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Transfer Pricing

Introduction
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INTRODUCTION

Contributed by: *Sanford W. Stark,* ***Morgan, Lewis & Bockius LLP***

Transfer pricing remains an unparalleled focus of the international tax community. International efforts led primarily by the Organisation for Economic Co-operation and Development (OECD), together with increasing unilateral efforts by individual governments worldwide, have created an ever more complex and contentious environment for multinational enterprises (MNEs) seeking to meet their global obligations. The COVID-19 pandemic, and the financial strains it has placed on governments over the past year, has only exacerbated these pressures.

OECD Leads Global Transfer Pricing Agenda Now Focused on Two-Pillar Framework

The OECD continues to lead international efforts to harmonise transfer pricing principles and obligations following its 2015 publication of final reports on its initiative to combat base erosion and profit shifting (BEPS) and its 2017 publication of revised Transfer Pricing Guidelines (TPG), including the publication of *Transfer Pricing Guidance on Financial Transactions* in February 2020. A number of countries have embraced the OECD's guidance in whole or substantial part. Most recently, and ongoing, the OECD has focused on addressing tax issues related to the growing digitalisation of the global economy. In 2019, the OECD suggested a two-pillar approach that was subsequently adopted as the framework for moving forward.

Pillar One focuses on allocating a greater share of profit to market/user jurisdictions by departing from traditional arm's-length pricing principles and physical nexus requirements. It does so through establishing a new taxing right for market/user jurisdictions to claim a share of an MNE's residual profits regardless of physical presence, together with arm's-length-determined compensation for baseline marketing and distribution activities physically undertaken in the market. Pillar One is intended to cover both highly digitalised businesses and consumer-facing companies with cross-border activities.

Pillar Two is intended to address BEPS challenges by establishing minimum global tax payment thresholds for large companies, regardless of where their income arises. Blueprints on Pillar One and Pillar Two released in October 2020 set "mid-2021" as the timeline for completing work on these projects.

Pillar One's move away from physical nexus requirements appears contrary to the emphasis on physical presence in the OECD's earlier BEPS work and the Guidelines. Those pronouncements placed heavy weight on the physical presence of personnel – including notably with respect to development, enhancement, maintenance, protection and exploitation (DEMPE) functions – in determining economic ownership of intangibles and assumptions of risk, and consequent profit and loss allocations, for transfer pricing purposes.

It remains to be seen whether Pillar One portends a broader movement away from the arm's-length standard – long the bedrock of international transfer pricing – or whether it is more reflective of the current political environment in which transfer pricing is seen as a tool to advance certain policy objectives. But regardless of which view ultimately prevails, Pillar One and the recent guidance it appears to contradict provide a clear example of the challenges facing MNEs as they try to navigate the shifting sands of the international transfer pricing environment.

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Unilateral Measures by Individual Jurisdictions Create Transfer Pricing Challenges for MNEs

Compounding these global challenges are the ever-increasing unilateral measures undertaken by individual jurisdictions to buttress their own transfer pricing regimes. Some of that activity has arisen in the direct context of the digitalisation debate, as countries unwilling to await unified OECD action have taken matters into their own hands by enacting jurisdiction-specific legislation. For example, a French digital services tax (DST) signed into legislation in mid-2019, with retroactive effect to 1 January 2019, applies a 3% tax to covered services with the acknowledgement that it is intended to be temporary pending a final, long-term solution to digital taxation by the OECD. The United Kingdom (UK) enacted a DST in 2020 that applies a 2% tax on the revenues of certain search engines, social media platforms and online marketplaces.

As of late March 2021, approximately half of all European OECD countries had announced, proposed or enacted a DST, with substantial inconsistency across the various approaches. Such a diverse array of legislation presents considerable challenges to targeted companies, the most significant of which are US-based.

Beyond the DST realm, individual jurisdictions have taken unilateral measures in other areas as well, relying on domestic measures even as they await and even support broader OECD initiatives. In Canada, for example, the Canada Revenue Agency (CRA) has looked to the "recharacterisation" rule in the Canadian Income Tax Act to try to recharacterise intercompany transactions that the CRA believes would not have occurred at arm's length. The CRA has advanced arguments under the recharacterisation rule in two recent cases, both times unsuccessfully, but shows no signs of abandoning the argument going forward. The CRA has even gone so far as to declare that, because it views the recharacterisation rule as a domestic anti-abuse measure, it will not negotiate application of the rule in the mutual agreement procedure (MAP) process, and that it will only participate in a MAP to enable the counterparty to provide correlative relief.

The UK diverted profits tax (DPT) is another example of a domestic measure to strengthen an individual jurisdiction's transfer pricing enforcement toolkit. The DPT targets MNEs that use what HM Revenue & Customs (HMRC) considers to be artificial arrangements to divert profits from the UK corporation tax net. Introduced on 1 April 2015, the DPT carries a punitive 25% rate (compared to the current UK corporation tax rate of 19%) on profits falling within its scope. There are two ways in which a taxpayer's multinational structure could be caught by the DPT:

- a company in the structure (UK or non-UK resident) is party to an arrangement that lacks economic substance; or
- avoidance by a non-UK company of a UK taxable presence.

A DPT charging notice from HMRC brings heightened transfer pricing scrutiny in addition to the risk of liability for a 25% charge on a portion of the taxpayer's profits. And to increase disclosure of potential DPT subjects, HMRC requires taxpayers requesting an advance pricing agreement (APA) to state their opinion as to whether the DPT is likely to apply to their arrangements.

Australia enacted its own DPT in 2017, aimed at ensuring that "significant global entities" pay tax consistent with the economic substance of their activities in Australia and preventing the diversion of profits offshore through related-party arrangements. Where arrangements are found to divert profits from Australia to a country with an effective tax rate below 24% and there is insufficient economic substance to justify those profits, a DPT liability is assessed at 40% of the diverted profits. In enacting the DPT, the Australian government stated that approximately 1,470 taxpayers were in the DPT's scope, 130 of which were estimated to be in the "high risk" category.

France has taken the concerning step of introducing the risk of criminal exposure in transfer pricing disputes. Following the OECD's November 2017 document entitled *Fighting Tax Crimes: The Ten Global Principles*, which stated that "it is important that jurisdictions have the possibility of applying criminal sanctions in respect of violations of the tax law", the French tax administration since 2018 has been obligated to forward to the public prosecutor any tax audit file that gives rise to a reassessment above EUR100,000 and the application of certain specified penalties. The law is considered so broad as to significantly increase the number of referrals and prosecutions, including potentially on issues of transfer pricing.

In addition to these and other statutory or regulatory enhancements to individual jurisdictions' transfer pricing frameworks, countries are also bringing to bear additional resources in aid of their transfer pricing enforcement efforts. In Belgium, for example, the specialised transfer pricing department ("TP cell") within the Belgian tax authority has, in recent years, expanded and significantly increased its activities, including in conjunction with local audit teams. The Belgian special tax investigation team (the team that typically conducts dawn raids) has also increased its focus on transfer pricing with some senior members from the TP cell having joined this team. Information gathered through dawn raids is often used by the team to perform and test functional analyses of the relevant Belgian taxpayers. The Belgian tax authority is also making increasing use of data mining and data analytics techniques to risk-assess taxpayers for potential transfer pricing exposures. The use of these techniques is growing in a host of other jurisdictions as well.

Increasing Use of APAs and MAPs to Address a Rise in Controversy/Litigation and the Risk of Double Taxation

The cumulative effect of all of the above is, not surprisingly, heightened controversy. Virtually every jurisdiction reports that transfer pricing audits are increasing in number, complexity and amounts assessed, and are increasingly accompanied by assertions of penalties. The increased audit activity is often unilateral, but not always so, with a reported growth in bilateral and multilateral audits as well. And the issues in scope span the gamut – for countries adhering to OECD guidance, there is a heavy focus on DEMPE functions and, where relevant, hard-to-value intangibles.

A number of jurisdictions are appearing to focus on intercompany financing transactions, challenging the interest rates charged on intercompany loans, the pricing of guarantee fees, and the nature and pricing of cash pool arrangements. Marketing intangibles are another source of controversy, as are business restructurings generally. And virtually all jurisdictions are witnessing or predicting a growth in transfer pricing litigation, as increasingly aggressive enforcement activities prove unresolvable at administrative levels. In this contentious environment, the risk of double taxation presents major concerns.

Fortunately, APAs and MAPs exist to help release pressure from the cauldron of global transfer pricing enforcement and mitigate double tax concerns, but those systems are already resource-constrained and demand appears only to be growing. A number of jurisdictions are establishing or growing their APA programmes, and many jurisdictions report increasing taxpayer demand for the certainty an APA can afford, but the process remains slow, with APAs often taking three years or longer to complete.

MAP availability is absolutely critical to resolving the competing claims, and double tax risks, arising from the landscape described above, and, as with APAs, a number of countries are establishing or growing their MAP resources. But the MAP network is at severe risk of overload even before the full impact of the OECD's BEPS initiatives is absorbed. In November 2020, the OECD released MAP statistics for 2019 and they reflected that "approximately 7 MAP cases were started every day in 2019 (3 transfer pricing cases and 4 other cases). This amounts to almost 2700 new cases in 2019 alone. This is more than in 2018 (+20% for transfer pricing cases and +10% for other cases) and means the number has nearly doubled since 2016. This trend is likely to continue with no significant reduction in MAP activity expected despite the COVID-2019 crisis. It is driven by a number of factors, including increased globalisation as well as growing confidence in and knowledge of the MAP process. Number of cases closed is increasing as well, but at a slower pace. Competent authorities were able to close more cases in 2019 than in 2018, but the increase cannot keep up with the increase in new cases. As a result, the inventories are increasing in the majority of jurisdictions, despite the fact that competent authorities have increased their capacity and closed approximately 50% more transfer pricing cases and 70% more other cases in 2019 than in 2016."

Impact of COVID-19 Exacerbates Tensions in the Transfer Pricing Landscape

Given all of the above, this is an extremely challenging time for taxpayers seeking to manage their global transfer pricing concerns. Important aspects of the landscape appear to be changing and evolving in real time, creating heightened uncertainty, increasing controversy and litigation, and risking overload of the APA and MAP processes designed to offset these pressures and avoid double taxation.

This confluence of circumstances already existed before the pandemic, and the financial strains on government coffers brought about by the pandemic only further exacerbate the tensions. Yet just as there is hope that we will begin to move beyond the pandemic, so too there is hope that past is prologue and the interested stakeholders will find a way to work through their differences to find common ground. But until then, it is sure to be an extremely interesting time for all involved.

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Morgan, Lewis & Bockius LLP is a global law firm with more than 2,200 legal professionals in 31 offices across North America, Europe, Asia and the Middle East. The firm's global tax practice includes nearly 80 practitioners and represents clients in all phases of tax-related planning, transactional, controversy and litigation matters. The team includes a former chief counsel of the Internal Revenue Service (IRS), a former legislation counsel for the US Congress's Joint Committee on Taxation, a former tax legislative counsel for the US Department of the Treasury, and many other lawyers who have held positions at the IRS, at Treasury, in the Justice Department's Tax Division, at the United States Tax Court and on Capitol Hill. Morgan Lewis's transfer pricing team has represented US and foreign-based multinational enterprises across all industries in some of the largest, most complex and important transfer pricing disputes in recent history.

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Sanford W. Stark is the tax group's deputy practice leader and a leader of the group's premier controversy and transfer pricing practices. He represents a number of the world's largest multinational companies in high-profile, high-stakes matters. Sanford's practice focuses on all stages of federal tax controversy and litigation, and includes substantial experience and expertise in transfer pricing. He teaches "Survey of Transfer Pricing" in the Georgetown University Law Center's graduate tax programme and is an elected member of the American College of Tax Counsel. Sanford is a frequent speaker on tax controversy and transfer pricing topics.

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