EMERGING TRENDS IN TRANSFER PRICING

45 minutes CPD

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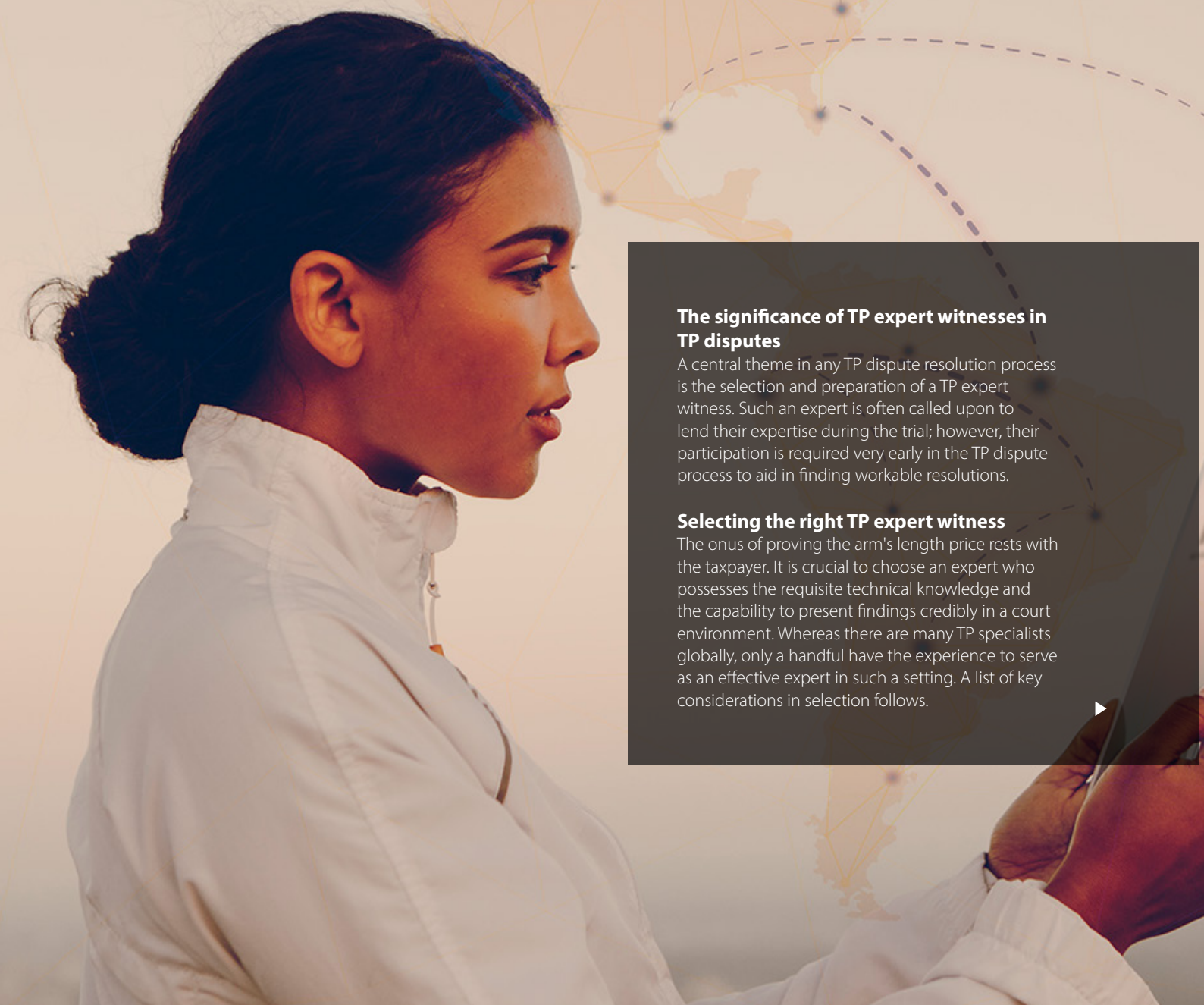
Transfer pricing (TP) disputes have always posed challenges to multinational enterprises (MNEs) and tax authorities. The interpretation and implementation of arm's length principles, the backbone of TP regulations, have led to an increasing number of TP disputes across the globe. This article considers emerging trends, emphasising the critical role of TP expert witnesses in any TP dispute.



The significance of TP expert witnesses in TP disputes

A central theme in any TP dispute resolution process is the selection and preparation of a TP expert witness. Such an expert is often called upon to lend their expertise during the trial; however, their participation is required very early in the TP dispute process to aid in finding workable resolutions.

Selecting the right TP expert witness

The onus of proving the arm's length price rests with the taxpayer. It is crucial to choose an expert who possesses the requisite technical knowledge and the capability to present findings credibly in a court environment. Whereas there are many TP specialists globally, only a handful have the experience to serve as an effective expert in such a setting. A list of key considerations in selection follows.

- Availability and commitment: Your chosen expert should be committed and available throughout the dispute resolution process.
- Credentials: An ideal expert should have both formal qualifications and hands-on experience in TP.
- Courtroom experience: Previous courtroom experiences enhance an expert's ability to withstand difficult cross-examination.
- Objectivity: The expert should appear impartial; this strengthens their credibility.
- Communication skills: Given the technical nature of TP, the expert should articulate complex concepts clearly.
- Compatibility: The legal team should have a synergistic working relationship with the expert.

Presenting evidence: Aids for the expert witness

During the evidence presentation, visual aids can be instrumental. Incorporating slide presentations, charts, graphs and diagrams can make technical evidence more digestible. Ensure that the factual foundation of the expert's opinions is accurate and not disputed. Showcasing the appropriate TP method, linked to TP guidelines, will aid the court (or forum) in understanding the significance of the testimony.

Transparency is essential. If there are limitations to the expert's opinions or if assumptions were made, these should be acknowledged upfront. Moreover, experts should strive for clarity by avoiding jargon where possible.

Preparing the TP expert witness for cross-examination

Anticipating potential challenges and areas of attack can bolster the expert's defences. Engaging in role-play sessions and simulated cross-examinations can acclimatise the expert to the courtroom environment. It is also beneficial for the expert to revisit their previous opinions, published works and other experts' reports to prepare comprehensively.

Recent global TP cases and emerging trends

In addition to the role of the expert, the landscape of TP disputes is evolving due to:

- Detailed guidance from OECD and domestic bodies on TP subjects such as business restructuring and intangibles;
- Dedicated audit teams trained in TP with external assistance; and
- TP as an avenue for aggressive tax optimisation, leading to more scrutiny.

Recent landmark cases, for example, the USA Coca-Cola case *(Coca-Cola Co. & Subsidiaries v. Commissioner,* 115 T.C. 145 [2020]) serve as models to prepare for TP disputes, as illustrated in Figure 1 below.

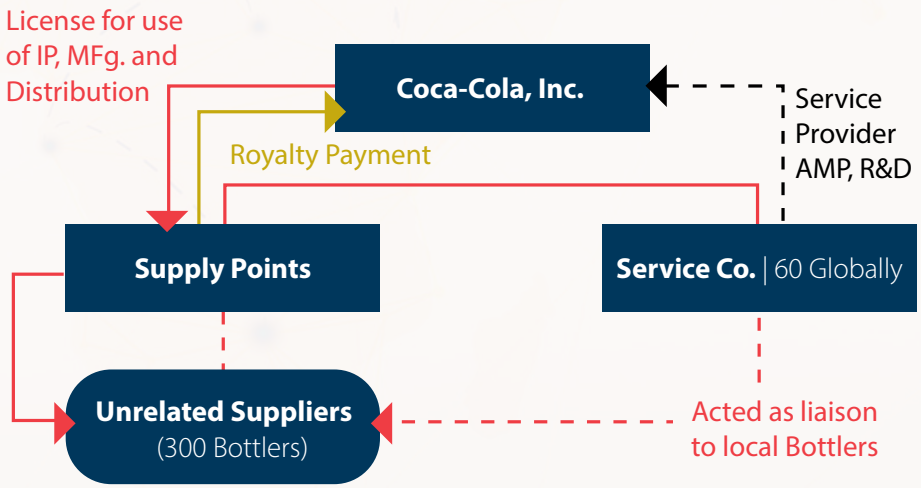


Figure 1: Model of the USA Coca-Cola case.

The court in the Coca-Cola case emphasised the need for coherence between legal agreements and TP policies. The court determined that the Cost-Plus-Method was the appropriate TP method to determine 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. Considering these findings, the court concluded that the CPM was "*ideally suited*" to determine Coca-Cola's compensation for the use of its intellectual property.

Recharacterisation

The Canadian Cameco case (*Her Majesty the Queen v. Cameco Corporation, Canadian Federal Court of Appeal*, Case No. 2020 FCA 112 [June 2020]) is an important decision about the recharacterisation of transactions, emphasising the distinction between hypothetical arm's length parties and specific taxpayers. Cameco was a Canadian headquartered uranium producer, refiner and processor. Cameco led a consortium of companies to negotiate purchase agreements for Russian uranium (and over time uranium from other suppliers). 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 but an unexpected jump in the price of uranium resulted in significant profits being realised by Cameco's Swiss subsidiary. The Canadian Revenue Authority (CRA) argued that all the profit should be recognised and taxed in Canada, arguing that: *(1)* the transaction was a sham; *(2)* the transaction should be recharacterised 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 judgement.

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.

Profit Split Method (PSM)

The Engie case (*Société Engie, Administrative Tribunal of Montreuil (1st chamber)*, Case No. 1812789 [Jan. 14, 2021]) focused on the PSM and its implementation in intercompany transactions. Engie carried out operations on the spot market under an intercompany service agreement. The subsidiaries entrusted their product to Engie, which found customers on the spot market and sold the excess liquefied natural gas. Engie was compensated with a cost +10% remuneration. The French Tax Administration recharacterised Engie as a co-entrepreneur instead of a simple service provider because the functions performed by Engie were over and above that of a simple service provider— Engie made sales on the spot market without receiving instructions from its subsidiaries— and, Engie bore almost all the risks related to the spot activity. Engie had a high value added intangible asset through the master sale and purchase agreement (MSPA) signed with the customers.

The French Tax Administration considered the most appropriate transfer pricing method to be a 50/50 PSM between Engie and its subsidiaries.

In a 2020 decision (Supreme Court of Cassation, Case No. 11387 [Feb. 25, 2020]), the Italian Supreme Court did not challenge the selection of the PSM but its practical determinations, accepting the Tax Office's statement that an additional allocation key (resulting in a higher allocation of profits to the Italian taxpayer) was appropriate. The allocation key related to the maintenance costs incurred by the three companies participating in the PSM, which was adjusted by the revenue authority.

In a Malawi TP unreported dispute, the revenue authority attempted to do the same in respect of contract manufacturing by a subsidiary in the agricultural sector with its associated Swiss enterprise conducting the marketing activities. The writer is lead counsel in this matter, which is due to be set down for trial in the near future. A similar unreported TP matter was argued by the writer in Tanzania and won by the taxpayer. The Tanzanian Tax Authority has not appealed the matter.

The application of the Residual PSM was disputed before the Japanese courts in the NGK case (The Tokyo High Court [appellate court], *NGK* case [NGK Insulators, Ltd.] [Mar. 10, 2022]). A Japanese resident entity manufactured ceramic products. NGK licensed patent and manufacturing know-how 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. As a result of demand driven by new EU regulations and improvements in manufacturing techniques at Sub A, Sub A's profitability significantly increased.

The royalty income from Sub A was thus below the arm's length price. NGK successfully argued that the depreciation expenses of Sub A should also be included in determining the factor for the profit split.

The court acknowledged that there is a factor, other than those relating to important intangible assets (i.e. scale profit), that can be included in the split step 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.

Marketing intangibles

A ruling by the French Supreme Court emphasised the importance of flagship expenses when assessing indirect transfers of profits abroad. Ferragamo France SAS, a French distributor, contributed to the brand value of its foreign-based parent company by incurring those expenses. Its gross margin that was higher than its comparables, but the company suffered operating losses over 13 years. The French Tax Administration noted that the taxpayer's salary costs and some other expenses were significantly higher than its comparables, which led them to conclude that this surplus expenditure was an advantage provided to its parent company. The French Supreme Court ruled against the taxpayer.

Management fees

Management fees and their deductibility have been in dispute in multiple jurisdictions.

The National Court of Spain in *Sierra Spain Shopping Centres Services SLU, National Court of Spain,* Case No. 151/2022 (Jan. 25, 2022) denied the deductibility of fees for strategic management services due to inadequate supporting documentation.

Similarly, the Administrative Court of Appeal of Versailles in *SAS Groupe LAGASSE EUROPE*, Administrative Court of Appeal of Versailles, Cases No. 18VE00059 and 18VE02329 (Jan. 28, 2020) held that invoices alone could not prove the performance of services.

The Tax Court in Zimbabwe in an unreported judgement, delivered a surprising judgement against a taxpayer despite providing evidence of the actual services rendered.

The Italian Supreme Court in *Italian Supreme Court of Cassation*, Decision No. 13085 (June 30, 2020) also emphasised that having an intercompany agreement was not enough to substantiate the effectiveness and benefit of the services to the recipient. A similar argument was advanced by the revenue authorities in Zimbabwe.

Financial transactions

In 2020, the OECD introduced guidance on the transfer pricing aspects of financial transactions for the first time. This was an endeavour to create consistency in the application of transfer pricing.

Elaborating on this, the French Supreme Court in A*pex Tool Group*, French Supreme Court, Case No. 441357 (Dec. 29, 2021) provided insights regarding the kind of evidence a taxpayer can furnish to show that the interest rate of an intragroup loan complies with arm's length principles. The Court opined that the risk profile of a borrowing company should be assessed considering the combined economic and financial situation of the company and its subsidiaries.

German courts (Federal Tax Court of Germany, Case No. I R 19/17, February 19, 2020, Federal Tax Gazette II 2021, 223, and Federal Constitutional Court of Germany, Case No. 2 BvR 1161/19, IStR 2021, 363 [March 4, 2021]) also grappled with similar issues, especially regarding unsecured loans between group entities. Notably, the German Federal Tax Court altered its stance, suggesting that the lack of collateral for a loan does not automatically violate the arm's length principle. Instead, a comprehensive evaluation should be made considering whether a third-party would have offered the loan under similar conditions. This points towards a nuanced understanding of transfer pricing in intercompany financing.

Final remarks

With increased TP audits occurring across the globe, taxpayers should consider alternate dispute resolution processes such as Advance Pricing Agreements, Alternative Dispute Resolution (ADR) processes and Mutual Agreement Procedures (albeit MAPs have not been successful in Africa) to manage their potential TP disputes and prevent revised tax assessments, penalties and double taxation.

Reviewing different TP cases throws light on future TP disputes and creates notable information to consider. For instance, the Coca-Cola case gives detail how to analyse a TP matter, prepare TP documentation, analyse marketing intangibles, ensure that legal agreements are properly executed and ultimately defend against a TP case. In addition, lessons can be learnt from experiences in using TP expert witnesses, which will be required early on in any developing TP dispute.