ANDERSEN

Global Transfer Pricing Insights

August 2023

Practical considerations for managing transfer pricing positions

Global TP Insights

Introduction

"In theory, theory and practice are the same. In practice, they are not."

Whether or not Einstein uttered those famous words (it's debatable), the point rings true, especially when it comes to managing your transfer pricing (TP) policy.

Hardly a day goes by without some new technical TP development, whether in terms of rules, guidance, audit practices, controversy, or something else. As a result, it's easy to get lost in the *theory* of TP and lose sight of what it all means from a practical perspective.

In this issue, we continue our focus on providing practical considerations when it comes to the TP function. While it's of course important to be aware of technical developments, awareness alone won't help you manage the TP function properly.

To do so, you'll need to manage the TP function as a set of on-going business processes, which involves translating technical developments into concrete decisions and/or actions. And this, in turn, involves a process of framing, itemizing, categorizing and prioritizing developments as they arise.

As always, the insights provided here are subject to changes in laws or rules, as well as the prevailing business environment of the countries in which you operate.

Please contact an Andersen advisor for a more detailed discussion of specific TP rules or to obtain further assistance with your TP issues.

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United States

Best Practices: Managing TP Quality as a Process

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"If you can't describe what you are doing as a process, you don't know what you're doing."
— W. Edwards Deming

It has been nearly eight decades since the late Prof. Deming first introduced the concept of *statistical process control* to U.S. occupation forces working to rebuild Japan in the aftermath of World War II. Over time, the concepts he developed grew into what we now call *Total Quality Management* (TQM).[1]

Originally, TQM applied statistical analysis to improve manufacturing processes.[2] Since then, however, TQM principles have been applied to generate significant, quantifiable improvements in nearly every facet of business operations, including corporate functions such as finance and tax. Because these principles are so powerful, in-house tax departments stand to benefit from considering their use in improving transfer pricing (TP) processes as well.

To understand how TQM principles can be adopted to improve an organization's internal TP function, one needs only to be reminded of the many ways in which an existing internal TP function may produce *defective outcomes*:

- Missing TP documentation[3]
- Incomplete TP documentation
- Missing (and/or misunderstood) TP policy
- Incorrect TP policy
- Improperly recorded TP positions
- Missed deadlines

TQM's framework of Define-Measure-Analyze-Improve-Control (DMAIC) is based on concrete, practical tools for designing and implementing sustainable process improvements. Exhibit 1, below, lists some of the many tools TQM experts apply.[4] While a full treatment of the DMAIC framework is beyond our scope, this article condenses key elements into practical suggestions to help you *evaluate, improve* and *control* the TP process.

1. Although for years he remained largely unknown in the U.S., his efforts were so influential in igniting Japan's industrial growth that Emperor Hirohito awarded him the *Order of the Sacred Treasure*. Today, the *Deming Prize*, awarded by the *Union of Japanese Scientists and Engineers* remains the oldest and most prestigious global award given to individuals and organizations who have successfully implemented TQM principles.
2. For example, a common metric used is DPMO which measures the number of Defects Per Million Opportunities. Its purpose is to measure the effectiveness (or ineffectiveness) of an existing manufacturing process and to gauge progress as the process is improved.
3. Here we are using the term broadly, to include documents separate from contemporaneous TP reports – e.g., memos, invoices, policy statements, etc.
4. Source: https://sixsigmamania.com/?p=55&utm_source=rss&utm_medium=rss&utm_campaign=dmaic-process-dmaic-model-why-how-to-use-it.

Exhibit 1. TQM's DMAIC Framework

Define	Measure	Analyze	Improve	Control
‣ Project charter – Business Case – Opportunity Statement – Project Goal – Scope – High level plan – Team resources ‣ Communication plan – A3 ‣ Project benefits (savings) ‣ VOC transformed to CCR's ‣ High level current state process map – SIPOC – Swimmlane map – Value Stream map ‣ Waste valk – Quick Wins ‣ Business risk management	‣ Data collection plan ‣ Operational definition ‣ Define list of measures – Takt time – Cycle time ‣ Baseline measure – Indentify measures locations – Measurement system evaluation – Measure execution ‣ Finacial How ‣ Porcess owner(s) indentification	‣ "As is" VA//NVA ‣ Process capability (Cp, Cpk) – Histogram ‣ Critical inputs evaluation ‣ Problem statements review ‣ Root causes evaluation – Pareto chart – Run Chart – Fish bone – 5 whys ‣ Budget evaluation – Budget baseline approved ‣ Business risk management ‣ Stakeholders review	‣ Solutions – Ideas generate – Solutions evaluation – Solutions selection – Link solutions to root causes ‣ New future state map ‣ 5S ‣ Kanban ‣ Work cell design – Layout change – Spaghetti diagram ‣ Solution selection – Pough matrix ‣ FMEA ‣ High level implementation plans	‣ Pilot solution – Evaluate pilot – Potential problem analysis ‣ Detailed implementation plan ‣ Standards and procedures ‣ Training plan ‣ Monitoring – Key metrics identification – Process control system ‣ Business risk management ‣ Financial benefits update ‣ Staekholders review ‣ Transition to process owner ‣ Opportunities replication

Evaluate

To what extent is your current TP process *effective* and further, to what extent is it efficient?

Process *Effectiveness* Should Be Defined Broadly

Because TP positions tend to attract both audit scrutiny and disputes with tax authorities, chances are that most of the attention internally relates primarily to the *effectiveness* of the TP function. And for many, their attention is limited to simply ensuring that TP reports are prepared, and intercompany agreements executed.

A more complete view of TP process *effectiveness*, however, would include:

- Minimizing surprises (e.g., last-minute adjustments, missing transactions/ agreements, etc.)
- Regular coordination with operating departments/business units
- Timely execution of tasks
- Minimizing, if not eliminating, re-work
- Open communication with process stakeholders (e.g., local controllers, business unit managers, etc.)
- Alignment between the TP policy and actual transaction flows, business operations

In other words, a fuller view of TP process effectiveness would account for unanticipated events that always seem to pop up, especially at the worst times. In fact, a fundamental insight of TQM is that by deconstructing what makes a process effective, one can identify *root causes* that may lead to problems later. Once identified, solutions can be developed to mitigate the root causes in the first place. While this may seem straightforward, it is commonplace to make the mistake of relying on actions that take place *after* the fact, such as quality inspections, to safeguard against defects. As Deming famously observed,

"Inspection to improve quality is too late, ineffective, costly. Quality comes not from inspection, but from the improvement of the production process."

Create a Simple Scorecard to Identify Priorities

To begin, it is important to first clarify priorities. Exhibit 2, below, provides a sample scorecard to help determine which actionable items should be prioritized. First, *itemize* all the tasks that drive the performance of the TP function. Next, *categorize* the level of each item's level of influence by assigning an importance rating to each one. Finally, *prioritize* each item by assigning a *level of concern* rating and multiplying it by the importance rating. Priorities are then given by the weighted scores for each item. As reflected in the example below, the Tax Director is concerned about not knowing whether all material TP transactions have been identified. This tends to be a common concern even for medium-sized multinationals, especially those that are actively acquiring new companies. The example also shows that the Tax Director is concerned about the audit-readiness of the company's TP position in each local jurisdiction. Also, because the scope of material TP transactions is uncertain, there are cascading concerns about whether the TP policy is aligned with indirect tax positions, as well as with the company's overall operational plans generally. TP positions for smaller companies may be more straightforward to manage, but it is easy to see that as the complexity of the organization increases, so does the complexity of the policy and process priorities for the TP function.

Exhibit 2. Sample Process Effectiveness Scorecard

#	Item	(a) Importance (1 to 10)	(b) Level of Concern (1 to 10)	(c) Weighted Score (=a*b)
1	All material interco transactions indentified	10	9	90
2	All material interco transactions analyzed, documented	10	9	90
3	All TP adjustments made in a timely manner	10	9	90
4	Interco agreements are up-to-date and readily available	10	8	80
5	New developmens (business, operational) have been discussed and if needed, analyzed & documented	10	6	60
6	TP policy has been amended for relevant new business developments	10	6	60
7	TP positions are audit-ready in each local jurisdiction	10	9	90
8	TP policy is aligned with company's operational goals/ objectives	10	8	80
9	TP policy is aligned with Finance Dept's goals/objectives	10	8	80
10	TP policy is coordinated with indirect tax areas (e.g., VAT, customs)	10	7	70

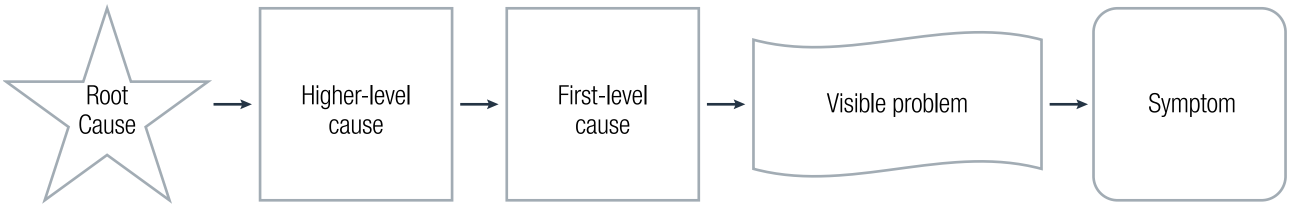
Improve

Once the process priorities have been identified, efforts can be made to evaluate the causes of any breakdowns in effectiveness. An enduring wisdom of TQM is that process defects occur because of breakdowns that happen somewhere *upstream* in the process. By identifying – and resolving – issues where they originate, a more systematic and sustainable solution can be developed.

Use Root Cause *Analysis* to Prevent *Defects*

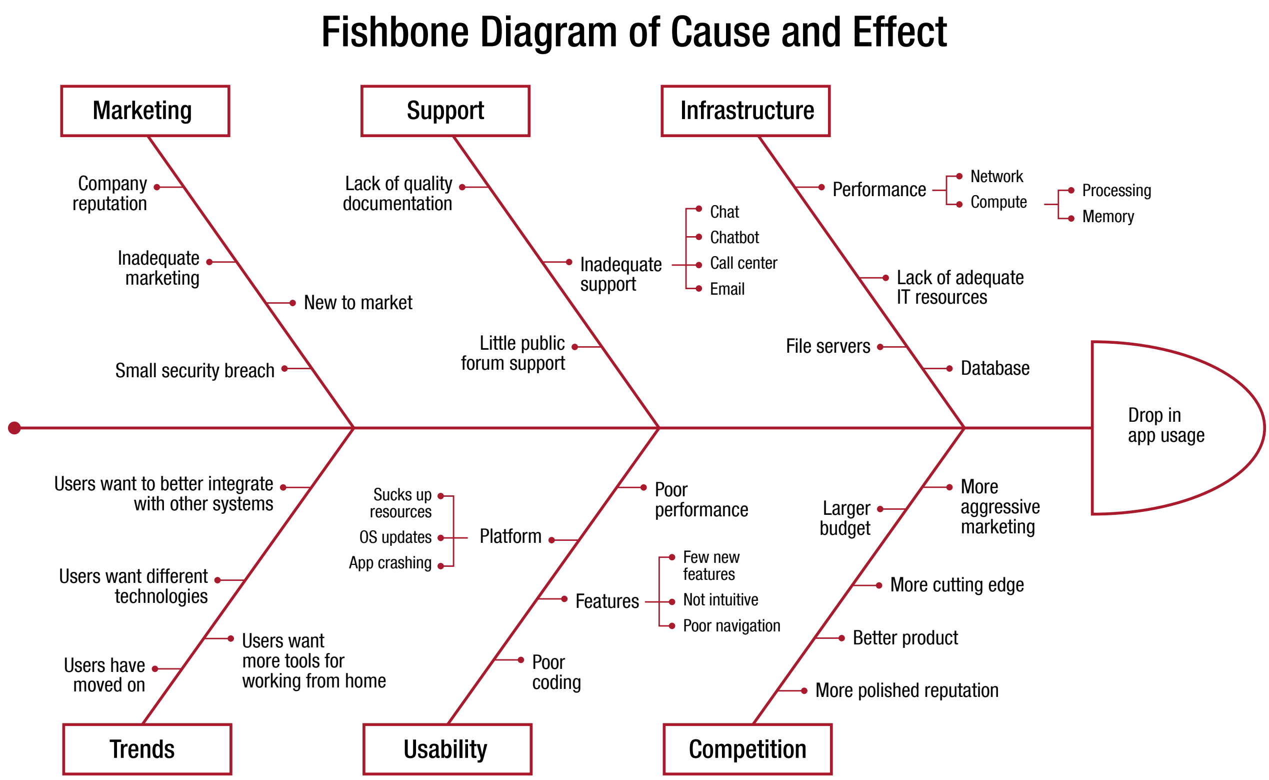
Root cause analysis (RCA) uses data and fact-finding to identify the events that lead to (cause) adverse outcomes (defects). The aim of RCA is simply to deconstruct the events (activities, decisions, etc.) that drive outcomes. It involves identifying in succession all the material events and their interrelationships.

Exhibit 3. Root Cause Analysis (RCA) Framework[5]



The TQM framework offers many practical tools for conducting a root cause analysis.

Exhibit 4. Visualizing RCA – Example[6]



5. Source: American Society for Quality (accessible at: https://asq.org/quality-resources/root-cause-analysis).

6. https://www.techtarget.com/whatis/definition/fishbone-diagram.

RCA Often Begins with a Visualization Exercise

A *fishbone* diagram is an easy way to visually depict the various events that ultimately drive the outcome at issue. The idea is a simple one: Break down the events – and their causes – in succession until it is no longer practical or meaningful to continue. The picture that emerges allows groups to then brainstorm about which causes to investigate further, whether through continued fact-finding or through analyzing past data. The investigation, in turn, focuses on isolating which causes to prioritize, based on their impact on the outcome at issue. In this regard, data analysis is key (when available), as it provides a quantitative basis for prioritizing potential areas for remediation.

Fishbone diagrams are just one type of visual tool, but there are others, including Pareto charts and scatter plots. A discussion of these tools and others may be found by visiting the American Society for Quality (ASQ) website (**https://asq.org/quality-resources/root-cause-analysis**).

Developing Sustainable Solutions Is a Group Exercise

Once identified, solutions may be created to prevent or minimize the occurrence of adverse outcomes. In developing a solution, however, it is important to keep in mind that the *process* for developing a *solution* is best done in a *group setting*. One of the enduring principles of TQM is that for any solution to be sustainable there must be sufficient buy-in by the stakeholders who would ultimately be required to implement the solution. Therefore, by widening the group of participants who analyze and brainstorm potential solutions, one is more likely to earn the buy-in needed. A proven approach to achieving this is to organize what is commonly referred to as a *kaizen* event. According to one prominent TQM certifying program[7]:

> *According to kaizen philosophy, the improvement of systems, programs and people is a continuous, ongoing process. Kaizen originated as a Japanese business approach and the word translates to the phrase "change for the good" in English. The philosophy involves employees at all levels of both manufacturing and service organizations and creating a culture of ongoing refinement and optimization.*
>
> *A kaizen blitz, also known as a kaizen event or kaizen activity, is a process improvement exercise performed by a team of employees in a limited timeframe. It's designed to make quick and easy process improvements in a focused area.*
>
> *Improvement tools employed in kaizens may include brainstorming, process mapping, value stream mapping, interviewing, check sheets, run charts, histograms, and Pareto charts. The goal is to develop quick, simple and sustainable solutions.*
>
> *Kaizen events are made up of the following characteristics:*
>
> 1. *Teams are made up of employees dedicated to the project. Team members work in the process under study. Lean Six Sigma (LSS) practitioners may lead the team, conduct kaizen training, or act as an advisor/coach.*

7. https://www.purdue.edu/leansixsigmaonline/blog/kaizen-training-lean-six-sigma-approach/#:~:text=A%20kaizen%20blitz%2C%20also%20known,improvements%20in%20a%20focused%20area.

2. *The project is clearly defined and preliminary data has already been gathered. The team usually works from a value stream map.*
3. *Implementation of solutions is immediate.*
4. *Kaizens events may last hours, days, or up to a week.*
5. *Kaizen solutions are low risk and low cost.*

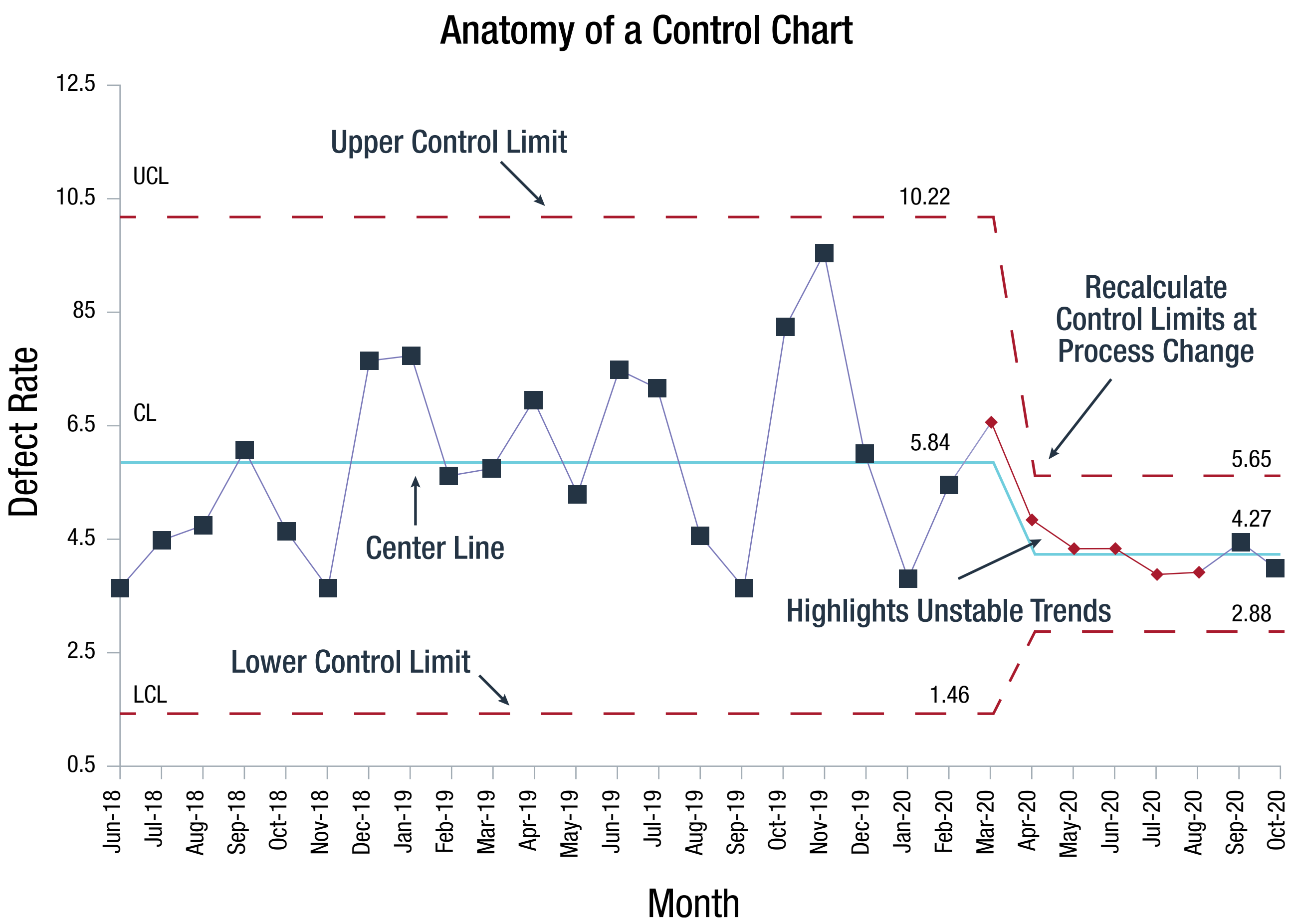
Control

The *control* phase is the last step in the improvement process. It involves imple-menting the new process changes revising policies/procedures retraining staff on new procedures establishing capabilities to measure/monitor the new process, such as control charts and creating/distributing an implementation plan.

Control Charts Gauge Actual Performance Over Time

In manufacturing processes, the control charts tend to be very data driven, aimed at showing the statistical variance of actual performance relative to the targeted goal (Exhibit 5). Tracking actual performance is important because it helps evaluate whether the solutions implemented in response to the RCA were effective. In a service-based process such as transfer pricing, however, the control *chart* might simply record whether certain goals were met and whether they were accomplished within the intended timeframes, so the amount of hard data needed may be more limited.

Exhibit 5. Example of a Control Chart[8]



8. Source: https://www.qimacros.com/control-chart/.

For TP Processes, Timeliness Is a Critical Factor

For example, one large client allocates the costs of various routine support services performed by its parent company for the benefit of its non-U.S.-based subsidiaries. From a TP *technical* perspective, this is one of the most straightforward types of transactions to evaluate. Nevertheless, a prior tax advisor had provided this particular client with a process which, according to the client, required almost 90 days to implement each quarter – clearly not a sustainable process, especially given the company's limited resources in terms of person-hours. After Andersen was invited to evaluate the company's TP policy, our immediate focus (after confirming the appropriateness of the TP policy from a technical standpoint) was to focus on the TP process. Our analysis determined that the process recommendations from the company's prior advisor were overly complicated. For example, their process recommendation required the company to analyze over 70 cost centers, most of which were unnecessary. Our approach aggregated the cost centers into 13 operational departments and simplified the amount of data to be reviewed manually, while still maintaining all the data traceability needed to sustain the position in the event of a future audit. Furthermore, our approach resulted in a quarterly process that could be executed within a *single day* as opposed to three months.

Another Operational Area Important to the TP Process Is IT

Depending on the nature of the transactions and the methods used, TP adjustments always require reference to internal financial data. For example, royalty transactions require sales data, services transactions require cost data (and in the U.S., require stock-based compensation data), manufacturing transactions may require asset data, and so on. Furthermore, the larger the company, the more complicated the data tends to become. For example, a large consumer products company may operate multiple business units organized around different product categories and/or brands. Allocating revenue and cost figures among the various business units, product categories, and brands is oftentimes not straightforward. In such cases, the TP process relies heavily on the IT department to ensure that the reporting capabilities of the ERP platform either: (a) properly reflect the data needed, or (b) are clear with respect to the *business rules* embedded in the reports and further, that the data needed to make all necessary adjustments are readily accessible.

Building a Smooth Working Relationship with IT Typically Requires an Effective Liaison Function

The TP and IT function each have their own business priorities and technical vocabularies. Moreover, each function tends to be siloed from the other, with neither being able to fully speak the other's *language*. Accordingly, because it is unrealistic to expect the IT organization to hire someone who understands TP issues, tax departments should try to recruit team members with at least some IT knowledge and experience. Or if that is not feasible, then when evaluating potential advisors, tax departments should inquire about the extent of *direct, hands-on* IT knowledge and experience held by each one. Maintaining a smoothly functioning working relationship with IT is almost always a critical process requirement, not just for TP but for the tax function generally.

Summary

Managing the TP function effectively often requires more than simply checking whether reports are prepared, adjustments are made, and agreements are in place. In this regard, TQM principles can be very helpful in setting up a sustainable TP process. Its great insight is that in order to minimize – if not eliminate – adverse outcomes (process *defects*), one must evaluate the upstream activities and events and then work to resolve any issues. Furthermore, a TP process that is effective will also be *efficient*, in both time and cost. As discussed here, process effectiveness is achieved by identifying and eliminating unnecessary complexity (i.e., what root cause analysis helps to identify). And unnecessary complexity, in turn, leads to inefficiencies. Finally, we will end with yet one more quote from Deming regarding the link between process improvement and leadership

> *"The aim of leadership should be to improve the performance of man and machine, to improve quality, to increase output, and simultaneously to bring pride of workmanship to people. Put in a negative way, the aim of leadership is not merely to find and record failures of men, but to remove the causes of failure: to help people to do a better job with less effort."*

APPENDIX

Improve

Below is a simple, high-level checklist of important items to evaluate with respect to the TP *policy.*

Policy Documentation	Items to Note
1. TP Reports	a. Avoid conclusory statements/assertions and ensure that the analysis is fact-based b. Explain company's value chain, especially any unique aspects c. Focus on key drivers and who contributes what d. Include a rigorous examination of alternative TP approaches that do not apply/are infeasible
2. Legal Agreements	a. Per the U.S. TP case *Coca-Cola v. Commissioner*, legal agreements must be updated to reflect current operations accurately b. Memos of Understanding (MoUs) where appropriate
3. Formal Analyses	a. Planning analyses b. Benchmarking – Per *3M v. Commissioner*, is now a must-have for certain markets
4. Internal Memos to File	a. Clarify how planning/benchmarking analyses are to be implemented b. Communicate with the future auditor to provide transparency, demonstrate good faith efforts, and promote goodwill
5. Internal Communications	a. Business plans/presentations b. Customer/product research studies c. Personnel org charts, changes d. Press releases
6. External Communications	a. 3P press releases b. News articles c. Evaluate user reviews written by customers to gauge consistency with statements made in reports, memos

Control

Below is a simple, high-level checklist of important items to evaluate with respect to the TP *process*. ■

Policy Documentation	Items to Note
1. IT Integration	a. Ensure data capture/reporting capabilities align with tax reporting and audit (i.e., traceability) needs b. Ensure system requirements are specified with ongoing/new system/module implementations
2. Organizational Communication	a. Ensure that other depts/business units are aware of TP/Tax goals, milestones b. Work to build working relationships and process buy-in with counterparts in other legal entities, operational areas c. Consider distributing an internal TP policy memo, which addresses process details, including: – Process org chart, including executive sponsors – List of stakeholders and their contact info – Stakeholder roles & responsibilities – Process calendar, including key milestones and timeframes

INDIA

India

Pillar Two in Global Anti-Base Erosion Model Rules and Its Impact in India

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Traditionally, multinational enterprises (MNEs) performed their business operations in various countries through their physical presence by way of setting up a branch, factories, offices, warehouses, etc. In today's digital era, the MNEs are transforming their business into digital platforms such as internet platforms, e-commerce, digital content firms, and social media platforms. MNEs operating through digital modes are expanding their business globally at a very rapid pace due to specific advantages in intangibles, technology, network effects, and digital assets. Traditional forms of business operations and physical presence in the host economy does not apply in the case of tech-based business models. These tech-based business models, using technology and resources spread globally, have certain implications such as production or distribution network, development of business strategies, employment, foreign direct investment (FDI) policy, fiscal outcomes, and direct and indirect taxation policies in host economies.

Therefore, with the current set of tax regulations and international tax laws, the tax administrations globally face challenges in imposing taxes on entities having substantial economic activities (using technology and digitalization of business operations) in different countries with no, or limited, physical presence in such markets. In October 2021, the members of the Organization for Economic Cooperation and Development (OECD)/G20 Inclusive Framework on Base Erosion and Profit Shifting (BEPS) (referred to as *Inclusive Framework*) agreed to a two-pillar solution to reform the international tax framework in response to the challenges of digitalization of the economy.

Pillar One focuses on the development of new nexus and profit allocation rules to assign more taxing rights to market jurisdictions and Pillar Two focuses on developing new Global Minimum Tax (GMT) rules. In this article, we will only cover the model rules relating to Pillar Two.

The Inclusive Framework members agreed to a coordinated system of Global anti-Base Erosion (GloBE) rules under Pillar Two that are designed to ensure large MNEs pay a minimum level of tax on the income arising from economic activities in each of the respective tax jurisdictions. To ensure that the minimum tax is collected from MNEs, GloBE Rules impose a top-up tax on profits arising in a jurisdiction where the Effective Tax Rate (ETR), determined on each jurisdictional basis, is below the minimum tax rate of 15%.

We briefly discuss the Pillar Two Model Rules[1] to understand their implications on India's domestic tax laws.

Scope GLoBE Rules

The GloBE Rules apply to Constituent Entities (CEs) that are members of an MNE Group that has annual revenue of 750 million euros or more in the Consolidated Financial Statements (CFS) of the Ultimate Parent Entity (UPE) in at least two of the four Financial Years immediately preceding the tested Fiscal Year (FY). If one or more of the FYs of the MNE Group is of a period other than 12 months, for each of those FYs the 750 million euros threshold is adjusted proportionally to correspond with the length of the relevant FY.

Excluded entities (i.e., government entity, international organization, non-profit organization, pension fund, investment fund, or real estate investment vehicle that is a UPE, Entity owned by one or more Excluded Entities) as defined in Article 1.5 of GloBE Rules *are not considered as CEs for GloBE Rules.*

Mechanism for Charging Top-up Tax Under GLoBE Rules

The GloBE Rules introduced the concept of Top-up Tax, which is calculated and applied at a jurisdictional level (i.e., Country-by-Country level). The GloBE Rules, using a standard base and definition of covered taxes, provide a framework to identify those jurisdictions where an MNE is liable to an ETR below 15%. These rules impose a coordinated tax charge that brings the MNE's ETR on low-tax income up to the minimum rate (after taking into account various adjustments as specified in the GloBE Rules).

As per GloBE Rules, the following steps are required to be performed in determining the Top-up Tax liability of the MNE Group[2]:

Step One	Identify the MNE Group falling within the scope and location of each CE within the MNE Group
Step Two	Determine the Income or loss of each CE
Step Three	Determine taxes attributable to Income of a CE
Step Four	Calculate ETR of all the CEs located in same jurisdiction and determine resulting Top-up Tax
Step Five	Impose Top-up Tax under Income Inclusion Rule and Undertaxed Payment Rule (UTPR) in accordance with agreed rule order

1. Tax Challenges Arising from Digitalisation of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two): Inclusive Framework on BEPS | OECD/G20 BEPS Project | OECD iLibrary (oecd-ilibrary.org)

2. The objective of this article is to understand the implication of Pillar Two on Indian tax regulations, therefore, the detailed computation mechanism as specified in the GloBE Rules in relation to each of the above steps are not discussed in this Article.

Once the Top-up Tax is determined in line with the step-by-step approach provided in the GloBE Rules, the next question asks which tax jurisdiction will collect the Top-up Tax from which entity of the MNE Group. GloBE Rules depart from the conventional rule of imposing tax at the individual taxpayer level, i.e., it is applied at the MNE Group level. Under the GloBE Rules, the liability of Top-up Tax can be discharged by MNEs in the following ways:

By Way of Implementation of GLoBE Rules in Domestic Tax Laws

Income Inclusion Rule (IIR)

- Imposing Top-up Tax (i.e., a difference in the GMT of 15% and ETR on the low-tax income earned by CEs of MNEs at each jurisdictional level) liability on the UPE or the Intermediate Parent Entity/Entities (IPE or IPEs) in proportion to the share of ownership interest held by such UPE or IPE/IPEs of an MNE group, by the country where such UPE or the IPE/IPEs as the case may be are headquartered.

- The first primary charge for payment of Top-up Tax is on the UPE. In case the country in which the UPE is located has not introduced IIR, then the Top-up Tax will be collected by the country where IPEs are located, and such country/countries have implemented IIR in its domestic tax laws.

- Further, countries may also introduce Qualified Domestic Minimum Top-up Tax (QDMTT) in their domestic tax laws for collecting Top-up Tax in cases where ETR in such countries is lower than the minimum rate of 15%. In such cases, QDMTT will apply first before the application of IIR and UTPR under the GloBE Rules.

- The Top-up Tax to be imposed under IIR on the UPE or the IPE of the MNE Group shall be equal to their respective allocable share of Top-up Tax in the Low Taxed Constituent Entities (LTCE).

- The GloBE Rules have specified various scenarios under which offset of Top tax is provided to MNE Groups to avoid a double taxation situation.

Example: Assume, the UPE of the MNE group is headquartered in Country A, and its subsidiary is in Country B, which is a low-tax jurisdiction with an ETR of 5%, then Country B can impose a QDMTT of 10% (i.e.,15% being minimum tax rate less 5% being ETR in Country B). In case Country B has not implemented QDMTT in its domestic laws, then Country A can impose Top-up Tax of 10% on the UPE of the MNE Group by implementing IIR provisions in its domestic tax laws. In case IIR is not implemented by Country A, then the Country (assuming Country C in the said example) in which the IPE of the MNE Group is located can implement the IIR in its domestic laws for the collection of Top-up Tax on income earned by LTCE i.e., where ETR is less than 15%.

Undertaxed Payments Rule

- UTPR is a part of the Top-up Tax on the LTCE which could not be collected by the UPE or IPEs under IIR. In simple terms, assume that there is a Top-up Tax liability of 100 euros on an LTCE located in Country A (low-tax jurisdiction), which has not implemented GloBE Rules. The UPE of such an entity is in Country B, which has also not implemented the GloBE Rules. The IPE of such MNE Group located in Country C (which has implemented IIR and UTPR both), has an ownership interest of 40% in LTCE, and the 60% balance of the ownership interest is owned by UPE. By application of IIR, the IPE could be able to collect the Top-up Tax to the extent of its allocable share i.e., 40% of 100 euros.

The remaining 60% of 100 euros will be considered UTPR Top-up Tax Amount to be paid in IPE jurisdiction.

- To collect the UTPR Top-up Tax amount from MNEs, UTPR denies deductions or requires an equivalent adjustment in the event a UPE's or IPE's allocable share of the Top-up Tax regarding an LTCE is not subject to tax under an IIR.

In addition to the IIR and UTPR, Pillar Two architecture also consists of two essential treaty-based rules:

- Switch-over rule (SOR): Applies where profits attributable to a Permanent Establishment (PE) are exempt under the tax treaty. SOR allows the resident state where the parent entity of such PE is located, to charge Top-up Tax up to the minimum rate under IIR, on low-tax income earned by PE.
- Subject to Tax rule (STTR): A treaty-based rule that allows source countries to withhold taxes concerning certain intragroup payments that are subject to lower tax rates in the recipient country.

In the order of priority, STTR being a treaty-based rule, applies in priority to GloBE Rules as the source jurisdiction can collect the tax at the time of payment of certain intragroup charges. Thus, the Top-up Tax imposed under the STTR in the source jurisdiction is considered while determining the ETR for purposes of the IIR and the UTPR. Under GloBE Rules, Top-up Tax can be collected first by application of IIR. If Top-up Tax could not be collected through IIR, then the UTPR mechanism will apply for the collection of Top-up Tax.

Where is India, and Where are Other Countries, Anchored?

India has a comprehensive taxation law, under which a person resident in India (which includes foreign companies having Place of Effective Management (POEM) in India) is subject to a tax on their global income, irrespective of the source of such income. Further, non-residents in India are subject to source-based tax on the income earned or accrued in India. India's current corporate tax rate including minimum alternative tax is higher than the GMT of 15% as prescribed in GloBE Rules.

Indian tax regulations also charge source-based taxes on income in the form of withholding tax on passive income earned in India and business incomes having nexus with India, such as royalty, fees for technical services (FTS), dividends and interest. Further, Indian tax regulations have implemented transfer pricing and other anti-abuse provisions to prevent the shifting of profits from India's tax jurisdiction.

Over 140 countries have come to a consensus to be part of the Inclusive Framework Agreement in connection with the historic Two Pillar solution. The GloBE Rules represent a common framework and are not mandatory sets of rules. Therefore, member countries are not forced to implement them in their domestic tax laws. India, being a member of 140 country pact, has agreed to the Two Pillar solution. Several other countries such as Singapore, Hong Kong, Korea, Malaysia, Japan, Indonesia, Australia, Mauritius, New Zealand, and so on have indicated that they would introduce these rules in their domestic laws. Countries in the European Union have launched a public consultation on GloBE Rules and the United Kingdom (UK) introduced draft legislation on IIR. The United States (U.S.) has initially committed to modifying its minimum tax regime, which is its domestic anti-avoidance rules or the global intangible low-taxed income (GILTI) and aligning it with OECD standards. The GILTI regime effectively imposes a worldwide minimum tax on foreign earnings. U.S. shareholders of controlled foreign corporations (CFCs) are subject to current taxation on most income earned through a CFC in excess of a 10% return on certain of the CFC's tangible assets – with a reduction for certain interest expense. However, the U.S. has enacted the corporate minimum tax proposal based on book profits, effective 2023 onwards.

Indian tax authorities may consider publishing a discussion paper to solicit input from stakeholders on potential GloBE provisions in domestic law after a global agreement under Pillar Two on the implementation of a global corporate minimum tax rate is reached. This will help develop a set of regulations that have consensus and consistency in both their design and implementation.

Impact on Overseas Headquartered MNEs Operating Through Its CEs in India

As discussed above, domestic laws in India already have higher corporate tax rates compared to GMT of 15% as prescribed in the GLoBE rules, therefore, India may not be considered a Low Tax Jurisdiction under GloBE Rules. Despite having higher corporate taxes than the GMT of 15%, there will be cases where the ETR for certain CEs of the Overseas headquartered MNEs will be less than 15% due to various tax incentives, exemptions, or deductions provided under the Indian tax laws.

Tax incentives are provided to boost the economic growth of the host country as it encourages FDI by various MNEs operating across the globe. Indian tax laws provide for the following tax incentives:

Profit/Income-based Incentives

To promote the growth of certain specific industries or businesses including start-ups, profit/income-based incentives are provided as a percentage of profit earned from eligible businesses, including tax holidays wherein the entities are not liable to income tax for a specific period, reduced corporate income taxes in certain cases, or loss carry-forward or set off against profits earned in the specified number of future years. Profit-based incentives provide tax relief based on income earned and not based on capital investment in eligible businesses by the companies.

Capital Expenditure Investment-Based Incentives

Capital expenditures/investment-based incentives provide relief in the after-tax cost of capital expenditure, including a 100% capital expenditure allowance in case of commencement of eligible business to promote the growth of specific industries, accelerated depreciation for certain manufacturing entities, tax credits, 100% allowance of certain contributions/expenditures by enterprises, etc. In addition, such incentives are provided under the law, to promote capital investment by companies into specific industries/sectors/geographical regions and to promote economic growth and development of such industries/sectors/regions.

In case any CEs of an overseas-headquartered MNE are claiming profit-based or capital expenditure-based tax incentives under Indian tax laws, such CEs may have ETR less than 15%. Therefore, the Overseas headquartered MNEs will be exposed to Top-up Tax in India as well. The countries in which the UPE of such MNE is headquartered or their IPE is headquartered may impose IIR or UTPR to collect Top-up Tax arising from such CEs operating in India and India may lose its opportunity to collect Top-up Tax in the above circumstances. In such a scenario, the Indian tax authorities may revamp the tax incentive strategy and introduce QDMTTs to increase its tax revenue on account of Top-up Tax arising in such situations.

However, India will have to analyze the impact of QDMTTs on the tax treaties to ensure that such CEs of overseas MNEs are not treated as less favorable compared to CEs of Indian-headquartered MNEs as they may be availing similar tax incentives.

Further, India may also impose STTR in its tax treaties with various countries, which overrides treaty benefits for certain related-party payments (including interest and royalties) that are not subject to a minimum rate of tax in the recipient country. Tax paid under STTR will be creditable as a covered tax to compute Top-up Tax liability under IIR and UTPR.

Impact on India-Headquartered MNEs Having Business Operations Outside India

There can be potential scenarios where the Indian-headquartered MNEs may be subject to Top-up Tax liability if any of its CEs operating outside India has an ETR lower than the minimum rate of 15%. These situations may arise on account of the following circumstances:

- CEs of Indian-headquartered MNEs are operating in low-tax jurisdictions where the effective corporate tax is less than 15%
- CEs of Indian-headquartered MNEs are availing various tax incentives in overseas jurisdictions due to which their ETR is less than 15%

India may implement IIR or UTPR rules in its domestic laws to collect the Top-up Tax arising in the above circumstances. India may also evaluate the implications of implementing STTR on certain intragroup payments by parent entities in India to the CEs operating outside India. However, while implementing the GloBE Rules, the Indian tax administration should ensure that GloBE Rules do not create the risk of double taxation to MNEs. Indian tax administrations may also evaluate whether the turnover threshold prescribed (i.e., 750 million euros) in GloBE Rules requires a reduction to cover more

MNEs under the scope of an IIR for India.

Key Takeaways on GLoBE Rules

India's corporate tax rate is higher than the GMT. Still, the CEs of MNE groups that are availing tax incentives may have ETRs lower than the minimum rate of 15%. It implies that high tax or moderate tax jurisdictions will also have a potential impact due to the implementation of GloBE Rules. Therefore, whether it is a low-tax jurisdiction or a high-tax jurisdiction, both may have to analyze and evaluate their existing tax incentive policies and tax laws to ensure the effective implementation of GloBE Rules.

Being a developing country, India should analyze the impact of the adoption of GloBE rules on the tax incentives offered under current tax laws. India should undertake a comprehensive assessment to determine whether Pillar Two measures are beneficial for the long-term economic growth of the country. To effectively implement GloBE rules, India should revamp its tax incentive policies which align with GloBE rules and at the same time create greater business opportunities for MNEs to operate in India vis-à-vis other countries.

As various countries have already agreed to the implementation of GloBE Rules, it becomes necessary for every member country to implement the GloBE Rules in their domestic laws, otherwise, such countries may lose their share of the Top-up Tax levied on the MNEs. Hence, India will have to analyze the impact of Pillar Two implementation individually considering the infrastructural, economic, and institutional reforms, which are essential for the economic growth of India.

The low-tax jurisdiction or tax incentives, which increase the Top-up Tax liability for MNE groups, may no longer be as lucrative an option as it was in the past for MNEs to continue their business operations in such jurisdictions. Therefore, the Indian government has an opportunity to revamp its corporate tax rates and tax laws in relation to other countries to make India a more lucrative opportunity for MNEs to operate, rather than low-tax jurisdictions which may increase the Top-up Tax liability for MNEs.

From the perspective of MNE groups, they may have to re-evaluate alternative investment locations, restructuring plans, and tax strategies at a global level. Pillar Two's objective is to discourage MNEs to restructure/set up their business in low-tax countries to avoid or reduce tax liability at a global level. As various countries have come to a common consensus for implementing Pillar Two, the global tax liability of MNEs will be adversely impacted due to the possibility of an increase in ETRs by low-tax jurisdictions.

MNEs may also have to evaluate the comparative attractiveness for business opportunities and tax policies in countries with higher tax rates in relation to those jurisdictions which are deemed as low-tax jurisdictions due to limitations of the minimum tax rate under GloBE Rules. However, tax benefit/costs at the global level would still be dependent upon the difference between the additional Top-up Tax rate and the rate of tax in higher tax jurisdictions. Thus, tax arbitrage may still come into play, albeit with limited advantage.

Canada

"So, You Want to Come to Canada, Eh?" – Transfer Pricing Considerations

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Globalization and the continued expansion of international trade have made intercompany pricing an important factor for many businesses. In an era of fiscal shortfalls, tax authorities see transfer pricing (TP) adjustments as low-hanging fruit, especially with the impending OECD changes (e.g., Pillar One, Pillar Two). As a result, Canadian and U.S. taxpayers must adjust to this uncertain environment by considering both their operations and potential aggressive scrutiny by both the Canadian and U.S. tax authorities.

Based on these uncertainties, companies that are deciding whether to expand operations into Canada should consult with a TP specialist who is well-versed in the issues that must be addressed in order for the plan to succeed from a TP perspective. Below are some common operational scenarios and associated TP considerations to assist companies in their decision-making process.

Overview of the Canadian Transfer Pricing Regulations

In Canada, the Canada Revenue Agency (CRA) adheres to the arm's-length principle as the basic rule governing the tax treatment of non-arm's length, cross-border transactions, and endorses the guidelines set forth by the OECD. The arm's-length principle requires that the reported profits from a transaction equal those that would have been reported had the transaction been undertaken by arm's-length parties. In the U.S., the Internal Revenue Service (IRS) adheres to a similar principle, namely the arm's-length standard.

What are the Common Canadian Operational Scenarios?

Salesperson

Fact pattern: U.S.-based multinational enterprise (MNE) has a Canadian subsidiary with salespeople. The salespeople are tasked with promoting the MNE's products in Canada by identifying sales leads, cold-calling protentional customers, addressing potential customer inquiries, providing demos of the product, etc.

TP Policy: Given the limited scope of functions and risks of the Canadian subsidiary, the appropriate TP policy would be to treat the Canadian entity as a captive service provider of sales support. The Canadian subsidiary would be reimbursed for its total costs plus a markup determined through a benchmarking analysis. Under this policy, the Canadian subsidiary is guaranteed a routine return on its services and all residual income/loss is allocated to the U.S.

Considerations: If possible, it is best to have the U.S. parent contract with Canadian customers. However, if for commercial reasons customers contract with the Canadian subsidiary, it can be acceptable so long as the Canadian subsidiary is not taking on additional functions and or risks that could require a different TP policy. Further, the U.S. parent should ensure that it does not perform activities (e.g., concluding contracts on Canadian soil) that could create a U.S. permanent establishment in Canada.

Distribution Entity

Fact pattern: U.S.-based MNE sets up a Canadian subsidiary to distribute a product. The distributor will be tasked with generating demand and selling products within Canada. Unlike a pure sales entity, the distributor will typically purchase products from its U.S. parent even if the TP policy limits inventory risk. Distribution entities are responsible both for sales activities within the region as well as the physical distribution/logistics functions related to getting a product to a customer. Note that while traditionally these entities distribute physical products, this model can also be used to distribute software or non-physical media within a region.

TP Policy: Distributors can typically be classified as *full-fledged* distributors, which are entitled to non-routine returns, and *limited-risk* distributors, which are entitled only to routine returns. A *limited-risk* distributor will perform some level of sales and marketing activities to generate demand in its region but will perform no strategic marketing. In addition, a *limited-risk* distributor will be shielded from inventory risk by relying on the principal to fund inventory risks. In contrast, a *full-fledged* distributor may be involved in strategic marketing activities and typically takes on all inventory risk. *Limited-risk* distributors are more common for companies entering new markets, but some *full-fledged* distributors can be used in certain circumstances.

For *full-fledged* distributors, it is important to establish that the sales price of products between related parties is at arm's length. This can be done by looking at comparable transactions or by determining that the gross margin earned by the distributor is consistent with the arm's-length standard/principle.

For *limited-risk* distributors, the Canadian subsidiary will typically target an operating margin consistent with the margin earned by comparable companies.

Considerations: A distribution model allows the Canadian customer to enter into contracts with Canadian customers. If a *limited-risk* model is used, the Canadian entity should ensure that its functions do not rise above the level of a limited-risk distributor. The CRA would expect that all value-added functions above those of a traditional distributor should either be performed by the U.S. parent or recharged as part of a separate TP policy (see *Other Services* section below).

Other Services

Fact pattern: U.S.-based MNE sets up a Canadian subsidiary to provide contract development services on its behalf. The contract development service provider will be tasked with providing development services of certain technology intangible property (IP) under the direction and oversight of the U.S. MNE (i.e., the U.S. MNE would manage, perform, and control all DEMPE activities with respect to the IP).

TP Policy: Similar to the pure sales entity, given the nature of the functions and risks of the Canadian subsidiary, the appropriate TP policy would be to treat the Canadian entity as a captive service provider. The Canadian subsidiary would be reimbursed for its total costs, plus a markup determined through a benchmarking analysis. Under this policy, the Canadian subsidiary is guaranteed a routine return on its services.

Considerations: From a Canadian perspective, when a cost-based TP methodology is used to determine the transfer price and the Canadian taxpayer receives government assistance, the CRA expects that the cost base should not be reduced by the amount of the government assistance received unless it can be proven that arm's-length companies would effectively share all or part of that assistance. In respect of the provision of contract research and development (R&D) services by a Canadian entity, the CRA expects that the benefit of any R&D credits, among others, remains in Canada. Further, the Canadian subsidiary should ensure that it does not exercise control or management over the above-noted DEMPE activities with respect to the IP.

Are Transfer Pricing Adjustments Allowed?

Throughout the year, adjustments may be made to ensure that the Canadian subsidiary ends the year with the targeted arm's-length return. That is, an upward adjustment (i.e., additional payment to the Canadian entity) will take place if the return is below the target/arm's-length range and conversely, a downward adjustment (i.e., payment back to the U.S. parent) will take place if the return is above the target/arm's-length range. From a Canadian perspective, the CRA allows TP adjustments to be made up to the filing due date of the tax return.

What are Some Key Transfer Pricing Differences Between Canada and the U.S. That Should be Kept in Mind?

- The CRA is widely considered to be one of the most aggressive tax authorities for enforcing and auditing TP worldwide.
- Unlike IRS, the CRA typically does not allow for the aggregation of multiple transactions (i.e., bundled transactions). The CRA reviews and adjusts transactions on a transaction-by-transaction basis.
- Taxpayers' burden of proof is much higher in Canada as compared to the U.S.
- The CRA examines the single-year full-range results of the comparable companies; IRS examines the three-year inter-quartile range. As a result, the CRA typically applies stricter comparability factors to the selected comparable companies.
- Under the Services Cost Method, IRS allows for certain low value-adding intra-group services to be charged at cost. The CRA does not have a similar method.

How Andersen Can Help

With an ever-changing and complex global tax environment, taxpayers should take a proactive approach to evaluate and review their global TP arrangements to ensure ongoing compliance, appropriate economic substance, and global tax optimization/efficiency.

Andersen's TP practice can help taxpayers proactively manage TP risks by assisting with:

1. Planning: Complete a formal assessment of the taxpayer's intercompany transactions and provide recommendations.

2. IP/Cost Sharing Planning: Properly value IP for tax purposes to safeguard against tax authorities, claiming that IP rights were transferred without reasonable compensation.

3. Benchmarking Analyses: Determine an arm's-length return/TP policy for inter-company transactions.

4. Compliance/Documentation: Assist with necessary compliance and documentation. Taxpayers are expected to analyze their related-party transactions and comply with the arm's-length principle. Documentation helps taxpayers tell a narrative that supports the functional/risk/asset profile of entities within the group, the appropriate transfer approach/method, and ratifies the results. Such documentation minimizes the risk of a negative TP adjustment made by the tax authority, provides a level of protection against a TP penalty,[1] and helps the review process go quickly and smoothly. Poor or insufficient documentation may lead to time-consuming and costly explanations to tax authorities and a shift in the burden of proof to the taxpayer. In Canada, the due date to prepare or obtain TP documentation is the filing date of the tax return.

5. Disclosures: Assist in the preparation of annual compliance forms, including T-106s, T1134s, and Country-by-Country Reporting.

6. Implementation: Assist with reviewing intercompany agreements, memos of understanding, internal TP policies, etc.

7. Transfer Pricing Adjustments: Consider whether company financials reflect TP adjustments. The CRA requires that any TP adjustments be made prior to the filing date of the tax return.

8. Dispute Resolution: Assist taxpayers with IRS and CRA TP-related audits and or MAP/APA-related services.

In addition, Andersen's tax practice can help companies with the set up (i.e., branch, corporation, ULC) and incorporation of the new Canadian entity as well as assist with any associated income, sales tax, and/or customs implications.

1. In Canada, a taxpayer who does not make reasonable efforts to determine and use arm's-length prices (e.g., prepare documentation) may be subject to a transfer pricing penalty that applies regardless of whether a tax liability results from any transfer pricing adjustment. The transfer pricing penalty is equal to 10% of certain adjustments under the Canadian Income Tax Act.

Germany

Transfer Pricing Changes to the German General Tax Code: Extended Cooperaiton – Factual Contemporaneous TP Documentation Requirement – New Sanctions Regime

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To modernize and speed up tax audits in Germany, the legislature amended the German General Tax Code (GTC) at the end of 2022 (published on December 20, 2022, in the Federal Law Gazette). Practice shows that the tax audits of internationally operating groups in Germany can take several years and are subject to controversial discussions between the tax authorities and the taxpayer, often resulting in significant transfer pricing (TP) adjustments. The number of Competent Authority proceedings initiated in Germany to avoid double taxation due to such adjustments also increased significantly over the past years (the inventory of TP-related Competent Authority cases at the end of December 2021 was 584). The new law intends to accelerate tax audits by changing the deadline to submit TP documentation and intensifying the cooperation between the taxpayer and the tax audit.

Selected examples of how the German legislature intends to reach such goals are briefly discussed below. The new law enters into force for taxation periods starting after December 31, 2024.

Transfer Pricing Documentation

Until now, taxpayers were required to submit Transfer Pricing Documentation (TPD) upon a specific request during a tax audit. The TPD must be submitted within 60 days after such request (30 days for so-called extraordinary transactions). The content of a TPD is similar to what the OECD proposes for documentation purposes. However, the German Ministry of Finance issued extensive administrative guidelines, which partially go beyond the scope of proposed OECD documentation requirements and, hence, increase the documentation burden for German taxpayers.

According to the new law, the tax authorities can request the submission of a TPD at any time (Sec. 90(4) s.1 GTC). The TPD must be submitted within 30 days upon request (Sec. 90(4) s.3 GTC). The new law no longer distinguishes between extraordinary and ordinary intercompany transactions. Hence, the deadline to submit a TPD covering regular cross-border intercompany transactions is shortened from 60 days to 30 days. Moreover, the new law requires the submission of TPD without any specific request

when a taxpayer receives a formal tax audit notification about the commencement of a tax audit (Sec. 90(4) s.2 GTC). Also, in this case, the 30 days' deadline must be observed.

Factually, the shortened deadline leads to a contemporaneous documentation requirement for many taxpayers since practice shows that even the previous submission deadline of 60 days was too short to prepare a usable TPD.

Sanctions

If a taxpayer delays the submission of usable TPD, a late filing penalty can be assessed. The law provides for a minimum penalty of 100 euros per day of delay with a maximum penalty of 1 million euros. Until now, the penalty has been assessed after the completion of the tax audit. According to the new law, such penalty can already be assessed during an ongoing tax audit and not only after the closure of the audit. The change aims to force the taxpayer to deliver TPD in a timely manner and to fulfill his cooperation duties without delay. Practice shows that tax auditors typically assess the penalty significantly above 500 euros per day, with the argument that the taxpayer should have been aware of the legal documentation requirement and the delay in presenting documents is not excusable.

The other, already existing, sanction remains unchanged, i.e., in case of income adjustments resulting from non-usable (or even no) TPD a penalty of 5%-10% of the income adjustment can be assessed (at least 5,000 euros).

Qualified Request for Cooperation

According to the new law, the tax authority can issue a formal qualified request for cooperation to taxpayers to force them to provide information to the tax audit (Sec. 200a (1) GTC). This request is, contrary to a regular tax audit request, an administrative act, and aims to challenge non-cooperative taxpayers to answer tax audit requests in a timely manner. Where a taxpayer does not respond to a qualified request within a one-month deadline, a new sanction regime applies (see below). The tax authority must not substantiate the reason for such a qualified request. The one-month deadline during which the qualified request must be answered by the taxpayer, may be extended in justified cases only.

New Sanctions Regime

The qualified request for cooperation is accompanied by a new sanctions regime.

In case the taxpayer does not satisfy the qualified request for cooperation within the one-month deadline, a delay penalty of 75 euros per day must be assessed for a maximum delay period of 150 days (maximum penalty equals 11,250 euros; Sec. 200a (2) GTC). Only an excusable delay allows the tax authority to refrain from assessing such penalty.

An additional penalty (surcharge) can be assessed if a taxpayer repeatedly violated its duty to cooperate (Sec. 200a (3) GTC). This is the case if the taxpayer was already subject to a delay penalty within the previous five years and it cannot be reasonably assumed that the taxpayer will fulfill the qualified cooperation request on time. Alternatively, the surcharge can also be assessed if it can be assumed that the taxpayer does not cooperate simply because of its economic capacity. This rule applies where the revenue of the taxpayer is at least 12 million euros or, in case the taxpayer, is part of a group of companies. The reported consolidated group revenues are at least 120 million euros in one of the years subject to the audit.
In both cases, a surcharge maximum of 25,000 euros per day can be assessed for a maximum of 150 days (maximum penalty equals 3.75 million euros).

Additional Changes

In addition to the above-mentioned legislative changes, other amendments to the GTC have been enacted, such as:

- The statutory limitation period is reduced to five years starting from the day of the announcement of a tax audit. After the five-year period, the assessment of taxes become time barred. In certain cases (e.g., tax abuse or if a qualified request for cooperation is not answered on time), the statutory period of limitation will be extended.
- In case of tax audit findings where the fact pattern also applies to post-audit periods, the taxpayer is obliged to file corrected tax returns with the tax authorities for subsequent tax years.
- The tax authority shall discuss on a regular basis preliminary audit findings as well as the resulting tax consequences with the taxpayer. In addition, the tax authorities and the taxpayer can agree on a framework for cooperation during the tax audit. Such framework does not only provide useful guidance for the taxpayer on how to cooperate with the tax audit, but it also secures that the tax authority does not issue a qualified request for cooperation. Hence, the qualified request, as well as the associated new sanctions regime, can be avoided if the taxpayers follow such a framework agreement.

The Takeaway

The goal of the legislator to speed up the execution time of tax audits and to intensify the cooperation of the taxpayer with the tax authorities shall be achieved by a factual obligation to prepare contemporaneous TPD and an extended penalty regime. Taxpayers falling under TPD requirements are well advised to establish internal processes which allow them to prepare TPD in a reasonable time frame. Especially given that tax authorities can request the submission of TPD at any time (e.g., during the tax assessment process), it would be prudent to have the TPD prepared when the tax returns are filed with the tax office. It should also be considered that Germany does not have any safe harbor rules, i.e., by law, every single transaction and also transactions of minor volume must be documented, which impedes the TPD efforts further. In the past, taxpayers typically agreed at the beginning of the audit which specific transactions should be documented and presented to the tax audit to minimize the documentation burden. Due to the shortened deadline, such approach is likely no longer possible. One must see if the shortened deadline to submit TPD is an effective measure to accelerate the audit process. There are always two parties involved: the taxpayer and the tax audit. Hence, also the tax audit examination activity needs to be accelerated to achieve the legislative goal. It's possible to agree with the tax audit to have regular status meetings about the auditors' findings in addition to agreeing with the tax audit about specific conditions on how the taxpayer shall co-operate with the tax audit. Those changes can indeed improve the tax audit process and especially the atmosphere in tax audits.

Although the new law becomes effective for taxation periods starting after December 31, 2024, taxpayers should start determining and implementing the documentation processes early enough to meet the new rules. As noted above, the German tax authorities have taken a tough and sometimes aggressive stance in TP audits. Hence, taxpayers should be able to provide TPD in a timely fashion to demonstrate a cooperative stance and improve the tax audit climate.

Netherlands

What to Do with Dutch Financial Service Companies and Their Equity at Risk?

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On July 1, 2022, the Dutch Ministry of Finance released an amended version of the Dutch Transfer Pricing Decree (2022 Decree). The 2022 Decree entered into force on July 2, 2022, and it does not provide for any grandfathering. The Dutch Transfer Pricing Decree was amended to align the decree with the OECD transfer pricing guidelines as the previous version was released in 2018. The 2022 Decree introduces several amendments, one of which concerns the level of control and the financial capacity of financial service companies.

Up to the introduction of the 2022 Decree, the remuneration of financial service companies in the Netherlands was generally not determined by the level of control that a financial service company (FSC) had, but rather on the basis of the risks (e.g., debtor risks, currency risks, market risks and operational risks) it incurred and guidance provided by the Dutch State Secretary of Finance.[1]

In this brief article, we will discuss the change and the challenges the 2022 Decree introduced for Dutch-based FSCs. More specifically, we will focus on possible ways to determine the at-arm's-length remuneration for FSCs under the 2022 Decree and compare this to the past practice.

Past Practice

Based on Dutch tax law, certain interest (and royalties) that flows through Dutch-based FSCs can be excluded from their Dutch tax basis. This can happen if the FSC functions as an intermediary to its creditor and its debtor of a financial flow (also known as *back-to-back* financing) and the creditor and debtor belong to the same group, while the FSC does not run any risk on these activities. In other words, exclusion of interest of a back-to-back loan of an FSC depends on the following three conditions:

- Group affiliation
- Loans that are *de jure* or *de facto* directly or indirectly linked to one another
- The absence of a real risk for the FSC

In this respect, the first two items will not be further discussed, assuming these are generally met in the financial service practice within a multinational group. Regarding the absence of incurring a *real risk*[2], the Dutch legislature introduced a safe harbor provision to minimize any uncertainty as to when an FSC runs a sufficient real risk for Dutch tax

1. The so-called question-and-answer decree for financial service companies (in Dutch: Vraag- *en antwoordbesluit dienstverleningslichamen*).

2. Article 8c paragraph 2 of the Dutch Corporate Income Tax Act 1969.

purposes. The safe harbor was introduced in the form of a capital requirement. The FSC meets this requirement by demonstrating that its capital (i.e., equity) is the lesser of:

- 1% of the amount of the outstanding loans
- Two million euros

This risk should also be properly reflected in the respective loan arrangements. This is generally addressed by adding a so-called *limited risk* clause. If the FSC meets the safe harbor provision, it should reflect this in its at-arm's-length (interest) margin on the incoming and outgoing funds. This means that the entity should be remunerated for the risks incurred. In addition, the margin will need to be increased with a remuneration for the financing service itself (i.e., the operational risk incurred).

Meeting the capital requirement, and thus not falling within the scope of this provision, has been important for FSCs in the Netherlands as this generally ensured:

- The issuance of a tax residency certificate by the Dutch tax authorities
- No automatic exchange of information
- Any foreign withholding tax could be credited with the Dutch corporate income tax due by the FSC[3]

Provided that this risk is combined with the special substance requirements for FSCs put forward by the Dutch legislature, this would also enable the possibility for concluding a so-called Advanced Pricing Agreement (APA) with the Dutch tax authorities.

A New Approach

Under the approach outlined in the 2022 Decree, strong emphasis is put on the

3. In case the spread would be substantial enough to create sufficient corporate income tax due to credit the foreign withholding tax with. This may not always be the case.

extent to which the FSC has the control (i.e., functions) and financial capacity to manage and bear the risks associated with obtaining and issuing loans when determining the at-arm's-length remuneration. In that respect, it is crucial that the FSC:

- Has control over the risks incurred
- Has sufficient financial capacity to bear the risk if it materializes

Although at first sight, there do not seem to be any differences in comparison to the situation prior to the 2022 Decree, the new TP Decree distinguishes between three situations, namely:

- The situation where the entity has full control over the credit risks *and* sufficient financial capacity
- The situation in which the FSC has no control *and/or* insufficient financial capacity
- The situation where the FSC has joint control with one or more other group companies *and* sufficient financial capacity

This approach is new. The 2022 Decree discusses how the risks should be allocated in these three cases, which on its own can be seen as a new development for Dutch FSCs in comparison to the past practice. However, the 2022 Decree, unfortunately, does not provide clear guidance on how to determine the level of control over the risks. The same applies with respect to determining the financial capacity of an FSC. One may argue that this is remarkable as determining the level of control and the financial capacity have become an essential part of assessing the transfer pricing analysis of an FSC. So far (and to date, as this legislation has not been changed) the financial capacity of an FSC was linked to capital requirement, being the lesser of 1% of the outstanding loans or two million euros. However, this approach is not based on the FSC's actual incurred economic risks and, therefore, may not be acceptable anymore when determining the FSC's financial capacity under the 2022 Decree.

What Next?

It remains uncertain how to determine the at-arm's-length remuneration of Dutch FSC under the 2022 Decree. Following the 2022 Decree, it seems that the capital requirement, which generally functioned as a safe harbor in the past, is no longer in favor (some suggestions have been made towards applying the Basal Accords which would imply an equity at risk of 8% instead of the aforementioned 1%).

As mentioned above, strangely enough the Dutch tax legislation on FSCs has not been amended to date. Consequently, the safe harbor still remains in place. The 2022 Decree may be regarded as guiding policy to the codification of the at-arm's-length principle, but in principle it does not bear legal enforceability for the Dutch tax authorities as it is not drafted and published by the Dutch legislature. Generally, a taxpayer may invoke a decree if it is in his/her favor while if it is not, the decree may be left aside. Hence, we may carefully conclude that so long as the Dutch tax legislation is not changed, for local Dutch tax purposes nothing has changed.

Nevertheless, the fact remains that the 2022 Decree is introduced and that sooner or later the Dutch tax legislation would have to follow suit. Therefore, in light of this certainty, it is advisable for Dutch FSCs to become accustomed to and take into account the new 2022 Decree, as it is mostly based on the OECD Guidelines. Given the ever-increasing substance requirements (with the Danish cases and ATAD III implementation coming ever closer) and the seeming push for FSCs to be more and more treated as banks, it is advisable for Dutch (and Europe-based) FSCs to invest in their Dutch (economic/operational) substance, and logically also increase their financial capacity (i.e., increase their equity at risk). ■

Practical Considerations for Managing Transfer Pricing Positions: The Challenging Transfer Pricing Landscape in Australia

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The extreme, advanced Australian Transfer Pricing (TP) regime enforced by its arduous compliance obligations, is challenging for most multinational enterprises (MNEs). The Australian Taxation Office (ATO) has, for many years, conducted risk review assessment programs and campaigns of Australian inbound and outbound MNEs perceived to have high risks of profit shifting and tax avoidance. The ATO has gained its information based on the annually filed international dealings schedules (IDS), the Country-by-Country Reporting (CbCR) forms, and income tax returns (ITRs).

On top of this, the Australian-located MNEs are facing new challenges in 2023 and 2024, from a revamp of the thin capitalization provisions with further TP-related implications, newly released practical compliance guidelines on intangibles arrangements to further updates on the BEPS Action plan 1-15 - Actions of Multilateral Instruments, Transparency, for all tax authorities of OECD's aim for a homogeneous global tax approach around Pillar One and Two. A recent Federal Budget announcement has manifested that Pillar Two will be implemented as of January 1, 2024 and will require a global minimum tax rate of at least 15% under a globally agreed set of rules that will require certain MNE groups to undertake annual calculations on a country-by-country basis.

Given that, the good news is that the ATO's TP requirements are heavily influenced and in alignment with the OECD TP Guidelines and the OECD intelligence in general – meaning that more likely than not to be considered positively by like-minded tax authorities as well as being a guide for the future transfer pricing requirements.

Further good news is that since 2017, the ATO has released many Practical Compliance Guidelines (PCGs) on their assessment of the risks linked with certain TP positions. We adapted these PCGs as valuable tools to develop and document robust TP frameworks and positions for MNE groups. We explain how this has helped many MNEs to navigate the harsh Australian transfer pricing landscape below.

The ATO's Changing Approach to TP Compliance

In Australia, the preparation of TP documentation is recommended on a self-assessment basis, but not mandatory. However, not having compliant contemporaneous TP documentation in place can result in high penalties and TP adjustments if challenged by the ATO.

MNEs with aggregated amounts of international related party dealings (IRPDs) greater than 2 million Australian dollars are obligated to disclose the details of their IRPDs in the Local File (e.g., in Australia, an XML formatted file submitted with the other CbCR reports) and the IDs attached) and the IDS attached with their annual income tax return. In the Local File and the IDS, MNEs must disclose the following details about their IRPDs: type of transaction, the magnitude of the transaction, financial arrangements, business restructurings, and level of TP documentation to support the arm's-length nature of the transactions.

The more significant and broader the scope of an MNE's IRPDs, the more likely the ATO is to review those dealings. MNEs with significant levels of dealings, whose financial performance is low compared to industry standards, are at the greatest risk of review.

The ATO has for many years collected all the data from the CbCR, IDS and ITRs into its comprehensive databases, which are then screened using algorithms for where the ATO assesses risks of non-compliance, avoidance, and profit shifting. The ATO uses the extracted data to plan and strategize for its risk review assessment programs and campaigns of Australian inbound and outbound MNEs.

Over the years, the ATO's activities through these programs involving audits, risk reviews, and PCGs have provided us with profound insights into the ATO's expectations and thinking regarding TP documentation and what is perceived as low-risk TP frameworks.

Further, this has solidified the ATO's shift of their expectation to documentation away from a pure pricing/benchmarking exercise, demonstrating that the IRPDs are following the arm's-length principle (ALP) towards an approach of providing supporting contemporaneous evidence of the behavior and motivation of the IRPDs or global TP structure being in harmony with the ALP. This is also OECD's thinking and together transitioning from the annual creation of TP documentation reliant on retrospective benchmarking to a holistic concurrent progressive approach of the entire business and value chain of the MNE. This latent regime shift is also evident in the last few years' court cases in Australia (i.e., Chevron, Singtel, Glencore) and other jurisdictions (i.e., Coca-Cola, others).

The regime shift is further obvious in the numerous PCGs the ATO released since 2016. The PCGs are indeed helpful as they showcase ATO's thinking and expectations, and often include risk ratings that assist taxpayers and their advisors to develop robust TP pricing positions.

The PCGs provide a self-assessment framework for MNEs to assess their risk rating to understand the ATO's initial perspective on particular TP issues. The higher the risk rating, the more likely the ATO will review the MNE's arrangement. The PCGs provide broad law administration guidance, addressing the practical implications of tax laws and outlining the ATO's consideration of what is viewed as low risk (unlikely to require scrutiny) and high risk (likely to attract scrutiny). Most of the PCGs also provide examples of arrangements ranked according to the ATO's risk assessments. These examples are very useful and we have used these for start-up MNEs as they provide almost recipe-like instructions for a successful entry into the Australian market with minimized risks for scrutiny by the ATO.

Some of the most useful PCGs include:

- PCG 2017/1 – ATO compliance approach to TP issues related to centralized operating models involving procurement, marketing, sales, and distribution functions
- PCG 2017/2 – Simplified transfer pricing record-keeping options
- PCG 2017/4 – ATO compliance approach to taxation issues associated with cross-border related party financing arrangements and related transactions
- PCG 2019/1 – Transfer pricing issues related to inbound distribution agreements
- PCG 2020/7 – ATO compliance approach to the arm's length debt test
- PCG 2021/5 – Imported hybrid mismatch rule – ATO's compliance approach (mismatches on account of arrangements between deductions and/or non-inclusions of payment between jurisdictions)
- PCG 2023/D2: Intangible arrangements

Practical Considerations to Ensure Robust TP Position in the Future

As evidenced in numerous PCGs, risk reviews and court cases, the ATO is clearly signaling that supporting contemporaneous evidence on the behavioral/motivational aspect is much stronger than retrospective benchmarking. We also find there are other issues with applying the retrospective benchmarking approach to fulfill TP documentation compliance and obligations such as:

- Australia is running out of comparable local independent benchmarks for MNEs.
- It is a backdated approach in a proactive forward-looking and moving business environment.
- Revisiting and updating TP documentation on an annual basis will most likely be more costly over time and will not provide MNEs with optimal protection if challenged by the ATO.

We have, for some time now, been using the concept of compiling contemporaneous evidence of the commercial reasoning to the IRPDs when preparing TP documentation. We believe this change also gets ahead of the current and upcoming challenges facing MNEs and will further ensure bulletproof TP positions for the future.

This change in approach to TP documentation can be used on any scale for both inbound and outbound MNEs. We are all about customizing the approach to the individual situation and circumstances and ensuring a balance between risk exposure, compliance burden, and costs for the MNE.

Our approach includes the following benefits:

- Holistic and will change as businesses move and expand
- Examines the entire value chain
- Can be included in the business decision model
- Can easily be converted into a global TP policy and intercompany agreements
- Annual compliance burden becomes a trivial and immaterial exercise
- Provide a better overview of global transfer pricing structure and assist in complying with PCGs' new requirements from BEPS like Pillar One and Pillar Two
- Assist with APA application and risk review/audit defense supporting evidence and documentation trail

Regardless of the size of the MNE, with TP risks exposure and new compliance challenges coming from the ATO and the OECD, we highly recommend a shift in mindset to a holistic forward-looking approach.

Irrespective of new rules, guidelines on whether consensus is met for Pillar One or Pillar Two or other ambitious OECD recommendations, a proactive approach to the TP position will make it much easier to tackle the new challenges as the new TP position will be based on actual commercial decisions and business plans. Therefore, the approach will document that the behavioral and motivational aspect of the IRPDs are at arm's length and follow the relevant PCGs, ensuring that it will be assessed as low risk if challenged by the ATO. ■

Poland

Transfer Pricing Complexity in Poland Ahead of Many Other European Countries

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Poland is one of the countries in Europe where new transfer pricing ideas agreed at the Organization for Economic Cooperation and Development (OECD) or European Union (EU) levels were implemented earlier than in many surrounding countries, while tax authorities become educated and more aggressive during transfer pricing (TP) reviews. This means the complexity of TP planning, documenting, and periodical checks is often higher than at the multinational enterprise's (MNE) HQ level. Below we present some of those specifics.

Growing Importance of the Synergy of TP Knowledge, Experience, and Specific Tools in Discussions with Tax Authorities in Poland

Currently, the co-existence of both a general arm's-length principle and a country-oriented arm's-length principle may be seen. It is manifested in the shaping of regulations, which suggest that intra-group transactions that increase the income of a local entity are treated differently from the ones that reduce profitability. While some countries have taken the opportunity to liberalize tax legislation, including transfer pricing, other countries responded by introducing more restrictive regulations that impose numerous obligations on taxpayers, which is the case in Poland. Earlier introduction of legislation means that there is more time for development of the practice of applying these rules by both tax authorities and taxpayers. The evolution of TP regulations will increase awareness and opportunities to understand the purpose of the current legislation and to anticipate the direction of further amendments. These local experiences also influence more cautious or more liberal perception of transfer pricing rules applicable in other countries.

In Poland, for example, TP regulations already existed in the 20th century. The OECD Reports accelerated the development of TP regulations and practice in the last decade. As of 2017, some transfer pricing concepts in Poland have been further developed, even compared to their definitions presented in the OECD reports (e.g., a general definition of related entities allowing for a broad interpretation of such parties, homogeneity of the controlled transaction, rejection of the hierarchy of methods, existence of comparative analysis and compliance analysis, additional TP obligations like TP report (TP) form and a statement of management boards).

Starting from 2019, the management boards of Polish entities shall sign the statement that local TP documentation has been prepared and that the transfer prices applied would have been accepted by unrelated parties in a comparable transaction. Furthermore, key information on related party transactions for a given tax year on a special TPR form must be submitted. In both cases, personal sanctions may apply in case of false or incorrect statement or information.

Since then, there have been changes almost every year in the interpretation of data concerning certain transactions and their scope presented in the TPR form. Consequently, several ways of presenting the input are possible. Some may be more beneficial for the reporting entity. This matters because TPR information is a tool that is designed to effectively choose transactions and entities for TP audits. As this tool also allows authorities to gather knowledge of a variety of transactions concluded by related parties, it can be useful for tax authorities when verifying submitted TPR and signed statement of selected entity (by comparing to TPRs submitted by entities in the same sector or in general).

There is constant evolution in the interpretation of the TP regulations and TP concepts operating in practice. Only Poland has rulings, interpretations, clarifications, recommendations of the Polish Transfer Pricing Forum, public TP debates/consultations.

In the period of 2019-2023, the practice of the following issues has also been developed:

- Restructuring between related entities
- Transactions concluded directly with entities from tax havens (not only with related entities)
- Reporting of mandatory disclosure regime (MDR) schemes (DAC6 reporting) applicable to related party transactions
- Application of exit tax rules
- Public disclosure of tax strategy by selected entities, including selected TP information
- Regulations regarding free of charge benefits

The recent years have not only brought changes to TP legislation or interpretations of existing regulations, but also the transfer of TP knowledge and specialists from consulting firms and universities to TP teams of the tax authorities. Combined with more effective tools for selecting entities for audit (TPR form) and strict sanctions for taxpayers and those representing them (based on Fiscal Penal Code), this requires more involvement of TP professionals and higher quality advice covering various types of transactions (financial, IP, services, goods and others).

These days, tax authorities feel increasingly comfortable for example when:

- Challenging profit split based on contribution analysis (by disputing: substance & functional analysis, the weights prepared by taxpayer, calculation of profit base to be split and taxed)
- Challenging non-equivalent mutual benefits resulting in a partly free of charge benefit/settlement that is regarded as not arm's length (e.g., a joint and several liability clause in the context of a credit line signed by several *debtors* but only one of them is using it)
- Challenging correctness of identification of related party transactions (less visible transactions: currency exchange, hedging, mortgages, and pledges securing

repayment of the debtor's obligation, joint and several liability of debtors)

- Analyzing restructurings between related entities (taxpayer can choose from 13 types of restructurings when submitting TPR form)
- Analyzing TP policies and looking for inconsistencies when implementing the results of TP analyses into the transfer prices used in current settlements

Taking all the above into account, only people with sufficient experience and practical knowledge can provide advice that secure TP position of the client.

The use of specific tools/databases equipped with data and functionalities allows for possible adjustments of internal data or calculation of a wider range of market prices, margins, mark-ups, commissions in comparison to analyses prepared on freely available external data.

Having access to various databases and knowledge on how to use them gives higher probability that the range determined because of the analysis will encompass the actual transfer price. Using information from more than one database can also increase confidence of the correct application of the TP verification method.

The combination of experience, knowledge and specific tools allows the advisors to provide TP services tailored to the situation, resulting in a more secured client's position. In addition, the effects of the services provided as result of that combination may last longer, depending on the adviser's approach or the client's expectations.

Given that the Polish legislative bodies have expressed approval for the further development of TP regulation, with reference to the OECD Guidelines, there is an opportunity to discuss and improve certain TP issues. An example of this is the need to develop concepts of substance and development, enhancement, maintenance, protection, and exploitation (DEMPE) analysis, which are interpreted in a rather narrow/limited way.

The Key Importance of Preparing TP Documentaton That Reflects the Actual Conduct of Analyzed Transaction

There were already provisions in Poland before 2022 that referred to the *actual conduct of the parties* in the definition of a controlled transaction and provisions sanctioning unreliably prepared TP documentation. Nevertheless, the issue of actual terms has been highlighted in the Polish tax regulations and in the Penal Fiscal Code. As of January 1, 2022, the amended provisions of the Penal Fiscal Code have entered into force. They impose personal (not corporate) sanctions for preparing local TP documentation that does not reflect the actual terms of the analyzed transaction. Personal sanctions may be also imposed on the board of directors for untrue statements that the local TP documentation has been prepared in accordance with the actual facts and that the transfer prices covered by the documentation are based on terms that unrelated parties would have agreed between themselves.

Verification of the actual course of transactions between related parties should be one of the primary objectives of any TP project, regardless of the personal or corporate sanctions introduced.

The actual course can be discussed with a local entity regarding a single transaction and current terms. But it also can be verified when discussing terms of other intercompany flows of local tested entity or when discussing terms with representatives of related counterparty or based on perspective of headquarters (e.g., by reference to a Master file). Also, the context of the recent past and near future may be important.

Finally, the results of the above work should be compared with the expectations of each party of the analyzed transaction, as it may turn out that the applicable terms of the newly concluded intercompany transaction do not correspond to the parties' expectations. The extent of the data reviewed and the insights from these analyses may affect the level of consistency of the TP, as well as the period during which TP advice/works will remain valid. A thorough analysis is primarily in the best interest of the client, as it allows, among other things, to identify:

- Differences between the contractual arrangements and actual arrangements executed on the day-to-day basis, e.g., under the contract the warranty costs should be reimbursed by the parent company, while they remain in the accounts of local related party or under the contract services provided should be settled based on actual costs incurred while they are settled based on budgeted costs and allocation key forecasts
- Inconsistencies in descriptions of functions, risks and assets provided by various representatives: central staff, local staff, back-office staff, operational staff, or insufficient knowledge at local staff about some terms of intercompany transactions set by central entity (mainly because of limited access to information kept by central personnel)
- Incorrect implementation of transfer pricing policies, including the results of benchmarks (e.g., the guarantee fee is calculated on the basis of the debt actually guaranteed, rather than on the basis of the guarantee amount required by the creditor, or is paid to a guarantor who does not have the assets/resources to repay the debt in the event of the debtor's default; e.g., entity applies contract manufacturing mark-up on costs of activities not covered by CM profile and not verified by CM benchmark)
- Sufficient substance within limited risk profile entities, but insufficient substance when analyzing a principal entity
- The high value of transfer pricing adjustment at the end of the year that is not the result of unforeseen or difficult to predict circumstances or is not a result of a mistake (e.g., if resulted from incorrect

implementation of proper benchmarks and giving one party almost all margin during reported year – so called a *hidden financing*)

Separate but key issues are asking the right questions, talking to the right people, and having the same understanding of the topics being discussed. If there are any doubts about understanding of the facts, it is beneficial to repeat the questions or ask other personnel with knowledge of the transaction under review.

TP audits become more and more detailed and specific due to the growing awareness of TP among the internal revenue officers. The reviews focus on the actual functions performed, the actual assets involved, and the actual risks born. Such topics like the substance and DEMPE analysis are discussed by auditors. Frequently the members of the audited company's personnel are asked for explanations. All differences between what was mentioned in the TP local file and what is the reality are brought to the daylight and may be used to question the pricing arrangements. It is therefore crucial to prepare or validate the files also based on interactions with various client representatives (central and local) instead of basing solely on group documentations and contract arrangements.

The Importance of DEMPE Functions in the Valuation of Arm's Length Trademark Fee Between Members of MNEs

OECD transfer pricing guidelines underline the importance of analysis of so-called DEMPE functions in the process of determining the arm's-length remuneration to the owner of the important intangible property (IP), including trademarks used by related parties. In some MNEs, the importance of those provisions has been neglected so far. As Poland is a common location for subsidiaries of foreign MNEs, many local entities pay license fees for trademarks they use, usually calculated as a percentage of their revenue. Also, Polish groups have been creating special purpose vehicles (SPVs) intended to hold the groups IP. Sometimes, those SPVs do not contain sufficient substance to let them perform the important functions related to development, maintenance, enhancement or exploitation of the trademarks. They are just the legal owners of the group's trademarks.

Polish tax authorities more frequently target such situations during the corporate income tax (CIT) or TP audits. Trademark fees are one of the first questions asked. The result is sometimes the recharacterization of the transaction and limiting the tax-deductible cost of the royalty payment only to the amount being the mere refund of administrative costs of the IP owner (without the costs of depreciation of the trademark), plus a small mark-up. This is the case of an Andersen client in Poland. Also, a recent court ruling upheld this position. This brings the discussion on how to secure at the group level that the royalties coming from the subsidiaries located in Poland do not get excluded from the calculation of the tax base for CIT purposes.

The first important factor is ensuring substance in the entity, which is the owner of the trademark. Such entity should play the active role in development of the trademark and its further enhancement. The owner performing central marketing functions is one of the strongest arguments. It may be done by the employed staff or engaged external services providers. Creating content of the brochures, internet site, advertising campaigns, developing the marketing strategy and principles are the possible functions which help prove that the trademark's owner plays the active role. If other entities from the MNE participate in this process, the costs incurred in the interest of the whole group should be re-charged to the trademark owner. The trademark owner should also be engaged in protecting the trademark from breach by other parties and involved in the cases where some wrongdoings could harm the value of the trademark. It is not necessary that the trademark owner also uses the trademark in its own commercial activities, but it is an additional argument if it does so, e.g., being also the operating entity within the group.

In light of the current developments in the TP audit practice in Poland, it becomes crucial to assess the DEMPE functions in the trademark transactions before a potential tax audit. In a case lacking substance, it is advisable to perform a restructuring of the functions to equip the trademark owner with sufficient share in the crucial value creation process.

As mentioned above, there is the need to develop concepts of *substance* and DEMPE analysis, which are interpreted in a rather narrow way. For example, when analyzing DEMPE in relation to a trademark, it is important to consider, among others, what values the trademark reflects and what activities contribute to maintaining or developing those values (not necessarily marketing and sales activities). If the trademark is used to communicate with resellers or wholesalers, the activities aimed at creating its values may be of a different nature than those performed when the communication is aimed at individuals. It may be that the trademark is even more important in communication with suppliers than with clients. It is also important in which phase of development the trademark is analyzed and in which segment it is positioned (premium, standard, economy). Launch phase will require a different set of resources and activities than a maturity phase. Are the tax authorities ready to accept that there are examples of matured premium trademarks that require only maintenance and protection, because development and enhancement activities are finalized, and exploitation activities are carried out to the maximum extent? Are they ready to accept that in such cases limited specific internal resources are sufficient to manage a significant number of external qualified subcontractors spread across the globe? Are they prepared to accept that having the resources and being on standby to perform the function of protection does not mean that a party is not performing that function if there were no events in the financial year that demonstrate the performance of those functions? There are other aspects to be developed in the DEMPE concept and it is worth involving the business, which has knowledge and knows examples that can support this development.

Our TP advisors in Poland provide the valuable support in TP audits and further appeal procedures by gathering various arguments against the recharacterization of the royalty payments. We also review the IP policies of our clients to find potential changes to safeguard their tax position in case they encounter the TP audit. ■

Thailand

Practical Considerations for Managing Transfer Pricing Positions

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Each year, multinational companies operating in Thailand must evaluate their transfer pricing (TP) models in compliance with the country's upgraded TP system. Thailand's corporate taxpayer is now faced with a myriad of new tax laws broadening the scope of TP audits and powers of Thailand's revenue officers, newer challenges from ever suspicious revenue officers with an ingrained reliance on discretionary power, and a revenue authority leveraging artificial intelligence systems to help finger the phony smart, the crazy brave, and their offensive transfer pricing.

This article discusses such challenges, offers practical considerations based on proven experience in managing TP positions, recommends potential remedial measures, and offers closing observations about moving forward in this often-hostile environment.

Regulatory Framework

To understand practical considerations in managing TP positions in Thailand, one should first understand the regulatory scaffolding behind Thailand's TP regime.

Thailand's Transfer Pricing Regime

Thailand's TP regime:

- Adopts an arm's-length principle-based framework
- Applies to all intercompany operations
- Requires complete comparability analysis for each type of intercompany transaction, including the characteristics, contractual terms, functional profile, economic principles, and business strategies
- Honors the OECD's five transactional profit methods
- Requires identification of the best method, tested entity, and comparable for each type of transaction and the use of an interquartile range
- Provides specific rules about intra-group services, intangible assets, business restructuring, and financial transactions

New Laws Broaden Powers of Thailand's Revenue Officers

Thailand introduced its TP regime in May 2002 with Departmental Instruction No. Paw. 113/2545, an interpretation of the general provisions of Secs. 65 bis and 65 ter of the Revenue Code. In 2019, the government then enacted Sec. 71 bis and ter of the Revenue Code, followed by Notification of the Director-General of Revenue Department on Income Tax Nos. 400 and 407 (Thai TP

Guidelines), all TP guidelines but with status as law.

Thai TP Guidelines, among its other upgrades, further regulate taxation and grant sweeping powers to Thailand's revenue officers. Revenue officers can now adjust revenue and expenses of a juristic company or partnership (*company*) if commercial and financial conditions of transactions between related companies are not determined according to the arm's-length principle. A company is a *related company* if it has:

- A direct or indirect state of at least 50% in another company
- 50% or more of its total shares held directly or indirectly by a shareholder, who also directly or indirectly holds 50% or more of the total shares in another company
- Relationships in terms of capital, management, or control in another company to the extent the other company cannot operate independently (Sec. 71 bis, paragraph 2)

Older Revenue Code Provisions Remain Effective

Thai Revenue Code provisions prior to Thai TP Guidelines remain in place. Such provisions grant Thailand's revenue officers with an arsenal of discretionary power over transfer prices for transfers of goods, provisions of services and money lending. Revenue officers can:

- Adjust prices of properties, services and loans transferred free-of-charge or at below *market price* without justification (Sec. 65 bis (4))
- Disallow purchases of goods as tax-deductibles if bought at higher than *market price* without justification (Sec. 65 ter (15)

- Disallow expenses that are either fictitious, or unrelated to the pursuit of profits or unrelated to business in Thailand (Sec. 65 ter (9), (13) and (14))
- Disallows expenses determined on, and payable out of, profits after the end of an accounting period (Sec. 65 ter (19))

Corporate Taxpayer's Basic Requirements by Law

A company that has related companies must, as of January 1, 2019, prepare specific information relevant to its related companies and the value of inter-company transactions with those corporate relatives each financial year. The data must be aggregated into a compendium, as prescribed by the Thai Revenue Department, commonly referred to as a *disclosure form*.

The disclosure form requires the company to provide a list of all related companies in Thailand and overseas, details and values of the controlled transactions between the company and each related company, and other information, i.e. the entity of the multinational group that is required to submit the country-by-country report, the business restructuring that results in a change in functions, assets, and risks of the company, and the disposal, distribution, or transfer of intangible assets during the tax year. The disclosure form must be submitted to the Thai Revenue Department within 150 days from the last day of the financial year. This provision applies regardless of whether *such relationships do not exist throughout a financial year or whether the entity engaged in inter-company transactions during a financial year*. This provision does not apply to companies that earn less than 200 million baht in that particular year (Sec. 71 ter, paragraph 3 and Ministerial Regulation No. 370).

Within five years after the submission of the disclosure form, revenue officers may notify the company to submit additional documents or evidence necessary for their analysis of the claimed transfer prices.

Practical Considerations

Thailand Revenue Officers: Old Habits Neither Die Hard, Nor Do They Just Fade Away

Specific TP regulations, as mentioned, do not supersede general provisions that empower revenue officers to audit. The revenue officers have the latitude to select the specific or general provisions of the Thai Revenue Code to legitimize their TP investigations and assessments. Revenue officers are typically familiar with these general provisions and the flexibility they afford. Hence, they prefer them to base their assessments on revenue or expenses when auditing transfer prices.

Sections 65 bis and 65 ter allow revenue officers greater liberty to conduct TP audits as they offer no definition of *market price*. Hence, revenue officers can exercise discretion about prices/rates and then cast the burden of proof to the company. For example, revenue officers may allege royalty fees paid to a foreign counterparty were beyond market price if the payment exceeded five percent of its total revenue — *Period!*

Red Flags to the Thailand Revenue Officer

The Thai Revenue Department uses various undisclosed criteria to identify audit targets. Based on our experience and observations, however, the following are red flags:

- High valued related-party transactions
- Transactions with affiliates in tax havens
- Extended losses or significant fluctuations in profitability
- Profit rations well below industry averages
- Prices or profits change substantially at the end of the tax holiday

Reliable Transfer Pricing Documentation: A First Line of Defense

Transfer pricing documentation based on Thai TP Guidelines could create a more level playing field for a company by preventing revenue officers from using certain subjective (and most-favored) pricing methods during audits. This documentation would also strengthen the company's TP position by justifying that the pricing adopted for the inter-company transactions is appropriate for its functional profile and business model in the value chain — an invaluable asset in preparation for potential TP audits. More importantly, reliable TP documentation can demonstrate that the adopted pricing policy is consistent with the arm's-length principles and the specific provisions of the Revenue Code.

Transfer pricing documentation must, according to the Thai TP Guidelines, highlight the nature of business (e.g., key inter-company transactions, business model and functional profile in the value chain), and select and apply the appropriate pricing method to determine the arm's-length nature of the company. This compendium should contain other supporting documents and evidence revenue officers consider essential to verify the arm's-length nature of the controlled transactions, such as agreements with related companies, budget and business plans, feasibility study, etc. All documents and evidence must be in Thai language.

Transfer pricing documentation must be accompanied with various supporting documents that substantiate underlying related-company transactions and TP position. Supporting documents may also include inter-company agreements, boards of directors' meeting minutes, budgets, business plans and feasibility studies, relevant correspondence, meeting notes, market research reports, and news clippings.

Consistency: A Key to Success, Along with Greatness

The typical Thailand revenue officer would conduct the TP audit with suspicion and mistrust. Afterall, the letter of the law and swollen government coffers are at stake, as are his reputation in the face of departmental rivalry, career advancement, and other possible perks. The corporate taxpayer's mundane concerns about profit pale in comparison to these righteous and principled pursuits of the revenue authority.

The revenue officer, during the audit, would likely judge company documents as second-rate evidence. The revenue officer might also request several supporting documents, such as the inter-company agreements, the group master file, price lists, breakdowns of sales revenue and financial results by groups of products, among others, to distill inconsistencies and contradictory claims and figures from these documents.

Hence, on one hand, the company should review the consistencies between the functional profile and business model in the value chain, and the adopted TP policy and those specified in the master file. Also, the company must ensure that all personnel in the relevant departments, such as management, procurement, production, or sales, are aware of, and strictly adhere to, the group's TP policy. On the other hand, if the company introduces any discrete price-related transactions with related companies, for example, a volume discount grant to a related company, the company can manage the TP risk by announcing such a discount policy that is applicable to related and independent parties.

APA: A Last Resort, If Available

A multinational enterprise in pursuit of greater certainty of its transfer pricing can file an application with the Thai Revenue Department for an Advance Pricing Agreement (APA). An APA is an agreement between the company and, typically, the Thai Revenue Department, detailing the pricing method the company will apply to its related-company transactions. The APA, in addition to other benefits, helps taxpayers proactively and cooperatively resolve actual or potential TP disputes in lieu of an invasive audit.

The Thai Revenue Department, however, only accepts bilateral APAs from entities resident in countries that are signatories to double taxation agreements with Thailand. The applicant must submit written documents, as required by the Thai Revenue

Department, and five copies of all related documents (in Thai and English languages.) Once concluded, the APA will become effective for the 3- to 5-year period.

Artificial Intelligence (AI): For Better and Worse

In 2019, simultaneously with enacting the Thai TP Guidelines, the Thai Revenue Department launched its computerized Risk-Based Audit System, a computerized system that collects information from that submitted by taxpayers and from Thailand's Customs Department, Excise Department, Bank of Thailand, Board of Investment, among others, to identify the high-risk companies for further investigation.

Revenue officers, by leveraging these systems, are more efficiently identifying TP audit targets and those who failed to submit disclosure forms. A universal TP database of companies is just one default benefit of this improved targeting.

Added Observations

An Ounce of Prevention Is Worth a Pound of Cure

So far, we have discussed reliable TP documentation as a first line of defense against predatory revenue officers. However, an internal, operational approach of continuous monitoring of TP positions can equally help the company fly below the radar. For example, the company can establish an internal command center to continuously and attentively monitor TP positions to help ensure adherence with its TP policy.

A continuous monitoring mechanism would help ensure that the company, setting aside the anomalous *non-price* factors, would achieve a stable stream of profits that falls within the arm's-length profit range, and beyond the focus of the government's AI watchdogs.

If arm's-length margins are disrupted by anomalous *non-price* factors, the company can diagnose the problem, identify root causes, gather supporting evidence, and make financial adjustments to prove beforehand that the adjusted profitability is consistent with the arm's-length principle when stripping out these *non-price* factors.

Further, where the group decides to alter the company's operating structure, e.g., business restructuring that alters functional profile, insofar that such a price factor would affect profitability, the company would need to safeguard the new TP position by determining the new arm's-length profit range and realign its TP policy and practice. Moreover, the company should review the relevant contractual framework and create a plan to manage possible risks, e.g., the Thai Revenue Department challenging goodwill or compensation between related parties, that may arise after termination of the particular contract. ■

Hungary

Hungary Transfer Pricing Amendments

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Reporting Obligation

The implementation of the new Hungarian transfer pricing (TP) rules has brought significant changes. According to the new TP rules, taxpayers face a new additional reporting obligation, as companies are required to provide information on their intercompany transactions subject to TP documentation as part of their annual corporate income tax (CIT) return. The new reporting obligation is applicable for CIT returns filed after December 31, 2022.

The content of the report is defined in the relevant decree of the Ministry of Finance, which requires the taxpayer to report data on:

- Type of the intercompany transaction (it could be chosen from a nomenclature)
- Nace Rev. 2 code that best describes the transaction
- Administrative data of the parties involved in the transaction
- Value of the transaction in the given tax year in Hungarian forints (per partner)
- Value of the TP adjustment to be applied to the CIT base in Hungarian forints (per partner)
- Applied TP method
- Applied profit level indicator
- Accounting standard applied by the tested party (HAS, IFRS, U.S. GAAP, other)
- Arm's-length range determined as a result of the comparable search
- Applicable adjusted transfer price determined in accordance with the arm's-length range

Arm's-Length Range

Under the previous rules, the minimum-maximum range could be considered as the arm's-length range instead of the interquartile range under certain conditions. The changes include the mandatory use of the interquartile range for comparable searches in public databases. If the transfer price used falls outside the arm's-length range, it must be adjusted to the median of the range. However, the taxpayer may choose another value within the range if it can be duly justified that it better reflects the pricing of the transaction under consideration. The mandatory use of the interquartile range and the median value for TP adjustments apply for the first time to tax years beginning in 2022.

TP Documentation Threshold

According to the former rules, all transactions between related parties were subject to TP documentation requirements if the transaction value exceeded 50 million forint/125

thousand euros (net of VAT) at arm's length in the relevant tax year. Based on the new rules, this threshold has been increased to 100 million forints/250 thousand euros. The amendment is applicable from the tax years beginning in 2022.

Default Penalty

Also introduced into the relevant regulation is that in 2022 the maximum penalty for failure to comply with TP documentation requirements will increase from 2 million forints/5 thousand euros to 5 million forints/12.5 thousand euros per document. In the case of repeated violations, the tax authority may impose a penalty of up to 10 million forints/25 thousand euros per document up from the previous 4 million forints/10 thousand euros.

The definition of TP documentation has also been changed effective in 2023. According to the previous definition, TP documentation consisted of a master file and a local file (per local entity), but the definition has been changed so that the master file and the local file(s) should be considered separate documents. In addition, all documentable transactions are to be examined in separate local files. As a result, the total penalty could be significantly higher.

Public CbCR Under the EU Public CbCR Directive

The Directive in General

Directive (EU) 2021/2101 of the European Parliament and of the Council (Directive) was published on December 1, 2021 and entered into force on December 21, 2021 — amending Directive 2013/34/EU on the disclosure of income tax information by certain legal entities. This introduced the rules for the public disclosure of income tax information by certain companies and branches on a country-by-country reporting (CbCR) basis.

Below are highlights of the key provisions and their practical implications.

Companies Subject to New Reporting Requirements

The Directive applies to both multinational enterprises (MNEs) with their head office in the EU and non-EU MNEs operating in the EU through a subsidiary or branch with a total consolidated turnover exceeding 750 million euros in each of the last two financial years.

For non-EU headquartered MNEs, the rules apply to a medium or large subsidiary (governed by the national law of a Member State and a qualifying branch in any of the Member States of the European Union.

Content of the Reporting Obligation

The Public CbCR Directive requires MNEs to disclose the following tax information:

- Name of the ultimate parent company or the standalone company, the financial year concerned, and the currency used
- Brief description of the nature of their activities
- Number of employees on a full-time basis
- Net turnover
- Profit or loss before income tax
- Income tax accrued and paid
- Amount of accumulated earnings

In terms of information disclosure, the Public CbCR Directive requires MNEs to disclose details of their economic activities in each EU Member State and in any jurisdiction that is in either Annex I (the so-called blacklist) or Annex II (the so-called graylist) of the EU list of non-cooperative jurisdictions.

Implementation of the Directive

Member States have agreed to transpose the Public CbCR Directive into national law by June 22, 2023. The first reporting year will be the year starting on or after June 22, 2024, at the latest, although a Member State may choose to apply the rules earlier.

Disclosure Requirements

For EU-based MNEs, the report must be published on the website of the ultimate parent company and filed with the commercial register of the Member State, where the ultimate parent company is subject to national law. For non-EU headquartered MNEs, each medium or large subsidiary or qualifying branch in the EU must publish the report on its website and file it with the commercial register of the Member State in which it is established, unless the non-EU parent enterprise (voluntarily) publishes the CbC report on its website and instructs an EU-based subsidiary or branch to also publish the report on its website and file it with the commercial register of the Member State in which it is established. The information in the report should be provided in at least one of the official languages of the EU and should be available free of charge to any third party within the EU.

Hungarian Implementation

Hungary has also adopted the provisions of the Directive requiring a certain group of companies to prepare a public report containing CbCR information. The amendment has been incorporated into Act C of 2000 on Accounting (Accounting Act).

The adopted rules determine the scope of those required to report corporate tax information as follows:

- A company that prepares consolidated financial statements within the scope of the Hungarian Accounting Act (ultimate parent company), if its consolidated revenue exceeded 275 billion forints (approximately 740 million euros) in two consecutive financial years
- A non-consolidated enterprise (independent enterprise) falling within the scope of the Hungarian Accounting Act, if its income according to the annual report exceeded 275 billion forints (approximately 740 million euros) in two consecutive financial years
- An enterprise that is obliged to prepare an annual report under the scope of the Accounting Act and is included in the consolidation of a parent company operating outside the law of an EU Member State, if its consolidated income exceeds 740 million euros in two consecutive financial years

- A Hungarian branch of a foreign company that falls within the scope of the Accounting Act and is included in the consolidation of a parent company that does not operate under the law of an EU member state, or was established by a company that does not operate under the law of an EU member state and is not included in the consolidation, if the annual net turnover of the branch exceeds 2.4 billion forints (approximately 6.4 million euros) in two consecutive financial years and the (consolidated) income of the ultimate parent company or the independent company exceeds 750 million euros in two consecutive financial years

It is not necessary to prepare and publish the CbCR information for those groups of companies that operate exclusively in Hungary.

A uniform form and an electronic reporting format are provided for the publication of the report. The report containing corporate tax information may be prepared in accordance with the Accounting Act or accordance with Council Directive 2011/16/EU.

The report must be published and filed at the same time as the annual (consolidated) report. The report must also be published on the company's website. It is important to note that the auditor is also required to issue a statement on the fulfillment of the disclosure obligation. The amendment came into force on January 1, 2023.

Romanian Implementation

Romania was also one of the first Member States to transpose the provisions of the Directive into national legislation, with rules similar to those implemented in Hungary.

Thus, in September 2022, public CbCR requirements were introduced into the Romanian legislation by Order no. 2048/2022.

The requirements entered into force on January 1, 2023, and apply to financial years beginning on or after January 1, 2023.

The deadline set by the Romanian legislation is significantly earlier than the deadline set by the Directive (i.e., June 22, 2024).

Romanian Companies Subject to the Reporting Obligations

Based on the Romanian legislation, the following companies are subject to public CbCR requirements:

- The Romanian ultimate parent companies of groups with a consolidated total turnover exceeding 3.7 billion lei (equivalent to 747,474,740 euros) in each of the last two consecutive financial years, operating in more than one tax jurisdiction.
- The Romanian medium and large subsidiaries, as well as the qualifying branches of non-Romanian ultimate parent companies (no distinction is made between EU and non-EU) of groups, with a consolidated total turnover exceeding 3.7 billion lei (equivalent to 747,474,740 euros) for each of the last two consecutive financial years.
- According to local legislation, medium and large subsidiaries are those entities that exceed at least two of the following criteria:
  - Total assets of 17.5 million lei (equivalent to 3.95 million euros)
  - Net turnover of 35 million lei (equivalent to 7.9 million euros)
  - Average number of employees during the financial year is 50

- A qualifying branch is a branch established by an entity that is not subject to the legislation of an EU Member State and whose consolidated net turnover exceeds 3.7 billion lei in each of the last two consecutive financial years, or an individual entity whose net turnover at the balance sheet date exceeds 3.7 billion lei in each of the last two consecutive financial years. The reporting obligation applies only to branches with a turnover exceeding 35 million lei in each of the last two consecutive financial years.

The Romanian legislation contains a safeguard clause that allows MNEs to postpone the disclosure of commercially sensitive information for up to five years. Sensitive information is any information that, if made public, would be seriously prejudicial to the commercial position of the MNE. Any omission should be clearly stated in the report, together with a reasoned justification. Information relating to tax jurisdictions on the EU list of non-cooperative jurisdictions is not subject to this protection.

Polish Implementation

Poland is currently in the process of implementing the Directive, i.e., it has not yet entered into force.

The draft amendments to the Polish Accounting Act prepared by the Polish Ministry of Finance to implement the Directive were published on the website of the Government Legislation Centre in November 2022. The draft has been submitted for public consultation. It is planned that the first reports will have to be submitted for the financial year starting after June 21, 2024.

Impact on MNE Tax Practice

The fact that Hungary and Romania have opted for early implementation (effectively two years earlier) has significant implications for EU and non-EU multinational groups with a presence in these countries.

The introduction of the requirement to publish global CbCR data before the date foreseen in the Directive allows MNEs investing in Hungary and Romania less time to prepare for this very complex requirement.

Separately, the rapid implementation of the Directive compared to other EU Member States will have an impact on the reporting of tax information at the Romanian, Hungarian and global levels. The mandatory data to be publicly reported includes information that can be considered essential for the conduct of business and the competitiveness of groups.

In addition, the time difference between the requirement to disclose corporate tax information for multinationals with a presence in Hungary and Romania and other multinationals without subsidiaries or branches in these countries may also negatively impact the capital markets and the market share of these multinational groups. ■