEs, which are involved in limited-risk sales activities and administrative functions in relation to the maintenance of the IP. In the current set-up, Product Group BV is remunerated via a service fee by Distribution & Trading Ltd. for contract R&D services performed, while the residual return of the IP is allocated to Distribution & Trading Ltd by means of a royalty charged to various affiliates for the access to the brand.

This creates a risk of a mismatch between the legal and economic ownership of the IP, as the return derived from the IP is for the vast majority attributed to the jurisdiction of the legal owner (i.e. Ireland) with no risk control functions, while the DEMPE functions are performed in a different jurisdiction where the economic owner is located (i.e. the Netherlands). Upon examination, this could result in tax authorities scrutinizing the allocation of profits between the related parties, which may result in transfer pricing adjustments and corresponding tax liabilities.

To mitigate this risk going forward, Product Group BV should ensure that the transfer pricing arrangements within the group are consistent with the functions performed, assets used and risks assumed by each party to a transaction. Product Group BV should document the allocation of DEMPE functions between its subsidiaries and ensure that the profits derived from the exploitation of the IP are attributed to the jurisdiction of the economic owner (i.e. the Netherlands). The jurisdiction of the legal owner of the IP should be solely entitled to a routine remuneration for its holding and administrative activities performed.[9]

In terms of the transaction, and as indicated above, this misalignment can result in transfer pricing adjustments being imposed at the level of the economic owner of the IP, whereby a corresponding adjustment can be made at the level of the legal owner of the IP. Additionally, if the corresponding adjustment is not accepted by the Irish tax authorities, the company can seek for protection against double taxation via, for example, the mutual agreement procedure (MAP).[10] However, in reality, the identification of double taxation is convoluted. Nevertheless, in case of consensus between both the Irish and Dutch tax authorities, the exposure would be limited to the amount of the profit re-allocated against the tax rate differential of both jurisdictions.

In the event the legal ownership would be transferred to Product Group BV, to align the legal and economic ownership of the IP, chapter IX of the OECD Guidelines should be carefully assessed on whether any indemnification payments and/or compensation payments are due as a consequence of the business restructuring. Nevertheless, the change in legal and economic ownership of the IP may affect the transfer pricing policies and transfer prices that are considered at arm's length, which may in turn lead to a corresponding adjustment.

Based on the authors' experience, an analysis according to chapter IX of the OECD Guidelines often is not performed by the target, and therefore it is difficult to determine in tax due diligence whether the business restructuring would lead to an exit payment and if it is subject to an exit payment. It is inherently difficult to quantify a potential compensation and/or indemnification payment exposure as generally only limited information is available during the tax due diligence process. As such, the authors often see the risks arising from business restructurings being covered by a (specific) tax indemnity in the share purchase agreement,[11] rather than an adjustment to the purchase price.

4. Corresponding Adjustments

Tax authorities impose adjustments for transfer pricing purposes if they are of the opinion that the price charged between two related parties in relation to an intercompany transaction is not in line with the arm's length principle (i.e., the transfer pricing

9. *OECD Guidelines*, para. 6.42.
10. *See also* sec 4.
11. The share purchase agreement (SPA) is a legal contract between the buyer and the seller of shares in a company. It outlines the terms and conditions of the share sale, such as the purchase price, the allocation of risks through warranties and indemnities, closing conditions, and any post-closing obligations of the parties.

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may be considered non-arm's length as per the functions performed, risks assumed and assets used). A transfer pricing correction (or speculation thereof) can arise due to various reasons, for example due to the example scenarios described in section 3.

In case any of the example scenarios from section 3. arises and the tax authorities determine that a company's return on its functions performed, risks assumed and assets deployed is not in line with the arm's length principle, a transfer pricing correction may be imposed to reflect the (in their view) arm's length situation.[12] In practice, the authors see that tax authorities perform their own transfer pricing analysis, such as benchmarks via databases or that they make use of competitor data to corroborate their view.

MNEs that engage in intercompany transactions should be aware of the transfer pricing rules in the jurisdictions they are active in and should ensure that their transfer pricing is consistent with these rules, as otherwise tax authorities may impose transfer price corrections.

In this respect, there are various types of transfer pricing adjustments, namely:

- *Primary adjustment:*[13] an adjustment that a tax administration in a first jurisdiction makes to a company's taxable profits as a result of applying the arm's length principle to transactions involving an associated enterprise in a second tax jurisdiction.
- *Corresponding adjustment:*[14] an adjustment to the tax liability of the associated enterprise in a second tax jurisdiction made by the tax administration of that jurisdiction, corresponding to a primary adjustment made by the tax administration in a first tax jurisdiction, so that the allocation of profits by the two jurisdictions is consistent.
- *Secondary transaction:*[15] a constructive transaction that some jurisdictions will assert under their domestic legislation after having proposed a primary adjustment in order to make the actual allocation of profits consistent with the primary adjustment. A secondary transaction is required when a primary adjustment cannot be made directly to the original entry.[16]

As indicated above, in case a primary adjustment is made as a result of the imposed correction by tax authorities, taxpayers generally seek for a relief of double taxation by means of a corresponding adjustment in the second tax jurisdiction. As a result, an adjustment in one country should in principle be mirrored by a correction in the opposite direction in the other country. In view of tax due diligence, a remaining exposure would therefore generally merely consist of the difference in the (effective) tax rate and possible penalties and/or interest, assuming that the jurisdictions involved are profitable and that both entities are in the scope of the transaction perimeter.[17] It should however be noted that substantial advisor costs may be involved in requesting a corresponding adjustment in the relevant jurisdiction and that should also be considered in determining the overall (cash) impact on the exposure identified.

In case a corresponding adjustment in the second jurisdiction would not be accepted by the local tax authorities, double taxation could occur. To avoid double taxation, countries may enter into tax treaties or agreements to provide relief or exemptions for taxes paid in the other jurisdiction. These agreements typically aim to eliminate or reduce the double taxation of income or assets and may include provisions such as tax credits, exemptions, or deductions.

Whilst most bilateral double taxation treaties include a provision for a MAP with the intent to arrive at a satisfactory solution, they generally do not impose a binding obligation on the contracting states to eliminate the double taxation.[18]

There is however a mechanism in place for the mitigation of double taxation within the European Union. Intercompany transactions taking place between entities resident in the European Union are in principle covered by the Tax Dispute Resolution Mechanisms Directive (2017/1852).[19] The Tax Dispute Resolution Mechanisms Directive establishes a procedure to resolve disputes where double taxation occurs between enterprises of different Member States. The Tax Dispute Resolution Mechanisms Directive provides for the elimination of double taxation by agreement between the contracting states including, if necessary, by reference to the opinion of an independent advisory body.

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12. An arm's length price is the price at which goods or services are sold between two unrelated and independent parties (in line with the arm's length principle).
13. *OECD Guidelines,* para. 4.68.
14. Id.
15. Id.
16. Subsequently, a secondary adjustment can be due following from imposing tax on a secondary transaction; *see* O*ECD Guidelines*, p. 25.
17. It is noteworthy that this under the assumption that the target entities are profit making. In case the target entities are loss-making, the adjustment may result in an increase of the taxable income and, in turn, a cash tax liability. To mitigate this (i) the payment of taxes resulting from the tax cash-out may be deferred until the entity is profit making or (ii) the loss may be carried forward.
18. OECD, *Model Tax Convention on Income and on Capital 2017 (Full Version)* (OECD 2019), available at https://doi.org/10.1787/g2g972ee-en (accessed 7 June 2023).
19. Council Directive (EU) 2017/1852 of 10 October 2017 on tax dispute resolution mechanisms in the European Union, Primary Sources IBFD.

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In addition, in case the competent authorities of jurisdictions involved in the intercompany transaction have an arbitration framework in place, this facilitates the process as it typically establishes a procedure to resolve disputes where double taxation occurs between the two jurisdictions.

In the scenario of a dispute involving both a tax treaty and the Tax Dispute Resolution Mechanisms Directive (2017/1852), it is of critical importance to consider which document supersedes. This determination is typically based on the countries involved and the specific article(s) within the tax treaty.

A typical scenario based on the facts presented in the case study is as follows:

> The transfer pricing applied in relation to the sale of sneakers within the Product Group is subject to scrutiny by tax authorities. The Indian tax authorities determine that the price paid by Product Group BV to Product Corp in India is too low and cannot be considered at arm's length based on internal benchmarking exercises performed and/or competitor data analysed. As a result, the Indian tax authorities impose a transfer pricing correction (i.e. primary adjustment) to increase the taxable profit in India.

Due to the primary adjustment the group is currently facing double taxation. To avoid double taxation, a corresponding adjustment could be made by Product Group BV to its own tax liability (in this situation a downward adjustment), so that the allocation of profits between the two jurisdictions is consistent with the primary adjustment and no double taxation occurs. It may also be the case that this process is conducted for part of the (recognized) transaction.

Theoretically this is how the adjustment mechanism is technically supposed to work. However, based on the authors' experience, in case it is deemed difficult to conclude on the way forward, a MAP may be triggered to resolve the disputes regarding the application of double tax conventions. A MAP procedure, however, comes with uncertainty and may take a long period of time and create cash flow disadvantages.

5. M&A and Insurance Market[20]

Considering the undertaking of risks in M&A transactions as described in the previous sections, the buyer and seller often seek protection against potential exposures (i.e. financial losses) that may materialize. Warranty and indemnity insurance (W&I) and specific tax insurance (STI)[21] have become widely accepted products to insure (unknown) tax risks associated with M&A transactions.[22] The number of transactions set up on the basis where the buyer takes out an insurance to cover (unknown) tax risks has increased significantly. It is viewed as a tool to manage the risks associated with M&A transactions, which enables a smoother and more efficient transaction process for the buyer and seller involved.

The basic principle of W&I insurance is that in general all (tax) risks that are unknown[23]to the buyer are covered by the insurance policy, with the exception of certain items or risk areas that are considered too abstract to be insurable. Transfer pricing is considered one of these areas, given that it is considered not an exact science (i.e. it is not always possible to determine a single correct arm's length price) and, therefore, generally is excluded from coverage under a W&I insurance policy.[24] This means that even in cases where no transfer pricing risks have been identified in tax due diligence, the insurance policy does not cover unknown transfer pricing risks.

Given the increased importance of transfer pricing in the international tax landscape, the main questions that need to be addressed are: why is transfer pricing generally excluded from coverage under a W&I insurance policy and is there any possibility to lift this exclusion and insure (unknown) transfer pricing risks under a W&I insurance policy? And if not, are there any alternatives to insure (unknown) transfer pricing risks identified in tax due diligence?

5.1. Why excluded?

Historically, insurance companies did not have in-house tax specialists that could assess potential risks related to tax and more specifically in relation to transfer pricing. Although more insurance companies have hired in-house tax specialists over the years, transfer pricing is still an area of taxation that is in constant development and considered, to some extent, subjective in

20. These criteria have been formulated on the basis of the authors' experience with W&I policies and discussions with brokers active in the Dutch tax insurance market.
21. Specific tax insurance can be sought for a specific tax topic whereas W&I insurance covers risks specifically arising from a transaction. Specific tax insurance can also be sought in case there is no transaction (e.g. to insure a dividend withholding tax position).
22. Generally the warranties and tax indemnity included in the SPA are leading for cover under the W&I policy, with certain exclusions made by the insurers for specific risk areas or disclosed matters.
23. Risks are considered "unknown" if the facts and circumstances giving rise to a claim have not been disclosed by the seller in a virtual data room, vendor due diligence report and/or tax fact book. Buyside tax due diligence reports are considered disclosed for purposes of the W&I policy and are considered "known" risks.
24. Other items generally excluded from the W&I policy are loss of tax assets or tax credits and secondary tax liabilities.

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nature. Despite there being elaborate guidelines from the OECD and other institutions (e.g. UN Model Tax Convention), local tax specialists and also local tax authorities may have different views on the pricing of certain (cross-border) transactions. This has resulted in increased scrutiny by local tax authorities of the transfer pricing policies applied and, therefore, the pricing of intercompany transactions adopted by taxpayers. Also, local tax authorities have opposite interests when it comes to pricing cross-border intercompany transactions, which may result in long discussions between tax authorities. In addition, not all countries have adopted the OECD Guidelines globally and there is no single "ultimate" competent court or authority that can render a final decision on how to interpret the OECD Guidelines in a cross-border dispute. As a result, transfer pricing is generally still excluded from the W&I insurance policy.

5.2. Is there any possibility to lift the exclusion?

Under certain conditions, insurers are willing to affirmatively cover certain identified tax risks under the W&I insurance policy,[25] for example, low tax risks that are identified and quantified in tax due diligence. This may also apply to low-risk transfer pricing matters. The following criteria play an important role in determining whether a transfer pricing risk may be covered: (i) jurisdictions involved, (ii) the number of legal entities in the target structure, (iii) the number and nature of intercompany transactions, (iv) the quality of transfer pricing and legal documentation, and (v) the quantification of the risk.

Based on the foregoing, the exclusion for transfer pricing could for example be lifted where there are only limited legal entities in favourable high-tax jurisdictions (such as the Netherlands and United Kingdom) with either limited intercompany transactions or only financial transactions, where bilateral and multilateral APAs are concluded and where appropriate transfer pricing and legal documentation (such as loan agreements, benchmark studies, Local and Master File and/or CbC reporting) is available. For example, in case the tax due diligence involves the jurisdictions and intercompany transactions as demonstrated in the case study of section 3., it is unlikely that transfer pricing risks can be covered under the W&I insurance policy. Nevertheless, it is important that as early as possible in the transaction, discussions are started with the insurance company to increase the chances of success to affirmatively cover transfer pricing risks under the W&I insurance policy.

5.3. Are there any alternatives possible?

Under certain conditions, specific transfer pricing risks identified in the tax due diligence, that cannot be covered under the W&I insurance policy, can be covered under a STI policy. Typically, this includes (more complex) transfer pricing risks with a low to medium risk level and with a potentially high cash tax out quantum. Depending on the specific nature of the risk and the comfort level that an advisor can provide on the likelihood of challenge by a tax authority, the risk can be insured. Especially in this case, it is important to address the risk with the insurers timely, as they may require a formal opinion or memorandum from a reputable tax firm to confirm the likelihood of the risk crystalizing. A STI in these circumstances could function as a transaction enabler both from a seller and buyer perspective, whereby the risk quantum is effectively reduced to the insurance premium and the transfer pricing risk identified is no longer part of discussions.

If the respective risk materializing is too high for the insurance company to cover a transfer pricing risk either under a W&I or STI policy, then the buyer could negotiate to deduct a (reasonable) estimate of the transfer pricing exposure from the purchase price. However, in many fast-paced transactions it is difficult to appropriately quantify the risk, and in such circumstance the "ultimum remedium" for a buyer is to seek for specific indemnification from the seller. It should be noted that in a competitive process this may be difficult and de facto the transfer pricing risk materializing into a cash tax liability lies with the buyer. Post-acquisition, the target may seek for protection against double taxation via a MAP to reduce the risk, in case it materializes.

6. Post-Acquisition Considerations

In the end, if the transaction takes place, there is one critical question that remains, namely: what are the post-acquisition considerations? Overall, as a result of the due diligence process, implementation of post-acquisition considerations require careful planning and management to ensure that the transfer pricing policies are aligned with the acquiring company's transfer pricing policies for a seamless integration and to additionally comply with local regulations. This is referred to as integration planning. Often, management may also take the decision to let the target operate on a stand-alone (i.e. rather autonomous) basis if this makes sense from a group perspective. Nevertheless, whether the target is integrated or operates as a stand-alone business unit, the acquiring company needs to ensure that the target complies with the arm's length principle and other local regulations, such as proper transfer pricing documentation.

As a result of the Tax Due Diligence process, transfer pricing risks may have been identified. Post-acquisition considerations are often overlooked in the speed of the acquisition process. Nevertheless, it is critical to optimize the group's tax position after a transaction. For example, it is critical to assess whether the group meets the transfer pricing documentation requirements

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25. Typically an affirmative cover is possible against an additional premium of 1%-5%, depending on the nature of the risk.

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post-acquisition, such as whether post-acquisition the target would be required to prepare Local and/or Master files due to the target becoming part of a larger group that already – or as a result of the business combination – exceeds the relevant revenue thresholds.

Thus, it would be beneficial for the acquiring company to assess the transfer pricing risks identified during the tax due diligence process to develop a plan to manage and mitigate these risks. As part of risk mitigation strategies, the acquiring company should continuously monitor the implementation of the transfer pricing policies on an ongoing basis to ensure (seamless) integration within the group. This is especially the case where the group intends to centralize the IP held by the target at the buyer's IP entity.

A typical case scenario based on the facts presented in the case study is as follows:

It is assumed that Product Group BV acquires a manufacturing company in India as part of its expansion strategy. During the tax due diligence it is identified that there is a risk that the transfer pricing policies of the target could potentially be scrutinized by tax authorities. Furthermore, the policies of the manufacturing company are not aligned with the transfer pricing policies of Product Group BV, while the functions, risks and assets grounding the transactions are similar.

Thus, as a result, Product Group BV needs to develop an action plan to integrate and align the transfer pricing policies of the target with its own transfer pricing policies. In essence, by taking post-acquisition items into consideration, Product Group BV can minimize its go-forward transfer pricing risks and ensure that the group's transfer pricing position (including the target) is aligned in terms of the functions performed, assets used and risks assumed within the new group.

7. Conclusion

In conclusion, the increased requirements for companies to document and properly support intercompany transactions in line with the arm's length principle, together with tax authorities frequently challenging the transfer pricing of SMEs and MNEs, has resulted in transfer pricing becoming one of the most important topics in the tax due diligence process.

If a target's transfer pricing policies and intercompany transaction are not properly substantiated and/or are inappropriately implemented, this can result in material cash tax liabilities for the target and, as a consequence, impact its value. Conducting a robust transfer pricing due diligence is therefore imperative to identify the transfer pricing risks that are present within the target, especially where the target operates in multiple jurisdictions and is undertaking a substantial number of cross-border intercompany transactions. With the number of transactions subject to W&I insurance coverage increasing rapidly and transfer pricing still generally being excluded from the W&I insurance policy, it is even more important to conduct a thorough transfer pricing investigation during the tax due diligence. This may allow for transfer pricing to be covered under the W&I insurance policy or specific transfer pricing risks being insurable under a STI policy, if addressed with insurers at an early stage in the tax due diligence process. As "ultimum remedium", in case coverage under a W&I or STI policy is not possible, a reduction of the purchase price or a specific indemnity could be sought from the seller.

The importance of conducting transfer pricing due diligence is not only linked to identifying historical tax risks in the target that may have a direct impact on the purchase price or result in (specific) indemnification from the seller, but may also provide for post-closing opportunities. Examples of such opportunities the authors see in practice are mostly related to the remediation of non-compliance with the arm's length principle or to potentially avoid adverse historical or go-forward tax consequences (e.g. by retroactively preparing transfer pricing documentation supporting the arm's length nature of the intercompany transactions). Additionally, other opportunities such as alignment of the target's transfer pricing model with the acquiring company or changing an inefficient transfer pricing model to optimize the overall ETR of the group can create a sustainable transfer pricing model for the future. This may be worthwhile to pursue for the acquiring company.

Therefore, whether it is identifying historical tax risks or identifying post-closing opportunities, transfer pricing due diligence is currently already an important tax due diligence topic and is expected to be of even greater importance in the foreseeable future.

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