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Global Practice Guides

Transfer Pricing

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Gibson Dunn & Crutcher LLP

2024

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Gibson, Dunn & Crutcher LLP is a full-service international law firm that advises on some of the most significant transactions and complex litigation around the world. Consistently achieving top rankings in industry surveys and major publications, Gibson Dunn & Crutcher is distinctively positioned in today's global marketplace, with more than 1,800 lawyers and 20 offices, including Abu Dhabi, Beijing, Brussels, Century City, Dallas, Denver, Dubai, Frankfurt, Hong Kong, Houston, London, Los Angeles, Munich, New York, Orange County, Palo Alto, Paris, San Francisco, Singapore and Washington, DC. Gibson, Dunn & Crutcher's global tax controversy and litigation group represents multinational corporations, privately held companies, investment funds, partnerships, sovereign wealth funds and individuals in resolving a broad range of complex domestic and cross-border tax disputes. It works with clients at all stages of tax controversy, ranging from audit and administrative resolution through to trial court proceedings and judicial appeals. The tax controversy and litigation lawyers work closely with the firm's market-leading corporate, commercial litigation, intellectual property, appellate and other practices in a variety of contexts.

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INTRODUCTION

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Transfer Pricing 2024 – Global Overview

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

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

The OECD continues to lead international efforts to harmonise transfer pricing principles and obligations. In 2022, the OECD published a new version of its Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the "OECD Guidelines") reflecting principles raised in the final reports on the OECD's initiative to combat base erosion and profit shifting (BEPS). With the participation of the G20 and Inclusive Framework members, many countries have embraced the OECD's guidance in whole or substantial part. Most recently, and ongoing, the OECD has focused on addressing tax issues related to the growing digitalisation of the global economy. Members of the OECD/G20 Inclusive Framework have now unanimously adopted a two-pillar approach. The group continues to issue guidance to countries that have enacted or are considering enacting legislation consistent with the two-pillar approach – Pillar One and Pillar Two.

The Pillar One proposal includes two parts – Amount A and Amount B. Under Amount A, MNEs with income above a certain threshold would be required to pay a "tax on residual profits" in countries where they generate significant revenue, without regard to physical presence. The tax would be calculated based on a formula that considers the MNE's sales, employees, and assets in each jurisdiction, as well as a fixed return for routine activities. The proposal also includes mechanisms for resolving disputes between countries and ensuring that the tax does not result in double taxation. Pillar One Amount A is intended to cover both highly digitalised businesses and consumer-facing companies with cross-border activities. Pillar One Amount B provides a simplified and streamlined approach to the application of the arm's length principle to baseline marketing and distribution activities. The OECD's February 2024 report on Amount B was incorporated into the OECD Guidelines as an annex, and jurisdictions can choose to apply the Amount B approach for fiscal years commencing on or after 1 January 2025. Individual countries have the option to apply the Amount B approach and, if applicable, whether it will be optional or mandatory for companies operating in that country.

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

It remains to be seen whether Pillar One Amount A portends a broader movement away from the arm's length standard – which has long been the bedrock of international transfer pricing – or whether it is more reflective of the current politi-

cal environment in which transfer pricing is seen as a tool to advance certain policy objectives. But regardless of which view ultimately prevails, Pillar One Amount A provides a clear example of the challenges facing MNEs as they try to navigate the shifting sands of the international transfer pricing environment. The OCED's current plan is to continue to work on an agreed Multilateral Convention to implement Pillar One Amount A, after an initial draft was released in October 2023.

Pillar Two of the OECD's plan focuses on achieving a minimum global tax rate of 15% for all MNEs above a certain income threshold. Pillar Two has progressed far more than Pillar One, with many jurisdictions already implementing legislation to incorporate Pillar Two effective in 2024. Pillar Two relies on the arm's length standard for pricing controlled transactions, and transfer pricing will remain important under the new regime.

Unilateral Measures by Individual Jurisdictions Create Transfer Pricing Challenges for MNEs

Compounding these global challenges are unilateral measures undertaken by individual jurisdictions to buttress their own transfer pricing regimes. While many countries have agreed to repeal their digital services taxes (DSTs) pending implementation of Pillar One Amount A, some continue to apply them or intend to implement them if Pillar One Amount A is not implemented. This uncertainty only adds to the complexity that MNEs face in the international market.

Beyond the DST realm, individual jurisdictions have taken unilateral measures in other areas as well, relying on domestic measures even as they await and apparently support broader OECD initiatives.

Canada

In Canada, for example, the Canada Revenue Agency (CRA) has looked to the "recharacterisation" rule in the Canadian Income Tax Act to try to recharacterise intercompany transactions that the CRA believes would not have occurred at arm's length. The CRA has advanced arguments under the recharacterisation rule in two recent cases, both times unsuccessfully, but shows no sign of abandoning the argument going forward. The CRA has even declared that, because it views the recharacterisation rule as a domestic anti-abuse measure, it will not negotiate application of the rule in the mutual agreement procedure (MAP) process. Instead, it will only participate in a MAP to enable the counterparty to provide correlative relief. Canada continues to focus on, and is looking to modernise, its general anti-avoidance rule.

The UK

The UK diverted profits tax (DPT) is another example of a domestic measure to strengthen an individual jurisdiction's transfer pricing enforcement tool kit. The DPT targets MNEs that use what HM Revenue & Customs (HMRC) considers to be artificial arrangements to divert profits from the UK corporation tax net. Introduced on 1 April 2015, the DPT currently carries a punitive 31% rate (compared to the current UK corporation tax rate of 25%) on profits falling within its scope. There are two ways in which a taxpayer's multinational structure could be caught by the DPT:

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

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A DPT charging notice from HMRC brings heightened transfer pricing scrutiny in addition to the risk of liability for a 31% charge on a portion of the taxpayer's profits. And to increase disclosure of potential DPT subjects, HMRC requires taxpayers requesting an advance pricing agreement (APA) to state their opinion as to whether the DPT is likely to apply to their arrangements.

Australia

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

France

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

Belgium

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

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

The cumulative effect of all the above is, not surprisingly, heightened controversy. Virtually every jurisdiction reports that transfer pricing audits are increasing in number, complexity and amounts assessed, and are increasingly accompanied by assertions of penalties. The increased audit activity is often unilateral, but there is also reported growth in bilateral and multilateral audits. And the issues in scope span the gamut – for countries adhering to OECD guidance, there

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is a heavy focus on DEMPE functions and, where relevant, hard-to-value intangibles.

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

Fortunately, APAs and MAPs exist to help mitigate double tax concerns. But those systems are already resource-constrained and demand appears only to be growing. Several jurisdictions are establishing or growing their APA programmes, and many jurisdictions report increasing taxpayer demand for the certainty an APA can afford. The process remains slow, with APAs often taking three years or longer to complete.

MAP availability is critical to resolving the competing claims, and double tax risks, arising from the landscape described above, and, as with APAs, a number of countries are establishing or growing their MAP resources. But the MAP network is at severe risk of overload even before the full impact of the OECD's BEPS initiatives is absorbed. In November 2023, the OECD released MAP statistics for 2022 which reflected that more than 2,300 MAP cases were closed in 2022. This was a decrease relative to 2021, resulting in a slight increase in ending inventory over the previous year.

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

While the COVID-19 crisis appears to be over, this remains an extremely challenging time for taxpayers seeking to manage their global transfer pricing concerns amid a more dynamic and uncertain economic environment. Important aspects of the landscape appear to be changing and evolving in real time, creating heightened uncertainty, increasing controversy and litigation, and risking overload of the APA and MAP processes designed to offset these pressures and avoid double taxation.

This confluence of circumstances already existed before the pandemic, and the financial strains on government coffers brought about by the pandemic and other macroeconomic events only exacerbated the tensions. Yet, there is also hope that the past is a prologue and that interested stakeholders will find a way to work through their differences to find common ground. Until then, it is sure to be an extremely interesting time for all involved.

BELGIUM

Law and Practice

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Loyens & Loeff is a leading law firm and the logical choice as a legal and tax partner for clients doing business in or from the Netherlands, Belgium, Luxembourg and Switzerland (the firm's home markets). Clients can count on personal advice from any of the firm's 1,000 advisers, based in one of its offices in the Benelux and Switzerland or in key financial centres around the world. Thanks to its full-service practice, sector-specific experience and thorough understanding of the market, the firm's advisers comprehend exactly what clients need. The transfer pricing team consists of experts from various tax areas, offering a fully integrated approach to transfer pricing matters. Expertise ranges from advice on strategy, documentation and interaction with other tax and legal issues to negotiations with (international) tax authorities and dispute resolution. Given the ongoing actions taken by the G20, OECD (BEPS) and the EU, transfer pricing has become more important than ever, and Loyens & Loeff is well equipped to provide seamless service both on tax and on legal aspects.

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1. Rules Governing Transfer Pricing

1.1 Statutes and Regulations

The Belgian legal provisions of particular relevance to transfer pricing are Articles 26, 79, 185 and 206/3 of the Belgian Income Tax Code 1992 (ITC).

- Article 26 ITC provides that the abnormal or benevolent advantages granted by a Belgian taxpayer to a non-Belgian company or establishment should be included in the taxpayer's taxable basis when granted to (among others) a non-resident related enterprise.
- Articles 79 and 206/3 ITC provide for an anti-abuse rule disallowing certain deductions that would have applied to that part of the result that arises from abnormal or benevolent advantages received by a Belgian taxpayer from a related enterprise.
- Article 185, Section 2(a) ITC governs the recognition of profits on cross-border commercial and financial transactions for Belgian taxpayers that are part of multinational groups. Any profits not recognised by an arm's length cross-border transaction are added to the taxpayer's taxable profit. Article 185 ITC is considered the codification of the OECD's arm's length principle in Belgian tax law.
- Article 185, Section 2(b) ITC allows a corresponding downwards profit adjustment for corporate income tax purposes where profits are included in the taxable basis of a related foreign company located in a treaty jurisdiction.
- Articles 321/1 to 321/7 ITC provide the obligation for taxpayers to file transfer pricing documentation if certain thresholds are exceeded (country-by-country reporting, master file and local file).

In February 2020, the Belgian Tax Administration (BTA) issued a circular letter on transfer pricing (Circ 2020/C/35) (the "TP Circular"). In the TP Circular, the BTA confirms adhering to the general principles included in the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017 (the "OECD Guidelines"). The TP Circular:

- provides an overview of the different chapters of the OECD Guidelines (including guidance on financial transactions);
- provides guidance on the allocation of profits to permanent establishments (PEs) (based on the Authorised OECD Approach as laid down in the 2010 report on the attribution of profits to PEs); and
- includes the BTA's interpretation and preference on specific topics.

Finally, the following are also relevant in the context of transfer pricing:

- Article 49 ITC (deductibility of expenses);
- Article 54 ITC (deductibility of interest, royalties and service fees);
- Article 55 ITC (deductibility of market-based interest);
- Article 198, Section 1, 10° (deductibility of payments to tax havens in the context of "actual and sincere transactions"); and
- Article 344, Section 2 ITC (non-opposability of transfer of assets to an affiliated company established in a tax haven).

Since the previous CFC-rule proved to be of little relevance in practice, Belgium recently shifted its CFC-legislation from Model B (transactional approach) to Model A (entity approach). The ATAD obliged member states to implement a CFC rule and left member states the option to either:

- include non-distributed specific types of passive income in the taxable basis of the controlling taxpayer (Model A); or
- include non-distributed income arising from non-genuine arrangements which have been put in place for the essential purpose of obtaining a tax advantage (Model B).

Model B implied that CFC income could only be taxed in Belgium if it is attributable to the "significant people" functions carried out by the Belgian controlling taxpayer (assessment based on the arm's length principle). By switching to Model A, the Belgian legislature disconnects the CFC-assessment from the arm's length principle.

1.2 Current Regime and Recent Changes

Years before the Belgian codification of the internationally accepted arm's length principle in Article 185 Section 2, ITC (in 2004), the BTA traditionally applied Articles 26, 79 and 206/3 ITC as a legal basis for performing transfer pricing corrections based on the principle of "abnormal or benevolent advantages". Although said notion was based on the arm's length principle, Belgian case law traditionally applied a more subjective approach to the notion of "abnormal or benevolent advantages", accepting that providing assistance to group entities in financial difficulties may under certain conditions not trigger the granting of an abnormal advantage. By taking the group relationship into account, Belgian case law went further than the "separate entity approach" followed by the OECD in the application of the internationally accepted arm's length standard.

Article 185 Section 2 ITC was introduced in 2004 to facilitate the interpretation of the notion of "abnormal or benevolent advantage" and thus to increase legal certainty for taxpayers. At the time, this provision was only applicable via tax rulings or mutual agreement procedures.

Following BEPS Action 13, Belgium introduced transfer pricing documentation obligations from 1 January 2016. Depending on certain thresholds, Belgian taxpayers are obliged to submit a country-by-country report (or notification), a master file and a local file with the BTA.

In addition to "non-public" CbCR obligations, the Law of 8 January 2024 amended the Belgian Code of Companies and Associations with respect to the disclosure of income tax information by certain companies (implementing EUR Directive 2021/2101 and commonly referred to as "public CbCR"). This legislation requires companies that are part of MNE groups with a total consolidated turnover of more than EUR750 million in each of the last two consecutive financial years to publicly disclose information regarding the income taxes paid and other tax-related matters, such as a breakdown of profits, revenues and employees per country. The public CbCR applies to financial years starting on or after 22 June 2024. For most Belgian entities, this implies that the new requirements will apply for the financial year starting 1 January 2025.

2. Definition of Control/Related Parties

2.1 Application of Transfer Pricing Rules

Article 26 ITC provides that when a Belgian company grants an abnormal or benevolent advantage to a non-Belgian company or establishment with which the Belgian taxpayer has a "direct or indirect relationship of interdependence", the advantage should be included in the Belgian taxpayer's taxable basis. The notion of "direct or indirect relationship of interdependence" has

a broader scope than "control" under Belgian company law. Whether or not two entities are in a relationship of interdependence is a question of fact. This may notably be the case when:

- the boards of directors of two entities consist in majority of the same persons;
- one entity depends on the other for the supply of raw materials; or
- one entity is the other entity's sole customer.

As regards Article 185 Section 2 ITC, a circular letter dated 4 July 2006 refers to the wording used in Article 1:20 Code of Companies and Associations (CCA), according to which "companies associated with a company" means:

- a) the companies over which said company exercises a power of control;
- b) the companies which exercise a power of control over said company;
- c) the companies with which said company forms a consortium; and
- d) the other companies which, to the knowledge of their governing bodies, are under the control of the companies referred to in a), b) and c).

Under Section 1:14(1) of the CCA, "control" is the ability to decide the appointment of the majority of the directors or the course of corporate policy, whether de facto or de jure.

For transfer pricing documentation requirements, the term "group" is defined as a collection of companies that are related by ownership or control in such a way that they are either required by prevailing accounting rules to prepare consolidated financial statements for financial reporting purposes, or would be required to do so if equity interests in any of the companies were traded on a regulated market.

3. Methods and Method Selection and Application

3.1 Transfer Pricing Methods

Belgian law does not list specific transfer pricing methods that taxpayers can use.

The rules set forth in the OECD Guidelines apply to the use of transfer pricing methods within Belgium. Indeed, with reference to the OECD Guidelines, the TP Circular states that the taxpayer is free to choose a transfer pricing method, provided that the method chosen results in an arm's length outcome for the specific transaction.

3.2 Unspecified Methods

Belgian law does not specify which methods a taxpayer should use. Hence, a taxpayer is free to choose its preferred method to set prices, provided that those prices are consistent with the arm's length principle. In practice, taxpayers generally use one of the five methods listed in the OECD Guidelines, although other methods may also be accepted depending on the case (eg, valuation techniques for transactions involving intangibles).

3.3 Hierarchy of Methods

Neither the law nor the TP Circular provide for a hierarchy of methods.

According to the TP Circular, where multiple methods can be applied in an equally reliable manner, a traditional method is preferable to a transactional profit method. Moreover, if the comparable uncontrolled price (CUP) method and another transfer pricing method can be applied in an equally reliable manner, the CUP method is preferred. This position is aligned with the OECD Guidelines.

3.4 Ranges and Statistical Measures

Belgium does not require the use of ranges or statistical measures.

In the TP Circular, the BTA recognises that transfer pricing is not an exact science, and a transfer pricing analysis will often result in a range of values in which the applicable price is situated. If the retained comparables are highly comparable and of equally high quality, each point within the full range is considered acceptable for the BTA. However, statistical methods can be used to increase the reliability of the results.

The BTA indicates that they favour the interquartile range (IQR) approach and will accept the result if the tested party falls within the IQR. The BTA further provides that an adjustment is needed if the result of the tested party falls outside the (IQR/full) range. Such adjustment will be made to a point within the range which is aligned with the facts and circumstances of the tested transaction. If it is not possible to designate a specific point within the range, the BTA's preference is to use the median.

3.5 Comparability Adjustments

Belgian law does not require applying comparability adjustments.

The position of the BTA, as reflected in the TP Circular, is aligned with the OECD Guidelines. Comparability adjustments should only be made if they improve comparability. The BTA emphasises the importance of duly documenting the purpose and reliability of an adjustment. The BTA further recognises that adjustments can be justified to account for differences in working capital between the tested party and the comparables.

4. Intangibles

4.1 Notable Rules

Belgian law does not impose notable rules specifically relating to the transfer pricing of intangibles.

The BTA generally applies the guidance included in Chapter VI of the OECD Guidelines to evaluate the arm's length character of a transaction involving intangibles. The TP Circular explicitly emphasises the importance of identifying those entities performing the so-called DEMPE functions (ie, development, enhancement, maintenance, protection and exploitation). According to the BTA, entities controlling important risks with respect to the DEMPE functions should be entitled to (part of) the overall return derived from the intangible.

According to the BTA, the most appropriate transfer pricing method for pricing transactions involving intangibles would generally be either:

- the profit split method;
- the CUP method; or
- the cost-plus method (this latter only to remunerate routine contributions – eg, development of internal accounting software).

The BTA further accepts the use of valuation techniques, such as:

- the discounted cash flows method;
- the relief from royalty method;
- the residual value method; or
- the premium profit method.

The BTA emphasises the importance of clearly documenting the reasons justifying the choice of a given method in the taxpayer's transfer pricing documentation.

4.2 Hard-to-Value Intangibles

Belgian law does not contain special rules regarding hard-to-value intangibles.

Where the BTA would want to make a transfer pricing correction, they would be bound by the ordinary statute of limitations (ranging between three and six years prior to the assessment year, depending on the case).

In its TP Circular, the BTA provides that in the case of hard-to-value intangibles, ex post results can be used as presumptive evidence to evaluate whether future developments or events having impacted on the ex post results could have been anticipated by the taxpayer, as well as to evaluate the reliability of the used assumptions when pricing the transaction.

Although the BTA considers that it can perform a price adjustment or impose a different payment structure if demonstrated that the assumptions were not correct or the future developments would have been taken into account when pricing the transaction, the BTA also recognises that no adjustment can be imposed by the mere fact that ex post results deviate from ex ante price arrangements.

4.3 Cost Sharing/Cost Contribution Arrangements

Belgium recognises cost sharing/cost contribution arrangements. No special rules are imposed. The BTA follows the OECD Guidelines in this respect.

5. Affirmative Adjustments

5.1 Rules on Affirmative Transfer Pricing Adjustments

There is no specific procedure allowing a taxpayer to perform upwards or downwards affirmative transfer pricing adjustments after filing its tax return.

Since 2018, no deduction of current year losses and deferred tax assets (eg, carry-forward tax losses) can be made on the taxable basis as adjusted as a result of a tax audit, except in relation to dividends received during the same taxable period. This applies where the BTA imposes a tax increase of (at least) 10%. Hence, a taxpayer may have an interest in spontaneously correcting its tax return and applying an upwards adjustment to its taxable basis if a transaction was not arm's length. By doing so, the taxpayer may avoid the possibility that a future adjustment upon an audit might constitute its minimum taxable basis.

A spontaneous upwards adjustment could be made in two ways depending on whether or not the tax assessment has been vested yet. As long as the tax assessment is not vested, a taxpayer could make an informal request with the competent tax service to correct its tax return. Following vesting of the tax assessment, the taxpayer can introduce a tax appeal against its own tax return within a one-year period.

A unilateral downwards adjustment is in principle not possible. The taxpayer will however be able to request a correlative downwards adjustment as a relief to double taxation following an upwards adjustment made in another country in the framework of a mutual agreement procedure under a tax treaty, the Arbitration Convention or the Dispute Resolution Directive.

6. Cross-Border Information Sharing

6.1 Sharing Taxpayer Information

Belgium has an extensive network of treaties and agreements under which various types of tax-related information are shared either automatically or on request.

As an EU member, Belgium has implemented EU Directive 2011/16/EU regarding the mandatory automatic exchange of information in the field of taxation (as repeatedly amended) providing for various exchange-of-information mechanisms, such as:

- the exchange of information on request;
- the exchange of cross-border tax rulings;
- the exchange of country-by-country reports; and
- the exchange of mandatory disclosure reports.

The BTA actively makes use of these instruments in the framework of transfer pricing audits (eg, selecting taxpayers subject to audit based on cross-border information received, making requests for exchange of information with foreign tax authorities in the framework of an audit).

Belgium has further adhered to the various OECD initiatives on the exchange of information in the framework of the BEPS project, such as the cross-border exchange of tax rulings and country-by-country reports.

7. Advance Pricing Agreements (APAs)

7.1 Programmes Allowing for Rulings Regarding Transfer Pricing

With the Law of 24 December 2002, the Belgian legislature introduced a system of advance decisions that provide legal certainty for taxpayers.

Within the existing system of advance decisions, a taxpayer can request a unilateral advance pricing agreement (APA) that specifically addresses transfer pricing (eg, the methodology used, comparables, critical assumptions regarding future events, etc). No separate procedure exists for APAs; they follow the same procedure as regular advance tax rulings.

An APA can be requested unilaterally, bilaterally or multilaterally. Typically, the request must be accompanied by a transfer pricing study that includes:

- a comparability analysis (including a functional analysis);
- a description of the transfer pricing method(s) used; and
- a transfer pricing benchmark.

The Belgian APA process is a performant system and an effective way for the taxpayer to avoid disputes with the BTA. Where a taxpayer has obtained an APA confirming the arm's length nature of its transfer pricing policy, the BTA is in principle bound by such agreement. Upon audit, the BTA may nevertheless verify whether the facts and circumstances underlying the APA have not changed and whether the transfer pricing policy confirmed in the APA has been correctly applied in practice.

The processing time for a unilateral APA application varies depending on the complexity of the file, the completeness of the information provided and the timing of submission. Nevertheless, if well prepared, it should be possible to obtain an APA within three to six months.

To obtain legal certainty in all jurisdictions affected by a particular transaction, a bilateral or multilateral APA can be requested. The number of bilateral or multilateral APA applications remains small compared to unilateral APAs. It is not possible to provide an exact timetable for the bilateral APA process as this will depend on several factors including the complexity of the case, the timely availability of information, etc. An additional factor is that a bilateral APA is a negotiation between states and timing will thus also depend on the agenda of the competent authorities and the jurisdictions concerned.

Based on statistical data, the average time to negotiate a bilateral or multilateral APA in Belgium is approximately 39 months with EU countries and 30 months with non-EU countries. While unilateral APAs are more commonly used, practice shows that the BTA also promotes bilateral or multilateral agreements and takes a co-operative stance with a view to achieving such agreements.

7.2 Administration of Programmes

Unilateral APA requests are handled by the Service for Advance Decisions (also known as the "Ruling Commission"), a well-functioning government body within the Federal Public Service (FPS) Finance acting autonomously from the BTA. Generally, the Ruling Commission has a co-operative attitude towards the taxpayer. The Ruling Commission is managed by a board of six leading college members, including a chairperson. Decisions are taken by a majority vote. In the case of a tie, the chairperson has a casting vote. Although decisions are taken autonomously by the Ruling Commission, other tax authorities may be consulted for advice during the ruling proceedings.

In order to examine the request as soon as possible, the Ruling Commission generally stipulates adding the following documentation to the APA request:

- identity of the parties and description of the group and its activities;
- duration of the APA;
- description of the intercompany transactions;
- details regarding the transfer pricing method;
- comparability study (if available), including a functional analysis;
- unilateral rulings concluded by the group (if any);
- the proxy of the person who filed the request;
- financial data of the concerned company; and
- references to the applicable legal provisions at hand.

Until a ruling is granted, any new information relating to the situation or transaction concerned must be added to the application.

Two phases of the unilateral APA application process can generally be distinguished: the pre-filing phase and the formal ruling application.

- In the first (and optional) phase, the formal ruling application is prepared by submitting a pre-filing application to the Ruling Commission (possible even on an anonymous basis). In this pre-filing application, the intended transaction as well as the background of the transaction are already accurately described and documented in detail. Moreover, during the pre-filing phase, consultations with the

designated team within the Ruling Commission already take place. The purpose of this phase is to come to a formal ruling request to be presented to the college.
- In the second phase, the formal ruling application is submitted to the college within the Ruling Commission, which decides on granting the ruling.

Applications are examined thoroughly, with the underlying facts as well as the assumptions being discussed through a constructive dialogue with the applicant. The applicant is expected to be fully co-operative throughout the process. The Ruling Commission can ask the opinion of the Central Income Tax Administration, but the final decision-making power remains with the Ruling Commission.

Although the BTA published some general guidance, no specific procedure for bilateral APAs has been established in Belgium. Bilateral APAs are concluded by the Belgian competent authorities (ie, the FPS Finance, General Administration of Taxes, Central Services, Service International Relations, Division Commentary). After the written request is filed by the taxpayer, essentially a discussion/negotiation between states takes place where an agreement may or may not be reached. During the negotiation process, the competent authorities may request additional information from the taxpayer. When the competent authorities reach an agreement, the decision will be signed by each competent authority involved.

7.3 Co-ordination Between the APA Process and Mutual Agreement Procedures

The request for a MAP must explicitly state whether the subject of the request has already been dealt with previously, in the context of a unilateral, bilateral or multilateral APA or other agreement concluded during a tax audit. If so, a copy of this APA or agreement must be handed over to the Belgian competent authority.

A taxpayer who has obtained a unilateral APA is not prevented from also submitting the aspects that were subject to the APA to the MAP. Indeed, the fact that the tax results from a unilateral APA does not, as such, allow the refusal of access to a MAP where the taxpayer considers that the taxation resulting from the APA does not comply with the applicable tax treaty.

7.4 Limits on Taxpayers/Transactions Eligible for an APA

All taxpayers subject to Belgian transfer pricing rules are in principle eligible for an APA. APAs may cover any (interpretative) issues and multiple issues at once (eg, transfer pricing and permanent establishments). However, an APA cannot be granted if:

- it would be inappropriate or ineffective because of the statutory or regulatory provisions referred to in the request;
- the request concerns application of any tax law concerning collection or prosecutions;
- at the time the application is filed, essential elements of the situation/transaction described are connected with a tax haven that does not co-operate with the OECD; or
- the operation or transaction described does not have economic substance in Belgium.

7.5 APA Application Deadlines

A unilateral APA is only valid if it is issued before the intended transactions or situations have produced effect from a tax perspective. The Ruling Commission takes the position that a situation/transaction has produced effect from a tax perspective from the moment the tax return related

to the taxable period during which the situation/transaction occurred is filed. On its website, the Ruling Commission specifies that the request for a unilateral APA should be submitted at the latest by 30 November of the calendar year to which the transaction relates (or eight months before the final deadline for filing the tax return for companies who do not keep their accounts by calendar year). In practice, the Ruling Commission requires that a subsequent request for a renewal of the APA be filed at the latest three to six months before the expiry of the existing APA.

For bilateral and multilateral APAs, a roll-back is possible (see **7.8 Retroactive Effect for APAs**).

7.6 APA User Fees

APAs can be obtained free of cost from the Ruling Commission, the Belgian competent authority.

7.7 Duration of APA Cover

In general, unilateral tax rulings are valid for a maximum period of five years unless the subject of the topic allows for a different period. Following a recent policy change, transfer pricing APAs confirming the pricing of a transaction are only valid for three years (in line with the considered validity period of the underlying benchmark study).

7.8 Retroactive Effect for APAs

A formal roll-back is not possible in the context of unilateral APAs in Belgium.

For practical reasons, the Belgian competent authority authorises initiating a bilateral APA on the first day of the financial year, even if transactions have already taken place between the first day of the financial year and the date of filing the application, provided that the application is filed no later than on the last day of the financial year.

For example, a person may submit a request for a multilateral APA on 25 July 2023 in which they ask for certainty for a period of five accounting years, namely from 1 January 2023 to 31 December 2027 (inclusive). Even though transactions have taken place between 1 January 2023 and the date of request (25 July 2023), the APA can be initiated from 1 January 2023. However, if the request is submitted on 22 March 2024, the accounting year 2023 cannot be the subject any further of the prior agreement, because the request must be submitted no later than the last day of that accounting year (in this case 31 December 2023). However, if relevant facts and circumstances are identical during previous tax years, the person may ask for a roll-back, allowing for applying the outcome of the bilateral APA for the previous years. The Belgian competent authority authorises a roll-back, but only if the applicable time limits (such as assessment periods) still permit it.

8. Penalties and Documentation

8.1 Transfer Pricing Penalties and Defences

Other than penalties for non-compliance with transfer pricing documentation filing obligations, Belgium does not impose penalties specifically applicable in the transfer pricing context. The general penalties applicable in cases of corporate income tax adjustments also apply in a transfer pricing context.

Please see **8.2 Taxpayer Obligations Under the OECD Transfer Pricing Guidelines** regarding the obligation to file certain transfer pricing documentation. An administrative fine may be imposed on companies in cases of non-compliance. This administrative fine ranges between EUR1,250 and EUR25,000 and may be imposed

from the second infringement. If the BTA can prove bad faith on the part of the taxpayer, a fine of EUR12,500 can be imposed from the first infringement.

Other than the obligations described in **8.2 Taxpayer Obligations Under the OECD Transfer Pricing Guidelines**, no formal obligations are imposed by Belgian law to support the arm's length character of intercompany transactions. The burden of proof for performing a transfer pricing correction lies with the BTA. Nevertheless, in practice it is highly recommended to have supporting transfer pricing documentation for material intra-group transactions in place to mitigate the risk of discussions in this respect.

In the case of an incomplete or incorrect tax return (including a transfer pricing correction upon an audit), the tax due on the income portion corresponding to the upwards adjustment shall be augmented by a tax increase between 10% (first infringement, unless waived in specific circumstances if good faith can be proven) and 200%. To prove the good faith of the taxpayer, availing of transfer pricing documentation can be very useful. Furthermore, an administrative fine of between EUR50 and EUR1,250 may be imposed. The additional tax vested will not trigger late payment interest. If a tax increase of at least 10% is applied, no deduction of current year losses and carry-forward tax attributes can be made on the amount of the upwards adjustment as a result of a tax audit (eg, carry-forward tax losses, but excluding dividends received during the same taxable period). Hence, the amount of the correction will be the minimum taxable base. This rule does not apply where the BTA waives the application of the tax increase of at least 10% in the case of good faith.

Please refer to **13.1 Options and Requirements in Transfer Pricing Controversies**.

8.2 Taxpayer Obligations Under the OECD Transfer Pricing Guidelines

From financial year 2016, Belgian legislation requires a taxpayer to file a country-by-country report, a master file and a local file if certain thresholds are met, as follows.

- Country-by-country report – multinational enterprise groups which, for the reporting period immediately preceding the last closed reporting period, report a total consolidated revenue of at least EUR750 million in their consolidated financial statements.
- Master file and local file – any Belgian group entity which, for the financial year immediately preceding the last closed financial year, exceeds one of the following criteria, as reflected in its standalone statutory annual accounts:
  - (a) a total of EUR50 million in operating and financial income, excluding non-recurring income;
  - (b) a balance sheet total of EUR1 billion; or
  - (c) an annual average headcount of 100 full-time equivalents.

The formats for these files are aligned with the OECD forms, except for the "Belgian local file" form which considerably deviates from the "OECD local file". The "Belgian local file" consists of:

- general business and financial information concerning the local entity; and
- financial information on intercompany transactions and transfer pricing methods.

There is, however, no strict legal obligation to also prepare and file the OECD local file report.

The local file report, as suggested by the OECD, is optional and can be attached to the Belgian local file form together with other supporting documentation such as benchmark studies. However, in practice availing of an OECD local file is recommended and generally expected by the BTA.

9. Alignment With OECD Transfer Pricing Guidelines

9.1 Alignment and Differences

Belgian law does not contain any rules deviating from the OECD Guidelines. Although not expressly stated in the law, the OECD Guidelines are generally followed in Belgian tax practice and applied by the BTA and the Ruling Commission. An exception in this respect is the Belgian local file form, which considerably deviates from the OECD local file report under Chapter V of the OECD Guidelines (see **8.2 Taxpayer Obligations Under the OECD Transfer Pricing Guidelines**).

The OECD Guidelines are consistently applied in published circulars. In the TP Circular, the BTA confirms adhering to the general principles included in the OECD Guidelines. The TP Circular provides an overview of the different chapters of the OECD Guidelines (including guidance on financial transactions) and refers extensively to several of the OECD Guidelines' paragraphs. Nevertheless, it is argued in legal doctrine that certain "clarifying positions" of the BTA in the TP Circular deviate from the OECD Guidelines (see **11.3 Unique Transfer Pricing Rules or Practices**).

Belgian case law has ruled on the position of the OECD Guidelines in Belgian practice. In two cases (case No 2016/AR/455 dated 8 June 2021 ("Uniclic"), and case No 2012/AR/2901 dated 16 September 2014 ("Beaulieu")), the Ghent Court of Appeal ruled that the OECD Guidelines are not obligatory or enforceable but are a mere recommendation. It proceeded by stating that the OECD Guidelines do contain internationally accepted principles which can be applied by the BTA as they provide sufficient guarantees in terms of objectivity and reliability.

In addition, in the 2021 case, the Court took a position on the non-retroactive application of the DEMPE concept in transfer pricing, in which it ruled that only the economical context and legal framework of the period to which the facts relate should be considered. The Court stated that a tax assessment can only be vested based on a more recent version of the OECD Guidelines if the new provisions are a mere clarification of the existing guidelines.

9.2 Arm's Length Principle

Belgian transfer pricing rules do not depart from the OECD's arm's length principle as laid down in Article 9 of the OECD Model Tax Convention.

In the TP Circular, the BTA endorses the arm's length principle as the internationally accepted standard for dividing profits of a multinational group between its members.

9.3 Impact of the Base Erosion and Profit Shifting (BEPS) Project

The OECD's BEPS project has strongly affected Belgium's transfer pricing landscape.

Belgium has adopted numerous measures resulting from or inspired by the BEPS recommendations, including the following in the field of transfer pricing.

- Belgium introduced a regime for the automatic exchange of information on tax rul-

ings (including all arrangements concerning transfer pricing and the allocation of profits to permanent establishments) issued on or after 1 January 2017.
- Belgium introduced transfer pricing documentation and reporting requirements through country-by-country reporting and the two-tiered master file and local file as a result of the implementation of EU Directive 2016/881/EU amending EU Directive 2011/16/EU regarding the mandatory automatic exchange of information in the field of taxation (BEPS Action 13). These requirements apply for financial years starting from 1 January 2016.

Upon publication of the BEPS final reports, the Belgian Minister of Finance stated that the new OECD guidance on BEPS Actions 8–10 will be applied by the BTA in transfer pricing audits. The BTA has since referred to these documents and reports published in the framework of BEPS as part of their daily practice, and has even done so in a case evaluating a prior transaction. In this respect, the Ghent Court of Appeal (No 2016/AR/455, dated 8 June 2021 ("Uniclic")) ruled that the application of the DEMPE functions guidance for evaluating transactions entered into prior to its publication constitutes a disallowed retroactive application of the OECD Guidelines.

The Belgian TP Circular adheres to the OECD Guidelines of 2017 and includes the OECD guidance on BEPS Actions 8–10.

9.4 Impact of BEPS 2.0

On 14 December 2023, the Belgian legislature transposed Directive (EU) 2022/2523 on ensuring a global minimum level of taxation for multinational enterprise (MNE) groups and large-scale domestic groups in the Union (known as Pillar II). The law includes a co-ordinated system of rules designed to ensure that large (domestic/MNE) groups with a consolidated revenue exceeding EUR750 million for at least two of the four previous years are subject to a minimum effective tax rate of 15%. The Belgian implementation of Pillar II is applicable to financial years starting on or after 31 December 2023.

In the context of the implementation of Pillar II in Belgium, the Belgian legislature has adapted the timeframe during which the Belgian R&D tax credit can be refunded (reducing it from five to four years). This would lead to the qualification of the R&D tax credit as a "qualified refundable tax credit", which has a more favourable impact on the effective tax rate calculations under Pillar II as compared to a non-qualified refundable tax credit.

9.5 Entities Bearing the Risk of Another Entity's Operations

Belgium follows the OECD Guidelines in relation to risk allocation. Risk will thus be allocated to the entity performing risk control functions and having the financial capacity to bear the risk. The TP Circular provides that such entity is entitled to the residual profits after having remunerated other entities on an arm's length basis. For transactions involving intangibles, the TP Circular provides that if an entity does not control any risk regarding the development of the intangible and does not manage the financial risks, such entity should only be entitled to a risk-free return.

10. Relevance of the United Nations Practical Manual on Transfer Pricing

10.1 Impact of UN Practical Manual on Transfer Pricing

The UN Practical Manual on Transfer Pricing does not have significant impact on Belgian

transfer pricing practice. To the authors' knowledge, there is no legislation, regulations, rulings or case law referring to said guidance. Belgium, being an OECD member country, follows the guidance provided by the OECD Guidelines. Belgium's tax treaties generally include a transfer pricing provision based on Article 9 of the OECD Model Convention and the OECD Guidelines are usually applied in practice to evaluate the arm's length character of transactions.

11. Safe Harbours or Other Unique Rules

11.1 Transfer Pricing Safe Harbours

Belgian law does not include safe harbours for transfer pricing purposes.

The BTA accepts the OECD's simplified approach for determining the arm's length remuneration of low value-adding intra-group services. Under said approach, the service provider can apply a profit mark-up of 5% on all costs related to the services (other than disbursements) and is subject to less detailed documentation requirements. The TP Circular explicitly clarifies which types of services may be within the scope of the simplified approach, in line with the OECD Guidelines.

11.2 Rules on Savings Arising From Operating in the Jurisdiction

Belgium has no specific rules governing savings that arise from operating in its jurisdiction. The TP Circular refers to the OECD Guidelines on how to deal with location savings in a transfer pricing analysis.

11.3 Unique Transfer Pricing Rules or Practices

Belgium does not have unique rules applicable in the transfer pricing context.

In its TP Circular, the BTA takes in the following notable positions (among others).

- If during a 12-month period a participant in a cash pool has held a given (minimum) amount as a deposit or as borrowing, such an amount can no longer be priced as a cash pool transaction, but should be priced as a loan. The reclassification of a structural cash pool deposit or borrowing in a term loan is a frequently observed topic during audits.
- According to the BTA, it is a rebuttable presumption that the cash pool leader is a mere service provider and that its remuneration could generally be determined using a cost-based approach.
- In the framework of a business restructuring of a "limited risk" entity remunerated with a transactional net margin method, the BTA considers that restructuring costs should be re-charged to the foreign group entity that made the decision to restructure and/or that benefits from the restructuring.
- According to the BTA, if the actual result of a company falls outside the range of arm's length outcomes, an adjustment should be made to the median of said range unless specific arguments are available to justify another point within the range.
- Synergies obtained through centralised procurement should be reallocated to the group and a centralised procurement company should be remunerated with a cost-plus method (unless it can be demonstrated that another method is more appropriate given the added value generated by said entity).

The Ruling Commission delivered a negative ruling on the transfer pricing consequences of a VAT refund for limited risk distributors of subsidised pharmaceutical products. This ruling reflects the position of the BTA on this specific topic, which has been the subject of controversy during recent years. The case concerned two companies subject to compensatory contributions on turnover regarding subsidised medicines, paid to the Belgian National Institute for Health and Disability Insurance (NIHDI). Both reached an agreement with the Belgian VAT administration accepting that these contributions result in a reduction of the taxable amount for VAT, entitling them to a refund of the VAT included in the contributions effectively paid to the NIHDI. The companies wished to obtain confirmation that these VAT refunds can be included in the calculation of the operating margin remuneration under the TNMM that both companies should realise for their routine distribution activities. The Ruling Commission and BTA take the position that this is not the case as only Belgian distributors are entitled to such refund, which should therefore be included in their taxable basis on top of the ordinary operating margin.

12. Co-ordination With Customs Valuation

12.1 Co-ordination Requirements Between Transfer Pricing and Customs Valuation

Belgium does not require co-ordination between transfer pricing and customs valuation.

However, transfer pricing adjustments can have a material impact on customs values when the latter are based on the company's transfer prices. The Court of Justice of the European Union recently ruled (C-529/16, dated 20 December 2017 ("Hamamatsu")) that transfer prices cannot be used to determine customs values if they are subject to retroactive transfer pricing adjustments.

The Belgian VAT authorities have not taken a position in light of this recent case law. It is nevertheless advisable for companies to obtain confirmation from the Belgian VAT authorities on the application of transfer prices on customs values in the event of retroactive transfer pricing adjustments. In this way, the possibility of overpaid customs duties not being recoverable can be avoided. In their circular letter 2018/C/9 on customs valuation, the Belgian customs authorities have set out their position regarding the acceptability of an intra-group price as customs value and amendments to the customs value based on a transfer pricing adjustment.

13. Controversy Process

13.1 Options and Requirements in Transfer Pricing Controversies

Taxpayers can challenge the results of a transfer pricing audit in administrative proceedings. If the proceedings in the administrative phase do not lead to the desired outcome, judicial proceedings can be initiated.

Administrative Proceedings

Taxpayers have a period of 12 months after receiving the tax assessment to initiate administrative appeal proceedings. The appeal can be lodged by filing a tax complaint, which will be examined by the General Adviser (*Adviseur-Generaal/Conseiller Général*) who issues a decision of notice. This decision is binding on the BTA, and does not allow an appeal by the BTA. In general, a decision may be expected within six months after filing the tax complaint.

It is important to note that the taxpayer can only initiate judicial proceedings after having received a (negative) decision from the regional tax service. By way of exception, a petition with the court can be lodged if the regional director does not provide its decision within six months after filing the tax complaint.

A taxpayer can file a request for mediation with the tax mediation service during the phase of administrative proceedings, meaning before the regional director has rendered its decision of notice or before initiating judicial proceedings when the administrative phase can be deemed otherwise exhausted. The tax mediation service can only facilitate mediation between the concerned parties and can only result in a non-binding proposal.

Judicial Proceedings

Where the taxpayer wishes to initiate judicial proceedings after exhausting the administrative appeal, a petition must be filed before the court of first instance. The petition must be filed within three months after the decision of notice by the General Adviser (*Adviseur-Generaal/Conseiller Général*).

The judgment of the court of first instance is open for appeal. Appeals must be brought before a court of appeal within one month after the judgment of the court of first instance is served.

Finally, the taxpayer can bring the judgment of the court of appeal before the supreme court (Court of Cassation). This should be done within three months after the judgment of the court of appeal was served. The Court of Cassation only decides on points of law, and will not reconsider findings of facts.

14. Judicial Precedent

14.1 Judicial Precedent on Transfer Pricing

Belgian transfer pricing case law is presently still quite limited (around five to ten relatively recent cases with significant practical relevance based on the current framework), but is gaining importance. As the number of transfer pricing audits is substantially increasing, this may lead to more case law in the future.

There is nevertheless extensive established case law on the interpretation of the notion of “abnormal or benevolent advantage”. Applying said notion under Articles 26, 79 and 206/3 ITC, the Belgian courts have traditionally advocated for a subjective and pragmatic approach. Therefore, the courts have accepted more subjective arguments to determine the arm’s length character of transactions, such as the global balance at group level, the specific characteristics of the group relationship and financial difficulties of group companies. In this respect, the Belgian courts have also accepted direct and indirect set-offs based on the economic reality in a group context.

14.2 Significant Court Rulings

The following recent cases are of particular relevance for Belgian transfer pricing practice.

Ghent Court of Appeal, 8 June 2021, No 2016/AR/455 (“Uniclic”)

This case concerned the arm’s length character of a royalty-free licensing arrangement between a domestic manufacturing company acting as a licensee of patented technology (in the flooring industry) owned by a foreign related company located in Luxembourg. The BTA considered that the Belgian entity performed certain functions and managed certain risks in relation to the for-

eign company's licensing activity and thus contributed to the foreign company's profits resulting from the exploitation of the patents without receiving any remuneration.

The BTA claimed, with reference to a functional analysis, that the Belgian domestic company performed all DEMPE functions (ie, development, enhancement, maintenance, protection, exploitation) in respect of the patents and also managed all important risks. Accordingly, by applying Article 26 ITC, the BTA included a significant part of the foreign company's profits in the domestic company's taxable base. The Court ruled against the BTA, making several interesting statements with respect to:

- the burden of proof (ie, on the BTA);
- the working in time and the value of the OECD Guidelines (ie, mere recommendations which in principle cannot be applied with retroactive effect – see **9.1 Alignment and Differences**); and
- clarifications regarding the allocation of DEMPE functions.

Antwerp Court of Appeal, 20 June 2017, No 2015/AR/2583 ("Philip Morris International")

This case dealt with the valuation of shares sold by a Belgian company to a Dutch related company. The BTA considered that the valuation of shares based on a discounted cash flow (DCF) method was too low and thus resulted in the Belgian seller granting an abnormal advantage to its Dutch parent company. The BTA used an alternative valuation method based on which the BTA arrived at a higher valuation.

The Court recognised that the BTA did not question the appropriateness of the DCF method as such, but merely that the discount rate used would be too high (and consequently lead to a lower price). The Court ruled that the BTA did not prove that the discount rate used would be incorrect or arbitrary. The Court concluded that when several valuation methods are available, the BTA cannot conclude that an abnormal or benevolent advantage is granted when it appears that the method applied by the taxpayer is appropriate and was correctly applied, even if an alternative valuation leads to a different result. In other words, the mere fact that the BTA arrives at a different price by applying a different method does not prove that an applied price is abnormal.

Antwerp Court of Appeal, 5 March 2019, No 2017/AR/1640 ("Opel")

This case dealt with the remuneration method of a Belgian entity acting as a manufacturer of cars sold to a German related entity. Here, the BTA argued that the profit split method used to distribute profits between the Belgian entity and the German related company was inappropriate as the Belgian entity had to be classified as a contract manufacturer acting on behalf of the German principal, and should therefore be entitled to a cost-plus remuneration (rather than a share in the overall loss based on the profit split method).

The Court ruled that a mere reference to the OECD guidelines to prove that another transfer pricing method is more appropriate is not sufficient to meet the burden of proof that lies with the BTA with respect to transfer pricing corrections. The Court ruled against the position of the BTA as the BTA could not provide a transfer pricing study showing that, considering the Belgian entity's functional and risk profile, a different transfer pricing method should have been applied. Furthermore, the BTA could not provide a benchmarking study in support of the proposed cost-plus remuneration. A reference to

arm's length remunerations accepted in previous APAs was not accepted here.

Brussels Court of First Instance, 20 June 2023, No 2021/2991/A

In this case, the Court reviewed and assessed a Belgian company's credit rating for determining the arm's length interest rate under an intercompany loan from a related Swiss lender. The loan had a floating interest increased with a credit margin dependent on the Belgian company's credit rating, which was determined by using Standard & Poor's "Corporate Methodology" ("S&P methodology"). The BTA argued that S&P methodology was not correctly applied and considered that the credit rating of the Belgian company was understated, resulting in excessive interest payments.

The Court concluded that the BTA successfully demonstrated that the taxpayer incorrectly applied the credit rating method but failed to prove the arm's length interest underlying the tax correction. Subsequently, the Court conducted its own analysis to come up with a different credit rating, taking into account the impact of implicit group support. The Court then allowed the BTA to determine a new interest rate based on the outcome of the Court's credit rating analysis and to issue a new tax assessment on that basis. The Court hereby brings some nuance to the (high) twofold burden of proof to the BTA – ie, the BTA should demonstrate that:

- the method applied by the taxpayer does not lead to an arm's length outcome (either because the method is inappropriate or was incorrectly applied); and
- another method providing another price is appropriate.

This gives the BTA a second chance to come up with the correct price based on the Court's properly determined credit rating.

15. Foreign Payment Restrictions

15.1 Restrictions on Outbound Payments Relating to Uncontrolled Transactions

Belgium does not have legislation on capital controls and does not impose other restrictions on outbound payments relating to uncontrolled transactions (except in exceptional situations, such as with UN sanctions).

Belgium levies withholding tax on payments of movable income (interest, dividends, royalties) subject to various exemptions and treaty reductions.

Belgian tax law further includes various rules denying the tax deductibility of certain outbound payments in specific situations (eg, payments to tax havens).

15.2 Restrictions on Outbound Payments Relating to Controlled Transactions

Belgium does not have legislation on capital controls and does not impose other restrictions on outbound payments relating to controlled transactions (except in exceptional situations, such as with UN sanctions).

As previously stated, Belgium levies withholding tax on payments of movable income (interest, dividends, royalties) subject to various exemptions and treaty reductions. Belgium also levies withholding tax on certain types of outbound service fees to related companies.

Belgian tax law also includes various rules denying the tax deductibility of certain outbound payments in specific situations (eg, payments to tax havens).

15.3 Effects of Other Countries' Legal Restrictions

Belgium does not have rules regarding the effects of other countries' legal restrictions.

16. Transparency and Confidentiality

16.1 Publication of Information on APAs or Transfer Pricing Audit Outcomes

Unilateral APAs are published on a no-name basis. The Ruling Commission publishes a report annually which includes a summary of the most relevant advance rulings rendered in the course of the year (including negative rulings). Bilateral APAs are currently not published by the Belgian competent authority.

The final decision of a procedure under the Dispute Resolution Directive is published in its entirety to the extent that the affected parties agree with such publication. If the affected parties or the Belgian competent authorities do not agree with such publication, an abstract of the final decision will be published.

A MAP under the Arbitration Convention will only be published if the competent authorities agree to publish the decision and if the affected persons consent thereto.

A MAP under a double tax treaty will not be published as the notes of the competent authorities and the decision are deemed to be confidential.

The outcome of transfer pricing audits is not published.

16.2 Use of "Secret Comparables"

Although there is no legislation or guidance prohibiting it, the BTA does not make use of "secret comparables" in transfer pricing assessments.

Trends and Developments

Contributed by:
Aldo Engels, Emile Bauwens, Emma Parduyns and Vincenzo Vilardi
Loyens & Loeff

Loyens & Loeff is a leading law firm and the logical choice as a legal and tax partner for clients doing business in or from the Netherlands, Belgium, Luxembourg and Switzerland (the firm's home markets). Clients can count on personal advice from any of the firm's 1,000 advisers, based in one of its offices in the Benelux and Switzerland or in key financial centres around the world. Thanks to its full-service practice, sector-specific experience and thorough understanding of the market, the firm's advisers comprehend exactly what clients need. The transfer pricing team consists of experts from various tax areas, offering a fully integrated approach to transfer pricing matters. Expertise ranges from advice on strategy, documentation and interaction with other tax and legal issues to negotiations with (international) tax authorities and dispute resolution. Given the ongoing actions taken by the G20, OECD (BEPS) and the EU, transfer pricing has become more important than ever, and Loyens & Loeff is well equipped to provide seamless service both on tax and on legal aspects.

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Introduction

During recent years, transfer pricing (TP) has been one of the main areas of focus of the Belgian tax administration (BTA) and of increased importance in Belgian tax practice. In 2020, the BTA issued a circular letter (the "TP Circular") providing a comprehensive overview of TP principles in the Belgian context. The TP Circular holds significant practical value and provides interesting insights into the BTA's views. In addition to a longstanding ruling practice, recent years have seen the emergence of case law that assesses existing rules in concrete situations. The latter is the consequence of the significant audit activity in Belgium by the dedicated TP cell within the BTA. This article highlights the latest developments in Belgian legislation, case law and practice.

Legislative Updates

Extension of statutory assessment deadlines

The general statute of limitations for Belgian corporate income tax is three years. This period can be extended in certain specific cases, such as fraud or following the receipt of information from foreign tax authorities. Following a recent legislative amendment, as of the assessment year 2023 (financial year starting on or after 1 January 2022) the assessment deadline for non-filing or late filing is extended to four years.

Additionally, for "semi-complex" filings from the assessment year 2023 onwards, an assessment deadline of six years applies. A corporate income tax return submitted by a taxpayer who is also obliged to submit TP documentation in Belgium (ie, local file, master file or country-by-country report) should be regarded as "semi-complex". Hence, all taxpayers subject to mandatory TP documentation filing now face an extended period of six years open for audit and reassessment."

Public country-by-country reporting

On 8 January 2024, new legislation amending the Belgian Code of Companies and Associations transposed Directive 2021/2101 with respect to public country-by-country reporting ("public CbCR"). This legislation requires companies subject to CbC reporting to publicly disclose the reported information (including income taxes paid, profits and revenues per country).

The public CbCR applies to financial years starting on or after 22 June 2024. For companies whose financial year coincides with the calendar year, this implies that the new requirements will apply for the financial year starting 1 January 2025, and the first public CbCR will need to be submitted by 31 December 2026 at the latest.

Controlled foreign companies (CFCs)

Since the previous CFC rule proved to be of little relevance in practice, Belgium shifted its CFC legislation from Model B (transactional approach) to Model A (entity approach) as from financial year 2023.

The EU Anti-Tax Avoidance Directive (ATAD) obliged member states to implement a CFC rule, and left member states the option to either:

- include non-distributed specific types of passive income in the taxable basis of the controlling taxpayer (Model A); or
- include non-distributed income arising from non-genuine arrangements which have been put in place for the essential purpose of obtaining a tax advantage (Model B).

Belgium initially opted for Model B, which implied that CFC income could only be taxed in Belgium if it is attributable to the "significant people" functions carried out by the Belgian controlling taxpayer (assessment based on the

arm's length principle). By shifting to Model A, the Belgian legislature disconnects the CFC assessment from the arm's length principle and chooses a stricter entity-based approach. The BTA can of course still make TP adjustments regarding non-arm's length transactions entered into by a Belgian taxpayer with a CFC based on the standard TP provisions.

Federal government agrees on new obligation to submit information on foreign group entities

In January 2024, the federal government reached an agreement to impose additional information obligations for Belgian companies part of an international group. They would become subject to the obligation to submit to the BTA information originating from foreign group entities with which they entered into transactions. In this way, the BTA could obtain (among others):

- financial statements;
- organisational charts;
- tax returns;
- board reports;
- tax assessments; and
- obtained rulings.

For the BTA, this would be an alternative to requesting an exchange of information with foreign tax authorities.

At the time of this article's publication, the draft bill has not yet been definitively submitted in anticipation of an opinion from the Council of State. It remains to be assessed whether such new information obligations would meet the proportionality test.

Pillar II

On 14 December 2023, the Belgian legislature transposed Directive (EU) 2022/2523 on ensuring a global minimum level of taxation for multinational enterprise (MNE) groups and large-scale domestic groups in the Union (known as Pillar II). The law includes a co-ordinated system of rules designed to ensure that large (domestic/MNE) groups with a consolidated revenue exceeding EUR750 million for at least two of the four previous years are subject to a minimum effective tax rate of 15%. The Belgian implementation of Pillar II is applicable to financial years starting on or after 31 December 2023.

Multiple TP aspects

The law includes multiple TP aspects and provides for an adjustment of GloBE income for cross-border transactions between related entities not priced at arm's length. An adjustment is also foreseen under certain conditions with respect to transactions between entities within the same jurisdiction.

Recent Case Law

Credit rating analysis to price intra-group debt

In a recent ruling, the court of first instance of Brussels reviewed and assessed the credit rating of a Belgian company for determining the arm's length interest rate under an intercompany loan provided by a Swiss related lender. The case sheds light on how the BTA and courts approach the credit rating determination process, making use of credit rating agencies' established methodologies and considering the impact of implicit group support.

The BTA claimed that the Belgian borrower should be considered a "core entity" under the S&P Group Rating Methodology, as a result of which it should have the same credit rating as the group to which it belongs. The BTA concludes that the credit rating of the Belgian borrower was understated, resulting in excessive interest payments to the Swiss lender.

In this judgment, the court confirms that the BTA bears the burden of proof regarding demonstrating the validity of a TP adjustment. Earlier leading case law confirmed that the burden of proof is twofold – ie, the BTA should demonstrate that:

- the method applied by the taxpayer does not lead to an arm's length outcome (either because the method is inappropriate or was incorrectly applied); and
- another method providing another price is appropriate.

In the case at hand, the court concluded that the BTA successfully demonstrated that the taxpayer incorrectly assessed the borrower's creditworthiness, but that the BTA failed to establish an arm's length interest rate itself (ie, the second step in the burden of proof was not met).

The court, however, did not end its assessment there but instead conducted its own analysis to arrive at a different credit rating. Indeed, as based on the court's analysis, not all criteria of the S&P Group Rating Methodology were met (referring, inter alia, to the Belgian borrower's relative profitability and the group annual reports). The court concluded that the Belgian borrower should be classified as a "highly strategic subsidiary", of which the standalone credit rating should be one notch below the credit rating of the Group. The court then allowed the BTA to determine a new interest rate based on the outcome of the court's credit rating analysis, and to issue a new tax assessment on that basis. The court hereby brings some nuance to the (high) twofold burden of proof to the BTA, by giving the BTA a second chance to come up with the correct price based on the credit rating as determined by the court.

Share capital contribution

In a ruling of the court of appeal of Brussels, it was confirmed that the taxable base of a Belgian company can be adjusted in respect of a non-arm's length benefit granted in the context of a share capital contribution to which the company was not legally a party. The case concerned a capital increase by a Luxembourg grandparent through the contribution of a receivable to its Belgian indirect subsidiary. The court decided that the Belgian parent company granted a non-arm's length benefit to its Luxembourg parent, as it agreed to a capital increase at a price per share well below the market value thereof. It stated that as a result, the Belgian parent's wealth decreased through the dilution of its participation in its Belgian subsidiary and the Luxembourg grandparent's wealth increased as it acquired a participation at a value exceeding that of the contributed receivable. Based on the foregoing, the court concluded that the transfer of value from the Belgian parent to the Luxembourg grandparent constitutes a non-arm's length benefit to be added to the Belgian parent's taxable basis.

Impact of "cash tax for audit adjustments"

A TP adjustment in Belgium can result in an unexpected effective tax cost or "cash tax", regardless of the taxpayer's tax situation in the year in which the adjustment occurs (eg, loss). Indeed, as from financial year 2018, upward (TP) adjustments accompanied by a tax increase of at least 10% constitute a minimum taxable base against which the taxpayer cannot offset losses or other tax attributes. This 10% tax increase applies automatically in the case of a violation of a provision of the Belgian Income Tax Code. Nevertheless, the BTA may waive a tax increase in the absence of bad faith. The BTA has discretionary authority in this matter. Therefore, the taxpayer has an interest in actively co-operating

with the BTA and demonstrating good faith in the context of a TP audit.

Recent case law confirmed that a tax increase of 10% in certain cases may have a penal character. In such cases, the court has the power to reduce the tax increase if it would be disproportionate. In assessing disproportionality, case law also considers the impact of the deduction limitation as a result of the "cash tax for audit adjustments" principle.

DEMPE approach

A recent ruling concerned a Belgian company that paid a 12.5% royalty on turnover for the licensing of a brand to a related Luxembourg company. According to the BTA, the Luxembourg licensor did not perform any DEMPE functions relating to the brand and should therefore only be entitled to a cost-plus return. The court rejected this approach and considered the tax assessment as arbitrary. The court notably considered that a tax assessment cannot be solely based on OECD guidelines as these are not mandatory law. In addition, the tax assessments related to financial years 2015 and 2016 – ie, the years prior to the publication of the 2017 OECD Guidelines incorporating the DEMPE concept (prohibition of retroactive application of new versions of the OECD Guidelines).

Finally, inspired by the EU Amazon case, the court rejected the position that the Luxembourg licensor was merely acting as a passive intellectual property (IP) owner, as, according to the court, by licensing its IP the licensor indeed actively exploits the IP and should receive a market-based consideration in return.

Noteworthy Rulings

Ruling on hard-to-value intangibles

The Ruling Commission rendered a ruling about the licensing of IP which is still in a developmental phase and qualifying as a hard-to-value intangible (HTVI) according to the OECD Guidelines and the TP Circular.

The ruling applicant performed a provisional IP valuation by using the discounted cash flows approach based on forecasted cash flows derived from the use of the IP by the licensee. A price adjustment mechanism was factored in, providing for a new valuation based on actuals and updated forecasts following the first year of commercialisation of the IP. If the newly calculated value deviates by more than 20% from the originally agreed price, a retroactive price adjustment will take place.

The Ruling Commission confirmed this approach and agreed that the IP would no longer qualify as an HTVI following the first year of exploitation.

Ruling on the impact of VAT refunds on limited risk distributors of subsidised pharmaceutical products

The Ruling Commission issued a negative ruling regarding the treatment of certain VAT refunds in the TNMM calculation method for a limited risk distributor (LRD) of subsidised medicines. This ruling reflects the position of the BTA on this specific topic, which has been the subject of controversy during recent years. The case concerned two companies subject to compensatory contributions on turnover regarding subsidised medicines, paid to the Belgian National Institute for Health and Disability Insurance (NIHDI). Both reached an agreement with the Belgian VAT administration accepting that these contributions result in a reduction of the taxable amount for VAT, entitling them to a refund of

the VAT included in the contributions effectively paid to the NIHDI. The companies wished to obtain confirmation that these VAT refunds can be included in the calculation of the operating margin remuneration under the TNMM that both companies should realise for their routine distribution activities.

The Ruling Commission delivered a negative decision and stated that the refund of Belgian VAT on RIZIV contributions should not be included in the calculation of the remuneration for routine distribution activities. Based on this position, the income from the VAT refunds is economically allocated to the LRD. This is in contrast to the costs (eg, contributions to the NIHDI and non-deductible VAT costs) which are economically borne by the foreign principal.

The Ruling Commission argued that in practice the Belgian LRD will pay the Belgian VAT directly via its own VAT return and will be the only party entitled to a VAT refund. The Ruling Commission further stated that the Belgian VAT can only be refunded to the party that originally remitted it to the Belgian State, and that a foreign principal does not dispose of a VAT taxable amount that can be revised.

Rulings on zero-profit allocation to Belgian permanent establishments

Various rulings have been rendered in cases where a foreign company availed of a Belgian permanent establishment owing to the activities performed by a third party or associated Belgian company in Belgium. The activities performed include, among others, certain services related to inventory management or sales support activities performed on behalf of the foreign entity.

In said rulings, the Ruling Commission confirmed that if the Belgian company receives an arm's length remuneration for the activities performed (which is always the case if it is a third party), no taxable profit should be allocated to the Belgian permanent establishment of the foreign entity. Indeed, in such case, the functions allocable to the permanent establishment are already remunerated at the level of the Belgian company.

Audit Practice

TP cell within the BTA

The BTA has a dedicated TP unit, which initiated a new wave of TP audits in 2024. In recent years, there has been a noticeable increase in both the number of conducted TP audits and the number of specialised TP auditors within the BTA's TP unit. In addition, specially trained officials within the Large Enterprises division and the Special Tax Inspection conduct TP audits. This creates a climate of thorough investigation and enforcement that is also observed in other countries.

Unlike previous circulars, the TP Circular does not provide specific indications regarding the cases in which TP audits are most likely. Companies are typically selected through an internal data mining process based on a risk assessment analysis, the indicators of which remain confidential.

Information request and pre-audit meeting

A TP audit typically begins with a standard broad questionnaire, consisting of around 30 questions and regarding (inter alia) the Belgian company's:

- organisational structure;
- supply chain;
- segmented P&Ls per business units;
- functional and risk profile;
- financial transactions; and
- transactions involving intangibles.

A recently observed trend is that the BTA's TP unit sometimes opts for a more customised questionnaire based on available information, or immediately sends a request for a so-called pre-audit meeting. Such a meeting allows the BTA to gain initial insights into how the Belgian company operates within the group and its applied TP policy. Even upon receipt of a questionnaire, the taxpayer can usually request a pre-audit meeting before responding in writing, which allows for discussing the questions orally and delineating the parameters of the audit.

Focus on certain topics during audit

Certain topics are frequently and thoroughly investigated during audits. For instance, the BTA tends to carefully review (inter alia):

- the reconciliation of the TP policy with the annual accounts;
- the alignment of the applied TP model with the functional profile;
- the origin of losses;
- the allocation of synergies related to procurement activities;
- the DEMPE functions in relation to IP; and
- the arm's length nature of intra-group service fees, including the cost base in a cost-plus remuneration, etc.

Moreover, the BTA particularly focuses on financial transactions, such as:

- the applied interest rate for remunerating intercompany debt;
- the arm's length character of a company's intra-group debt level; and
- the arm's length character of cash pool arrangements.

BRAZIL

Law and Practice

Contributed by:
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William Freire Advogados has a tax department that is renowned for its expertise in the mining, steelmaking, agribusiness, and energy sectors, offering comprehensive tax services and agile responses to client demands. Led by Paulo Honório, alongside Rodrigo Pires and Bruno Feitosa, the tax consultancy department provides a wide range of services, including tax planning, asset restructuring, investment structuring, tax review, and legal opinions. Paulo Honório, a recognised expert in the field, prepares legal opinions for significant cases in the mineral, infrastructure, energy, and agribusiness sectors. In tax litigation, the firm has a strong presence before CARF (Federal Administrative Court) and ANM (in cases involving mining royalties), handling disputes with expertise and diligence. Its key work areas include international tax planning for foreign investors, advisory on tax effects arising from M&A operations in Brazil and handling relevant tax disputes before administrative and judicial courts.

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1. Rules Governing Transfer Pricing

1.1 Statutes and Regulations

In Brazil, transfer pricing rules are regulated by Federal Law No 14,596/2023, whose application is mandatory from the year 2024, and in Normative Instruction No 2,161/2023, published by the Federal Revenue Service, to better regulate the application of transfer pricing rules.

Brazilian legislation also provides for the possibility of formalising a consultation with the Federal Revenue Service, with the aim of clarifying doubts regarding the application of the rules. Such consultations, when publicly answered by the Federal Revenue Service, are inserted into the national legal system, notably as an instrument for interpreting tax rules and making mandatory that any tax authorities obey the parameters established in the response to the consultation.

1.2 Current Regime and Recent Changes

The first regulation of transfer prices in Brazil occurred in 1996, through the enactment of Law No 9,430/1996. The model then adopted provided for the application of transfer pricing methods, whenever transactions with goods, services and rights were verified, as well as the payment or receipt of interest from related parties.

Although there was a provision for the levy of transfer pricing rules on transactions involving “rights” (intangibles), none of the methods provided for in the governing legislation were sufficient to test transactions of this nature, which made compliance with this obligation impossible, which is why it was not possible to apply transfer pricing rules to this asset class. The concept of related parties was, primarily, based on the corporate link, direct or indirect, and the concept of significant influence was not adopted.

The methods provided for by the original wording of Law No 9,430/1996 allow them to be divided into two groups: (i) those whose essence is price comparison; and (ii) those that are limited to data collection and application of fixed margins. In the first, we have independent prices compared in imports, and sales prices in exports. In the second, we have the resale price minus profit, acquisition, or production cost plus profit, etc, in which there are margins set for profit, cost and transaction value. Those methods were criticised by the OECD, as will be pointed out below, especially when adopting fixed presumption margins.

In 2012, in a first attempt to bring the Brazilian model closer to OECD standards, Law No 12,715 was enacted, which created two new methods, PCI, for imports, and PECEX, for exports. Such methods were closer to the arm’s length principle, as they determined that the parameter prices would be obtained based on market quotations. It was an exclusive application model for commodities. Although it represented an improvement and modernisation of Brazilian standards, the model had flaws, notably with regard to the concept of commodities, the comparability criteria and the regulation of adjustments to be made in comparable operations.

The obligation to adopt the two new methods (PCI for imports, and PECEX for exports of commodities) – to the detriment of the possibility of opting for the most favourable method, which existed until then – was justified in the explanatory memorandum of Provisional Measure No 563/2012, later converted into Law No 12,715, “in order to prevent manipulation of values in import operations or exports”.

Parallel to the enactment of Law No 12,715/2012, discussions on transfer pricing between the Bra-

zilian Federal Revenue Service (RFB) and the OECD intensified amid the OECD/G20 BEPS Project, with two dialogue events held in 2014 and 2015. In 2017, at the invitation of Brazilian authorities, the OECD, with support from the European Commission, held a technical event in Brazil, the aim of which was to provide a reciprocal understanding of transfer pricing systems. Still in 2017, the RFB highlighted a team of auditors to conduct technical studies with the aim of identifying similarities and differences between Brazilian practices and those adopted by the OECD.

The following year, a group of technical studies was officially launched to examine the similarities and divergences, including gaps, between Brazil and the OECD Transfer Pricing Guidelines. The group had members from the RFB and the OECD.

In conclusion, it was pointed out that, combined with other unique features of the system, such as the rigid fixed margin approach and the freedom to select the transfer pricing method, the transfer pricing system in Brazil led to negative results in the form of:

- Base Erosion and Profit Shifting (BEPS), often combined with double non-taxation – profits that by international standards would be allocated to Brazil end up transferred to entities established in low or no taxation jurisdictions. This prevents Brazil from collecting tax revenue in relation to profits from economic activities carried out in the country.
- Double taxation – there are documented cases where the same profits were allocated to a Brazilian entity due to rigidity of prescribed profit margins on inbound and outbound transactions and, at the same time, allocated to the related foreign party in a jurisdiction where the arm's length principle is used. This results in economic double taxation, in which both legal entities are taxed on the same amount of profit. This double taxation places a higher cost on trade and investment in Brazil when compared to other countries, which discourages the expansion of existing foreign investment, as well as new investments, and harms Brazil's integration into global value chains.
- Unequal conditions of competition – as it tends to favour some multinational companies by enabling reduced taxation, which benefit from situations for erosion of the tax base and transfer of profits (BEPS), and in other situations causing excess taxation due to double taxation caused due to the gaps and divergences between the Brazilian transfer pricing system and the international standards.

In view of the conclusions highlighted in the study, technical, legislative and taxpayer debates began, so that a new transfer pricing system could be implemented in Brazil.

As a result, on 14 June 2023, Law No 14,596 was published, revoking the transfer pricing standards then in force and establishing a new methodology in alignment with OECD Guidelines, adopting the arm's length principle as a parameter for adjusting prices charged in controlled transactions, replacing the fixed margin system.

Such is the alignment of the OECD with the new Brazilian model, that Normative Instruction No 2,161/2023, published by the Federal Revenue Service to regulate the matter, expressly determines that the guidelines embodied in the report "OECD Transfer Pricing Guidelines for Multinationals Enterprises and Tax Administra-

tion 2022", as well as its future amendments, are subsidiary sources for the interpretation and integration of transfer pricing control standards.

2. Definition of Control/Related Parties

2.1 Application of Transfer Pricing Rules

Controlled Transactions

Before the enactment of Law No 14,596/2023, transfer pricing rules applied only to transactions (i) carried out between related parties, and (ii) involving goods, services or rights as well as the payment and remittance of interest, excluding the payment of royalties that had a specific limitation.

Law No 14,596/2023 expanded the spectrum of application of transfer pricing rules, which are now mandatory for "any commercial or financial relationship between two or more related parties, established or carried out directly or indirectly, including contracts or arrangements in any form and series of transactions."

This concept includes, for example:

- transactions with tangible goods, including commodities;
- transactions involving intangibles;
- services of any kind;
- cost-sharing contracts;
- business restructuring, including the termination or renegotiation of commercial or financial relationships;
- financial operations, including debt operations, intra-group guarantees, centralised treasury management agreements and insurance contracts;
- transactions that have as their object the disposal or transfer of assets, including shares and other interests, even if they occur in capital return or subscription operations; and
- any sale, assignment, loan, rental, licensing, advance and contribution.

It is concluded that any economic interaction existing between related parties is subject to verification of adequacy through the transfer price. The concept of the standard is so comprehensive that even omissions found in the course of commercial relations can be subject to adequacy analysis for transfer pricing. In other words, if one of the related parties remains inactive, when a certain active conduct is expected from them, in compliance with common market practice, this omission may be subject to transfer pricing rules.

Related Parties

The rule taken from Law No 14,596/2023 and Normative Instruction No 2161/2023 also innovates in the concept of related parties. The previous regulations adopted a criterion in which the verification of corporate ties (direct or indirect) predominated for the purposes of classifying the parties as "related".

Under the primacy of economic substance, the influence of one party over the other, exercised directly or indirectly, is considered as related whenever the influence of one party over the other is verified, and which may cause the transaction carried out not to occur under market conditions. The influence must be verified based on the characteristics of the transaction and the commercial and economic ties between the parties. Whenever business and economic circumstances demonstrate the existence of significant influence of one party over the other, the application of transfer pricing rules becomes mandatory, even if there is no corporate link between the parties. In addition to related parties, transfer

pricing rules are also mandatory for transactions carried out with an individual or legal entity resident or domiciled in a country that does not tax income or that taxes it at a rate lower than 17%, or that is a beneficiary privileged tax regime.

3. Methods and Method Selection and Application

3.1 Transfer Pricing Methods

In view of the alignment with the OECD Transfer Pricing Guidelines for Multinational Companies and Tax Administrations, the methods adopted by Brazilian legislation are the same as those regulated by the OECD. The methods are described in this section. However, first the authors present the practices that must precede the choice and application of methods.

Delineation of the Controlled Operation

Once the controlled transaction has been identified, its real economic content must be extracted from it (delineation). This task requires knowledge and analysis of:

- the economic sector in which the taxpayer operates and the elements that affect the performance of a company's commercial operation in that economic sector;
- the taxpayer's organisational structure;
- the functions, assets and relevant risks assumed by the entities that are part of the group in which the taxpayer is included; and
- the production chain and its added value.

The delineation of the economic content of the transaction must be done based on the analysis of the factual and circumstantial elements of the transaction, and it is recommended to check the economically relevant characteristics listed below, always seeking the options realistically available for the transaction.

- Contractual terms of the transaction – the attribution of rights and obligations between the parties, written or unwritten, the analysis of facts and circumstances and evidence of the effective conduct of the parties, which will supplement or, in the event of a divergence, take precedence over written documents (primacy of economic substance over legal form).
- Of the functions performed by the parties to the transaction (functional analysis), considering the assets used, which can be known from the analysis.
- Of the economically significant risks assumed (risk assessment), a task that requires the following analyses:
  - (a) the specific identification of economically significant risks for the transaction;
  - (b) the identification of how economically significant risks are contractually assumed by the parties to the controlled transaction;
  - (c) the identification of how related parties operate in relation to the assumption and management of economically significant risks; and
  - (d) the specific characteristics of the goods, rights or services that are the subject of the controlled transaction and in the comparability analysis are those that may lead to differences in their value.
- The economic circumstances of the parties and the market in which they operate:
  - (a) the geographic location and the existence of regional markets;
  - (b) the size of markets and other characteristics, including those that give rise to locational advantages or disadvantages (location savings) and potential cost savings;

- (c) competitiveness in markets and the relative position of buyers and sellers;
- (d) the availability of substitute goods and services;
- (e) the levels of supply and demand in the market as a whole and in particular regions;
- (f) the purchasing power of consumers;
- (g) the nature and extent of government regulation of the market, including government policies;
- (h) production costs, including land, labour and capital costs;
- (i) transport costs;
- (j) the market level (retail or wholesale); and
- (k) the existence of an economic, business or production cycle.

• The business strategies pursued by the parties to achieve their commercial objectives that may be considered relevant may include, as appropriate and by way of example:
- (a) innovation and development of new products;
- (b) degree of diversification and risk aversion;
- (c) adaptation to political and economic changes; and
- (d) duration of contracts and other factors that influence the daily condition of the business.

In the process of outlining the economic content of transactions, which must be based on the criteria described above, the options realistically available to each party to the controlled transaction must be considered.

This task aims to assess whether in a market transaction there would be more advantageous conditions for one of the contracting parties, which would show that the arm's length principle was despised.

When analysis of the transaction leads to the conclusion that unrelated parties, acting in comparable circumstances and behaving in a commercially rational manner, considering the options realistically available to each party, would not have realised controlled transaction as outlined, the transaction may be disregarded or replaced with an alternative transaction for the purpose of determining the terms and conditions that would be established by unrelated parties in comparable circumstances and acting in a commercially rational manner.

It should be noted that the new legislation is guided by the primacy of the economic substance over the legal form, in such a way that for the purposes of applying the transfer pricing rules, the real economic content intended must be found, even if contrary to the legal form adopted by the parties to regulate the transaction.

Once the content and economic objective of the transaction are known, it is verified whether the interactions between the parties adapt to the conduct usually observed in market transactions. If there are deviations in the interaction between the related parties, there is a need to make adjustments, as will be the case explained in the following paragraphs.

Comparability Analysis Procedures

The comparability analysis must be carried out for the purpose of comparing the terms and conditions of the controlled transaction, with the conditions that would be established in market operations, considering for this purpose:

- (1) the economic delineation of the operation;
- (2) determining the period to be covered in the analysis;
- (3) verification of the existence of comparable operations (carried out with unrelated parties);

- (4) the selection of the most appropriate method and, depending on the method, the choice of the profitability indicator and the tested party;
- (5) the identification of potential comparables, including the determination of the essential characteristics that must be present in any transaction between unrelated parties so that it can be considered potentially comparable, taking into account the design of the controlled transaction and the comparability factors;
- (6) identifying and making reasonably accurate comparability adjustments when appropriate; and
- (7) the interpretation and use of the data collected with the determination of appropriate remuneration in accordance with the arm's length principle.

Application of Methods

Once the economic content has been outlined and the comparable operation has been identified, proof of suitability of the tested transaction must occur by using the most appropriate method among those provided for in the governing legislation.

There is another relevant innovation: the previous rule allowed taxpayers to adopt the method of their preference. The new legislation determines the choice of the most appropriate method among the following.

- Comparable Independent Price (PIC) – which consists of comparing the price or consideration value of the controlled transaction with the prices or consideration values of comparable transactions carried out between unrelated parties.
- Resale Price minus Profit (PRL) – which consists of comparing the gross margin that an acquirer of a controlled transaction obtains in the subsequent resale carried out to unrelated parties with the gross margins obtained in comparable transactions carried out between unrelated parties.
- Cost Plus Profit (MCL) – which consists of comparing the gross profit margin obtained over the supplier's costs in a controlled transaction with the gross profit margins obtained over the costs in comparable transactions carried out between unrelated parties.
- Transaction Net Margin (MLT) – which consists of comparing the net margin of the controlled transaction with the net margins of comparable transactions carried out between unrelated parties, both calculated based on an appropriate profitability indicator.
- Profit Sharing (MDL) – which consists of the division of profits or losses, or part thereof, in a controlled transaction in accordance with what would be established between unrelated parties in a comparable transaction, considering the relevant contributions provided in the form of functions performed, assets used and risks assumed by the parties involved in the transaction.

The most appropriate method is that which provides the most reliable determination of the terms and conditions that would be established between unrelated parties in a comparable transaction, including the following aspects.

The PIC method will be considered the most appropriate when there is reliable information on prices or consideration amounts arising from comparable transactions carried out between unrelated parties, unless it can be established that another method is more appropriately applicable. The legislation under discussion determines that this is the preferred method adopted for transactions with commodities.

Tested Party

Another innovation to be highlighted is the concept of "tested party".

Unlike the provisions then in force in Law No 9,430/1996, which determined that the transfer pricing test be carried out from the perspective of the Brazilian taxpayer, Law No 14,596/2023 brings the possibility that the tested party is the entity abroad, when the method can be applied more appropriately and for which more reliable data from comparable transactions carried out between unrelated parties is available.

It should be noted the alignment of this new rule with the OECD Guidelines, which define tested party as "that to which a transfer pricing method can be applied in the most reliable way and for which the most reliable comparable can be found, that is, most of the time it will be the one that has the least complex functional analysis."

The functions performed, the assets used and the risks assumed by the parties to the controlled transaction may influence the definition of the tested party.

The following methods require the selection of one of the parties to the controlled transaction, whose respective financial indicator will be examined:

- PRL;
- MCL;
- MLT; and
- the first stage of the CDM residual analysis (CDM is the method in which profits and losses are divided on the basis of the contributions made by the relevant parties).

The CUP method (known as PIC in Brazil) involves a two-sided analysis where the price is negotiated between two parties participating in the transaction. By using this method, the need to determine which of the related parties should be the tested party for transfer pricing purposes is eliminated. This issue may arise when employing the other two traditional transaction methods. These methods establish a transfer price based on the viewpoint of the tested party in the analysis. For instance, in the resale price method, the tested party in the transfer pricing analysis is the related party sales company. Conversely, in the cost plus method, the tested party is the related party manufacturer.

3.2 Unspecified Methods

The Brazilian standards authorise the use of another method, other than those described in the governing law, as long as the alternative methodology produces a result consistent with that which would be achieved in comparable transactions carried out between unrelated parties.

The use of other methods comprises generally accepted economic asset valuation techniques or models, in particular income-based valuation methods, such as the discounted cash flow methodology which, in general, is more appropriate in the case of transactions that have as their intangible objects that are difficult to value or corporate interests for which it is not possible to identify reliable comparables at the time of their transfer between related parties.

For this hypothesis, the taxpayer must maintain documents and records that demonstrate the calculation methodology applied in the adopted method, the established parameters and criteria, as well as proof that it is the most appropriate method.

3.3 Hierarchy of Methods

The PIC method (CUP in OECD Guidelines) is presumably the most appropriate whenever there is reliable information on prices or consideration amounts arising from comparable transactions carried out between unrelated parties.

As this is a presumption, the taxpayer can use another method, even if there is reliable information about prices and values of the transaction (which would give rise to the application of the PIC), as long as he proves that in view of the facts and circumstances of the transaction The chosen method must be the most appropriate for the operation being evaluated.

When there is reliable information on comparable independent prices for a traded commodity, including quotation prices or prices practised with unrelated parties (internal comparables), the PIC method will be considered the most appropriate to determine the value of the commodity transferred in the controlled transaction, unless it can be established, according to the facts and circumstances of the transaction and the functions, assets and risks of each entity in the value chain, that another method is applicable more appropriately, with a view to observing the arm's length principle.

The limitations of the PIC method are as follows.

- Finding closely comparable uncontrolled transactions can be challenging due to the strict comparability standard required, especially regarding product comparability.
- External comparable uncontrolled transactions are typically hard to come by in practical applications.

Aside from that, one should always seek which method is most appropriate for implementing the arm's length principle.

3.4 Ranges and Statistical Measures

The new transfer pricing rules in Brazil introduce the concept of "Comparable Range".

The Comparables Range should be used when the application of the most appropriate method leads to a range of observations of financial indicators of comparable transactions carried out between unrelated parties, the appropriate range will be used to determine whether the terms and conditions of the controlled transaction are in accordance with the arm's length principle.

When regulating the matter, the Normative Instruction establishes that the determination of the Interval of Comparables will be carried out by adopting the following procedures:

- the range must be composed of observations obtained from comparable operations;
- selected observations that have a lower degree of comparability in relation to the controlled transaction or that are not sufficiently reliable must be eliminated;
- after the elimination of these transactions, if uncertainties remain regarding the degree of comparability of the comparable transactions with respect to the controlled transaction that have not been precisely identified or quantified and adjusted or if any uncertainty regarding reliability remains, the interquartile range will be considered as the range appropriate; and
- if there are no uncertainties about the degree of comparability of the comparable transactions in relation to the controlled transaction, nor about their reliability, the complete range will be considered the appropriate range.

In summary, there are two hypotheses for using the Comparables Interval:

- in cases where the controlled transaction indicator is within the comparable range, the principle of arm's length is applied; and
- in cases where the controlled transaction indicator is not included in the comparable range, the controlled transaction will be assigned the value of the average of the values identified in the appropriate range.

3.5 Comparability Adjustments

Law No 14,596/2023 determines the performance of comparability adjustments, as long as they are reasonably precise, to eliminate the material effects of differences in relation to the controlled transaction or the tested party, observing that:

- comparability adjustments to eliminate materially relevant differences should be made if, and only if, they are expected to increase the reliability of the results;
- comparability adjustments must be made after applying consistent criteria to transactions between unrelated parties that reveal the highest degree of comparability;
- the same difference must not be adjusted more than once using the same comparability adjustment, or different adjustments, so that the effect of the adjustment that eliminates the same difference multiple times is not computed;
- the need to make numerous or substantial comparability adjustments may indicate that transactions between unrelated parties are not sufficiently comparable; and
- each adjustment must be duly justified and documented, including the provision of information that demonstrates the need for each of the adjustments with reference to the differences, with demonstrations of the basis for making the adjustments, the procedures adopted and the calculations carried out, with details of all steps followed, variables used and results obtained in comparables.

Examples of comparability adjustments are:

- adjustments to accounting standards and consistency, including exchange rate adjustments;
- adjustments for differences in functions, risk assumption, assets and capital, including working capital; and
- adjustments to contractual terms, including, for example, sales conditions (volume, payment term and International Commercial Terms – Incoterm), conditions for amortisation or early settlement of debt and contractual options.

4. Intangibles

4.1 Notable Rules

Although Law No 14,596 dedicates a specific section to deal with transfer pricing on intangibles, the matter still pending detailed regulation by the Federal Revenue Service.

Therefore, controlled operations with this asset class are subject to the general rules for transfer pricing.

4.2 Hard-to-Value Intangibles

Law No 14,596 dedicates a specific section to deal with transfer pricing on intangibles, however the matter still pending detailed regulation by the Federal Revenue Service.

Under the terms of the Law, in controlled transactions involving intangibles that are difficult to

value, the following must be considered for the purpose of valuing the transaction:

- uncertainties in pricing or valuation existing at the time of the transaction; and
- the reflections of these uncertainties in the formatting of the contract between the parties, especially with regard to the adoption of short-term contracts, the inclusion of price adjustment clauses or the establishment of contingent payments, as well as unrelated parties would have done in comparable circumstances.

Information available in periods after the controlled transaction was carried out can be used by tax authorities to verify the correct use of the criteria listed above.

Once these criteria are not met, the governing legislation determines that the value of the transaction be adjusted for Income Tax and Social Contribution purposes, and the adjustment must be measured based on annual contingent payments that reflect the uncertainties arising from pricing or evaluation of the intangible assets involved in the controlled transaction.

By regulating the possibility of using another method, other than those listed in the legislation, the standard points out that the use of alternative methods, especially those based on income, such as the discounted cash flow methodology will, in general, be more appropriate in the event of transactions involving intangibles that are difficult to value or corporate interests for which it is not possible to identify reliable comparables at the time of their transfer between related parties.

However, this is a mere recommendation, and it is not mandatory that taxpayers follow this criterion for the purposes of testing transactions involving intangibles that are difficult to value.

4.3 Cost Sharing/Cost Contribution Arrangements

Law No 14,596/2023 defines cost sharing as contracts in which two or more related parties agree to share the contributions and risks related to the acquisition, production or joint development of services, intangibles or of tangible assets, based on the proportion of benefits that each party expects to obtain from the contract.

Those who, in relation to it, exercise control over economically significant risks and have the financial capacity to assume them and who have the reasonable expectation of obtaining the benefits, are qualified as participants in the expense sharing contract:

- services developed or obtained; or
- of intangibles or tangible assets, through the attribution of participation or rights over such assets and that are capable of exploiting them in their activities.

Although transfer pricing legislation expressly determines the levy of its rules on expense sharing contracts between companies in the same group, the Normative Instruction published by the Federal Revenue Service does not dedicate any specific regulations, nor does it determine the use of specific methods for the calculation of the transfer price on such transactional modality.

5. Affirmative Adjustments

5.1 Rules on Affirmative Transfer Pricing Adjustments

Adjustments can be made by the parties to the controlled transaction until the end of the cal-

endar year with a view to adjusting the value of the transaction, adapting it to the arm's length principle.

Adjustments of this nature must be reflected in the accounting records of the Brazilian taxpayer, as well as the other parties to the controlled transaction.

Furthermore, the compensatory adjustment must be supported by the issuance of an appropriate tax document.

This adjustment can be made after the end of the year but must occur before the date of sending the Tax Accounting Bookkeeping (Brazilian Tax Return).

6. Cross-Border Information Sharing

6.1 Sharing Taxpayer Information

In recent decades, Brazil has signed a series of treaties and joined mutual co-operation programmes for sharing tax information. Among the most relevant expedients, the authors list the following:

- Brazil has been a member of the OECD Global Forum on Transparency and Information Exchange for Tax Purposes since 2010.
- Double taxation agreements, as a rule, include devices that allow the exchange of information between contracting states. Currently, Brazil has agreements in force with the following jurisdictions:
  - South Africa;
  - Germany;
  - Argentina;
  - Austria;
  - Belgium;
  - Canada;
  - Chile;
  - China;
  - South Korea;
  - Denmark;
  - United Arab Emirates;
  - Ecuador;
  - Slovakia;
  - Spain;
  - Philippines;
  - Finland;
  - France;
  - Hungary;
  - India;
  - Israel;
  - Italy;
  - Japan;
  - Luxembourg;
  - Mexico;
  - Norway;
  - Netherlands;
  - Peru;
  - Portugal;
  - Czech Republic;
  - Russia;
  - Singapore;
  - Sweden;
  - Switzerland;
  - Trinidad and Tobago;
  - Türkiye;
  - Uruguay;
  - Ukraine; and
  - Venezuela.
- Tax Information Exchange Agreement – TIEA, developed by the OECD Global Forum in 2002 and deals with the exchange of tax information.
- Convention on Mutual Administrative Assistance in Tax Matters, signed by the Member States of the Council of Europe and the member countries of the OECD, promulgated through Decree No 8,842/2016.

- FACTA – Foreign Account Tax Compliance Act, Agreement signed between Brazil and the USA, promulgated through Decree No 8,506/2015, which provides for the regulation of tax accounts and investments that are outside the United States, but that belong to North American citizens (US persons).
- Argentina – Agreement on the Exchange of Information for Tax Purposes Relating to Previous Periods.
- United Kingdom – Agreement for the Exchange of Information Relating to Taxes.
- Switzerland – Agreement for the Exchange of Information Relating to Taxes.

Finally, customs co-operation agreements must also be mentioned – mutual recognition agreements and technical co-operation agreements, through which there is mutual dialogue and collaboration between Brazilian tax authorities and other jurisdictions.

7. Advance Pricing Agreements (APAs)

7.1 Programmes Allowing for Rulings Regarding Transfer Pricing

Law No 14,596/2023 implemented the procedures for Simplification Measures and Other Measures and the Specific Consultation Process in Matters of Transfer Pricing. In summary, these mechanisms may resemble APA. Although they are pending regulation by the Federal Revenue Service, the governing law establishes the following definitions.

Simplification Measures and Other Measures

The Special Secretariat of the Federal Revenue Service of Brazil may establish specific rules to regulate the application of the arm's length principle to certain situations, especially for:

- simplify the application of the comparability analysis steps, including to waive or simplify the presentation of documentation;
- provide additional guidance in relation to specific transactions, including intangible transactions, cost-sharing agreements, business restructuring, centralised treasury management arrangements and other financial transactions; and
- provide for the treatment of situations in which the information available regarding the controlled transaction, the related party or comparables is limited, in order to ensure the adequate application of the provisions of this law.

Specific Consultation Process Regarding Transfer Pricing

The Federal Revenue Service of Brazil may establish a specific consultation process regarding the methodology to be used by the taxpayer to comply with the arm's length principle in relation to future controlled transactions and establish the requirements necessary for the request and fulfilment of the query.

Aspects such as:

- selection and application of the most appropriate method and financial indicator examined;
- selection of comparable transactions and appropriate comparability adjustments;
- determination of comparability factors considered significant for the circumstances of the case; and
- determination of critical assumptions regarding future transactions.

Submission of a consultation request will be subject to a fee in the amounts of:

- BRL80,000; and
- BRL20,000, in the case of a request to extend the period of validity of the response to the consultation.

It should be emphasised that the procedure for presenting a consultation, as well as for the materialisation of Simplified Measures and Other Measures, has not yet been regulated by the Federal Revenue Service.

7.2 Administration of Programmes

The administration of the APA will be the responsibility of the Special Secretary of the Federal Revenue Service, linked to the Ministry of Finance.

7.3 Co-ordination Between the APA Process and Mutual Agreement Procedures

This matter has not yet been regulated.

7.4 Limits on Taxpayers/Transactions Eligible for an APA

This has not yet been regulated in Brazil.

7.5 APA Application Deadlines

APA application deadlines is a topic that has not yet been regulated in this jurisdiction.

7.6 APA User Fees

This topic has not yet been regulated in this jurisdiction.

7.7 Duration of APA Cover

APA cover has not yet been regulated in Brazil.

7.8 Retroactive Effect for APAs

The matter of retroactive effect for APAs has not yet been regulated in this jurisdiction.

8. Penalties and Documentation

8.1 Transfer Pricing Penalties and Defences

The Brazilian taxpayer must present the documentation and provide information necessary to demonstrate its transactions subject to transfer pricing control, including that necessary for the design of the transaction and the comparability analysis.

In this context, the following documents must be presented.

- Country-by-Country Declaration – containing information relating to the global allocation of revenues and assets and income tax paid by the multinational group to which it belongs, together with indicators related to the global economic activity of the multinational group, in line with the Action 13 of BEPS.
- Global File – containing information relating to the structure and activities of the multinational group to which it belongs and the other entities that are part of the multinational group, in line with Actions 8 and 9 of the BEPS.
- Local File – containing information relating to controlled transactions and the parties involved in controlled transactions, in line with BEPS Actions 8 and 9.

The Global File and the Local File must be presented in electronic format and deposited in the Federal Revenue Service's own environment (RFB's Virtual Service Center – e-CAC), within three months after the deadline set for transmission of the ECF of the corresponding calendar year.

Exceptionally for the 2024 financial year, these declarations may be sent up to the last business

day, respectively, of the 2025 and 2024 calendar years.

The Country-to-Country Declaration must be presented by filling out a specific section of the ECF (Brazilian Tax Return).

The taxpayer is exempt from sending the Local File in cases where the value of the controlled transactions is less than BRL15 million.

For transactions between BRL15 million and BRL500 million a simplified shipping method is defined.

For controlled transactions exceeding BRL500 million, the Local File must be sent in its entirety, as regulated by Normative Instruction No 2,161/2023.

Sending the Global File is also waived in cases where the total controlled operations are less than BRL15 million.

In the event that the taxpayer fails to provide the information necessary for the precise delineation of the controlled transaction or for carrying out the comparability analysis, the tax authority will be required to adopt the following measures:

- allocate, to the Brazilian entity, the functions, risks and assets attributed to another party of the controlled transaction that do not have reliable evidence of having been effectively performed, assumed or used by it; and
- adopt reasonable estimates and assumptions to carry out the transaction design and comparability analysis.

In addition, the following specific penalties apply.

- Regarding the Global Archive and the Local Archive:
  - (a) fine equivalent to 0.2%, per calendar month or fraction thereof, on the value of the taxpayer's gross income for the period to which the obligation refers, in the event of failure to submit it in a timely manner; or
  - (b) fine equivalent to 3% of the value of the taxpayer's gross income for the period to which the obligation refers, in the event of presentation without meeting the requirements for its presentation.
- As for the Global File, a fine of 0.2% on the value of the consolidated revenue of the multinational group for the year prior to which the information refers, in the event of presentation with inaccurate, incomplete or omitted information.
- Regarding the lack of timely presentation of information or documentation required by the tax authority during a tax procedure or other prior inspection measure, or for other conduct that entails embarrassment to the inspection during the tax procedure, a fine equivalent to 5% of the value of the corresponding transaction, as priced by the tax authority.

The fines applied will not be less than BRL20,000 and may not exceed the amount of BRL5 million.

Taxpayers will always be guaranteed the right to contradictory and full defence, being able to present the reasons why they do not agree with the tax authority's understanding.

8.2 Taxpayer Obligations Under the OECD Transfer Pricing Guidelines

The declarations required by Brazilian legislation are in line with those provided for in the OECD Transfer Pricing Guidelines.

Therefore, the Brazilian taxpayer must deliver the following documents to the Brazilian authorities.

- Country-by-Country Declaration, containing information relating to the global allocation of revenues and assets and income tax paid by the multinational group to which it belongs, together with indicators related to the global economic activity of the multinational group.
- Global Archive, containing information relating to the structure and activities of the multinational group to which it belongs and the other entities forming part of the multinational group.
- Local File, containing information relating to controlled transactions and the parties involved in controlled transactions.

9. Alignment With OECD Transfer Pricing Guidelines

9.1 Alignment and Differences

Brazilian legislation for transfer pricing was significantly modified in 2023 through the enactment of Law No 14,596, the application of which is mandatory for the year 2024.

The changes brought about by the legislation under discussion aimed to fully align Brazilian practices with the OECD Guidelines.

The need for such alignment was described in the document "The New Price System for Transfer: Improvement of the Brazilian Tax System and Promotion of Trade and Investment", signed jointly by the Federal Revenue Service and the OECD:

"Recognizing that the current Brazilian system weakens the country's tax and development interests, it was concluded that alignment with the international standard would be the best option for Brazil. Full alignment was considered necessary, as, otherwise, significant gaps would remain in the system, with negative effects on legal certainty in tax matters, the cost of compliance, as well as the risks of persistent double taxation and loss of revenue taxes. Full alignment is defined as the adoption of and commitment to the international transfer pricing standard, including the arm's length principle and the guidelines for its application contained in the OECD Guidelines.

Total alignment does not imply completely abandoning the objectives of simplicity, ease of administration and tax compliance and legal certainty in tax matters. These objectives can be achieved through the introduction of safe harbors designed in accordance with the arm's length principle, including carefully considered input criteria, to ensure that transfer pricing results are broadly consistent with the results produced by the full comparability analysis in accordance with the OECD Transfer Pricing Guidelines.

The OECD Secretariat has analyzed the final version of Provisional Measure 1,152/2022 and considers that the Provisional Measure incorporates fundamental principles and concepts covered by the OECD instruments on transfer pricing and contained in the OECD Guidelines on Transfer Pricing for Multinational Enterprises and Tax Administrations (2022) and reflected in the United Nations Practical Manual on Transfer Pricing for Developing Countries (2021). There are some provisions that, while still aligned with international standards, adopt a more prescriptive approach due to the traditions of the Brazilian tax system. These devices aim to reduce the burden of complying with tax obligations and provide legal certainty in tax matters for

taxpayers and also improve the efficiency of tax administration. However, such provisions, even following such an approach, offer taxpayers the possibility of determining results based on analysis of facts and circumstances in a manner consistent with the international standard."

Therefore, it is possible to state that the current Brazilian rules are very close to the standards required by the OECD of its signatories, so that it can be concluded that there is full alignment with the body's Guidelines.

9.2 Arm's Length Principle

From the publication of Law No 14,596/2023, the arm's length principle started to be adopted as an adequacy paradigm for controlled transactions.

With the publication of the aforementioned standard, every transaction subject to transfer pricing calculation must, by applying the most appropriate method, demonstrate that its pricing occurred under circumstances and conditions consistent with market practices, in compliance with the arm's length principle.

This principle replaces the fixed margin model previously adopted by Brazilian legislation for the purpose of verifying the adequacy of controlled operations.

9.3 Impact of the Base Erosion and Profit Shifting (BEPS) Project

Since the first decades of the millennium, Brazil, as a member of the G20, has been at the forefront of important agendas relating to projects that shape the rules of international taxation, such as Transparency and Exchange of Information for Tax Purposes, the OECD BEPS Project/G20 and the Two-Pillar Solution to Address Fiscal Challenges Arising from the Digitalization of the Economy.

From this perspective, the influence of BEPS actions on Brazilian fiscal policy is undeniable, notably with regard to transfer pricing and information sharing rules.

The main influences of BEPS on Brazilian legislation are:

- Law No 12,973/2014 – update of taxation rules on a universal basis (CFC Rules) – BEPS Action 3;
- Normative Instruction No 1,571/2015 and Normative Instruction No 1863/2018 – provide for mandatory provision of information regarding financial operations of interest to the Brazilian Federal Revenue Service and on the final beneficiary of legal entities (UBO) – Action 12 of BEPS;
- Normative Instruction No 1,681/2016 – Country-by-Country Declaration – BEPS Action 13;
- Normative Instruction No 1,689/2017 – later replaced by Normative Instruction No 2,058/2021 – deals with the consultation process – Action 5 of the BEPS; and
- Normative Instruction No 1,846/2018 – MAPA – BEPS Action 14.

Parallel to this, Brazil advanced in studies to align Brazilian transfer pricing practices with OECD guidelines, which culminated in the issuance of Law No 14,596/2023, which, as already pointed out in this document, represents total alignment with the standard of the OECD, consequently, with great influences from BEPS.

9.4 Impact of BEPS 2.0

As transfer pricing rules in Brazil fully adhere to OECD Guidelines, it is a logical consequence that the policies implemented by that body to

combat tax avoidance and evasion are reflected in the Brazilian rules, notably the policies arising from BEPS.

Given this context, it is undeniable that the influence of BEPS 2.0 could positively affect Brazilian tax revenue, particularly with regard to activities developed by the "digital economy".

However, as this is still an incipient topic in Brazil, it is not possible to predict, with a certain degree of security, the future effects and their possible deviations.

At the moment, there are no relevant initiatives in the government or in the National Congress to approve laws to implement Pillars 1 and 2 of BEPS 2.0.

9.5 Entities Bearing the Risk of Another Entity's Operations

To the extent that transfer pricing legislation values the functions performed by the parties, the assets used and the risks assumed in the operation as elements of the economic delineation of the controlled transaction, such criteria being fundamental for its comparability with market operations, the assumption of risks by another entity can significantly influence the calculation of the transfer price.

More than that, given the need to determine the tested party in specific cases, the "risk" element may be relevant to shift the perspective of the tested party from one jurisdiction to another.

In any case, such elements must be the subject of a case-by-case analysis, in which, in addition to the risk, other transactional elements must be weighed.

10. Relevance of the United Nations Practical Manual on Transfer Pricing

10.1 Impact of UN Practical Manual on Transfer Pricing

Unlike what happens with the "OECD Transfer Pricing Guidelines for Multinationals Enterprises and Tax Administration 2022", to which Brazilian legislation assigns the status of subsidiary sources for the interpretation and integration of transfer pricing control standards, the UN Practical Manual on Transfer Pricing is not elevated to the same level, which is why it does not have any normative force in Brazil.

However, the document can serve as a consultation instrument for applicators of Brazilian transfer pricing rules, when involving situations similar to those under analysis by the consultant.

11. Safe Harbours or Other Unique Rules

11.1 Transfer Pricing Safe Harbours

In the event of a controlled transaction consisting of the provision of services with low added value, the taxpayer may opt for a simplified approach to applying the transfer pricing rules, according to which the remuneration for said services must have a gross profit margin, calculated on all direct and indirect costs related to the transaction, of:

- at least 5%, in cases where the service provider is a legal entity domiciled in Brazil;
- a maximum of 5%, in cases where the provider is a related party abroad;
- for the purposes of applying this simplified rule, only those services that:
  - (a) have a supportive nature;

(b) are not part of the main activities of the related party or multinational group;
(c) do not require the use of unique and valuable intangible assets and do not contribute to their creation;
(d) do not imply the assumption or control of economically significant risks by the service provider and do not lead to the creation of such a significant risk for him; and
(e) do not contribute significantly to the creation, increase or maintenance of value in the multinational group, to the essential capabilities or to the chances of success of the multinational group's business.

Services that the multinational group also provides to unrelated parties cannot be considered low-value-added services.

If necessary, an appropriate allocation method or apportionment criterion must be used to determine the cost of low-value-added intragroup services among group members in proportion to the benefits or benefits expected for each group member.

11.2 Rules on Savings Arising From Operating in the Jurisdiction

Brazil does not adopt policies of this nature.

11.3 Unique Transfer Pricing Rules or Practices

As Brazilian practices are fully aligned with OECD guidelines, there is no rule that can be highlighted as exclusive to Brazilian practice.

12. Co-ordination With Customs Valuation

12.1 Co-ordination Requirements Between Transfer Pricing and Customs Valuation

Considering that the anti-avoidance function present in the transfer pricing control rules also manifests itself in the rules that determine customs valuation, reflections naturally arise about the possible effects of the transfer pricing rules on typical customs taxes. After all, both normative frameworks intend to compare transactions carried out with the parameters that would be verified for these same transactions if carried out without any favouritism by the contracting parties.

At this point, it should be noted that the RFB categorically intended to separate the two institutes in Law No 14,596/2023, the content of which is clear regarding its applicability only to income taxes: "This Law provides for transfer pricing rules relating to Corporate Income Tax (IRPJ) and Social Contribution on Net Profit (CSLL)."

If it is true, therefore, that Law No 14,596/2023 does not produce automatic effects on the customs valuation procedure, the new set of transfer pricing rules in Brazil, especially as it is based in the best implementation of the arm's length principle, can be used as a reference for the customs valuation procedure, under the terms and limits imposed by the rules relating to customs law.

Transfer pricing rules can be taken into account by the applicator of customs value rules, as evidenced by Comment No 23.1 of the WCO Customs Valuation Technical Committee, which allows the customs authority to use information found in price studies of transfers prepared

by the importer to assess the circumstances of the sale. This guideline was incorporated in several passages of Normative Instruction No 2,090/2022, namely in the part where it reproduces the aforementioned Comment 23.1: "a study on transfer prices can constitute a good source of information, if it contains relevant information about the circumstances of the sale. On the other hand, a study on transfer pricing may not be relevant or appropriate due to the substantial and significant differences that exist between the Agreement's methods for determining the value of imported goods and those of the OECD Transfer Pricing Guidelines."

13. Controversy Process

13.1 Options and Requirements in Transfer Pricing Controversies

The application of transfer pricing rules follows the same procedure as the administrative and judicial process of tax claims.

The process can be summarised as follows.

Administrative phase:

- Tax assessment – it is the administrative act by which the tax authority determines the taxpayer's tax obligation, identifying the amount to be paid.
- Assessment notification – the taxpayer is notified of the tax collection through an official document sent by the tax authority.
- Challenge or administrative appeal – the taxpayer has the right to challenge the tax assessment by filing a challenge or administrative appeal, demonstrating any errors in the charge or legal reasons for the challenge.
- Administrative decision – the tax authority analyses the objection or appeal and issues an administrative decision, whether or not it accepts the arguments presented by the taxpayer.
- Payment or registration in active debt – if the administrative decision is unfavourable to the taxpayer and there is no longer any possibility of appeal, he/she must pay the tax or the tax authority may register the debt in active debt for judicial collection.

Judicial phase:

- Lawsuit – if the taxpayer disagrees with the administrative decision, he/she can appeal to the judiciary, filing a lawsuit to contest the collection of the tax.
- Tax foreclosure – if the court decision is unfavourable to the taxpayer, the Public Treasury may initiate the tax execution process to collect the tax, if the taxpayer does not make the spontaneous payment.

14. Judicial Precedent

14.1 Judicial Precedent on Transfer Pricing

There is no administrative or judicial case law on the new criteria defined by Law No 14,596/2023.

Regarding previous practice, there are a number of disputes and controversies. However, given that this document focuses on the year 2024, the authors will not delve into the existing disputes regarding the repealed legislation.

14.2 Significant Court Rulings

There is no administrative or judicial case law on the new criteria defined by Law No 14,596/2023.

15. Foreign Payment Restrictions

15.1 Restrictions on Outbound Payments Relating to Uncontrolled Transactions

Before the enactment of Law No 14,596/2023, royalties could only be deducted in the amount of 5% of the expense incurred, as determined by Law No 3,470/1958.

With the publication of the new transfer pricing rules, the limitation on the deductibility of royalties was revoked, with such expenses being fully deductible if it is an uncontrolled operation.

With the exception of royalty operations, there are no limitations on capital remittances abroad.

15.2 Restrictions on Outbound Payments Relating to Controlled Transactions

Before the enactment of Law No 14,596/2023, royalties could only be deducted in the amount of 5% of the expense incurred, as determined by Law No 3,470/1958.

With the publication of the new transfer pricing rules, the limitation on the deductibility of royalties was revoked, however, the transaction must be subject to analysis of adequacy to the arm's length principle if it is a controlled transaction.

With the exception of royalty operations, there are no limitations on capital remittances abroad.

15.3 Effects of Other Countries' Legal Restrictions

There are no policies of this nature in Brazil.

16. Transparency and Confidentiality

16.1 Publication of Information on APAs or Transfer Pricing Audit Outcomes

As a general rule, inspection processes are confidential, with publicity only given to the parties involved.

Regarding APA, the matter, although provided for in Law No 14,596/2023, is still pending regulation by the Federal Revenue Service.

16.2 Use of "Secret Comparables"

There are no policies regarding secret comparables in Brazil.

Trends and Developments

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Machado Meyer Advogados is a firm with a 50-year history of providing innovative legal solutions to its clients. Its strategic foresight and anticipation of industry trends allow it to navigate confidently through the increasingly complex and innovative legal landscape. The firm's growth trajectory has mirrored the dynamic expansion of Brazil, demonstrating its adaptability and resilience in a rapidly changing environment. Always drawn to challenges, the firm has consistently prioritised investment in personal growth, development of new practice areas and the exploration of new sectors, with the aim of providing the best legal intelligence to its clients. Comprising a team of creative, tenacious individuals committed to continual learning and development, the firm is relentless in its pursuit of the best legal solutions. Adopting a future-focused approach, Machado Meyer Advogados aims to align its operations with the demands of the global landscape while making a positive impact on society in general.

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New Transfer Pricing Rules in Brazil

Introduction

As is well known by the international tax community, Brazil introduced transfer pricing legislation ("TP Legislation" or "TP Rules") in 1996, through Law No 9,430, with an official justification to implement internationally recognised best practices in terms of cross-border transactions and protection of the corporate taxable basis, and with an inspiration on the Transfer Pricing Guidelines enacted by the Organization for Economic Co-operation and Development ("OECD TP Guidelines"). Despite the inspiration, it was clear from the outset that Law No 9,430 implemented a peculiar regime, with relevant deviations from the OECD TP Guidelines, which brought, in some cases, complexities to adapt to the global TP tests made by multinational enterprises (MNEs), and in other cases a simplification of the selection of the available methods and their respective burden of proof.

This reality started to change in 2017, when Brazil initiated its candidacy for accession to the OECD and faced some concrete challenges to achieve adhesion, among which was the full alignment of its TP Legislation. This led to the launch, in 2018, of a joint project implemented by the Brazilian Revenue Service (RFB) and the OECD to revise the Brazilian TP Legislation and identify the potential benefits of full alignment and the most appropriate transition regime.

The joint project attested that the Brazilian TP Legislation was considered divergent internationally due to its formulary approach, which relied on objective criteria not specifically designed to determine the market prices but instead operated based on legal presumptions and fixed margins, regardless of the specificities of the industry involved. Additionally, the legislation in force since 1996 enabled taxpayers to elect the most favourable method (ie, the one resulting in the lowest TP adjustment), provided it was suitable for the economic and commercial underlying reality and the available data.

The Brazilian TP Legislation remained practically unchanged since 1996, regardless of subsequent updates to the OECD TP Guidelines. The growing isolation on the matter became evident in January 2022, when the US enacted the Foreign Tax Credit – FTC Act (TD 9959), restricting the deduction of Brazilian tax credits in cases of corporate taxation imposed in Brazil on adjustments to taxable profits resulting from a breach of the OECD standards, particularly regarding the arm's length principle.

In response, in December of the same year, the Brazilian government issued Provisional Measure No 1,152, introducing new TP Legislation, aligned to the OECD TP Guidelines (2022), which would apply as of January 2024. In June 2023, this provisional measure was converted into Law No 14,596, following the legislative process, and the RFB initiated the regulation, employing public consultation. As of the present moment, the RFB has not yet completed the regulation process; the enacted regulation (Normative Instruction RFB No 2,1621/2023) covers only the general TP guidance, while the specific guidance on a series of matters and transactions remains pending, resulting in significant uncertainty in this regard.

Despite the delays in the full regulation of Law No 14,596/2023, since 1 January 2024, Brazil has initiated the enforcement of the new TP Legislation. The implementation of the new legislation and its full regulation by the RFB poses challenges due to the significant departure from the past normative frameworks guided by the formulary approach. This represents a major shift in the TP framework in Brazil and garners

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attention from MNEs operating in the country, tax authorities, practitioners, and, eventually, administrative and judicial courts.

The forthcoming years are anticipated to be marked by considerable doubts and uncertainties in navigating this issue. Compliance extends beyond the mere adherence to OECD standards or drawing from experiences in other jurisdictions; it entails implementing rules with high complexity and a good level of subjectivity driven by global economic, commercial and operational factors while considering the nuances of the Brazilian legal system and the intricacies of Brazilian tax administration. The formal and in certain cases litigious relationship existing among taxpayers and tax authorities in Brazil is also an element of concern. To counterbalance those challenges, the sophisticated and well-known technological tools implemented by the RFB to receive tax returns and implement inspections might result in a more transparent inspection environment when it comes to TP, but this is still to be seen.

New Brazilian TP Rules: a paradigm shift

TP Rules are constructed to address the economic interdependence among related companies from a corporate income tax perspective. These companies, often linked through corporate relationships or personal connections, may negotiate terms and conditions of cross-border transactions differently than those agreed upon by independent entities in similar circumstances.

As such, TP Rules are guided by the arm's length principle, which embodies the concept of free market competition. The underlying assumption is that MNEs employ intra-group arrangements to shift revenue, costs, and expenses across jurisdictions, strategically engaging in tax planning to alleviate the overall tax burden of the economic group, thereby affecting the tax bases of the respective states. Consequently, TP Rules function as a mechanism to depict transactions between related parties as if they were conducted by independent entities, adhering to the prevailing market conditions.

Given this concept, it is important to analyse the normative evolution of the Brazilian TP Legislation.

At first glance, the new Brazilian TP Legislation seems to encompass a wider range of comparable transactions, if compared to the previous legislation. The TP Rules prevailing until 2023 were confined to import and export transactions and interest payments, whereas the revised regulations now extend to include import and export transactions, intra-group services, financial transactions, intangibles (including those with difficult valuation), cost contribution arrangements, and business restructuring.

The application of these new TP Rules involves a two-phase analysis.

First, there is the delineation of the transaction(s) to be assessed, which requires more than a mere examination of the transaction's formal elements, especially its contractual aspects. It necessitates an evaluation of the underlying reality of the relevant facts to ascertain whether the formal perspective aligns with the material one, with the latter taking precedence over the former. Additionally, there exists a corrective power allowing for the adjustment of transactions based on what unrelated parties in similar circumstances would typically intend to do.

Second, a comparative examination is conducted using the most appropriate method, no longer prioritising the most favourable method but rather the one that best aligns with market conditions, as outlined in a non-exhaustive list of

methods. Whereas under the previous Brazilian TP Legislation, controlled prices were based on objective and limited criteria, the updated regulations now govern the terms and conditions of transactions under subjective parameters and open economic and commercial concepts, demanding a comprehensive and subjective analysis (aligned to the functional analysis).

Originalities of Brazilian TP rules: divergence from the OECD model

As previously mentioned, despite aligning with the OECD Guidelines (2022), the new Brazilian TP Rules introduce innovations that significantly impact their application.

First, concerning the concept of related parties, these entities are influenced, directly or indirectly, by another party, resulting in differences in transactions' terms and conditions compared to those between unrelated parties in comparable transactions. This circular definition utilises the final results of TP Rules, such as verifying divergences from market conditions, to establish their preliminary assumption for application, namely, the concept of related parties. Additionally, Article 4 of Law No 14,596/2023 provides a non-exhaustive list of related parties, including cases where one entity is directly or indirectly under common control or where the same partner, shareholder, or holder holds 20% or more of the share capital of each one.

It is worth noting that the international standard sets this threshold at 25%. Therefore, the Brazilian criterion represents an innovation that impacts the determination of transactions subject to TP Rules by broadening their scope and the comparability examination since transactions not meeting this threshold cannot be used as comparables; yet ordinary databases may not meet this requirement. Consequently, Normative Instruction No 2,161/2023 (Article 21 (Section 3)) stipulates that, if fewer than four comparables are identified, considering all appropriate filters for their selection, the use of a reliable independence criterion based on a participation percentage of 25% will be accepted if it enhances the reliability of the range of comparables. It is noteworthy that this rule appears provisional, as databases are currently not adequately prepared for the 20% threshold.

Second, regarding the transactions controlled by TP legislation, they now encompass a broader scope. This expansion notably includes transactions conducted by entities or individuals with related or unrelated parties residing or domiciled in jurisdictions that do not tax income or tax it at a maximum rate lower than 17%, or those who are beneficiaries of a preferential tax regime. This application of TP legislation aims to serve a purpose that is not reflected in the international standard and imposes limitations on the comparables available for the comparability examination. It is important to note that the 17% minimum threshold is a unique percentage advocated by Brazilian tax authorities, which does not align with the global minimum tax (Pillar Two) set at 15%. Furthermore, in practical terms, this application of TP rules draws special attention to the concept of a series of transactions, particularly when involving jurisdictions that do not tax income or tax it at a maximum rate lower than 17%, or a preferential tax regime. In such cases, Brazilian entities may bear the burden of controlling the series of transactions. This becomes relevant as it impacts the transactions performed by the Brazilian entity, potentially increasing the respective tax base for corporate income tax purposes.

Third, concerning the transactions governed by TP legislation, a controversy arises regarding

whether corporate transactions (eg, reduction of share capital) are subject to TP Rules. Article 3(VII) of Normative Instruction No 2,161/2023 defines that transactions involving the disposal or transfer of assets, including shares and other equity interests, are subject to TP rules, even if they occur in operations of return of capital or capital subscription. It is important to note that this provision is exclusive to the normative instruction; it is not found in Law No 14,596/2023, raising potential discussions of legality if it exceeds the framework established by the law.

This provision has sparked a lengthy discussion with the Brazilian tax authorities concerning Article 22 of Law No 9,249/1995 which states that assets and rights of a legal entity delivered to the owner, the partner, or the shareholder as a return of their participation in the share capital may be valued at their book value or market value. Despite this clear rule, the RFB intends not to apply it, insisting on the obligation of using market standards. Nevertheless, this rule has not been revoked by new TP legislation. In our opinion, Article 3(VII) of Normative Instruction No 2,161/2023 should only apply to transactions characterised as commercial or financial transactions concluded between related parties, mainly in the context of business restructuring, and not necessarily to all corporate transactions. In this scenario, Article 22 of Law No 9,249/2023 appears to be a specific rule that should prevail regarding the other cases, allowing parties to decide whether to perform the transaction at their book value or the market value, when no commercial or financial transaction is in place.

Fourth, in the context of applying TP Rules, several critical aspects warrant consideration.

- The RFB aims to prioritise the Comparable Uncontrolled Price (CUP) method over others. However, outside of highly standardised transactions, this approach is not widely adopted internationally. It remains uncertain as to whether tax authorities will maintain this stance.
- Regarding comparables, uncertainty persists concerning whether the database will contain adequate information about Brazilian entities and transactions. While Brazilian legislation does not mandate testing the Brazilian entity, there are scenarios where it will be necessary to test the Brazilian entity. Challenges related to information acquisition and the unique characteristics of the Brazilian market could present significant hurdles for TP application.
- Brazil has opted for a model that incorporates compensatory adjustments, enabling taxpayers to readjust transaction prices in accordance with TP Legislation. As outlined in Article 50 of Normative Instruction No 2,161/2023, this option requires accounting records, the issuance of credit and debit notes, or fiscal and commercial documentation, all endorsed by the legal representatives of the entities. These adjustments can be made until the tax return is filed, provided they are documented in the accounting records. The efficacy of compensatory adjustments hinges on their acceptance in other jurisdictions. In cases where they are not permitted, taxpayers are limited to spontaneous adjustments, which do not reduce the tax basis.
- Despite the introduction of a specific consultation process and the RFB's explicit desire to foster a more collaborative relationship with taxpayers, it is crucial to grasp the limitations of consultations. This process solely involves defining the methodology for TP application and does not facilitate negotiation or validation of calculations with tax authorities. Past experiences with ordinary consultations have generated uncertainty about the efficacy of

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this mechanism. Once an opinion is issued, taxpayers not only attract the attention of the RFB but also risk the opinion being regarded as binding. Any deviation could prompt the issuance of an infraction notice.

Conclusion: doubts and controversies

The new TP Legislation represents a significant shift for Brazil within the international tax arena, driven by its explicit commitment to align with OECD standards and pursue membership of the organisation. While the legislation aligns with OECD TP Guidelines, it introduces unique features in both its normative framework and practical application. MNEs must carefully consider these innovations when crafting their global TP policies and preparing TP calculations and documentation, including global and local files. Historically, Brazil has been under-represented in such documentation, necessitating a comprehensive review of Brazilian entities' transactions and their involvement in the economic activities of the group. Furthermore, it is crucial to acknowledge that Brazilian legislation possesses distinct characteristics, and a one-size-fits-all approach based on models adopted elsewhere may face scrutiny from Brazilian tax authorities. It is essential to recognise that the RFB's control of TP may differ from conventional methods accepted elsewhere.

Moreover, the application of the arm's length principle and the pursuit of market conditions do not always yield a uniform outcome, given the diverse variables and prices encompassed in market terms and conditions. In the authors' view, tax authorities should consider this variability, allowing for some flexibility in their assessments and acknowledging the inherent subjectivity in taxpayers' analyses in a deferential position. Excessive scrutiny may lead to a rise in litigation, bringing highly technical discussions to courts unfamiliar with the intricacies of commercial and economic transactions, often surpassing their expertise. This underscores a critical issue, particularly within the international arena, as divergent TP adjustments across jurisdictions can lead to instances of double taxation. This challenge is exacerbated by Brazil's relatively limited number of double tax treaties, none of which contain provisions akin to Article 9(2) of the OECD Model Convention, which mandates mutual agreements for harmonising treatment (ie, ensuring that the adjustment made by one jurisdiction is offset by the other). While the Brazil–United Kingdom Double Tax Treaty represents a pioneering effort in establishing such a mechanism, its approval by the Brazilian Congress is pending – therefore, it is not yet in force. It is important to acknowledge that, in other double tax treaties, the absence of Article 9(2) does not preclude the use of mutual agreements as a mechanism to address double taxation resulting from TP adjustments; it is merely a discretionary procedure, and to date, Brazil has limited experience in utilising this mechanism.

The upcoming years bring significant uncertainty for taxpayers. While tax authorities have long been preparing for this moment by drafting legislation, training tax officers, and focusing on specific economic sectors, taxpayers now confront a new legislative landscape without a transitional period, exacerbated by pending regulations. In this "year zero", we are reassessing TP with entirely new parameters and preparing fiscal documentation. The balance of power seems to favour tax authorities over taxpayers in this scenario. While there is no single answer to navigating this new reality, one idea gradually becomes clear: taxpayers must progressively calculate TP throughout the year, ensuring that fiscal documentation produced elsewhere accurately reflects the economic activities of Brazilian entities in business.

CANADA

Law and Practice

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Osler, Hoskin & Harcourt LLP assists clients facing the rapidly changing international tax landscape, including proposals to rewrite Canada's transfer pricing rules. It has significant experience in strategy development and planning, disclosure and compliance requirements, exposure and risk assessment, and tax disputes and litigation. It has particular expertise in the management of transfer pricing audits (including referrals to the transfer pricing review committee), mutual agreement procedure requests, administrative appeals at the notice of objection level and advance pricing arrangements as a potential means of mitigating risk. The firm advises on the conduct of appeals before the Canadian courts and acts on the majority of significant transfer pricing disputes in the Tax Court of Canada. It was counsel in the first transfer pricing case on the scope and application of the current Canadian transfer pricing legislation (Cameco) and represented the taxpayer in the first and only transfer pricing case to be heard by the Supreme Court of Canada (GlaxoSmithKline).

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1. Rules Governing Transfer Pricing

1.1 Statutes and Regulations

The primary source of Canada's transfer pricing rules is Section 247 of the Income Tax Act (ITA). Under Subsection 247(2) of the ITA, transactions (or series of transactions) in which Canadian taxpayers and non-arm's length non-resident persons are participants must adhere to terms and conditions that are comparable to those that would have been established if the participants were dealing at arm's length. If the terms and conditions of these transactions do not adhere to the arm's length principle, adjustments are to be made for purposes of the ITA.

When the Canada Revenue Agency (CRA) makes an upward transfer-pricing adjustment under Subsection 247(2) of the ITA (known as the "primary adjustment"), there may be a secondary adjustment subject to non-resident withholding tax. This secondary adjustment is based on the premise that a benefit has been provided to a non-resident person due to the excess amount paid to them or the insufficient amount received from them.

There is a body of transfer pricing case law under Section 247 – and the prior transfer pricing rule in former Subsection 69(2) – which also forms part of Canada's transfer rules. The OECD Transfer Pricing Guidelines (the "OECD Guidelines") have been referred to by the courts as secondary sources and interpretive aids. The draft amendments discussed below propose to make Canada's rules consistent with OECD Guidelines (see also **9.1 Alignment and Differences**).

The CRA also issues administrative guidance on its interpretation and application of Canada's transfer pricing rules through the issuance of information circulars and Transfer Pricing Memoranda (TPM). CRA's longstanding Information Circular IC 87-2R (IC 87-2R) was cancelled in 2019 and has not been replaced. The CRA's stated rationale for the cancellation was to align its administrative guidance with the OECD Guidelines. IC 87-2R provided the CRA's administrative guidance on a broad set of transfer pricing issues. While there are TPMs on specific issues, the cancellation of IC 87-2R leaves considerable gaps.

1.2 Current Regime and Recent Changes

Section 247 of the ITA was introduced in 1997 to align with the OECD Guidelines arm's length principle. Before that, transfer pricing in Canada was primarily governed by Subsection 69(2) of the ITA.

The current version of Subsection 247 has two branches: a traditional pricing rule that adjusts the terms and conditions of transactions or series that do not satisfy the arm's length principle, and a "recharacterisation" rule that provides for the substitution of an alternative transaction or series with arm's length terms and conditions, if the actual transaction or series would not have been entered into by arm's length parties and was entered into primarily to achieve a tax benefit. Each branch has a different test for its application and different consequences. The traditional pricing rule in paragraphs 247(2)(a) and (c) has been interpreted and applied in several court cases, such as GE Capital and GlaxosmithKline. The second branch in paragraphs 247(2)(b) and (d) has been less frequently considered, but recent cases including Cameco have clarified its scope and limits. These cases are discussed in **14.2 Significant Court Rulings**.

On 6 June 2023, Canada launched a transfer pricing consultation (the "Consultation Paper") including draft amendments to Section 247 that,

amongst other things, would introduce a consistency rule with the 2022 OECD Guidelines. The draft amendments represent the first substantial rewrite of Section 247 since the provision was first enacted and are intended to address perceived issues arising from the courts' guidance in the Cameco case, which was decided in favour of the taxpayer. The draft amendments would keep the adjustment of non-arm's length dealings for tax purposes, but would use a new concept of a "delineated transaction or series" based on the parties' "actual conduct" and other factors to compare to arm's length conditions. The draft amendments would also introduce a new non-recognition and replacement rule, representing a new approach to the recharacterisation rule in current paragraphs 247(2)(b) and (d).

2. Definition of Control/Related Parties

2.1 Application of Transfer Pricing Rules

The concept of "dealing at arm's length" is central to the application of Canada's transfer pricing rules. Section 251 of the ITA defines this relationship in two ways.

First, persons who are "related" are deemed not to deal at arm's length, regardless of the nature of their dealings and the actual terms and conditions of their transactions. In the context of corporate groups, the question of whether persons are related turns on the standards for "control". Generally, control means ownership of shares having more than 50% of the voting rights in the election of the board of directors of a corporation. Corporations are related if one controls the other or they are both controlled by the same person. This means that the transfer pricing rules apply to transactions between a Canadian-resident and non-resident corporation, where one is either the parent or controlling shareholder of the other or both are subsidiaries of a common parent.

Second, Section 251 of the ITA states that it is a question of fact whether persons who are not related deal at arm's length. The determination that unrelated persons are factually not dealing at arm's length has been made if, in fact, they do not act independently of one another or they are influenced by some common interest, connection, or scheme.

3. Methods and Method Selection and Application

3.1 Transfer Pricing Methods

Section 247 establishes the relevant standard, being the arm's length principle, but does not prescribe specific methods to comply with that standard.

The Consultation Paper requests input on whether Canada should adopt the approach to pricing low value-adding intra-group services (ie, cost plus 5%) introduced in the 2017 OECD Guidelines, either as a mandatory approach or a safe harbour. The Consultation Paper also indicates that Canada will consider the implementation of Amount B of Pillar One of the Inclusive Framework on Base Erosion and Profit Shifting (BEPS) once the proposals are finalised.

To apply the arm's length principle, the CRA recommends using one of the five methods endorsed by the OECD, namely:

- the comparable uncontrolled price (CUP) method, which compares the price of a transaction between related parties with the price of a similar transaction between independent parties;

- the resale price method, which deducts an appropriate gross margin from the resale price of a product or service purchased from a related party and resold to an independent party;
- the cost plus method, which adds an appropriate mark-up to the costs incurred by a supplier of a product or service to a related party;
- the transactional net margin method (TNMM), which compares the net profit margin of a transaction between related parties with the net profit margin of a comparable transaction between independent parties; and
- the transactional profit split method, which allocates the combined profit or loss of a transaction between related parties according to their relative contributions to the value creation.

3.2 Unspecified Methods

No particular transfer pricing methods are specified in the transfer pricing provisions of the ITA. In addition to the OECD methods described in **3.1 Transfer Pricing Methods**, the CRA recognises that other methods may be appropriate in some cases, as long as they are consistent with the arm's length principle and are well supported by facts and analysis. The CRA may challenge the use of unspecified methods and adjust the transfer prices if it considers that the method does not comply with the arm's length principle or does not produce a reasonable result. Therefore, the taxpayer should exercise caution before using an unspecified method. Canadian courts have accepted and used non-OECD methods in transfer pricing cases. For example, in McKesson (2013 TCC 404) the Tax Court accepted the taxpayer's "other" method for pricing the discount for a factoring financing transaction, although it disagreed on some factors and risks that influenced the ultimate discount rate. Similarly in GE Capital (discussed in **14.2 Significant Court Rulings**), the court used the yield approach to price a financial guarantee.

3.3 Hierarchy of Methods

Canada does not have a formal hierarchy of methods for transfer pricing purposes, but rather a flexible approach that aims at finding the most appropriate method for each case, consistent with the OECD Guidelines. TPM-14 2010 Update of the OECD Transfer Pricing Guidelines (31 October 2012) (TPM-14) addresses the changes made in the 2010 OECD Guidelines to replace the previous recommendation of a hierarchy of methods in the 1995 OECD Guidelines with a more flexible approach that considers the specific facts and circumstances of each case. In TPM-14, CRA has indicated that it considers the changes in the 2010 OECD Guidelines to support a "natural hierarchy" of methods, which reflects the relative reliability and availability of data for different methods (traditional transaction methods such as CUP are preferred over transactional profit methods).

3.4 Ranges and Statistical Measures

Canada does not require the use of ranges or statistical measures in transfer pricing, but rather accepts the use of the most appropriate transfer pricing method and the most reliable comparable data for each case.

In GlaxoSmithKline (discussed in **14.2 Significant Court Rulings**), the Supreme Court of Canada acknowledged that a transfer price is acceptable if it is within an arm's length range. The CRA has previously accepted the use of a "range of results".

However, IC 87-2R cautioned against the use of ranges or statistical measures, stating specifically that CRA "does not endorse the use of sta-

tistic measures". However, that circular has been cancelled and the comments in GlaxoSmithKline imply that taxpayers can use any point within an arm's length range, and are not limited to the median or the interquartile range.

3.5 Comparability Adjustments

Canada's transfer pricing provisions do not require comparability adjustments, but the CRA endorses the approach to performing comparability analysis in the OECD Guidelines in TPM-14. Canadian courts have expressly acknowledged the validity of comparability adjustments. In Cameco, one of the taxpayer's experts used comparability adjustments to account for differences in the terms and conditions of contracts under the CUP method. The Crown argued that the adjustments were unreliable and distorted the price, but the Tax Court found them to be appropriate and in line with OECD guidance.

4. Intangibles

4.1 Notable Rules

Canada does not have specific rules relating to the transfer pricing of intangibles.

4.2 Hard-to-Value Intangibles

Canada does not have specific rules relating to hard-to-value intangibles. The Consultation Paper includes a discussion of the approach to "hard-to-value intangibles" introduced in the 2017 OECD Guidelines. The Consultation Paper states that the Canadian government thinks the draft amendments to Section 247 and the guidance in the 2022 OECD Guidelines (which is consistent with the 2017 revisions) are sufficient, and that Canada does not need specific rules relating to hard-to-value intangibles.

4.3 Cost Sharing/Cost Contribution Arrangements

Canada recognises cost sharing/cost contribution arrangements. The general transfer pricing rules in Section 247, which are used to evaluate if a transaction is at arm's length, apply to such arrangements. An arrangement that is a "qualifying cost contribution arrangement" as defined in Section 247 is not subject to a transfer pricing penalty, even if an adjustment is made to the terms and conditions of such an arrangement under Subsection 247(2). See **8.1 Transfer Pricing Penalties and Defences**.

5. Affirmative Adjustments

5.1 Rules on Affirmative Transfer Pricing Adjustments

The ITA permits a taxpayer to make affirmative transfer pricing adjustments after filing tax returns, but such adjustments are subject to the Minister's discretion and, in the case of adjustments that increase the taxpayer's liability under the ITA, may also give rise to interest and penalties.

While the Minister is required to assess a taxpayer's initial return "with all due dispatch", any reassessment after the Minister has done so is discretionary; the Minister may reassess a taxpayer within certain defined limitation periods (for transfer pricing adjustments, this is generally seven years after the issuance of an original notice of assessment). Therefore, the Minister is not required to reassess a taxpayer to reflect a requested adjustment after filing the initial return, but may do so. If the Minister does reassess a taxpayer for any reason (eg, to process audit adjustment(s)), then the taxpayer is entitled to object to the reassessment, including on a basis that diverges from the position taken

by the taxpayer in its return. The Minister is, in that circumstance, effectively required to reassess the taxpayer to reflect the resolution of the objection either by the Appeals Division of the CRA or the courts.

Taxpayer-requested adjustments that have the effect of increasing the taxpayer's tax liability ("upward" adjustments) may give rise to interest and applicable penalties. The CRA has discretion to waive interest and penalties within a statutory limitation period on application by the taxpayer. In certain circumstances, the taxpayer may pursue an affirmative adjustment through the CRA's Voluntary Disclosures Program, and interest and penalties may be cancelled or waived through that process.

"Downward" transfer pricing adjustments that have the effect of reducing the taxpayer's liability for tax under the ITA are subject to Ministerial discretion under Subsection 247(10) of the ITA. Such adjustments are to be made only if, in the opinion of the Minister, the circumstances are such that it would be appropriate that the adjustment be made.

6. Cross-Border Information Sharing

6.1 Sharing Taxpayer Information

Canada has an extensive treaty network consisting of in-force bilateral tax treaties with 94 jurisdictions, and is a party to the Convention on Mutual Administrative Assistance in Tax Matters (MAAC) as well as bilateral tax information exchange agreements (TIEAs) in force with 24 jurisdictions. Canada's bilateral treaties and TIEAs generally provide for the exchange of information relevant to the administration or enforcement of domestic tax laws and the protection of confidentiality of same, while the CRA relies on the MAAC to support a broad platform of information exchanges including the automatic exchange of information under Country-by-Country Reporting and the exchange of financial account information under the Common Reporting Standard.

7. Advance Pricing Agreements (APAs)

7.1 Programmes Allowing for Rulings Regarding Transfer Pricing

Canada has an advance pricing arrangements (APA) programme, to which taxpayers may be eligible to apply if they are subject to the transfer pricing rules or are carrying on business through a permanent establishment in Canada or in a jurisdiction with which Canada has a treaty.

7.2 Administration of Programmes

The Competent Authority Services Division of the CRA (CASD) administers both the APA programme and the Mutual Agreement Procedure (MAP) programme.

7.3 Co-ordination Between the APA Process and Mutual Agreement Procedures

Both the APA and MAP programmes are administered by CASD, and a taxpayer seeking advance certainty, as well as a resolution of past years' adjustments in respect of the same jurisdiction, may pursue both processes concurrently. There is no formal co-ordination between the two programmes, but generally CASD will try to achieve efficiencies; eg, by assigning the same team to both processes, issuing queries common to both processes, and conducting a single set of site visits/functional interviews.

7.4 Limits on Taxpayers/Transactions Eligible for an APA

Any taxpayer seeking to resolve transfer pricing issues on a prospective basis may apply for APA consideration, but the CRA may determine that a request is not suitable for the APA programme. In IC94-4R2, International Transfer Pricing: Advance Pricing Arrangements (22 February 2024) (APA Circular), the CRA provides guidance on its administration of the APA programme, including the circumstances in which it may determine that a taxpayer and its proposed covered transactions are not suitable for APA. Although the APA Circular emphasises that each request is evaluated based upon its individual facts and circumstances, it lists the following common reasons why a case may not be suitable for APA:

- the CRA has concerns that the transactions involve tax avoidance or BEPS;
- the business recently underwent (before the APA term) or is expected to undergo (during the APA term) a significant transformation;
- aspects of the transactions are not expected to stay consistent (for reasons other than inflation or significant changes in the economic environment);
- the business has not been carried on long enough to complete an economic analysis of taxation years for which tax returns have been filed;
- the taxpayer chooses not to include all cross-border intragroup transactions in their request without sufficient reasons, or where CASD believes they should be included and the taxpayer disagrees;
- the legal contracts are not aligned with the "actual conduct" of the parties;
- there is current litigation involving the transaction for past years;
- the transaction requires a determination that does not involve a treaty article;
- the taxpayer is seeking a permanent establishment (PE) determination under a treaty or the request requires allocation of profits to a PE under specific circumstances;
- the transactions involve a business restructuring, shifting or eliminating functions, selling or transferring assets, closing plants or allocating extraordinary gains and losses (which may be one time in nature); and
- for transactions involving intangibles, the ownership and development of the intangibles is unclear, there is no business purpose for holding the intangibles in a specific entity or jurisdiction, or the intangibles are hard to value.

The APA Circular also states CRA's preference for bilateral (BAPA) or multilateral (MAPA) APAs, but acknowledges that there may be cases where a unilateral APA remains appropriate, such as where the related party operates in a non-treaty jurisdiction, the covered transaction is not sufficiently material to justify a BAPA or MAPA, the foreign competent authority does not have an APA programme, or the taxpayer's request to the foreign competent authority was rejected.

7.5 APA Application Deadlines

Under the CRA's administrative policy, CASD must have received a complete APA "prefiling package" providing sufficient details about the tax period to be covered, the parties, the proposed covered transaction and transfer pricing methodology (TPM) within 180 days after the end of the first tax year that is to be covered by an APA. If a complete prefiling package is not received by that date, the first taxation year will not be considered as an APA year but may be considered a rollback year (see **7.8 Retroactive Effect for APAs**).

7.6 APA User Fees

There is no user fee for access to the APA programme. However, the CRA (or foreign tax authority) may ask for the opinion of an independent expert to help evaluate an APA submission, at the taxpayer's expense. There may also be circumstances in which the taxpayer will be asked to bear costs for exceptional items such as data and analysis that is available only at a considerable cost. The APA Circular notes that such circumstances will be rare.

7.7 Duration of APA Cover

There is no definitive guidance with respect to the duration of an APA, but it is typical for an APA to cover five taxation years that are APA years. As described in **7.5 APA Application Deadlines**, the earliest APA year must have ended no more than 180 days prior to submission of a complete prefiling package. Additionally, the APA may cover rollback years (see **7.8 Retroactive Effect for APAs**).

7.8 Retroactive Effect for APAs

A taxpayer may request for an APA to cover non-statute barred taxation years that are prior to the APA period. These are referred to as rollback years. CRA guidance in TPM-11, Advance Pricing Arrangement (APA) Rollback (28 October 2008) states that the CRA will usually agree to APA rollback where a request for contemporaneous documentation has not been issued by the taxpayer's field auditors (referred to as the tax services office or TSO), the facts and circumstances are the same as the APA years, the foreign tax administration and TSO have both agreed to accept the APA rollback request, and the taxpayer has filed appropriate waivers of the statutory limitation period for reassessing the requested rollback years.

8. Penalties and Documentation

8.1 Transfer Pricing Penalties and Defences

A penalty equal to 10% of the total transfer pricing adjustment for a taxation year applies under Subsection 247(3) of the ITA if such adjustment exceeds the lesser of CAD5 million and 10% of the taxpayer's gross revenue for the year. The Consultation Paper proposes to increase the absolute threshold for penalties to CAD10 million, noting that the current CAD5 million threshold has not been adjusted since the penalty was introduced in 1997.

A taxpayer is not liable for the transfer pricing penalty if it made reasonable efforts to determine and use arm's length pricing for the transaction giving rise to the adjustment, or if the transaction is a "qualifying cost contribution arrangement" (which amongst other conditions requires the participants to have made reasonable efforts to establish a basis for contributing to certain costs). To date there has been no judicial guidance on what constitutes "reasonable efforts", although the CRA has issued guidance in TPM-09 Reasonable efforts under Section 247 of the Income Tax Act (18 September 2006).

A taxpayer that does not meet the contemporaneous documentation requirements set out in Subsection 247(4) of the ITA in respect of a transaction is deemed not to have made reasonable efforts to determine and use arm's length pricing or to have a qualifying cost contribution arrangement. Subsection 247(4) requires the taxpayer to make or obtain, on or before the documentation due date (generally the due date for the taxpayer's tax return for the year), records or documents providing a description that is complete and accurate in all material respects of:

- the property or services to which the transaction relates;
- the terms and conditions of the transaction and their relationship, if any, to the terms and conditions of each other transaction entered into between the participants in the transaction;
- the identity of the participants in the transaction and their relationship to each other at the time the transaction was entered into;
- the functions performed, the property used or contributed and the risks assumed, in respect of the transaction, by the participants in the transaction;
- the data and methods considered and the analysis performed to determine the transfer prices or the allocations of profits or losses or contributions to costs, as the case may be, in respect of the transaction; and
- the assumptions, strategies and policies, if any, that influenced the determination of the transfer prices or the allocations of profits or losses or contributions to costs, as the case may be, in respect of the transaction.

Where a transaction occurs in more than one taxation year or fiscal period, the documentation must be updated to reflect material changes on or before the documentation due date for each period in which a change occurs.

In addition to making or obtaining the documentation described in Subsection 247(4) by the documentation due date, in order to avoid the transfer pricing penalty, a taxpayer must provide such documentation within three months of a request by the CRA. No extensions are contemplated by the statute. In practice, a contemporaneous documentation request letter initiates a transfer pricing audit and triggers this strict three-month deadline.

8.2 Taxpayer Obligations Under the OECD Transfer Pricing Guidelines

The ITA includes country-by-country (CbC) reporting requirements in line with Chapter V (Documentation) of the OECD Guidelines. In general, a Canadian-resident ultimate parent entity of a multinational enterprise (MNE) group, or in certain circumstances a Canadian-resident constituent entity of an MNE group, is required to file a CbC report if the total consolidated revenue of the MNE group for the prior fiscal year is at least EUR750 million.

The documentation required in Subsection 247(4) of the ITA (see **8.1 Transfer Pricing Penalties and Defences**) is broadly similar to the local file contemplated by the OECD Guidelines, with some distinctions. One notable difference is that Subsection 247(4) does not contain an exception for immaterial transactions. In the Consultation Paper, the government proposes to bring the content required in Canada's documentation requirements in line with the OECD local file, except that in place of the materiality threshold it proposes reduced documentation requirements for low-risk transactions.

Canada does not currently require a master file. The Consultation Paper proposes to require members of MNE groups that are subject to the CbC reporting requirements to file the OECD master file in prescribed form on request by the CRA.

9. Alignment With OECD Transfer Pricing Guidelines

9.1 Alignment and Differences

In general, Canada's transfer pricing rules incorporate the arm's length principle, and the CRA administers the rules with a view to adhering to

the OECD Guidelines, the OECD transfer pricing methods, OECD documentation requirements, and the OECD dispute resolution mechanisms. Canada supplements the arm's length principle with additional domestic rules and guidance on specific issues, such as recharacterisation, penalties and secondary adjustments.

Although the CRA, taxpayers and the courts look to the OECD Guidelines for interpretative guidance on the application of the arm's length principle, it should be noted that they do not currently have the force of law in Canada. Canadian courts have acknowledged that the OECD Guidelines can be useful in interpreting Section 247 of the ITA, but only the statute itself has legal authority. Under the current regime, the OECD Guidelines are an interpretive aid or secondary source that can assist courts in applying the arm's length principle in a consistent and reasonable manner.

The draft amendments in the Consultation Paper would introduce a "consistency rule" that would require Canada's transfer pricing rules to be applied to achieve consistency with the amounts determined under the OECD Guidelines (defined as the 2022 edition, or any other text prescribed by regulation), unless the context otherwise requires.

9.2 Arm's Length Principle

Canada's transfer pricing rules are based on the arm's length principle and do not depart from it – eg, by using formulary apportionment.

The Consultation Paper states that the primary goal of the proposals is to align Canada's rules with international consensus on the arm's length principle. The Consultation Paper asserts that the existing transfer pricing rules in Section 247 lack specificity and fail to provide explicit guidance on the application of the arm's length principle. However, one of the proposals introduced for consultation is to introduce a set of "guardrails" that would require intercompany loans to be priced by reference to a limited range of conditions, including limiting the terms of such loans to five years, requiring the use of the credit rating of the MNE group as a whole and removing subordination features and embedded options. Described in the Consultation Paper as a "streamlined approach", this proposal departs from the arm's length principle and the OECD Guidelines.

Other streamlined approaches proposed in the Consultation Paper are the approach to pricing low value-adding intra-group services in the OECD Guidelines and standardised returns for distribution activities (Amount B), both of which arguably represent departures from the arm's length principle but are incorporated in the OECD Guidelines.

9.3 Impact of the Base Erosion and Profit Shifting (BEPS) Project

Canada has been an active participant and supporter of the BEPS project, and has implemented or committed to implement several of the BEPS actions. In 2016, Canada adopted CbC reporting to align with the BEPS minimum standards and has supported elements of the BEPS project related to transfer pricing.

9.4 Impact of BEPS 2.0

Canada is a signatory to the OECD/G20's Inclusive Framework BEPS statement in respect of the two pillar framework.

- Pillar One, which would give more taxing rights to source or market jurisdictions where multinational enterprises (MNEs) have significant economic presence or generate revenue

from digital services, regardless of their physical presence or nexus.
- Pillar Two, which would introduce a global minimum tax (GMT) of 15% on the income of MNEs, to ensure that they pay a fair share of tax wherever they operate and to prevent the erosion of the tax base of other jurisdictions.

As a backstop to Pillar One, Canada has introduced the Digital Sales Tax Act (DSTA), which would impose a 3% tax on certain revenue earned by large businesses (both domestic and foreign) from select digital services and the sale or licensing of certain Canadian user data. The DSTA is included in legislation before Parliament for approval and has a proposed coming into force date of 1 January 2024, with retroactive effect to 1 January 2022. The DSTA would apply to online marketplace services, online advertising services, social media services, and user data. However, the DSTA may be repealed or modified once a multilateral agreement on Pillar One is reached and implemented, which the OECD is still targeting for 2025.

Canada has also released draft legislation to implement Pillar Two. The Global Minimum Tax Act (GMTA) would apply to fiscal years beginning on or after 31 December 2023. The GMTA implements two aspects from Pillar Two: the income inclusion rule (IIR) and the qualified domestic minimum tax test (QDMTT). The IIR would impose a top-up tax on MNE groups headquartered in Canada where the effective tax rate is below the minimum 15% rate. The QDMTT would apply to low-tax income of Canadian entities. The third rule, the undertaxed profits rule, which is to come into effect one year later, is a backstop that can apply to low-taxed income not brought into charge under the other Pillar Two rules.

9.5 Entities Bearing the Risk of Another Entity's Operations

In general, transfer pricing analyses in Canada are conducted on the basis of the functions performed, assets owned, and risks assumed by the participants to the cross-border transaction or series, having regard to the substantive legal rights and obligations defined by the applicable commercial law. This includes relevant intercompany agreements.

10. Relevance of the United Nations Practical Manual on Transfer Pricing

10.1 Impact of UN Practical Manual on Transfer Pricing

The UN Practical Manual on Transfer Pricing (the "UN Manual") has little relevance or influence on transfer pricing practice or enforcement in Canada. While the UN Manual could be referred to as an interpretive aid or secondary source, it is expected that this document would be given less weight than the OECD Guidelines (which are more closely tied to the legislative process enacting Canada's transfer pricing rules).

11. Safe Harbours or Other Unique Rules

11.1 Transfer Pricing Safe Harbours

Canada does not currently use or support any transfer pricing safe harbours. However, the transfer pricing consultation released in June 2023 discusses various simplified methods and safe harbour options. This includes streamlined pricing approaches for low value-adding intra-group services, standardised returns for distribution activities and intra-group loan conditions. With respect to low value-adding intra-group

services and standardised returns for distribution activities (Amount B), it is uncertain whether Canada will introduce these either as mandatory simplified methods or as safe harbours. Intra-group loan conditions (discussed at **9.2 Arm's-Length Principle**) are currently proposed not as a safe harbour, but as a set of guardrails on intercompany financing.

11.2 Rules on Savings Arising From Operating in the Jurisdiction

There are no specific rules in Canada that apply to savings that arise from operating in Canada.

11.3 Unique Transfer Pricing Rules or Practices

Canada has two notable rules that apply generally to the financing of foreign subsidiaries' active business activities by Canadian corporations. Subsection 247(7) of the ITA exempts the interest on certain loans made by Canadian-resident corporations to their controlled foreign affiliates from transfer pricing adjustments under Subsection 247(2). Similarly, Subsection 247(7.1) exempts a guarantee provided by a Canadian-resident corporation to lenders for the repayment of loans owing by controlled foreign affiliates. In the case of each exemption, the loan proceeds must generally be used by the controlled foreign affiliate in an active business.

12. Co-ordination With Customs Valuation

12.1 Co-ordination Requirements Between Transfer Pricing and Customs Valuation

While there is some co-ordination between transfer pricing and customs valuation, the price used for income tax purposes may not be the same as the price used for custom purposes.

The CRA administers the ITA, which requires taxpayers to use the arm's length principle and the most appropriate transfer pricing method to determine the income or loss from transactions with non-resident related parties. The Canada Border Services Agency (CBSA) administers the Customs Act, which requires importers to declare the correct value of imported goods on a transactional basis for customs duty and tax purposes.

In IC 06-1 Income Tax Transfer Pricing and Customs Valuation (5 October 2006) (IC 06-1), CRA addressed the different considerations and adjustments that may apply to each regime.

For customs purposes, the preferred method of valuation is the transaction value method, which is based on the price paid or payable (ie, the invoice price) for the imported goods when sold for export to Canada, subject to certain additions and deductions. For related parties, the transfer price is the starting point for determining the transaction value, but it may not be the same as the final value declared to customs.

For income tax purposes, the transfer price is the amount that would have been charged or paid by unrelated parties dealing at arm's length for the same or similar transactions, under the same or similar circumstances. The transfer price may be subject to adjustments based on the functional analysis, the comparability analysis, the arm's length range, and the transfer pricing documentation.

IC 06-1 notes that the transaction value method for customs is similar to the CUP method for transfer pricing, as both rely on the comparison of prices between related and unrelated parties. However, the circular also acknowledges that there may be situations where the CUP method

is not the most appropriate method for transfer pricing, or where the transaction value method is not applicable for customs.

13. Controversy Process

13.1 Options and Requirements in Transfer Pricing Controversies

A taxpayer that disputes an adjustment made following a transfer pricing audit has 90 days from the notice of reassessment to file a notice of objection, which will be considered by the Appeals Division of the CRA (CRA Appeals). Most corporate taxpayers are required to pay (or, if accepted by the CRA, to post adequate security for) 50% of the aggregate amount of tax, interest and penalty in dispute notwithstanding the filing of an objection. In the case of an assessment of non-resident withholding tax pursuant to a secondary adjustment, 100% of the amount assessed may be collected up-front.

The mandate of CRA Appeals is to provide an impartial review, which may result in confirmation, reversal, or variance of the reassessment under objection. If CRA Appeals confirms the reassessment (or varies it only in part), or if more than 90 days have elapsed since the filing of an objection and CRA Appeals has not informed the taxpayer of its decision, then the taxpayer may appeal the reassessment to the Tax Court of Canada. The Tax Court of Canada has exclusive original jurisdiction to hear and determine appeals of assessments made under the ITA.

Some matters arising in respect of the Minister's exercise of duties and powers under the ITA fall within the jurisdiction of the Federal Court of Canada rather than the Tax Court. The Federal Court hears applications for judicial review of many discretionary decisions made by the Minister. In this regard, the case of Dow Chemical Canada ULC deals with the proper forum for challenging the Minister's denial of a taxpayer's request for a downward transfer pricing adjustment in reassessing the taxpayer. The Tax Court of Canada (2020 TCC 139) determined that it was empowered to review the Minister's decision under its exclusive jurisdiction to hear appeals from assessments under the ITA. The Federal Court of Appeal (2022 FCA 70) reversed that decision, finding that the matter was more properly for judicial review in the Federal Court, which has the power to quash the Minister's opinion, if appropriate. The Supreme Court of Canada (SCC File No 40276) heard the taxpayer's appeal on 9 November 2023; its decision is under reserve.

Decisions of the Tax Court and the Federal Court may be appealed to the Federal Court of Appeal, while decisions of the Federal Court of Appeal may be appealed to the Supreme Court of Canada only with leave. Leave to appeal is generally granted only in cases of public importance.

Tax disputes in general may be resolved by settlement at any stage in the process, but such settlements are enforceable against the Minister only if they are principled in the sense of producing an outcome that could have been ordered by a court based on an application of the law to the agreed facts. "Compromise" settlements that do not reflect a plausible application of the ITA are unenforceable. In practice, the vast majority of transfer pricing disputes are resolved at the CRA Appeals stage or by way of MAP.

A request for competent authority relief (ie, MAP) may be made in applicable cases and within the timeline provided for in the applicable treaty. Where a taxpayer intends to seek MAP, it is advisable to file a notice of objection within

the ordinary deadline to preserve the taxpayer's right to seek relief through the Canadian courts in the event the MAP is unsuccessful. CASD will consider a request for MAP provided that the taxpayer's domestic dispute is placed in abeyance pending the MAP outcome.

14. Judicial Precedent

14.1 Judicial Precedent on Transfer Pricing

Because most transfer pricing cases are resolved at the audit, objection, or MAP stage, the body of Canadian judicial precedent on transfer pricing is somewhat limited. The adjudicated pricing outcomes that have emerged over the past three decades have been heavily dependent on their individual facts and circumstances and as such are of limited predictive value in determining arm's length pricing for particular transactions. However, the reported decisions do provide guidance on the interpretation of the transfer pricing provisions of the ITA and the framework for their application.

14.2 Significant Court Rulings

The most significant judicial decisions in respect of the Canadian transfer pricing rules are GE Capital, GlaxoSmithKline and Cameco.

- In General Electric Capital Canada Inc v Her Majesty the Queen, 2010 FCA 344 (GE Capital), the Federal Court of Appeal held that "implicit support" of a core subsidiary may factor into the arm's length pricing of a financing guarantee. For purposes of applying the arm's length principle to the guarantee fee charged to the Canadian-resident subsidiary (Canco) by its US-resident parent, the appellate court held that the appropriate framework is to situate Canco as a core subsidiary of a multinational group with the same salient features (eg, the parent company's credit rating) as the actual group of which it is a member, as these factors would be relevant to an arm's length guarantor.
- In GlaxoSmithKline Inc v Her Majesty the Queen, 2012 SCC 52, the Supreme Court of Canada considered the pricing of an active pharmaceutical ingredient (API) acquired by the Canadian-resident distributor (Canco) from its non-resident affiliate (Seller). Canco enjoyed intellectual property rights (including patent, trade mark and know-how) under a licence agreement with its parent company (IP owner) to distribute the branded pharmaceutical product along with a suite of other products developed and owned by the IP owner, subject to certain restrictions, including, effectively, a requirement to purchase API from the Seller. The court held that the arm's length price for the API must be evaluated having regard to all of the "economically relevant characteristics" of the transaction, which, in this circumstance, included the requirement to purchase API from the Seller, as this was a requirement that would be equally applicable to an arm's length distributor seeking to sell the branded product.
- In Cameco v Her Majesty the Queen, 2020 FCA 112, the Federal Court of Appeal considered the "recharacterisation" branch of the transfer pricing provision, holding that a transaction or series may be subject to recharacterisation only if no arm's length party would have entered into that transaction or series of transactions. The Crown had failed to demonstrate that this condition was met with respect to the taxpayer's sales of uranium it produced to its Swiss affiliate, which sold that uranium along with uranium purchased pursuant to long-term agreements with certain arm's length parties at a

time when market prices had increased. The Crown's application for leave to appeal to the Supreme Court of Canada was denied.

15. Foreign Payment Restrictions

15.1 Restrictions on Outbound Payments Relating to Uncontrolled Transactions

Canada's transfer pricing rules do not restrict outbound payments relating to uncontrolled transactions.

15.2 Restrictions on Outbound Payments Relating to Controlled Transactions

Canada's transfer pricing rules do not restrict outbound payments relating to controlled transactions.

15.3 Effects of Other Countries' Legal Restrictions

Canada's transfer pricing rules are silent as to the effect of other countries' legal restrictions.

16. Transparency and Confidentiality

16.1 Publication of Information on APAs or Transfer Pricing Audit Outcomes

The CRA publishes an annual report on its MAP programme, including such items as statistical information regarding its case inventory, the average time to complete a negotiable case, and aggregated information regarding the outcomes of such cases. A similar report is published in respect of the APA programme with programme statistics.

16.2 Use of "Secret Comparables"

The Canadian transfer pricing provisions do not prohibit the use of "secret comparables". The ITA empowers the CRA to collect confidential information from third parties in the context of an audit, and the CRA's position is that it may use such information for the purpose of forming the basis of a transfer pricing adjustment (ie, as "secret comparables") as a last resort, after every effort has been made to develop an assessing position based on publicly available information. See in this regard TPM-04 Third-Party Information (27 October 2003).

Although it may provide such information as is necessary for the taxpayer to understand the basis of the assessment and as such does not directly or indirectly reveal the identity of the third party, the CRA maintains the confidentiality of third-party information unless and until the taxpayer files an appeal with the Tax Court of Canada. At that stage, the CRA will contact the third party prior to releasing the information to allow the third party to pursue a confidentiality order from the court.

Trends and Developments

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Miller Thomson LLP is a national business law firm with approximately 525 lawyers across five provinces in Canada. The firm offers a full range of services in litigation and disputes, and provides business law expertise in mergers and acquisitions, corporate finance and securities, financial services, tax, restructuring and insolvency, trade, real estate, labour and employment, as well as a host of other specialist areas. Clients rely on Miller Thomson lawyers to provide practical advice and good value. The firm has close to 60 tax practitioners, with its transfer pricing lawyers primarily located in its Vancouver, Calgary, Toronto and Montreal offices. From planning to controversy, the firm's transfer pricing lawyers have advised multinational companies in numerous sectors, including but not limited to, automotive, forestry, telecommunications, pharmaceuticals, software, business management, fashion, and banking and finance.

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The Rise in Court Intervention in Transfer Pricing Disputes

There are more transfer pricing disputes making their way to court in Canada. Here, transfer pricing disputes have been primarily resolved through one of two methods: a request for Competent Authority assistance under the Mutual Agreement Procedure (MAP) of a treaty or by way of a Notice of Objection filed with the Canada Revenue Agency (CRA) in respect of the Notice of Assessment or Reassessment.

In circumstances where taxpayers cannot have their matter adequately resolved at the Notice of Objection stage, taxpayers have increasingly pressed their cases to the tax court of Canada for resolution. The tax court functions as a trial court, with all that implies. A taxpayer can appeal a decision of the tax court to the Federal Court of Appeal. A further appeal to the Supreme Court of Canada is possible. However, the taxpayer must first file a leave application and the Supreme Court may grant leave or dismiss the application.

The OECD Transfer Pricing Guidelines

It is important to keep in mind that Canada, as a member of the Organisation for Economic Co-operation and Development (OECD), fully endorses the OECD Transfer Pricing Guidelines. For instance, the Canadian taxing authority affirms that the arm's length principle should be the prevailing approach to transfer pricing.

Consequently, Canada's published administrative guidelines reflect the guidance provided in Chapter II of the OECD's Transfer Pricing Guidelines. In Canada, there is a preference for domestic comparables over foreign comparables. It is true, however, that foreign comparables are acceptable provided that such comparables meet identical standards of comparability. It is interesting to note that the CRA does use secret comparables for transfer pricing assessments but this is not the common practice.

Existing legislation and developments

It would be a mistake to conclude that in Canada the transfer pricing rules operate in a vacuum. Put simply, there are a number of sections in Canada's income tax legislation and regulations that deal with the tax treatment of intangibles, assets and expenses in relation to services. While Canada does not have specific legislation related to the transfer pricing of financial transactions, Canada does have rules related to thin capitalisation and, more generally, the tax treatment of financial transactions. Moreover, the federal government proposed new rules that were to come into force in 2023 that are designed to limit the deduction of interest and are in line with the recommendations of the OECD's base erosion and profit shifting (BEPS) Action 4 Report. Canada has also introduced anti-hybrid rules that are consistent with the OECD's BEPS Action 2 recommendation.

An increase in audits

These recent legislative developments and the increasing number of cases heading to the courts point to the reality that the Canadian federal government is spending more resources on auditing transfer pricing activities and making it tougher on companies to meet compliance requirements. Now, it makes very good sense for companies involved in transfer pricing matters to be proactive on the defence front in order to ensure that if the CRA comes knocking with an audit, companies are properly and fully prepared to respond. This early audit protection approach has served multinational clients exceptionally well and has effectively limited the time, cost and energy needed to respond to such CRA audits.

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The COVID-19 pandemic may be one explanation as to why there has been an increase in audit activity by the Canadian taxing authorities. The financial ramifications of the COVID-19 pandemic continue to persist. For example, like many countries affected by the outbreak of the pandemic, the Canadian federal government increased spending to implement new measures to respond to the pandemic. Significant spending has, in turn, led to significant deficits. Some commentators have suggested that tax audits, and transfer pricing audits specifically, will be an area of focus for the federal government and the Canada Revenue Agency.

Anticipation of new rules

In mid-2023, the Federal Department of Finance released a consultation paper and legislative proposals that included major changes to the transfer pricing rules. These changes included amendments to the transfer pricing adjustment rule and changes to specific administrative practices. The government's expressed objective is to provide the application of the arm's length principle that is in line with the international consensus. In reference to administrative practices, the government aims to adopt a more simplified and modern approach to documentation and penalty provisions that is in line with the international community of states.

CHINA

Law and Practice

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Jincheng Tongda & Neal Law Firm is one of the most pre-eminent tax practices in China. Jincheng Tongda & Neal Law Firm's (JT&N) tax law and tax planning practice provides tax-related legal advice for a broad range of domestic and international clients, including those engaged in aviation, energy, transportation and technology. JT&N's tax attorneys have taken part in numerous transactions and litigation involving both past and present tax issues, and have extensive experience as tax administrators of, and advisers to, domestic and transnational corporations. The firm has also directly participated in the development of China's Tax Law, deriving highly relevant experience and unique insights. JT&N is especially well known in terms of responding to tax authority investigations, handling corporate and individual tax planning, and advising on taxes relating to transactions. The team closely monitors updated and new legal policies delivered by national, regional and local authorities, as well as following academic trends in related areas.

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1. Rules Governing Transfer Pricing

1.1 Statutes and Regulations

Transfer pricing management means that the tax authorities, in accordance with the relevant provisions of Chapter 6 of the Income Tax Law and Article 36 of the Collection and Administration Law, review and evaluate whether the business transactions between the enterprise and its related parties (hereinafter referred to as related party transactions) comply with the principle of arm's length transactions and a general term for investigation and adjustment work.

- Chapter 6 of the Income Tax Law of the People's Republic of China (PRC);
- Article 36 of the Tax Collection and Administration Law of the People's Republic of China;
- Chapter 6 of the Regulations of the People's Republic of China on the Implementation of the Enterprise Income Tax Law of the People's Republic of China;
- Articles 51 to 56 of the Rules for the Implementation of the Tax Collection and Administration Law of the People's Republic of China;
- the Measures for Implementing the Special Taxation Adjustments (for Trial Implementation) (Guo shui fa [2009] No 2);
- the Announcement of the State Administration of Taxation on Matters Relating to the Improvement of the Management of Connected Declarations and Contemporaneous Information (SAT Announcement No 42 of 2016);
- the Announcement of the State Administration of Taxation on Matters Relating to the Improvement of the Management of Appointment Pricing Arrangements (SAT Announcement No 64 of 2016); and
- the Measures for the Administration of Procedures for Special Tax Adjustments and Mutual Negotiation (SAT Announcement No 6 of 2017),

and other laws, administrative regulations and departmental rules provide for the management of transfer pricing and anti-avoidance.

1.2 Current Regime and Recent Changes

On the basis of international rules and in combination with China's actual situation, the relevant departments have continuously improved the regulations related to transfer pricing management.

- In 1991, China introduced the transfer pricing tax system for the first time.
- In 2001, transfer pricing and special tax adjustments were formally included in the Law of the People's Republic of China on Administration of Taxation and Collection, but the contents were relatively simple.
- In 2002, the Rules for Implementation of the Law of the People's Republic of China on Administration of Taxation and Collection further clarified the transfer pricing of related enterprises, business transactions between independent enterprises, pricing principles and methods, and the circumstances, methods and period of special tax adjustments.
- In 2007, with the improvement of legislative technology, the Law on Enterprise Income Tax and its Implementing Regulations made a special chapter on special tax adjustments.
- In 2009, the State Administration of Taxation (SAT) issued the Implementation Measures for Special Tax Adjustments (Trial Implementation) (*Guo shui fa* [2009] No 2), which provide systematic regulations on special tax adjustments in terms of general provisions, related declaration, contemporaneous information management, transfer pricing methodology, transfer pricing investigation adjustments, reservation pricing arrangements, cost shar-

ing agreements, controlled foreign company management, capital weakness management, general anti-avoidance management, corresponding adjustments and international consultations, legal liabilities, etc.

- In 2015, the SAT attempted to issue the Special Tax Adjustment Implementation Measures (Draft for Public Comments), unsuccessfully, and since 2016, it has revised Document No 2 by issuing normative documents, successively issuing:
  - (a) SAT Announcement No 42 of 2016 to improve the management of related declarations and contemporaneous information;
  - (b) SAT Announcement No 64 of 2016 to improve the management of appointment pricing arrangements; and
  - (c) SAT Announcement No 6 of 2017, introducing for the first time the concept of "Special Tax Investigation Adjustment" to differentiate it from the previous "Transfer Pricing Investigation and Adjustment", and improving the transfer pricing methodology, transfer pricing investigation adjustment and other contents.

2. Definition of Control/Related Parties

2.1 Application of Transfer Pricing Rules

Transfer pricing management mainly focuses on business transactions between enterprises and their related parties. According to Article 109 of the Regulations on the Implementation of the Enterprise Income Tax Law, Article 51 of the Tax Collection and Administration Law and the Announcement of the State Administration of Taxation on Matters Relating to the Improvement of Affiliated Reporting and Management of Contemporaneous Information, the term "affiliates" as used in China's transfer pricing rules refers to companies, enterprises and other economic organisations that are directly or indirectly owned or controlled by a third party or have other relationships that are linked in terms of interests, such as in terms of capital, operations, purchases and sales, and so forth, or other companies, enterprises and economic organisations with relations in terms of interests.

With regard to control, Chinese law requires that a resident enterprise or a Chinese resident directly or indirectly hold singly more than 10% of the voting shares of a foreign enterprise and jointly hold more than 50% of the shares of the foreign enterprise; or a resident enterprise, or a resident enterprise and a Chinese resident, does/do not meet the foregoing criteria for the proportion of shares held by the resident enterprise or/and the Chinese resident, but it constitutes substantial control over the foreign enterprise in respect of its shares, capital, operation, purchase and sale, and so forth.

With respect to affiliation, there is no need for a 50% or more shareholding requirement under Chinese law, as long as one party directly or indirectly owns more than 25% of the shares of the other party; both parties directly or indirectly hold more than 25% of the shares of the same third party; or the total amount of loan funds between the two parties accounts for more than 50% of the paid-in capital of either party or more than 10% of the total amount of all loan funds of either party is guaranteed by the other party (with independent financial institutions). The other party guarantees (except for loans or guarantees with independent financial institutions) or has other substantial common interests.

3. Methods and Method Selection and Application

3.1 Transfer Pricing Methods

Pursuant to Article 111 of the Regulations for the Implementation of the Enterprise Income Tax Law, transfer pricing methods include:

- the comparable uncontrolled price method, which refers to the method of pricing in accordance with the price at which parties to transactions without affiliation conduct the same or similar business transactions;
- the re-sale price method, which refers to the method of pricing in accordance with the price at which merchandise is purchased from a related party and re-sold to a party to transactions without affiliation, less the gross profit on the sale of the same or similar business;
- the cost-plus method – a method of pricing based on cost plus reasonable expenses and profit;
- the net profit method – a method of determining profit based on the level of net profit made by parties to unrelated transactions conducting the same or similar business transactions; and
- the profit-splitting method – a method of distributing the consolidated profits or losses of an enterprise and its related parties among the parties using reasonable criteria.

3.2 Unspecified Methods

Article 42 of the Enterprise Income Tax Law provides that an enterprise may propose to the tax authorities the pricing principles and calculation methods for business transactions between it and its related parties, and that the tax authorities will enter into an appointment pricing arrangement after consulting and confirming with the enterprise. In addition, Item 6 of Article 111 of the Regulations for the Implementation of the Enterprise Income Tax Law provides that taxpayers may use other methods of pricing in addition to those listed in the first five items that are consistent with the principle of independent transactions.

3.3 Hierarchy of Methods

The pricing methods are closely contrasted, and the tax authorities can flexibly choose reasonable transfer pricing methods based on comparability analysis according to the actual situation.

3.4 Ranges and Statistical Measures

There is no mandatory requirement for such measures in China's laws, but when the tax authorities analyse and assess whether the related transactions of the investigated enterprises comply with the principle of independent transactions, they can choose statistical methods such as the arithmetic average method, weighted average method or quartile method according to the actual situation, and calculate the average or quartile range of the profits or prices of the comparable enterprises year by year or on average for more than one year.

3.5 Comparability Adjustments

According to Article 15 of the Measures for the Administration of Adjustment and Mutual Negotiation Procedures for Special Tax Investigations, the tax authorities shall conduct a comparability analysis when implementing transfer pricing investigations. The comparability analysis generally includes five aspects:

- the characteristics of the assets or services traded;
- the functions performed, risks assumed and assets used by the parties to the transaction;
- the contract terms;
- the economic environment; and
- the business strategy.

4. Intangibles

4.1 Notable Rules

There are provisions on transfer pricing of intangible assets in the Measures for the Administration of Adjustment and Mutual Negotiation Procedures for Special Tax Investigation.

- The comparability analysis links – if the comparable non-controlled price method is adopted, when transferring the right to use or ownership of intangible assets, the category, use, applicable industry and expected return of the intangible assets – the development investment of the intangible assets, the conditions of the transfer, the degree of exclusivity, the substitutability, the degree and period of protection under the laws of the relevant countries, the geographic location, the life span of the intangible assets, the research and development stage, the maintenance, improvement and renewal of the rights, costs and expenses of the transferee, functional risks, amortisation method and other special factors affecting the value of the intangible assets.
- The allocation of intangible asset income should match the economic activities and value contribution. Enterprises that only own intangible assets without contributing to the value of intangible assets should not participate in intangible asset income distribution. In the process of formation and use of intangible assets, enterprises that only provide funds but do not actually perform the relevant functions and bear the corresponding risks should only obtain a reasonable return on the cost of funds.
- The royalties shall match the economic benefits brought by the intangible assets, and if they do not, the tax authorities shall make special tax adjustments to the royalties under statutory circumstances.

4.2 Hard-to-Value Intangibles

China has not yet landed the OECD's findings of difficult-to-value intangible assets from a legislative perspective.

4.3 Cost Sharing/Cost Contribution Arrangements

China recognises cost-sharing agreements. In addition to specific cost-sharing methods, the Announcement of the State Administration of Taxation on Regulating the Management of Cost-Sharing Agreements also stipulates that an enterprise shall, within 30 days from the date of signing (changing) a cost-sharing agreement with a related party, submit a copy of the cost-sharing agreement to the competent tax authorities, and attach a copy of the "Reporting Form on Annual Related Business Transactions of Enterprises in the People's Republic of China" to the annual enterprise income tax return. The tax authorities shall strengthen the follow-up management of cost-sharing agreements and implement special tax investigation adjustments for cost-sharing agreements that do not comply with the principles of independent transactions and matching of costs and revenues. If, during the period of implementation of a cost-sharing agreement by an enterprise, the actual revenues shared by the participant are not in proportion to the apportioned costs, compensatory adjustments shall be made in accordance with the actual situation. If the participants do not make compensatory adjustments, the tax authorities shall implement special tax investigation adjustments.

5. Affirmative Adjustments

5.1 Rules on Affirmative Transfer Pricing Adjustments

Articles 98, 100 and 101 of the Measures for the Implementation of Special Tax Adjustments (for Trial Implementation) provide that where one party to a connected transaction is subject to a transfer pricing investigation adjustment, the other party shall be allowed to make a corresponding adjustment to eliminate double taxation. An enterprise shall file an application for corresponding adjustment within three years from the date when the enterprise or its related party receives the notice of transfer pricing adjustment, and the tax authorities shall not accept the application if it exceeds three years. However, the corresponding adjustment will not be made for taxes already withheld involving the payment of interest, rent and royalties by the enterprise to its overseas related parties.

6. Cross-Border Information Sharing

6.1 Sharing Taxpayer Information

To date, China has signed three multilateral tax agreements, namely:

- the Multilateral Convention on Mutual Assistance in Tax Administration;
- the Multi-Variable Inter-Authority Agreement on Automatic Exchange of Tax-Related Information on Financial Accounts; and
- the Multilateral Convention on the Implementation of Measures Concerning Tax Agreements to Prevent Base Erosion and Profit Shifting.

In addition, China has signed separate tax information exchange agreements with ten countries, including the Bahamas, the British Virgin Islands, and the Cayman Islands. The OECD released the second round of peer review report on tax information exchange in Mainland China in 2020, which shows that Mainland China has entered into a number of tax information exchange agreements with ten other countries through Double Taxation Agreements (DTAs), Tax Information Exchange Agreements (TIEAs), and Multilateral Mutual Assistance in Tax Administration and Administration (MCAA) treaties. In total, Mainland China has established tax information exchange relationships with 162 countries/regions.

7. Advance Pricing Agreements (APAs)

7.1 Programmes Allowing for Rulings Regarding Transfer Pricing

An enterprise may enter into a reservation pricing arrangement with the tax authorities in respect of the pricing principles and calculation methods for the enterprise's connected transactions in future years in accordance with Article 42 of the Enterprise Income Tax Law, Article 113 of the Regulations for the Implementation of the Enterprise Income Tax Law, Article 53 of the Rules for the Implementation of the Law on the Administration of Taxation and the Implementation of the Special Taxation Adjustment (for Trial Implementation) and Article 46 of the Special Taxation Adjustment Implementation Measures.

7.2 Administration of Programmes

The appointment pricing arrangement shall be accepted by the tax authorities of the cities and autonomous regions above the district.

7.3 Co-ordination Between the APA Process and Mutual Agreement Procedures

In order to eliminate the problem of international double taxation, Articles 47 to 61 of the Administrative Measures on Adjustment and Mutual Negotiation Procedures for Special Tax Surveys stipulate the mutual negotiation procedures, linking the negotiation of appointment pricing arrangements with the mutual negotiation procedures for transfer pricing. The Article states that, according to the relevant provisions of the tax agreements signed by China, the State Administration of Taxation may, based on the application of the enterprise or the request of the tax authority of the contracting party of the tax agreement, initiate the mutual consultation procedure to carry out consultation and negotiation with the tax authority of the contracting party of the tax agreement, so as to avoid or eliminate the international double taxation caused by the matters of the special tax adjustments. Mutual consultation includes:

- negotiation of bilateral or multilateral reservation pricing arrangements; and
- negotiation of corresponding adjustments caused by the implementation of special tax investigation adjustments by one party to the tax agreement.

7.4 Limits on Taxpayers/Transactions Eligible for an APA

Enterprises applying the appointment pricing arrangement are required to fulfil the conditions that (i) the amount of connected transactions occurring in the year is RMB40 million or more; (ii) they fulfil the obligation to make connected declarations in accordance with the law; and (iii) they prepare, preserve and provide the information for the same period as required, and are applicable to the connected transactions for three to five consecutive years starting from the year after the year in which the enterprise submits the formal written application.

7.5 APA Application Deadlines

Enterprises shall submit a written application report on the appointment pricing arrangement to the tax authorities within three months from the date of receipt of the formal notice of talks from the tax authorities.

7.6 APA User Fees

Taxpayers who fulfil the conditions may apply to the tax authorities for an appointment pricing arrangement without having to pay dues.

7.7 Duration of APA Cover

The appointment pricing arrangement applies to connected transactions for three to five consecutive years starting from the year following the year in which the enterprise submits its formal written application.

7.8 Retroactive Effect for APAs

If the enterprise's connected transactions in the year of application or previous years are the same or similar to the year to which the appointment pricing arrangement applies, the pricing principles and calculation methods determined by the appointment pricing arrangement may be applied to the assessment and adjustment of the connected transactions in the year of application or previous years upon the enterprise's application and the approval of the tax authorities.

8. Penalties and Documentation

8.1 Transfer Pricing Penalties and Defences

If a taxpayer fails to submit to the tax authorities an annual report form on the enterprise's related

business transactions in accordance with the regulations, or fails to keep the same period of time or other relevant information, it shall be dealt with in accordance with the provisions of Articles 60 and 62 of the Levy Management Law; if it refuses to provide the same period of time or other relevant information on the related transactions, or if it fails to provide false or incomplete information to truly reflect its related business transactions, it shall be dealt with in accordance with the provisions of Articles 70, 96, 44 of the Income Tax Law and 115 of the Regulations for the Implementation of the Levy Management Law. The refusal to provide relevant information on related transactions such as contemporaneous information or the provision of false and incomplete information that fails to truly reflect its related business transactions shall be dealt with in accordance with Article 70 of the Levy Control Law, Article 96 of the Implementation Rules of the Levy Control Law, Article 44 of the Income Tax Law and Article 115 of the Implementation Regulations of the Income Tax Law. Where special tax adjustments are involved, additional tax and interest may also be required.

The way for taxpayers to avoid legal liabilities is to file complete and truthful relevant information in a timely manner in accordance with the provisions of the tax law.

Taxpayers are required to submit contemporaneous information in accordance with the regulations, which mainly includes organisational structure, production and operation, related transactions, comparability analysis, and the selection and use of transfer pricing methods. If taxpayers do not submit contemporaneous information in accordance with the regulations, they are legally liable according to the aforementioned provisions.

8.2 Taxpayer Obligations Under the OECD Transfer Pricing Guidelines

Taxpayers are required to file the main document, the local document, and the special matter document (including the cost-sharing agreement special matter document and the capital weakening special matter document) in accordance with the regulations. In addition, a resident enterprise with one of the following circumstances should file a country report when filing the annual related business transaction report form:

- the resident enterprise is the ultimate controlling enterprise of a multinational enterprise group and the total amount of all types of revenues in its consolidated financial statements in the previous fiscal year exceeds CNY5.5 billion; and
- the resident enterprise is designated by the multinational enterprise group as the reporting enterprise for the country report.

9. Alignment With OECD Transfer Pricing Guidelines

9.1 Alignment and Differences

With the improvement of the legislation, especially the issuance of the Measures for the Administration of Special Tax Investigation Adjustment and Mutual Consultation Procedures, the harmonisation of China's transfer pricing regulatory system with the OECD Transfer Pricing Guidelines has been substantially improved. However, some deviations still exist. For example, the Transfer Pricing Guidelines (2022 edition) have made additional revisions to the Guidelines on the Application of the Transaction Profit Split Method, the Guidelines on the Application of Tax Administration on Intangible Assets Difficult to Value, and the Guidelines on Transfer Pricing of Financial Transactions on the basis of the 2017

edition, but China has yet to introduce corresponding or specific transfer pricing laws and regulations.

9.2 Arm's Length Principle

The transfer pricing rules do not deviate from the arm's length principle. The arm's length principle is the basic principle on which transfer pricing is based, and it is the key for the tax authorities to determine the transfer price to be applied in unconventional transactions. The selection of an appropriate pricing method based on comparability analysis and the elimination of the impact of differences in the conditions of controlled transactions and those of independent enterprises through reasonable and accurate adjustments are precisely the embodiment of the arm's length principle.

9.3 Impact of the Base Erosion and Profit Shifting (BEPS) Project

The State Administration of Taxation (SAT) attaches great importance to the four minimum standards of harmful tax competition (involving domestic preferential tax system), prevention of agreement abuse, country-specific reporting and dispute resolution contained in the BEPS project results, and actively promotes their transformation and implementation in China, and has successively issued a series of regulations and normative documents to strengthen the management of anti-avoidance, such as the Measures for the General Administration of Anti-Avoidance, and the Measures for the Administration of Indirect Transfer of Property by Non-Resident Enterprises. Drawing on the nine theoretical achievements involving special tax adjustments in the BEPS Action Plan, the General Administration of Taxation, combined with the domestic practical experience in special tax investigation and adjustment work over the years, supplemented, modified and refined the relevant contents of the Notice of the State Administration of Taxation on the Issuance of Measures for the Implementation of Special Tax Adjustments (for Trial Implementation), and in March 2017 issued the "Administrative Measures for Special Tax Investigation Adjustment and Mutual Consultation Procedures" (the "Measures"), which regulate or update the transfer pricing methodology and special tax investigation adjustments.

In order to fulfil its commitment on minimum standards, the SAT issued the Announcement of the State Administration of Taxation on Matters Relating to the Improvement of Related Matters on Connected Declarations and Contemporaneous Information in May 2016, which clarifies the contents of contemporaneous information and country-by-country reports, and at the same time, combines with the years of anti-avoidance work practice to refine the contents of connected declarations. Appointment pricing arrangement is an effective way to prevent tax disputes and improve tax certainty. China started the practice of appointment pricing arrangement since the late 1990s and has continuously revised and adjusted it according to the development situation, and issued the Announcement of the State Administration of Taxation on Matters Related to the Improvement of the Management of Appointment Pricing Arrangement. China has incorporated BEPS-related results in the negotiation or revision of tax agreements, especially the four minimum standards have been landed one after another in terms of tax agreements, and has also incorporated some non-minimum standard recommendations of BEPS results, such as the inclusion of provisions on the application of tax agreements to tax transparency bodies in the newly negotiated or revised tax agreements with the Congo (Brazzaville), Argentina, New Zealand, Italy, India, and others, the new double-resident enterprise Gabi rules, etc. The implementation

of many achievements has led to the continuous improvement of China's transfer pricing legal framework.

9.4 Impact of BEPS 2.0

Although China has not yet introduced a domestic policy, China has joined the two-pillar statement in 2021, China's finance and taxation department has been deeply involved in the BEPS 2.0 project throughout, and the tax department has already indicated that it will steadily push forward the relevant rules to land in China on the basis of a comprehensive analysis. This shows that China is supportive of the BEPS 2.0 project.

The "two-pillar" programme superimposes the contradictory and potentially conflicting rules on the division of taxing rights and new systems such as the single tax system and the formula allocation method on top of the existing rules in the form of common technical standards, which is a compromise programme for making "moderate but significant" changes to the established international tax framework. The potential impacts of BEPS 2.0 on China are mainly reflected in the following aspects:

- the rapid transformation of profit distribution mechanism to formula allocation method;
- the choice of subsidies and tax incentives;
- the step-up of tax transparency;
- the convergence of the global tax base; and
- the impact on the global tax governance tradition.

9.5 Entities Bearing the Risk of Another Entity's Operations

There are currently no relevant regulations in the PRC concerning this.

10. Relevance of the United Nations Practical Manual on Transfer Pricing

10.1 Impact of UN Practical Manual on Transfer Pricing

The United Nations Practical Manual on Transfer Pricing for Developing Countries has a positive impact on transfer pricing practice in China. For example, the manual provides some guidance on key issues such as valuation of intellectual property rights, the nature and generation of intangible assets and the ownership of assets among entities that are members of a multinational group, which will promote transfer pricing practice in China and provide a further scientific basis for the resolution of some difficult issues. However, the UN Operational Manual also leaves room for improvement, for example, the relevant sections of the manual rarely discuss the valuation of intra-group royalty rates. For developing countries, member entities are usually licensees rather than owners of valuable intangible assets, and it is difficult to analyse the relevant issues thoroughly and provide guidance to developing countries on the issue by discussing in a relatively short space what constitutes a royalty rate in line with the principle of independent trading.

11. Safe Harbours or Other Unique Rules

11.1 Transfer Pricing Safe Harbours

Transfer pricing safe harbours exist in China. The Ministry of Finance State Administration of Taxation Circular on Tax Policy Issues Relating to Pre-tax Deduction Standards for Interest Expenditures by Related Parties of Enterprises (*Cai Shui* [2008] No 121), and the chapter on Capital Weakness Management of the Implementation Measures for Special Tax Adjustments (for Trial

Implementation) stipulate that interest expenditures are not subject to pre-tax deduction. The ratio of financial enterprises accepting creditor investments from related parties to their equity investments is 5:1, and the ratio for other enterprises is 2:1. Interest in excess of this shall not be deducted before tax, and shall be allocated among related parties in accordance with the ratio of the actual interest paid to each related party to the total amount of interest paid to the related parties, among which the interest allocated to the domestic related parties with a higher effective tax burden than the enterprise is permitted to be deducted. The interest paid directly or indirectly to the overseas related parties shall be treated as dividends distributed and subject to enterprise income tax in accordance with the difference between the income tax rates applicable to dividends and interest respectively, and if the amount of income tax withheld is more than the amount of income tax payable on the basis of dividends, the excess shall not be refunded.

11.2 Rules on Savings Arising From Operating in the Jurisdiction

This is mainly reflected in Chapter 8 of the Special Tax Adjustment Implementation Measures (for Trial Implementation), the chapter on the management of controlled foreign enterprises. If a resident enterprise, or an enterprise controlled by a resident enterprise and a resident individual, which is established in a country (region) where the effective tax burden is lower than 50% of the level of the tax rate stipulated in Article 4(1) of the Income Tax Law, does not distribute or reduces the distribution of its profits not due to the reasonable needs of its operation, the portion of the said profits attributable to the resident enterprise shall be included in the current income of the resident enterprise.

11.3 Unique Transfer Pricing Rules or Practices

The formulation of China's transfer pricing regulations has also taken into account Chinese reality on the basis of international rules. For example, in terms of the requirements for contemporaneous information, compared with the OECD BEPS action plan, there are additional requirements for the main body of transfer pricing documentation and local documentation in China. Another example is that there are difficulties in the practical application of the principle of independent transaction in developing countries, and China recognises the core position of the principle of independent transaction in the field of transfer pricing. However, when the independent transaction principle is considered difficult to be implemented accurately, the Chinese tax authorities do not rule out the possibility of introducing some other principles to analyse transfer pricing cases. A further example is the existence of territorial special factors in China, and in analysing territorial special factors, China adopts the method of identifying the existence of a territorial special factor, confirming whether the territorial special factor generates additional profits, quantifying and measuring that additional profit, determining the appropriate transfer pricing methodology for allocating that profit, which is quite different from the analytical methodology in the OECD Transfer Pricing Guidelines, and so on.

12. Co-ordination With Customs Valuation

12.1 Co-ordination Requirements Between Transfer Pricing and Customs Valuation

There is no mandatory requirement for the co-ordination of transfer pricing and customs valu-

ation. However, due to the significant differences in the positions, focuses and audit calibers of customs and tax supervision, customs and tax authorities may arrive at different fair price reference standards for the same cross-border connected transaction, and it is very necessary to co-ordinate transfer pricing and customs valuation. Multinational enterprises can take corresponding measures in practice to take into account the different requirements of tax and customs. For example, when Customs conducts valuation investigations on imported goods, it will collect and refer to the contemporaneous information documents submitted by enterprises to the tax authorities. Therefore, enterprises in the preparation of the same period of information documents, especially the process of local documents, can take into account the requirements of the Customs and Excise authorities, taking into account the results of the net profit and gross profit of comparable enterprises, to ensure that the net profit and gross profit are located in a reasonable range of comparable enterprises. If it is indeed impossible to obtain a more satisfactory profit result, based on the relevance and differences of profit indicators, and taking into account the market environment, business cycle, stage of development of the enterprise and other special matters, it is possible to make preparations for the collection of evidence and analysis and explanation in advance.

13. Controversy Process

13.1 Options and Requirements in Transfer Pricing Controversies

The tax authorities, based on the Enterprise Annual Affiliated Business Transaction Report Form filled out by the enterprise, summarise, analyse and identify the amount of business transactions between the affiliated enterprises, so as to determine the object of transfer pricing key investigations, and then report to the competent leadership for approval and implementation of the investigation of the enterprise organisation.

Implementation of the Transfer Pricing Audit

- Select cases of transfer pricing, determine the investigated enterprises, and then issue the Notice of Tax Inspection.
- When the tax authorities implement the special tax investigation, they may, in accordance with the legal authority and procedures, adopt the methods of field investigation, access to the information in the account books, inquiries, inquiries into the deposit accounts or savings deposits, issuance of letters of concurrence, offsite investigations, and exchange of international tax information. For the investigated enterprises adopting electronic information system for management and accounting, the tax authorities may require the enterprises to provide relevant tax-related information.
- The information required to be provided by the enterprises shall be issued with a notice of tax matters, and the enterprises may be investigated on-site and the relevant persons may be interviewed, so as to understand the business substance of the enterprises such as functions, risks and assets and to find out the suspected points of tax avoidance.
- After the investigation, if the enterprises' connected transactions are in line with the independent transaction principle, the tax authorities shall make a conclusion on transfer pricing investigation and serve a Notice of Conclusion on Special Tax Investigation to the enterprise. If it is not in line with the principle of independent transaction, the enterprise shall conduct consultation and

negotiation with the enterprise after the formation of the preliminary adjustment opinion, and after the consultation and negotiation, the enterprise shall be issued the Notice of Preliminary Adjustment of Special Taxation Investigation, and the enterprise shall have the opportunity to provide written materials if there are any objections and further explanations of defences within seven days; if there are no objections to the preliminary adjustment opinion, the tax authorities shall issue the Notice of Adjustment of Special Taxation Investigation.

- The enterprise shall be entitled to submit a request for the adjustment of special taxation – according to the adjustment notice issued by the tax authority, the enterprise may request the tax authorities of both countries to carry out the corresponding adjustment and mutual consultation procedures in order to eliminate the double taxation problem arising from the transfer pricing adjustment.

If a taxpayer is not satisfied with the audit result, he/she may file an administrative reconsideration; if he/she is still not satisfied with the administrative reconsideration, he/she may file an administrative litigation with the People's Court in accordance with the law.

The filing of administrative reconsideration or administrative litigation has the requirement of tax clearance prior to filing, and the taxpayer must pay or discharge the tax, interest, late payment or provide corresponding guarantee before applying for administrative reconsideration and filing administrative litigation in accordance with the law.

Not all administrative cases related to transfer pricing are under the jurisdiction of a single court. Administrative cases are under the jurisdiction of the People's Court where the administrative organ that initially issued the administrative act is located. Cases subject to reconsideration may also be subject to the jurisdiction of the People's Court at the location of the reconsideration organ. With the approval of the Supreme People's Court, the Higher People's Court may, in the light of the actual circumstances of the trial, determine that a number of people's courts shall have jurisdiction over administrative cases across administrative districts. Taxpayers enjoy the right to choose to a certain extent. For example, in cases where two or more People's Courts have jurisdiction, the taxpayer may choose one of the People's Courts to file a lawsuit. If a taxpayer files a lawsuit in more than two People's Courts with jurisdiction, the People's Court that files the case first shall have jurisdiction.

If a party does not accept the first instance decision of a People's Court, he has the right to appeal to a Higher People's Court within 15 days from the date of delivery of the judgment. Where a party does not accept a ruling of the People's Court of first instance, he or she has the right to appeal to a People's Court of a higher level within ten days from the date of delivery of the ruling. If no appeal is lodged after the deadline, the People's Court's judgment or ruling of first instance shall take legal effect. The People's Court shall form a collegial panel and hold a hearing on the appeal. If, after reviewing the files, investigating and questioning the parties, no new facts, evidence or reasons are put forward, and the collegial panel considers that a hearing is not necessary, it may not hold a hearing. When a People's Court hears an appeal case, it shall conduct a comprehensive review of the judgment and ruling of the People's Court of first instance and the administrative act under appeal. A People's Court hearing an appeal shall render a final judgment within three months from

the date of receipt of the appeal. Where special circumstances require an extension, the Higher People's Court shall authorise it, and where an extension is required for the hearing of an appeal by a Higher People's Court, the Supreme People's Court shall authorise it.

14. Judicial Precedent

14.1 Judicial Precedent on Transfer Pricing

On the one hand, China's tax authorities have strictly enforced the law and stepped up efforts to combat tax evasion, and since 2022, the amount of transfer pricing back-tax revenue has continued to set new historical records. On the other hand, the courts have been fair in administering justice and testing the scientific nature of transfer pricing-related regulations in the course of various special tax adjustment cases. The relevant jurisprudence is the specific application of laws and regulations, as well as the supplementation of transfer pricing rules. However, China has not yet published any official guiding cases or typical cases, and there is relatively little research material on transfer pricing jurisprudence, and the construction of jurisprudence library needs to be further improved.

14.2 Significant Court Rulings

The authors have not published any official guiding cases or typical cases on transfer pricing, and it is not possible to clarify which cases are the most important and have the most far-reaching impact.

15. Foreign Payment Restrictions

15.1 Restrictions on Outbound Payments Relating to Uncontrolled Transactions

China controls foreign exchange, and payments to non-controlled companies are required to go through the required filing and registration procedures or report information, and to submit to the bank information including contracts (agreements), invoices (payment notices) containing the subject matter of the transaction, the main body, and other elements, or settlement lists (payment lists) listing the subject matter of the transaction, the main body, and the amount of the transaction, and other elements. The bank examines the authenticity and reasonableness of the transaction in accordance with the three principles of business development. Under the current trend of tighter regulation of outbound funds, financial institutions may also submit to a higher-level banking institution for review when large-value outbound payments are involved.

15.2 Restrictions on Outbound Payments Relating to Controlled Transactions

Against the background of foreign exchange control, there are certain restrictions on payments to controlled companies. However, in order to promote the facilitation of trade and investment and serve the real economy, the State Administration of Foreign Exchange issued the Provisions on the Administration of Centralised Operation of Cross-border Funds of Multinational Corporations (*Hui fa* [2019] No 7), the Provisions on the Administration of Centralised Operation of Foreign Exchange Funds of Multinational Corporations (*Hui fa* [2015] No 36), and other documents, stipulating that multinational corporations meeting the conditions may, in accordance with the needs of their busi-

ness operations, select a domestic enterprise as the host enterprise centralised operation and management of funds of domestic and foreign member enterprises, and carrying out one or more of centralised foreign debt line, centralised overseas lending line, centralised collection and payment of current account funds, and rolling difference net settlement.

15.3 Effects of Other Countries' Legal Restrictions

China applies Chinese law to cases over which it has jurisdiction. Where it has entered into bilateral or multilateral agreements with other countries, it handles cases in accordance with the relevant agreements. In cases over which it does not have jurisdiction, it fully respects the application of the laws of other countries by the countries or regions that do have jurisdiction.

16. Transparency and Confidentiality

16.1 Publication of Information on APAs or Transfer Pricing Audit Outcomes

The SAT will publish the Annual Report on China's Appointment Pricing Arrangement (APA) in both Chinese and English, which will introduce China's APA implementation procedures and the development of related work. However, both parties are obliged to keep confidential all specific information materials obtained during the negotiation process of appointment pricing arrangement between tax authorities and enterprises. Except for cases where the information should be provided to the relevant authorities in accordance with the law, the tax authorities shall not disclose the information related to the appointment pricing arrangement in any way without the consent of the taxpayer. Similarly, the tax authorities will not disclose the specific results of a transfer pricing audit of a tax subject on their official website.

16.2 Use of "Secret Comparables"

Enterprise tax-related information usually has a certain commercial value and shall be kept confidential by the tax authorities when the law does not provide for its disclosure. The acquisition of such secret comparable data by others through illegal means may lead to trade secret infringement.

COSTA RICA

Law and Practice

Contributed by:
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KPMG Costa Rica is part of KPMG, a global organisation and professional services firm providing audit, tax, legal and advisory services. KPMG firms operate in 143 countries and territories, and in FY23 collectively employed more than 273,000 partners and people, serving the needs of businesses, governments, public-sector agencies and not-for-profit organisations. KPMG Costa Rica has 14 partners and more than 350 professionals. Its main office is located in San José, and its transfer pricing team has expertise in planning, compliance and documentation, financial reporting, implementation and dispute resolutions. Its main clients are in the sectors of financial services, manufacturing, distribution of raw materials and final goods, retail, logistics and transportation, real estate, agriculture, entertainment, energy and pharmaceutics. Relevant recent work includes litigation support in a transfer pricing adjustment proposed by the tax authority for approximately USD2 million to a pharma distribution taxpayer (focusing primarily on comparable analysis).

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1. Rules Governing Transfer Pricing

1.1 Statutes and Regulations

Article 81 bis of Law 7092 and Articles 74 to 83 of the Income Tax Law Regulations, Decree 43198-H, incorporate the arm's length principle and regulate the application of transfer pricing rules in Costa Rica.

In accordance with the referred Law and Regulations (more specifically Article 82 of the Regulations), taxpayers must have the information, documentation and analysis of transfer prices that support the calculation of the consideration agreed between related parties. The documentation and information related to the calculation of transfer prices must be kept during the term provided for in Article 109 of the Tax Code.

Additionally, taxpayers that qualify as large taxpayers and/or that are under the free trade zone regime, or that exceed the accumulated amount of intercompany transactions of 1,000 base salaries in the corresponding year, must file an annual informative form of the transactions they carry out with related parties, in accordance with Article 81 of the aforementioned Regulations.

1.2 Current Regime and Recent Changes

The Costa Rican tax administration issued Guideline No 20-03, published in 2003, many years before the matter of transfer pricing was formally included in tax legislation. This Guideline enabled the tax authority to assess transactions between related parties. The authorities made tax adjustments when the analyses concluded that the transactions between related parties did not observe the market price (not a full application of the arm's length principle). This approach was confirmed by the Constitutional Court, which stipulated that as long as international procedures (such as the OECD Guidelines) were followed, such procedure was in accordance with the law.

Further rules were included in the Income Tax Regulations in 2013. In 2016, a resolution incorporated the obligation to prepare and file the transfer pricing return. A second resolution issued in 2017 (amended in 2019) detailed the terms by which the local and master files are to be prepared.

In 2019, an important tax reform amended the Income Tax Law, among other topics. Article 81 bis was included, referring to transfer pricing obligations and finally resolving the discussions on the legal status thereof. In 2021, a decree amending the Income Tax Regulations entered into force. The current Costa Rican transfer pricing rules are aligned with the OECD Guidelines.

2. Definition of Control/Related Parties

2.1 Application of Transfer Pricing Rules

Related parties are considered to be those established in Article 2 of the Income Tax Law, as well as those residing abroad or in the national territory, that participate directly or indirectly in the management, control or capital of the taxpayer or of both parties, or that for any other objective reasons exercise a systematic influence in their decisions regarding the price. Also, transactions involving non-cooperative jurisdictions must be analysed.

One of the following conditions must be met:

- one party directs or controls the other or owns, directly or indirectly, at least 25% of its share capital or voting rights;

- five or fewer people direct or control both legal entities, or jointly own, directly or indirectly, at least 25% of the share capital or voting rights of both persons, when dealing with legal entities that constitute the same decision-making unit; or
- two or more legal entities each form a decision-making unit with respect to a third legal entity, in which case all of them will form a decision-making unit.

For these purposes, a natural person is also considered to have a participation in the share capital or voting rights, when the ownership of the participation, directly or indirectly, corresponds to the spouse or person linked by family relationship (online, direct or collateral), by consanguinity up to the fourth degree or by affinity up to the second degree.

Related parties will also be considered to be:

- in a business collaboration contract or a joint association contract, when any of the contracting parties or associates participate, directly or indirectly, in more than 25% in the result or profit of the contract or the activities derived from the association;
- a person residing in the country and its permanent establishments abroad; and
- a permanent establishment located in the country and its parent company residing abroad, another permanent establishment thereof, or a person related to it.

3. Methods and Method Selection and Application

3.1 Transfer Pricing Methods

Local legislation provides for the following transfer pricing methods:

- comparable uncontrolled price method;
- cost-plus method;
- resale price method;
- profit split method;
- transactional net margin method; and
- international market prices for commodities (transfer pricing sixth method).

3.2 Unspecified Methods

Costa Rica does not allow a taxpayer to use methods not specified by law.

3.3 Hierarchy of Methods

The law does not establish a hierarchy of methods. The taxpayer must choose the best method and justify it.

3.4 Ranges and Statistical Measures

Article 80 of the Income Tax Regulations states that in appropriate cases (ie, where there are two or more comparable observations), the interquartile range will be determined using the series of the identified comparables. If the price or margin of the analysed transaction is outside the range contained between the first and third quartile, the value or price is not considered as arm's length, and the median is established as the arm's length price.

3.5 Comparability Adjustments

Reasonable adjustments can be made to eliminate the material effects of differences in comparability.

4. Intangibles

4.1 Notable Rules

The Income Tax Law rules that royalty expenses cannot exceed 10% of the taxpayer's income despite compliance with transfer pricing rules.

4.2 Hard-to-Value Intangibles

There are no special rules for hard-to-value intangibles.

4.3 Cost Sharing/Cost Contribution Arrangements

There are no specific rules on this topic. However, in an analysis of substance over form, the tax authority assesses:

- the basis of calculation;
- the distribution drivers;
- the documentation; and
- in particular, the value added and its relationship with taxable income.

5. Affirmative Adjustments

5.1 Rules on Affirmative Transfer Pricing Adjustments

A taxpayer may amend a tax return after receiving a transfer pricing adjustment in a related entity. It is not automatic and is not initiated by the tax authority.

6. Cross-Border Information Sharing

6.1 Sharing Taxpayer Information

Costa Rica has a small double tax treaty network with Spain, Germany, Mexico and the United Arab Emirates. Additionally, Costa Rica is member of the Organisation for Economic Co-operation and Development (OECD) and has a contractual and moral obligation to comply with the related recommendations issued to it.

Costa Rica is also a signatory to the Convention on Mutual Administrative Assistance in Tax Matters, and is a member of the Global Forum on Transparency and Exchange of Information for Tax Purposes.

7. Advance Pricing Agreements (APAs)

7.1 Programmes Allowing for Rulings Regarding Transfer Pricing

Taxpayers may request an advance pricing agreement from the tax administration in order to determine the valuation of transactions between related persons, prior to their execution. Such request must be accompanied by a proposal from the taxpayer based on the value of the transactions that would have been agreed upon by independent parties.

7.2 Administration of Programmes

Programmes are administered by the tax authority, the *Dirección General de Tributación, Ministerio de Hacienda*.

7.3 Co-ordination Between the APA Process and Mutual Agreement Procedures

Costa Rica has not yet signed any APA with a taxpayer, so there is no experience in this regard.

7.4 Limits on Taxpayers/Transactions Eligible for an APA

There are no limits, and any transaction or taxpayer can be eligible. It is important to note that when a consensus between the taxpayer and the tax administration is not reached, the process stops, and no appeal is allowed.

7.5 APA Application Deadlines

An APA application can be filed at any time.

7.6 APA User Fees

Currently, no APA user fees are charged.

7.7 Duration of APA Cover

An APA covers five years, which are determined by two alternatives:

- as the tax period in which the application is filed and the following four tax periods; or
- that the five fiscal periods begin in the fiscal period following the date of filing the application.

7.8 Retroactive Effect for APAs

An APA cannot have retroactive effect, and could only cover the current and future fiscal years.

8. Penalties and Documentation

8.1 Transfer Pricing Penalties and Defences

The penalty for not submitting the information requested by the tax authority in time is 2% of the prior year's revenue with a minimum of three base salaries and a maximum of 100 base salaries.

8.2 Taxpayer Obligations Under the OECD Transfer Pricing Guidelines

Taxpayers are required to prepare all files and reports contemplated by the OECD Transfer Pricing Guidelines.

9. Alignment With OECD Transfer Pricing Guidelines

9.1 Alignment and Differences

Costa Rica transfer pricing rules are fully aligned with the OECD Transfer Pricing Guidelines.

9.2 Arm's Length Principle

Costa Rica transfer pricing rules are based on the standard arm's length principle.

9.3 Impact of the Base Erosion and Profit Shifting (BEPS) Project

Costa Rica is member of the OECD/G20 Inclusive Framework on BEPS and has also agreed to the Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy. Costa Rica has adopted and included specific rules in the Income Tax Law – ie, BEPS Actions 4, 8, 9, 10 and 13, related to transfer pricing.

9.4 Impact of BEPS 2.0

Costa Rica has not yet adopted a position on the OECD's BEPS 2.0 initiatives involving Pillar One and Pillar Two, and there is no public discussion yet on this topic. The adoption of BEPS 2.0 is seen as having a particular impact on free trade zone companies.

9.5 Entities Bearing the Risk of Another Entity's Operations

There are no specific rules in this regard; however, the tax authority may require all supporting documentation, including a local file, to validate the relevant transaction from a transfer pricing point of view.

10. Relevance of the United Nations Practical Manual on Transfer Pricing

10.1 Impact of UN Practical Manual on Transfer Pricing

Costa Rica does not consider the UN Practical Manual on Transfer Pricing when setting transfer pricing rules.

11. Safe Harbours or Other Unique Rules

11.1 Transfer Pricing Safe Harbours

There are no transfer pricing safe harbours in place.

11.2 Rules on Savings Arising From Operating in the Jurisdiction

Costa Rica does not have specific rules governing savings arising from operating entities in the country.

11.3 Unique Transfer Pricing Rules or Practices

Costa Rica does not have any notable unique transfer pricing rules or practices.

12. Co-ordination With Customs Valuation

12.1 Co-ordination Requirements Between Transfer Pricing and Customs Valuation

There is no obligation to co-ordinate, and in fact there is no co-ordination between transfer pricing and customs valuation.

13. Controversy Process

13.1 Options and Requirements in Transfer Pricing Controversies

The conclusion of a tax audit may lead to a transfer pricing adjustment against the taxpayer. In such case, the taxpayer has the right to challenge the tax adjustment following the administrative procedure, and to subsequently take the matter to court, if necessary – ie, they may renounce the administrative procedure and challenge the tax adjustment immediately at the judicial level. It is not mandatory for any taxpayer to pay the disputed amounts before challenging the matter either at the administrative level or before court.

Taxpayers are normally inclined to challenge any tax adjustments first by following the administrative procedure. This is mainly because there are no judicial courtrooms specialised in tax matters or transfer pricing issues. Consequently, the administrative tax procedure carried out before the tax authority and the Ministry of Finance provides some technical comfort that is worth exploring.

The administrative procedure grants the taxpayer with the possibility of filing a reversal recourse against the tax adjustment. This recourse is studied and resolved within the tax authority. If the reversal recourse is rejected, the taxpayer may file an appeal to ensure further review of its case. The appeal will be studied and resolved by a higher resolution body, within the Ministry of Finance (and which is independent of the tax authority). This higher resolution body within the Ministry of Finance issues the final ruling on the matter, at the administrative level. If the ruling is against the taxpayer, the tax authority may initiate collection efforts against the taxpayer.

The party affected by the resolution issued by the Ministry of Finance (ie, the losing party – either the taxpayer or the tax authority) may decide to file a lawsuit and continue challenging the tax adjustment before court.

Once the matter is addressed at court, the case is assigned to a tribunal. Three judges will review the case and issue a judicial ruling. The ruling issued by the tribunal may be appealed, and the appeal must be filed before the Supreme Court of Justice, which is the highest court tier within

the domestic judicial system. Contrary to ordinary courtrooms, the Supreme Court of Justice has magistrates that are either tax experts or are knowledgeable on tax matters, granting taxpayers a final opportunity to obtain a technical review of the case. There is no court specialised in transfer pricing issues, which means that transfer pricing disputes will be subject to the same procedure mentioned above.

14. Judicial Precedent

14.1 Judicial Precedent on Transfer Pricing

There are few judicial precedents on transfer pricing in Costa Rica. Very few cases have gone all the way to the Supreme Court. Most cases have been ruled in favour of the tax authority, mainly arguing that the taxpayer did not provide enough proof to reject the tax auditor analysis. From a technical perspective, these cases have not been profoundly analysed.

14.2 Significant Court Rulings

Special reference is made to a ruling of the Constitutional Court validating the use of the OECD Transfer Pricing Guidelines, as soft law, before the relevant rules were included in the Income Tax Law. The following should be noted.

- No 20-03: tax treatment of transfer pricing, according to the arm's-length principle by the *Dirección General de Tributación* (tax authority). It was established that the application of the transfer pricing regulations involved technical regulations and such application was in accordance with the legal system.
- No 1365-2013: Nestlé Costa Rica SA. The company alleged unconstitutionality of the transfer pricing rules; the company lost the case.
- No 475-2013: Colgate Palmolive Costa Rica SA. The company alleged unconstitutionality of the transfer pricing rules; the company lost the case.
- No 383-2022: on the most appropriate transfer pricing method and application according to the OECD Guidelines.

15. Foreign Payment Restrictions

15.1 Restrictions on Outbound Payments Relating to Uncontrolled Transactions

There are no restrictions on outbound payments relating to uncontrolled transactions.

15.2 Restrictions on Outbound Payments Relating to Controlled Transactions

There are restrictions on outbound payments relating to controlled transactions. The limitation applies to technical or financial assistance and for royalty charges, which cannot exceed 10% of the taxpayer's gross income.

15.3 Effects of Other Countries' Legal Restrictions

Expenses of a local entity that are incurred with a non-cooperating country or "tax haven" are considered transactions with related parties. Such countries are:

- Bosnia-Herzegovina;
- North Korea;
- Cuba;
- Iraq;
- Norfolk Island;
- Kyrgyzstan;
- North Macedonia;
- the Maldives;
- Montenegro;

- Oman;
- Palestine;
- East Timor; and
- Uzbekistan.

16. Transparency and Confidentiality

16.1 Publication of Information on APAs or Transfer Pricing Audit Outcomes

No APAs have yet been signed with taxpayers. Transfer pricing outcomes may be published maintaining the confidentiality of the process.

16.2 Use of "Secret Comparables"

The use of "secret comparables" is prohibited by law.

Trends and Developments

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KPMG Costa Rica is part of KPMG, a global organisation and professional services firm providing audit, tax, legal and advisory services. KPMG firms operate in 143 countries and territories, and in FY23 collectively employed more than 273,000 partners and people, serving the needs of businesses, governments, public-sector agencies and not-for-profit organisations. KPMG Costa Rica has 14 partners and more than 350 professionals. Its main office is located in San José, and its transfer pricing team has expertise in planning, compliance and documentation, financial reporting, implementation and dispute resolutions. Its main clients are in the sectors of financial services, manufacturing, distribution of raw materials and final goods, retail, logistics and transportation, real estate, agriculture, entertainment, energy and pharmaceutics. Relevant recent work includes litigation support in a transfer pricing adjustment proposed by the tax authority for approximately USD2 million to a pharma distribution taxpayer (focusing primarily on comparable analysis).

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Introduction

In October 2023, the Costa Rican Ministry of Finance communicated its plan to strengthen the capacities for transfer pricing analysis supported by:

- the Organisation for Economic Co-operation and Development (OECD);
- the Board of Secretariats of Finance (in Spanish, COSEFIN);
- the Spanish State Agency;
- the German Embassy; and
- the Inter-American Centre of Tax Administrations (CIAT).

At that meeting, the authorities expressed their interest in providing legal certainty for direct foreign investment in Costa Rica and the Central American region. This co-operation takes the form of training, control and audit assistance, and technology management in tax audit process, among others.

Under the tax audit function of the local tax authority, the *Direccion General de Tributacion* (DGT), discussions and adjustments are ongoing based on local tax law and the OECD Transfer Pricing Guidelines. However, legal uncertainty continues to arise from extensive interpretations or the use of criteria which are not adequately justified, in areas such as:

- rejection of comparable companies or transactions for geographical reasons or operating losses; and
- segmentation of economic activities of the taxpayer by applying proportionality ratios based on assumptions, etc.

Disputes are not being resolved at the administrative stage, and most continue to the judicial stage. At judicial level, disputes are being resolved for audits of fiscal years prior to 2019, years in which there was no provision in the Income Tax Law and the Income Tax Rulings were not updated. In the court decisions, there is no technical, in-depth review or discussion on the matter or use of comparative law. A few cases are resolved every year, most of which have been decided against the taxpayer.

Owing to the attractiveness of Costa Rica as a location for manufacturing operations, service centres, and research and development, using exemption regimes such as Free Trade Zones, the institutions involved in co-operation with the Ministry of Finance can be expected to develop more robust teams to enhance legal certainty, detect aggressive tax planning, and streamline control and audit activity. The authors are not aware of recent tax audits on intangible transactions and of the DEMPE (development, enhancement, maintenance, protection and exploitation) analysis.

Alleged Use of Estimations in Tax Audit Adjustments

The tax authority has been carrying out transfer pricing analyses of the distribution activities of end-consumer goods, regarding both multinational and local economic groups. In Costa Rica, the mandatory analysis of the arm's length principle also applies to local intercompany transactions. To carry out its analysis, the tax authority has segmented sales to related parties and third parties, and across all the profits and losses lines, both in cost of sales and general expenses.

In a tax dispute which is still being conducted at administrative level, a taxpayer has been asked to perform the segmentation of the income statement. The taxpayer could segment the cost of sales; however, it has been explained that sell-

ing, general and administrative (SG&A) expenses, as well as sales and distribution expenses, cannot be directly segmented. The tax authority used the proportionality of the cost of sales for each segment to the full cost of sales to assume the allocation of the SG&A to related parties and third parties. In this case, the analysis, explanations and the taxpayer's financial statements were completely omitted, as was the justification of the tax authority in assuming that this proportionality ratio would lead to an accurate result.

There is an interesting precedent for the court regarding this type of assumption applied by the tax authority. In Resolution 00098-2021, the Administrative Dispute Tribunal annulled the adjustment determined by the DGT. Two issues in this resolution are of note.

First, the taxpayer provided a timely and comprehensive transfer pricing study, showing alignment with overall corporate policies as well as with the OECD Transfer Pricing Guidelines. The resolution noted that the tax authority did not assess this documentation and therefore did not refer to it for rejection. The taxpayer provided the necessary evidence to enable the judge to understand and assess whether he had committed a tax offence.

Second, the tax authority, as read in the resolution, did not evaluate the accounting as a certain basis and did not substantiate the rejection in line with the legal criteria in force. The court indicated that the reason given by the authority for considering the accounting irregular was that the taxpayer obtained operating losses. The court found that "negotiation below cost could result from many business-related reasons, but the tax authorities had to respect this, especially since there was no evidence to suggest a different situation". It made clear that the authority retains its power to verify transfer prices based on the facts.

In the above-discussed case at administrative level, the taxpayer also provided a transfer pricing study as well as its accounting books and financial statements, and met requirements during the audit process. In contrast to the case before the court, in this case the tax authority did not expressly disregard the accounting and the study of transfer pricing, but performed its own transfer pricing study, applying the segmentation explained above and taking certain sections from the study presented by the taxpayer. In the section on the selection of comparables, the authority prioritised the geographical location to be developed later.

Both cases also differed in terms of the method applied by the tax authority. The case resolved at the judicial level used the comparable uncontrolled price (CUP) method, and the second case used the transactional net margin method (TNMM). The technical growth of the tax audit team over time is noted here, but there is no doubt that there is a major gap to be bridged.

Local taxpayers and multinational companies doing business in Costa Rica are recommended to conduct an ongoing analysis of their transfer pricing policies, considering the criteria applied by the DGT and the rulings at the different stages of resolution. Some disputes could be mitigated with anticipation by taxpayers, managing potential risks throughout the tax period.

Selection of Comparable Companies by Geographical Location

In the aforementioned administrative case, the tax authority rejected the selection of comparables made by the taxpayer as it considered that a geographical filter was not applied. A transfer

pricing study made by the tax auditor applies filters and selects comparables that result from a single country, different from the residence of the taxpayer and its economic group.

Legal doctrine and case law have recognised the difficulty of selecting comparables, especially in developing countries. Costa Rica and several countries in the region do not have sufficient, robust, reliable public databases that allow for a transfer pricing analysis. Faced with this difficulty, the answer is a more focused analysis of assets, functions and risks to enable reasonable conclusions to be drawn from both sides in the process.

Paragraph 3.38 of the OECD Transfer Pricing Guide clearly identifies and allows the use of several approaches, for:

- the same industry with comparable geographic markets;
- the same industry and other geographic markets; and
- the same geographic market and different industries.

As has been pointed out, progress is seen in the authority's technical analyses, but in-depth analyses in line with the applicable regulation is still lacking.

Importance of the Tax Audit Procedure

In Costa Rica, the obligation to determine the arm's length principle in transactions between related parties applies to all taxpayers. There are no monetary thresholds, and it includes both cross-border and local operations. There is a requirement to prepare a local file and a master file on an annual basis, to document the computation of the income tax. These are filed upon request of the tax authority. The informative return also applies for intercompany transactions, though its presentation is suspended.

Although transfer pricing audits are carried out, few have occurred and have been targeted at large taxpayers (although the obligation exists for all taxpayers). These circumstances have led to taxpayers not perceiving an imminent or high risk, so it is often found that they have no or insufficient documentation. The risk is increased when the authority requires them to provide information and they are not prepared to respond in time and form, exposing them to adjustments of material amounts and difficulties in sustaining a dispute at the next stages of the process.

In Resolution 000383-S1-2022, the First Chamber of the Supreme Court of Justice confirmed the adjustment made by the DGT, in which the transfer pricing method was rejected. The judge considered that the taxpayer did not provide the information and documentation that the tax auditor required for his work at the correct stage of the audit procedure.

As well as the central issue of selecting a transfer pricing method, this resolution emphasises the importance of having appropriate documentation, a local file and a master file, as well as global and local transfer pricing policies to enable levelled discussions with auditors. It does not ensure that disputes are resolved as technically as possible; as already pointed out, there is still a lack of knowledge of complex transactions throughout the litigation process. However, if the taxpayer is unable to prove their position, the chances of a ruling in their favour are minimal.

Advanced Pricing Agreement (APA)

In 2019, Costa Rica included in its Income Tax Law the possibility to negotiate APAs with the

tax authority. By the end of 2023, the DGT indicated that it is not yet ready to start APA negotiations. No petitions are being accepted until the tax authority's internal team has the required expertise. It has been pointed out in taxpayers' forums that when it is launched, priority will be given to large taxpayers.

It is important to mention that the network of treaties for avoiding double taxation is small – ie, the treaties are with Spain, Mexico, Germany and the United Arab Emirates. On the other hand, Costa Rica is the 38th member of the OECD. It is also an important destination for investment, for a number of reasons, including legal certainty. This highlights the time lag regarding this type of instrument that is so relevant to corporate groups doing business in the country.

Transfer Pricing Tax Return

In Costa Rica, there is an obligation to prepare an annual transfer pricing return for large taxpayers and companies benefiting from the Free Trade Zone. Its presentation is suspended as there are not currently the technological capabilities to receive it in the tax authority.

At the end of 2023, the tax authority's officials indicated that their submission should be understood as being suspended rather than as being required to make it available for delivery at the request of the tax authority. This position has led to uncertainty among forced taxpayers as no official format for their preparation has been published.

It is recommended for obligated taxpayers to perform and keep the transfer pricing documentation, local file and master file. As an additional measure, it is recommended to perform the transfer pricing return published by the tax authority as a draft, and to be prepared for any requirement from the tax authority.

Conclusions and Recommendations

Transfer pricing in Costa Rica is still at an early stage for taxpayers, the tax authority and judges. While the regulation exists and there is clear application of the OECD recommendations in this area, implementation continues to cause uncertainty and parties remain stuck in long controversial and material processes.

The recommendation to multinationals with a presence in the country continues to be to maintain:

- properly supported and regularly evaluated transfer pricing policies;
- local and master files for each tax year; and
- sufficient documentation that supports intercompany transactions.

During the fiscal period, it is also advisable to assess compliance with local policies.

CYPRUS

Law and Practice

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Kinanis LLC has been offering legal and consulting services in Cyprus since 1983, evolving from a traditional law firm to an innovative cutting-edge multidisciplinary law firm that combines exceptional expertise in law, tax and accounting. From its establishment, the firm's focus has been heavily business-oriented and always abreast with the latest global developments and innovations. Kinanis LLC is committed to providing top-quality legal, tax planning and accounting services tailored according to each client's particular needs, based on experience and expertise. The firm's practice areas include: corporate and commercial law; litigation; employment law; M&A and corporate reorganisations; tax advisory and compliance; transfer pricing; VAT; banking and finance; financial services; funds and regulatory compliance; capital markets and listings; accounting; immigration; trusts; estate planning and succession; anti-money laundering and regulatory compliance; blockchain consulting; intellectual property; data protection and privacy; and real estate.

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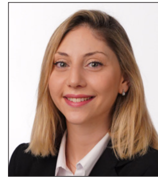

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1. Rules Governing Transfer Pricing

1.1 Statutes and Regulations

On 30 June 2022, transfer pricing (TP) regulations were voted on and incorporated into the Cyprus Income Tax Law, with effect from 1 January 2022. Cyprus has thus introduced broad TP regulations requiring OECD-compliant TP documentation, based on BEPS Action 13 recommendations.

1.2 Current Regime and Recent Changes

On 30 June 2017, the Cyprus tax authorities published a circular on back-to-back financing arrangements, with effect from 1 July 2017 – this was abolished on 5 January 2023 (with effect from 1 January 2022) following the introduction of the TP regulations.

The circular required that a comparability analysis for the purpose of describing intra-group financing transactions be performed for determining the applicable arm's-length remuneration. The main factors examined in the comparability analysis are the requirements for sufficient equity level for assumption of risks and adequate substance in Cyprus.

The new TP regulations, effective from 1 July 2022, require the following.

A summary information table (SIT) must be completed and submitted electronically by all taxpayers by the same deadline as for tax returns.

The SIT includes information on related parties with which the company transacts, and the nature and value of the transactions. The nature of the transactions is divided into categories including:

- goods;
- services;
- intellectual property and intangibles;
- financial transactions; and
- other transactions.

A local file must be prepared when the materiality threshold of EUR5 million in the category of financing transactions and EUR 1 million in the remaining categories is met.

The thresholds consider the aggregate amount of each category and are based on reference to the absolute values of the controlled transactions for each category occurring in a tax year.

Local files should be prepared for the local entity, and must include:

- the company's management and organisational structure;
- a general description of the activities of the group;
- the group structure;
- the key competitors;
- the relevant financial information, including the audited financial statements;
- the summary schedules of the relevant financial data; and
- an explanation of the use of the TP results to arrive at taxable income.

Also, local file preparers should include:

- a description of the controlled transactions;
- copies of the intercompany agreements;
- a detailed functional analysis with respect to each documented category of transaction;
- the selection and application of the most appropriate TP method;
- the conclusion of the arm's length price;
- any relevant adjustments; and
- the decision of the advance pricing agreement (APA) or tax ruling, if any.

The auditor of the company must review the Cyprus local file to ensure its quality by the deadline of submission of the corporation tax return for the tax year in question.

A master file must be prepared when the consolidated revenues of the group exceed EUR750 million.

The required information for the preparation of a master file relates to the strategies and policies followed by the group, rather than the entity. The contents of the master file must include:

- the group organisational structure;
- a description of the multinational enterprise's (MNE) business activities, including the drivers of business profit;
- the TP policies of the group; and
- the geographic markets for the group's products and services.

Additionally, the group's intangibles must be listed, together with the MNE's intercompany financial activities and tax positions.

The following assumptions apply.

For the local file, persons that engage in controlled transactions with arm's length value of less than EUR5 million per annum in the category of financing transactions or less than EUR1 million in the remaining categories in aggregation (ie, sale/purchase of goods, provision/receipt of services, financing transactions, receipt/payment of intellectual property licensing/royalties, etc) are exempt from the obligation to prepare a Cyprus local file. However, they must prepare simplified TP documentation, as per Circular 6/2023 on simplification measures for entities not exceeding the local file threshold. Such entities may also be eligible to apply the applicable safe harbour rule set by the tax authorities.

For the master file, only Cyprus tax-resident entities that are the ultimate parent or surrogate parent entity of an MNE group falling under the scope of country-by-country reporting have an obligation to prepare and maintain a master file. All other persons are exempt from this obligation.

It should be noted that the threshold for the requirement of local file preparation was initially set at EUR750,000 per category of transactions. This threshold was subsequently increased on 1 February 2024, with retroactive effect from 1 January 2022 onwards, following an announcement by the Cyprus tax authorities.

The TP documentation file should be maintained by the taxpayer in electronic or paper format, and should be prepared in a generally acceptable language, preferably in English. However, the Cyprus tax authorities may request its translation into Greek if necessary.

The documentation file must be maintained in Cyprus for six years, and must be provided to the tax authorities within 60 days from the date that a relevant request has been received by the company or by any other company that is authorised by the company to act as its representative. It must also include a special chapter explaining the events affecting the information and data included in the documentation file and that are related to changes in the market conditions.

The documentation file must be updated every tax year, and the update must be completed within 12 months from the end of the tax year in which the need for the update has arisen.

The Commissioner of Taxation has the power to determine specific issues concerning updates that are deemed necessary regarding the content of the documentation file, either on an annual or permanent basis.

In February 2023, the Cyprus tax authorities, in an effort to ensure clear interpretation of the TP regulations and their correct application and practice, published Frequently Asked Questions providing answers to the most common queries of both taxpayers and TP practitioners. The Commissioner of Taxation will also issue further guidance as to the requirements of the documentation file and the summary table, acceptable TP methods, and the methods of establishing the interquartile range or the profit margin.

Also, in an exchange-of-information context, Cyprus implements country-by-country reporting requirements under the Assessment and Collection of Taxes Law Decree of 2017.

It is important to note that although Cyprus is not a member of the OECD, the Cyprus tax authorities refer to OECD materials for guidance in the field of taxation.

2. Definition of Control/Related Parties

2.1 Application of Transfer Pricing Rules

The arm's length principle has been incorporated into Section 33(3) of the Cyprus Income Tax Law and shall be interpreted in line with the OECD TP Guidelines.

Said section defines associated enterprises, providing the following 25% relationship test.

A company is connected with another company where:

- a person and persons connected with that person hold, directly or indirectly, a participation in at least 25% of the voting rights or share capital or have the right to a share of at least 25% of the income of both companies; or
- a group of two or more persons holds, directly or indirectly, a participation in at least 25% of the voting rights or share capital or has a right to a share of at least 25% of the income of each company, and the group either consists of the same persons or could be regarded as consisting of the same persons by treating a member of either group as replaced by a person with whom they are connected.

A company is connected with another person where:

- a person and persons connected with that person hold, directly or indirectly, a participation in at least 25% of the voting rights or share capital or have a right in at least 25% of the income of that company; or
- a group of two or more persons acts together with the intention of securing, directly or indirectly, at least 25% of the voting rights or share capital or right to a share of at least 25% of the income of a company.

3. Methods and Method Selection and Application

3.1 Transfer Pricing Methods

The Cyprus tax authorities suggest that the methods used by taxpayers are in line with the

methods specified in the OECD TP Guidelines, which are the following:

- comparable uncontrolled price (CUP) method;
- resale price method (RPM);
- cost-plus method (CPM);
- transactional net margin method (TNMM); and
- profit split method (PSM).

3.2 Unspecified Methods

It used to be common practice in Cyprus to use the capital asset pricing model (CAPM) for fully functional financing companies. However, further to the publication of Circular 7/2023 on 7 July 2023 by the Cyprus tax authorities, the most appropriate method for determining the arm's length pricing for financing transactions, including those of a back-to-back nature, is the CUP method. The application of the CAPM will only be permitted in exceptional cases, upon a pre-approval in the form of a ruling obtained by the Cyprus tax authorities. The Circular is effective from the tax year 2023.

3.3 Hierarchy of Methods

Cyprus has no hierarchy on the selection of the most appropriate method. The approach adopted by the Cyprus tax authorities is in line with OECD guidance, which urges practitioners to assess each case differently and to conclude on the most appropriate method on a case-by-case basis – though where a CUP exists, it should be preferred.

3.4 Ranges and Statistical Measures

Cyprus does not require the use of ranges or statistical measures.

3.5 Comparability Adjustments

The Cyprus tax authorities require comparability adjustments to be performed where reasonably accurate.

4. Intangibles

4.1 Notable Rules

Cyprus introduced an intangible property (IP) regime, which is in line with the OECD's guidance and development. Specifically, the Cyprus IP regime is in line with both the provisions of the OECD BEPS Action 5 on "Harmful tax practices" and with EU rules.

The Cyprus IP box regime applies to qualifying IP which is developed in Cyprus. In order for a Cyprus IP holding company to benefit from the favourable tax regime, it must satisfy certain conditions of the IP box regime. According to the regime, 80% of "qualifying profit" generated from qualifying IP rights using the "nexus" approach will be considered as a deemed expense for corporation tax purposes.

According to the nexus approach, the level of the qualifying profits is positively correlated to the extent that the claimant of the IP regime undertakes its R&S activities and performance to develop the qualifying asset within the same company. The remaining 20% will be subject to the normal corporation tax rate of 12.5%. Thus, the qualifying profits will have an effective tax rate of as low as 2.5%.

Qualifying assets for the purposes of the IP regime include the following:

- patents;
- copyrighted software programs; and
- other intangible assets that are non-obvious, useful and novel.

Trade marks and copyrights are excluded for IP regime purposes.

Qualifying persons under the IP regime include Cyprus tax residents and Cyprus tax-resident permanent establishments (PEs).

4.2 Hard-to-Value Intangibles

There are no special rules regarding hard-to-value intangibles.

4.3 Cost Sharing/Cost Contribution Arrangements

There are no special rules that apply to cost sharing/cost contribution arrangements.

5. Affirmative Adjustments

5.1 Rules on Affirmative Transfer Pricing Adjustments

Cyprus does not permit a taxpayer to make affirmative TP adjustments after filing tax returns unless a revised tax return is also submitted.

6. Cross-Border Information Sharing

6.1 Sharing Taxpayer Information

Cyprus has signed over 60 double tax treaties and tax information exchange agreements. The Cyprus tax authorities may share information with other jurisdictions; however, fishing expeditions are not accepted.

7. Advance Pricing Agreements (APAs)

7.1 Programmes Allowing for Rulings Regarding Transfer Pricing

Cyprus has incorporated into its new TP regulations the opportunity for advance pricing agreements (APAs) to determine, in advance of controlled transactions, an appropriate set of criteria for the selection of pricing over a fixed period of time.

These criteria include:

- the method that is used or will be used;
- the comparable data and the relevant adjustments that might be needed;
- critical assumptions as to the functional profile and the market conditions; and
- any other matter that may relate to the pricing of the transactions with related parties.

Where the APA includes a request for consultation with the tax authorities of other states with which Cyprus has a double tax treaty in place (bilateral or multilateral APA), the taxpayer must submit this request with all supporting documents to the foreign tax authorities as well. In this case, the Commissioner of Taxation may hold consultations with the foreign tax authorities using the mutual agreement procedures (MAPs) provided in the double tax treaty concluded between the contracting states.

The formal exchange of views between the competent tax authorities takes place in the form of an exchange of position documents, which shall be made available to the applicant in accordance with the provisions that restrict and prohibit the use of information contained in an international agreement to which the Republic of Cyprus is a party and in the provisions of EU law.

When an APA is agreed, the prices of the intra-group transactions will be considered at arm's length provided that they follow the APA's details on pricing. During the tax review, the authorities will only ensure that what is agreed in the APA has been followed when pricing the transactions, and that the assumptions, circumstances

and terms on which the APA is based are still applicable.

The documentation relating to the APA must be maintained by the company for the period where it is obliged to maintain books and records for each tax year that the APA relates to.

The APA may be revised during the period to which it applies, where the taxpayer so requests or after a request by the Commissioner of Taxation if:

- the critical assumptions on which the APA is based are proven to be inadequate;
- there is a substantial change in the critical assumptions or conditions that makes it impossible to comply with the provisions of the APA; or
- the MAP of the applicable treaty for the avoidance of double taxation or the EU Convention on the elimination of double taxation (90/436/EEC) is exercised in the case of correction of the profits of related companies for the transactions of the same taxpayer.

The revised APA will be applicable from the date of issue of the revised version until the end of the period of the APA that was initially agreed.

The APA may be recalled by the Commissioner of Taxation during the period in which it is active if:

- it is found that the facts and critical assumptions on which the APA is based are inadequate, due to false interpretation or defects for which the taxpayer is responsible; or
- it is found that the taxpayer has not complied with substantive conditions or obligations as set out in the APA.

Where the APA is recalled, it is considered as never having been issued in the first place.

The APA may be cancelled by the Commissioner of Taxation during the period in which it applies if:

- it is found that there has been a substantial change of the critical assumptions or conditions on which the APA was based;
- it is found that the taxpayer has not complied with substantive conditions or obligations as set out in the APA; or
- there is a substantial change in the tax provisions which substantially affects the APA.

The Commissioner of Taxation is not allowed to cancel the APA if it is possible to revise it (see above). However, where the APA has been cancelled, its validity ceases from the date indicated in the decision-of-cancellation document.

7.2 Administration of Programmes

The Cyprus tax authorities have ten months to reach a decision on an APA, from the day of application. However, the Commissioner of Taxation can extend this period to 24 months.

7.3 Co-ordination Between the APA Process and Mutual Agreement Procedures

Since APA provisions were recently introduced in 2022, there is not yet practice regarding co-ordination between the APA process and MAPs.

7.4 Limits on Taxpayers/Transactions Eligible for an APA

There are no limits on which taxpayers or transactions are eligible for an APA.

7.5 APA Application Deadlines

The law and current guidance do not provide a period during which a taxpayer must file an APA application.

7.6 APA User Fees

Relevant guidance regarding the fee for a taxpayer seeking an APA is expected to be issued by the tax authorities.

7.7 Duration of APA Cover

The period of validity of an APA cannot exceed four years.

7.8 Retroactive Effect for APAs

An APA is not applicable to a tax year that has lapsed before the time of submission of the APA.

8. Penalties and Documentation

8.1 Transfer Pricing Penalties and Defences

Failure to provide a local file or master file within 60 days upon request from the Cyprus tax authorities is penalised as follows:

- EUR5,000 if submitted from 61 to 90 days after the request date;
- EUR10,000 if submitted from 91 days to 120 days after the request date; and
- EUR20,000 if submitted more than 120 days after the request date.

The penalty for failure to submit the SIT is EUR500.

8.2 Taxpayer Obligations Under the OECD Transfer Pricing Guidelines

The documentation file must consist of the master file and the Cyprus local file, and should be accompanied with the summary table of transactions. A master file must be prepared when the consolidated revenues of the group exceed EUR750 million. Further, a country-by-country report must be submitted for groups with revenue exceeding EUR750 million.

9. Alignment With OECD Transfer Pricing Guidelines

9.1 Alignment and Differences

Although Cyprus is not a member of the OECD, in practice the Cyprus tax authorities refer to OECD materials for guidance.

9.2 Arm's Length Principle

Cyprus TP rules do not depart from the arm's length principle.

9.3 Impact of the Base Erosion and Profit Shifting (BEPS) Project

Cyprus is, to a great extent, in compliance with the minimum requirements of the OECD's Base Erosion and Profit Shifting (BEPS) project. In particular, the new TP legislation has been introduced with the aim of complying with Action Points 8–10 "Aligning transfer pricing outcomes with value creation" of the BEPS initiative.

9.4 Impact of BEPS 2.0

There is no clear guidance regarding Cyprus' perspective on the OECD's BEPS 2.0 initiatives.

9.5 Entities Bearing the Risk of Another Entity's Operations

There are no provisions in the legislation for one entity to bear the risk of another entity's operations by guaranteeing the other entity a return.

10. Relevance of the United Nations Practical Manual on Transfer Pricing

10.1 Impact of UN Practical Manual on Transfer Pricing

The UN Practical Manual on Transfer Pricing does not have any impact on TP practice or enforcement in Cyprus.

11. Safe Harbours or Other Unique Rules

11.1 Transfer Pricing Safe Harbours

As per Circular 6/2023, published by the Cyprus tax authorities on 6 July 2023, entities entering into cross-border transactions can use the safe harbour rules, which are only applicable for entities not exceeding (or that should not be exceeding) the total aggregate amount of EUR5 million of related party transactions in the category of financing and the aggregate amount of EUR1 million of related party transactions in the remaining categories.

The safe harbour rules apply to the following types of transactions.

Types of Transactions

Provision of financing in the form of loans or cash advances to related parties

These are funded out of financial means, such as:

- bonds;
- loans from related parties;
- interest-free loans from the shareholders;
- cash advances; and
- bank loans.

The applicable safe harbour will be 2.5% after the deduction of allowable expenses. The minimum return of 2.5% will be applicable on the average balance of loan receivable for the relevant tax year, including the interest accrued but not paid.

Provision of financing in the form of loans or cash advances to related parties

These are funded out of own capital (such as issued share capital and share premium, non-refundable capital contributions, and retained earnings).

The applicable safe harbour will be the ten-year government bond of the borrower's country plus 3.5%. The minimum return will be applicable on the average balance of loan receivable for the relevant tax year, including the interest accrued but not paid.

Receiving financing in the form of loans, bonds or cash advances from related parties, that carry an interest rate, to the extent that the funds borrowed are used in the business

The applicable safe harbour shall not exceed the ten-year government bond for Cyprus plus 1.5%. The minimum return will be applicable on the average balance of loan payable for the relevant tax year, including the interest accrued but not paid.

Conducting of low value-adding services

For the purposes of this Circular, low value-adding services are defined as services that:

- are of a supportive nature;
- are not part of the core activities of the group; and
- do not involve unique and valuable intangibles or a significant risk for the service provider.

The applicable safe harbour should be a minimum 5% mark-up on the relevant costs. If the entity under examination is the recipient of low value-adding services, 5% shall be the maximum applicable mark-up.

The use of safe harbour rules on the above-mentioned types of transaction must be supported by an appropriate minimum documentation. Such documentation will include a short description of functional analysis and characterisation of the entity, based on the functional analysis performed. For financing-type transactions (see above), the documentation must also include:

- analytical descriptions of the loans;
- the criteria met for the use of safe harbour; and
- the relevant numerical analyses that led to the taxable income.

For the low value-adding services, the minimum documentation must consist of:

- descriptions of the low value-adding services;
- justification of the reasons the services considered eligible for the safe harbour; and
- the relevant analyses and calculations.

The use of safe harbour should be declared in the relevant section of the taxpayer's income tax return. If reliable internal comparables are available, the taxpayer is not permitted to use the safe harbour rules.

The simplified TP documentation must be made available within 60 days upon the CTA's request, by the taxpayer or a person authorised to act as a representative of the taxpayer.

The provisions of unilateral safe harbour rules described above in cross-border transactions will be reportable under the DAC6 legislation in Cyprus, under Hallmark E.1.

11.2 Rules on Savings Arising From Operating in the Jurisdiction

Cyprus does not have specific rules governing savings that arise from operating in Cyprus.

11.3 Unique Transfer Pricing Rules or Practices

Cyprus does not have any notable unique rules or practices applicable in the TP context.

12. Co-ordination With Customs Valuation

12.1 Co-ordination Requirements Between Transfer Pricing and Customs Valuation

Cyprus does not require co-ordination between TP and customs valuation.

13. Controversy Process

13.1 Options and Requirements in Transfer Pricing Controversies

The relevant legislation in Cyprus was introduced in 2022; therefore, there is no (or, at most, a limited) TP controversy process. A taxpayer can challenge the results of a TP audit through the tax tribunal. The taxpayer is not obliged to pay the tax before applying to court.

14. Judicial Precedent

14.1 Judicial Precedent on Transfer Pricing

Cyprus TP legislation was introduced in 2022; therefore, judicial precedent on TP in Cyprus

does not yet exist. As such, UK, EU or other common law jurisdiction judicial precedent may be used.

14.2 Significant Court Rulings

As TP legislation was only recently introduced in 2022, there are no court rulings yet.

15. Foreign Payment Restrictions

15.1 Restrictions on Outbound Payments Relating to Uncontrolled Transactions

Cyprus does not restrict outbound payments relating to uncontrolled transactions provided they are incurred wholly and exclusively for the production of taxable income.

15.2 Restrictions on Outbound Payments Relating to Controlled Transactions

Cyprus does not restrict outbound payments relating to controlled transactions, provided such payments are incurred wholly and exclusively for the production of taxable income and are at arm's length.

15.3 Effects of Other Countries' Legal Restrictions

Cyprus does not have rules regarding the effects of other countries' legal restrictions.

16. Transparency and Confidentiality

16.1 Publication of Information on APAs or Transfer Pricing Audit Outcomes

Cyprus does not publish information on APAs or TP audit outcomes. As the concept is rather new, little information is available to publish.

16.2 Use of "Secret Comparables"

There is no guidance for prohibiting the use of "secret comparables". Also, since the relevant legislation is fairly new, at this point the tax authorities do not refer to "secret comparables".

Trends and Developments

Contributed by:
Marios Palesis and Theodora Charalambous
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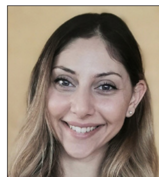

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Cyprus has consistently remained a top choice among foreign companies and individuals owing to its stunning coastline, favourable legal framework and enticing tax incentives. Recently, Cyprus elevated its tax regime by integrating transfer pricing (TP) regulations into its laws, aligning with the standards set by the Organisation for Economic Co-operation and Development (OECD). This marks a significant milestone for the island, demonstrating its ability to maintain a balance between attractiveness and regulatory certainty in its tax environment.

On 30 July 2022, the Cyprus Parliament voted for the introduction of the Transfer Pricing Regulations in Cyprus to enhance certainty. The new regulations are effective from 1 January 2022 and are aligned with the OECD standards. In particular, the new regulations go hand in hand with what the OECD provides in the TP Guidelines and the Base Erosion and Profit Shifting (BEPS) Action Plans 8–10 and 13.

The need for a solid TP legal framework in Cyprus began with the inclusion of the arm's length principle in Section 33 of the Cyprus Income Tax Law. This need was further triggered following the Tax Department's publication of a Circular on back-to-back financing arrangements, requiring Cyprus companies engaged in such arrangements to support earned margins with a TP analysis. The lack of assembled relevant law and guidance on the practice and application of TP had resulted in great ambiguity in the field.

With the introduction of the TP regulations, TP experts now have a clear understanding of taxpayers' obligations in Cyprus, which no longer lags behind other countries in this regard.

Associated Enterprises

TP obligations and/or the need for compliance arises when, regardless of the nature of the transactions, such transactions are between related parties.

The revised Section 33(3) of the Cyprus Income Tax Law gives the following definition for associated enterprises:

A company is connected with another company where:

- the same person and persons connected with that person hold, directly or indirectly, a participation in at least 25% of the voting rights or share capital or have the right to a share of at least 25% of the income of both companies; or

- a group of two or more persons holds, directly or indirectly, a participation in at least 25% of the voting rights or share capital or have a right to a share of at least 25% of the income of each company, and the group either consists of the same persons or could be regarded as consisting of the same persons by treating a member of either group as replaced by a person with whom they are connected.

A company is connected with another person where:

- that person and persons connected with that person hold, directly or indirectly, a participation in at least 25% of the voting rights or share capital or have a right in at least 25% of the income of that company; or
- a group of two or more act together with the intention of securing, directly or indirectly, at least 25% of the voting rights or share capital or right to a share of at least 25% of the income of a company.

Arm's Length Principle

TP, both in theory and in practice, relies on the arm's length principle. The arm's length principle provides that when two connected parties transact with each other, the terms and conditions attached to that transaction should be the same as in a comparable transaction under comparable circumstances in the open market, between unrelated parties. The arm's length principle is the cornerstone of the current TP rules.

New TP Regulations

The new TP regulations in Cyprus provide guidance on the application of the arm's length principle in practice. In brief, they require taxpayers to document the following.

- A summary information table (SIT), which is completed and submitted electronically by all taxpayers by the same deadline as for the TD4 corporate income tax return. The SIT includes information on related parties with whom the company transacts, and the nature and value of the transactions. The nature of transactions is divided into categories including:
  (a) goods;
  (b) services;
  (c) intellectual property (IP) and intangibles;
  (d) financial transactions; and
  (e) other transactions.
- A local file where the materiality threshold of EUR5 million in the category of financial transactions is met between related parties.
- A local file where the materiality threshold of EUR1 million in the remaining categories (goods, services, IP and other transactions) is met between related parties.
- A master file where the consolidated revenues of the group exceed the amount of EUR750 million.

The above apply with the guidance of the OECD's materials.

According to law, a documentation file must be maintained on intra-group transactions performed between:

- companies that are residents in the Republic of Cyprus; or
- permanent establishments of foreign companies in the Republic of Cyprus.

Obliged entities with accumulated intra-group transactions per category, equal or below the amount of EUR5 million for financing and EUR1 million for the remaining categories of transactions per tax year, and based on the arm's

length principle, are exempt from the obligation to maintain the Cyprus local file. However, they must prepare simplified TP documentation. Such companies are also not obliged to maintain the master file, provided they are not the ultimate parent company or surrogate parent entity as defined in the law on administrative co-operation in the field of taxation.

Deadlines

The local file, master file and simplified report should be prepared until the date of submission of the tax return for the relevant tax year, and should be made available to the tax authorities upon their request. Also, a licensed auditor should undertake an assurance quality review of the local file by the submission deadline of the taxpayer's tax return.

The documentation file must be updated every tax year, and the update must be completed within 12 months from the end of the tax year in which the need for the update arose. The Commissioner of Tax has the power to determine specific issues concerning updates that are deemed necessary as regards the content of the documentation file, either on an annual or permanent basis.

Simplified TP Documentation

To ensure that entities not subject to the requirement of preparing a local file comply with the arm's length principle, in July 2023 the Cyprus tax authorities published the Transfer Pricing Circular 6/2023, setting new requirements for those entities not exceeding the materiality thresholds in the respective category of related party transactions.

The simplified TP documentation for entities exempted from the requirement of local file preparation must include the following minimum content:

- short description of functional analysis (functions, assets, risks);
- characterisation of the entity, based on the functional analysis performed;
- rationale of selection of the most appropriate TP method; and
- determination of the arm's length results, based on the benchmark analysis.

Circular 6/2023 also implies the utilisation of unilateral safe harbour rules, where applicable. Entities engaging in cross-border transactions may employ these safe harbour rules, which are exclusively applicable to entities that do not exceed (or that should not exceed) the thresholds for local file preparation in the relevant category. It should be noted that the provisions of unilateral safe harbour rules in cross-border transactions will be reportable under the DAC6 legislation in Cyprus, under Hallmark E.1.

It is critical to emphasise that the initial threshold for local files was established at EUR750,000 per category of transactions. However, in response to numerous requests from taxpayers and tax experts, on 1 February 2024 the Cyprus tax authorities announced an increase to the materiality threshold for tax years 2022 and onwards, to:

- EUR5 million for related party transactions in the category of financing transactions; and
- EUR1 million for the remaining categories of related party transactions (trade of goods/services/IP/other).

Advance Pricing Arrangement

A significant introduction of the regulations was the option of an advance pricing arrangement

(APA). Cyprus taxpayers can now seek a pre-agreement with the Cyprus Tax Department for the selection of the most appropriate set of criteria in determining TP over a fixed period of time, not exceeding a period of four years.

Where the APA includes a request of consultation with the tax authorities of other states with which Cyprus has a double tax treaty in place (bilateral or multilateral APA), the taxpayer must submit the same request with all the supporting documents to the foreign tax authorities as well. In this case, the Commissioner of Taxation may hold consultations with the foreign tax authorities using the mutual agreement procedure (MAP) provided in the double tax treaty concluded between the contracting states.

The formal exchange of views between the competent tax authorities shall take place in the form of an exchange of position documents, which shall be made available to the applicant in accordance with the provisions that restrict and prohibit the use of information contained in an international agreement to which the Republic of Cyprus is a party, and with the provisions of EU law.

The APA will be examined by the Commissioner of Taxation, who will decide whether to accept or reject it. The decision should be communicated to the taxpayer within ten months. The Commissioner can extend this period to 24 months, provided that the taxpayer is notified about the delay.

An APA can be revised, revoked or cancelled in the case of erroneous assumptions or failure of the taxpayer to comply with fundamental conditions or obligations agreed with the Commissioner. If the APA procedures prove to be functional, many hands will be untied and some of the decisions regarding the approach reached by the Commissioner can be used for paradigms in the future.

Tax Department's Issuance of Frequently Asked Questions

The first guidance on the interpretation of the new TP rules was set out by the Tax Department in the form of frequently asked questions (FAQ), published in February 2023. The answers mainly concerned:

- the way a taxpayer can assess the aggregation of amounts;
- the selection of the correct category for certain transactions;
- other technicalities in assessing the need for a benchmark study update; and
- the completion of the SIT.

An important remark was the clarification that the threshold is based on reference to the absolute values of the controlled transactions for each category occurring in a tax year. For instance, purchases and sales need to be considered cumulatively in assessing the trigger of a local file obligation.

Also, the Tax Department's FAQ explained that for intra-group loans the TP benchmark analysis must be updated and be performed again for the relevant tax year when:

- new loans are provided or received by the company;
- significant terms of the existing loans are changed or amended;
- the functional profile of the company changes; or
- the market and economic conditions change significantly.

This is similar to the previously published FAQ regarding the interpretation and application of the Circular.

Among the points clarified was the abolishment of the back-to-back Circular – in fact, on 5 January 2023 the Commissioner published a Circular abolishing the back-to-back Circular with effect from 1 January 2022. This raises questions regarding the treatment of back-to-back financing arrangements that do not meet the local file threshold and that therefore cannot be supported by a local file, for the tax year 2022 and onwards.

Penalties

To guarantee compliance with the law, the regulations intend to penalise taxpayers who fail to provide the local file or master file upon request by the Cyprus tax authorities. The local file and master file must typically be provided to the Cyprus Tax Department within 60 days upon request. The penalties for late or non-compliance vary from EUR5,000 (for late submission) to EUR20,000 (no submission or where delay in providing the documentation exceeds 120 days).

There is also imposition of a EUR500 penalty for failure to submit the SIT.

Documentation Content

The new regulations also list the requirements regarding mandatory content of documentation. Local files should be prepared for the local entity and must include:

- the company's management and organisational structure;
- a general description of the activities of the group, group structure and key competitors;
- relevant financial information, including audited financial statements;
- the summary schedules of the relevant financial data; and
- explanation of use of the TP results to arrive at taxable income.

In addition, local file preparers should include:

- a description of the controlled transactions;
- copies of the intercompany agreements;
- a detailed functional analysis with respect to each documented category of transactions;
- the selection and application of the most appropriate TP method;
- the conclusion of the arm's length price;
- any relevant adjustments; and
- an APA decision or tax ruling, if any.

For the master file, the required information relates to the strategies and policies followed by the group rather than the entity. The contents of the master file must include:

- the group's organisational structure;
- a description of the MNE's business activities, including the drivers of business profit;
- the TP policies of the group; and
- the geographic markets for the group's products and services.

Also, the group's intangibles must be listed, together with the MNE's intercompany financial activities and tax positions.

Cyprus taxpayers having transactions with a related party should consider the impact of the new rules and thresholds, and accordingly should undertake relevant analyses, perform benchmarks and establish arm's length pricing for the controlled transactions. The final step for a taxpayer is to put the required TP documentation in place, to ensure appropriate Cyprus tax compliance.

INDIA

Law and Practice

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Grant Thornton Bharat LLP (GTBLLP) is one of the largest fully integrated assurance, tax and advisory firms in India. The firm has over 10,000 employees and has offices in 18 locations across the country. The transfer pricing (TP) practice has seasoned TP professionals with over two decades' experience. The team has extensive experience in handling a variety of TP assignments, including complex advisory, compliance, documentation, litigation and dispute resolution/avoidance. With access to various databases and tools, the firm has successfully supported large multinationals from a range of industries, such as real estate, healthcare and pharma, automotive, consumer goods, industrial equipment and technology, with their TP requirements.

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1. Rules Governing Transfer Pricing

1.1 Statutes and Regulations

Indian transfer pricing (TP) regulations are contained in Chapter X (Sections 92 to 92F) of the Income Tax Act, 1961, under the title "Special provisions relating to avoidance of tax". These regulations are required to be read with Rules 10A to 10THD of the Indian Income Tax Rules, 1962. In addition to this, the Indian government regularly issues circulars, instructions and notifications in order to streamline, update, clarify and/or operationalise the TP provisions.

1.2 Current Regime and Recent Changes

The TP regulations were introduced in India in 2001 to prevent erosion of the country's tax base. While the provisions were initially made applicable to "international transactions" only, in 2012 the scope of the provisions was expanded to also include a certain category of "specified domestic transactions". Over the past two decades, the regulations have evolved in response to various global and local developments. This primarily includes the following key changes:

- the setting-up of the Dispute Resolution Panel (DRP) in 2009, with the intention to provide an alternative dispute resolution mechanism, which could facilitate expeditious resolution of TP disputes;
- the introduction of the Indian advance pricing agreement (APA) programme in 2012 and the safe harbour rules in 2013, with the intention of reducing TP litigation in India and providing certainty to taxpayers;
- the use of multiple years' data and the range concept in benchmarking analysis permitted in 2014 to align Indian TP regulations with global practices;
- the introduction of a three-tier TP documentation structure in 2016 to align Indian TP documentation requirements with the OECD's recommendation in BEPS Action Plan 13; and
- the introduction of secondary adjustment provisions and limiting interest deduction for thinly capitalised companies in 2017.

2. Definition of Control/Related Parties

2.1 Application of Transfer Pricing Rules

The Indian TP regulations recognise the "arm's length principle" and require income from an international transaction/specified domestic transaction between associated enterprises to be computed having regard to the arm's length price. The Indian TP regulations lay down detailed definitions of the terms "associated enterprises", "international transactions" and "specified domestic transactions", respectively. Below is a high-level overview of these terms.

Associated Enterprises (AEs)

Broadly speaking, two enterprises are considered as AEs if either:

- one party (directly or indirectly) participates in the management, control or capital of the other party; or
- a common party (or parties) participates in the management, control or capital of both enterprises.

For the purpose of this definition, the law lays down 13 specific instances where the abovementioned conditions are deemed to be satisfied. These include direct or indirect holding of shares carrying more than 26% of the voting power.

International Transaction

This primarily refers to a transaction between two (or more) AEs involving:

- purchase, sale or lease of tangible or intangible property;
- provision of services;
- lending/borrowing of money;
- cost-sharing arrangements; or
- any other transaction having a bearing on the profits, income, losses or assets of such AEs, provided one of the parties is a non-resident for tax purposes in India.

However, the Indian TP regulations also extend to certain transactions undertaken by a taxpayer with domestic or overseas third parties, where there is a prior agreement in relation to said transaction between such third party and the taxpayer's AE, or where the terms of said transaction are determined in substance between such third party and the taxpayer's AE.

Specified Domestic Transactions

The following categories of domestic transactions are also covered within the ambit of Indian TP regulations, provided their aggregate value exceeds INR200 million:

- the transfer of goods or services between different sub-units of an entity claiming or eligible to claim a tax holiday under specified sections of the Indian Income Tax Act, 1961; or
- any business transacted between an entity claiming a tax holiday or concession under specified sections of the Indian Income Tax Act, 1961, and a closely connected person.

The term "closely connected person" has not been defined under the Indian TP regulations, and is therefore generally given a very wide interpretation by taxpayers and tax authorities alike.

3. Methods and Method Selection and Application

3.1 Transfer Pricing Methods

The Indian TP regulations adopt the concept of "most appropriate method" for computation of the arm's length price. For this purpose, a taxpayer may use any of the following six methods, according to which is the most appropriate:

- comparable uncontrolled price (CUP) method;
- resale price method (RPM);
- cost-plus method (CPM);
- profit split method (PSM);
- transactional net margin method (TNMM); and
- such other method as may be prescribed by the Central Board of Direct Taxes.

The "other method" or "sixth method" allows the use of any methodology that takes into account the price that has been charged or paid, or that would have been charged or paid, for the same or a similar uncontrolled transaction between third parties. This allows taxpayers to explore the use of various data points, such as quotations, valuation reports, standard rate cards, etc, for the purpose of an arm's length analysis.

3.2 Unspecified Methods

The Indian TP regulations require taxpayers to compute the arm's length price using any of the six prescribed TP methods (see **3.1 Transfer Pricing Methods**). However, generally speaking, the other method prescribed under the law acts as a "residuary method", which allows taxpayers some flexibility for using data around prices that would have been charged between third par-

ties under a comparable scenario for the arm's length exercise.

3.3 Hierarchy of Methods

Indian TP law does not provide any preference or hierarchy within the prescribed methods. The "most appropriate method" acts as the general rule for computing the arm's length price. However, taxpayers are required to document appropriate reasons for selecting a method as the most appropriate method, as well as their reasons for rejecting the other methods.

3.4 Ranges and Statistical Measures

The arm's length range concept was introduced in India in 2014. Indian TP law adopted the 35th to 65th percentile as the arm's length range. Where the transaction price falls outside the prescribed range, the median of the data set is considered as the arm's length price. However, a taxpayer can use the benefit of range only when:

- the arm's length price is computed using the CUP method, the TNMM, the RPM or the CPM; and
- the data set comprises six or more comparable entries.

Furthermore, detailed provisions are prescribed for the manner of computing the above range, and such range should not be computed using simple Excel-based formulas.

Where the above-mentioned conditions are not met, the arm's length price is computed in the following manner:

- the arithmetic mean is considered as the arm's length price (where there is more than one comparable data point); and
- where the arithmetic mean is used, a tolerance band of 3% (1% for wholesale traders) from the actual transaction price is available to the taxpayer.

3.5 Comparability Adjustments

The Indian TP regulations require a suitable adjustment for any differences, including functional and other differences, between the related party transaction and the comparable uncontrolled transaction(s), or between the enterprises entering into such transactions, which could materially affect the price/margin in the open market.

4. Intangibles

4.1 Notable Rules

The TP provisions applicable to other related party transactions in general are equally applicable to the transactions involving intangibles. There are no specific provisions under the Indian TP regulations in respect of intangibles. However, the definition of the term "international transaction" includes a specific reference to "intangible property".

Furthermore, an inclusive definition of the term "intangible property" has also been laid down under the Indian TP regulations, which is quite extensive and covers various types of assets/rights within its ambit, such as:

- marketing intangibles (eg, trade marks, logos, etc);
- technology intangibles (eg, patents, technical know-how, etc);
- artistic-related intangibles (eg, literary works and copyrights, musical compositions, etc); and
- customer-related intangibles (eg, customer lists/relationships, customer contracts, etc).

4.2 Hard-to-Value Intangibles

The Indian TP regulations do not recognise the concept of hard-to-value intangibles. However, practically, Indian tax authorities may challenge the valuation of an intangible based on future forecasts, wherein the actual results vary from such forecasted values.

4.3 Cost Sharing/Cost Contribution Arrangements

The Indian TP regulations are applicable to mutual agreements or arrangements between associated enterprises, including cost-sharing/cost-contribution arrangements. However, the Indian TP regulations do not contain any detailed provisions or lay down any specific guidance for analysing such arrangements.

5. Affirmative Adjustments

5.1 Rules on Affirmative Transfer Pricing Adjustments

Taxpayers have an option to offer suo moto adjustments in their return of income, where they believe their controlled (related party) transactions are not at arm's length. Such adjustments should also be disclosed in the accountant's report (Form No 3CEB) – ie, the certificate required to be furnished annually in respect of such related party transactions. It is also important to analyse the applicability of secondary adjustment provisions while offering such suo moto adjustments.

Taxpayers may still have an option to revise these documents after filing them. While legally there is no provision for revision of the accountant's report (Form No 3CEB) in India, experience has shown that taxpayers are able to submit such revision request online.

Furthermore, a return of income may be revised, should the taxpayer discover any omission or wrong statement therein, more than three months prior to the end of the relevant assessment year ("assessment year" refers to the 12-month period starting from April 1st after the close of the relevant financial year on March 31st) or before the completion of the audit by the tax authorities, whichever is earlier.

Further, a person may furnish an updated return of income with effect from 1 April 2022 for the relevant assessment year at any time within 24 months from the end of the relevant assessment year (subject to fulfilment of certain prescribed conditions).

6. Cross-Border Information Sharing

6.1 Sharing Taxpayer Information

India has entered into agreements with various jurisdictions to:

- avoid double taxation;
- grant relief from double taxation;
- exchange information to prevent tax evasion/avoidance (or investigation of such cases); and
- co-operate with each other in the recovery of taxes.

Thus, India has a strong tax treaty network that includes double-tax avoidance agreements (DTAAs) with around 104 countries (a comprehensive agreement with 96 countries/territories and a limited agreement with eight jurisdictions) and tax information exchange agreements with 23 countries/territories.

7. Advance Pricing Agreements (APAs)

7.1 Programmes Allowing for Rulings Regarding Transfer Pricing

The advance pricing agreement (APA) programme was introduced in India in 2012. A taxpayer can opt for a unilateral, bilateral or multilateral APA, and this can provide TP certainty to taxpayers for five prospective years with a roll-back option for four previous years. Thus, an APA can provide certainty for a total of nine years using the roll-back option.

7.2 Administration of Programmes

The Indian APA programme is administered by the Central Board of Direct Taxes (CBDT) with the help of a specialised and designated team constituted for this purpose. This team consists of income tax authorities as identified by the CBDT and may include nominated experts in economics, statistics, law or any other field.

7.3 Co-ordination Between the APA Process and Mutual Agreement Procedures

The Indian APA regime allows taxpayers to opt for a unilateral, bilateral or multilateral APA. In respect of a bilateral or multilateral APA, the competent authorities of the countries involved (including India) are required to first reach an arrangement through a mutual agreement procedure (MAP). This arrangement must be accepted by the taxpayer before a bilateral or multilateral APA can be entered into.

7.4 Limits on Taxpayers/Transactions Eligible for an APA

Any taxpayer who has undertaken an international transaction or is contemplating undertaking an international transaction is eligible to file for an APA. An APA can be applied to any category of international transaction. While there is no limit on the value of international transactions that may be covered under an APA, the expected aggregate value of such international transactions can affect the total statutory fee payable to the Indian government for applying such an APA. However, an APA cannot be applied for specified domestic transactions.

7.5 APA Application Deadlines

In the case of an international transaction that is of a continuing nature, the APA application must be filed before the beginning of the first financial year out of the future years proposed to be covered under the APA. For example – if the APA application seeks to cover five years starting from financial year (FY) 2024–25 to FY 2028–29, the application must be filed before 1 April 2024.

However, for an international transaction proposed to be entered for the first time, the application may be made at any time before actually undertaking such a transaction. For example – if the taxpayer is proposing to provide certain services for the first time to its foreign associated enterprise from 1 July 2024, the APA application in respect of such a transaction can be filed before 1 July 2024 and the time limit of 1 April 2024 will not apply here.

7.6 APA User Fees

Taxpayers are required to pay a statutory fee before making any APA application. Such fee varies from INR1 million to INR2 million, depending on the likely aggregate value of international transactions expected to be entered into during the period proposed to be covered under the APA.

Furthermore, an additional fee of INR500,000 is required to be paid by taxpayers opting for a roll-back.

7.7 Duration of APA Cover

The Indian APA programme seeks to provide certainty to taxpayers for five prospective years. The law also offers a roll-back option for the previous four years, subject to certain conditions. Thus, in India, an APA can give certainty for a total of nine years with roll-back, and five years without roll-back.

7.8 Retroactive Effect for APAs

As discussed in **7.1 Programmes Allowing for Rulings Regarding Transfer Pricing**, subject to a few conditions, the roll-back option is available in India to cover the previous four years under the APA.

8. Penalties and Documentation

8.1 Transfer Pricing Penalties and Defences

Taxpayers in India are subject to the following key annual compliance requirements in respect of their related party transactions.

- The accountant's report in Form 3CEB is mandatorily required to be electronically filed by every person who has entered into international transactions (including deemed international transactions) or specified domestic transactions on or before 31 October 2024. Form 3CEB contains a brief summary of international transaction(s) and/or specified domestic transactions, along with the method used to justify the arm's length nature of such transactions. This report is required to be certified by a chartered accountant.
- TP documentation or a local file is required to be prepared and kept ready on record on or before the above due date. For international transactions (including deemed international transactions), such documentation is required if the aggregate value of the transactions entered during a year exceeds INR10 million.

TP documentation or a TP study is a detailed contemporaneous document maintained by the taxpayer to justify the arm's length pricing of transactions, which should include various prescribed particulars such as:

- a business overview of the group, associated enterprises and the taxpayer;
- an overview of the industry/market in which the taxpayer operates;
- functional, asset and risk analysis;
- reasons for selection/rejection of a method;
- economic analysis; and
- other prescribed particulars/documents.

Nevertheless, even if the value of international transactions is less than INR10 million, the taxpayer will have to maintain basic documentation to demonstrate the arm's length nature of such transactions.

Apart from the above, India also has provisions pertaining to master file and country-by-country reporting (CbCR).

The Indian TP regulations lay down specific penalties to ensure adherence to the above compliance requirements. Failure to furnish Form 3CEB on or before the due date can attract a penalty of INR100,000.

Furthermore, Indian TP law prescribes onerous penalties equivalent to 2% of the value of the transaction, which may be levied in the event of:

- failure to keep the TP documentation ready on or before the due date;
- failure to report any international or specified domestic transaction;
- maintaining/furnishing incorrect information or an incorrect document; or
- failure to furnish the TP documentation on request to tax authorities within the permitted time period.

The law also provides for penalties in respect of non-compliances pertaining to the master file and CbCR. Failure to file the master file may attract a penalty of INR500,000. On the other hand, the law prescribes penalties in the range of INR5,000 to INR50,000 per day for non-compliances relating to CbCR, depending on the number of days over which such non-compliances continue. Providing inaccurate information pertaining to CbCR may attract an additional penalty of INR500,000.

Separately, other administrative penalties provided under Indian tax law, including penal interest, may also be levied in the event of TP scrutiny/adjustments.

Taxpayers may safeguard themselves from some penal provisions in the case of any failure to comply with the provisions of tax laws, provided they are able to demonstrate the existence of a "reasonable cause" for such failure. Completing timely and transparent tax filings, the availability of robust documentation to support their position and opinions, and co-operation with the tax authorities during the course of audits are a few factors that may help the taxpayer in establishing such reasonable cause when any penalties are assessed. Taxpayers may alternatively choose an appeal before the appellate authorities against an order imposing such penalty.

8.2 Taxpayer Obligations Under the OECD Transfer Pricing Guidelines

The Indian TP regulations are largely modelled on the TP principles laid down under the OECD TP Guidelines, including TP documentation requirements. Indian TP regulations have always required taxpayers to prepare TP documentation or perform a TP study annually to substantiate the arm's length nature of their international/specified domestic transactions. However, in 2016, keeping up with the country's commitment to the OECD's BEPS action plans, the Indian government introduced the concept of three-tier TP documentation in India and re-aligned TP documentation requirements in India with the OECD's recommended structure. As a result of this change, taxpayers who are part of a multinational group (MNE or "MNE Group"), are required to comply with the following requirements.

Local File

The local file refers to the annual TP documentation discussed earlier. The TP documentation is required to be contemporaneous and should be maintained on an annual basis. This is not a new reporting requirement and, conceptually, it has always been part of the Indian TP regulations.

Master File

The master file is a new reporting requirement, which was introduced in India in 2016 pursuant to the OECD's BEPS action plans. It is required to be electronically filed in Form No 3CEAA (Part A and Part B) where the value of international transactions during the relevant accounting year exceeds INR500 million (INR100 million in the case of intangible related transactions) and where the consolidated group turnover exceeds INR5 billion. However, Part A of the master file (Form 3CEAA) is required to be filed even if the above thresholds are not met. Where there is more than one constituent entity that may or

may not be resident in India, one of these entities may be designated to complete such filing.

CbCR

CbCR is also a relatively new reporting requirement, introduced in India in 2016. CbCR is required to be electronically filed by the ultimate parent entity (UPE) of an MNE group that is resident in India, having an annual consolidated group revenue in the immediately preceding accounting year of more than INR64 billion. The statutory due date for e-filing is 12 months from the end of the reporting accounting year of the UPE. The UPE can designate another group entity as an alternative reporting entity for the purposes of filing CbCR.

Where the UPE is outside India, in a country with which India has an agreement for the exchange of CbCR-related information, the Indian constituent entity is obliged to file a notification specifying the details of the group entity filing such CbCR. Such notification must be filed at least two months before the due date of the CbCR filing.

Local filing of the entire CbCR may also be required if:

- the UPE is a resident of a country with whom India does not have an agreement for the exchange of CbCR;
- the UPE is not obliged to file CbCR in its jurisdiction; or
- there has been a systematic failure on the part of the UPE's jurisdiction to share information and such failure has been intimated to the Indian entity.

9. Alignment With OECD Transfer Pricing Guidelines

9.1 Alignment and Differences

India is not a member of the Organisation for Economic Co-operation and Development (OECD). The Indian TP regulations do not make any specific mention or reference to the OECD TP Guidelines. However, the TP legislation in India is in line with the OECD TP Guidelines (with certain modifications), including the broad structure of the three-tier TP documentation, comparability analysis, TP methods, etc.

Both taxpayers and the tax authorities have placed their reliance on the OECD TP Guidelines, especially in cases where guidance is not available under domestic legislation. Similarly, the OECD TP Guidelines are often referred to/relied upon in judicial rulings in India.

9.2 Arm's Length Principle

The Indian TP regulations require that income (or expense) resulting from a controlled transaction should be computed having regard to the arm's length price.

9.3 Impact of the Base Erosion and Profit Shifting (BEPS) Project

India is a key partner country that actively participates in various committees, workshops and working groups of the OECD. The OECD and India have enhanced their co-operation in dealing with issues related to TP and to promoting better tax compliance in order to help prevent cross-border disputes. As part of the G-20 Group, India has played an active role in the OECD's project for prevention of Base Erosion and Profit Shifting (BEPS) and is committed to the outcomes of the BEPS project.

Pursuant to the BEPS action plans, India has introduced various changes in its domestic TP regulations, including:

- the introduction of three-tier TP documentation in 2016 in response to the BEPS Action Plan 13;
- publication of detailed guidance on MAPs in August 2020 (which was also updated in June 2022), in order to implement the recommendations of BEPS Action Plan 14 on "Making Dispute Resolution More Effective" (the guidance provides that the Indian competent authorities will endeavour to – note, not commit to – resolve disputes under the MAP route within 24 months); and
- the introduction of interest limitation rules in 2017 in order to deal with the thin capitalisation challenges highlighted in BEPS Action Plan 4.

9.4 Impact of BEPS 2.0

BEPS Action Plan 1 sought to address the tax challenges of a digital economy. It recommended some interim options that could be adopted until global consensus is reached. The options were:

- introducing a new nexus rule – significant economic presence (SEP);
- withholding tax on certain types of digital transactions; and
- an equalisation levy (EL).

Thereafter, India introduced the EL vide Finance Act, 2016, and the SEP provisions vide Finance Act, 2018, as interim measures in response to various tax challenges posed by the digital economy.

The EL is 6% on consideration received for online advertising, provision of digital advertising space or facilities/service for the purposes of online advertisements. EL 2.0 was introduced in the Finance Act, 2020. EL 2.0 is 2% on non-resident e-commerce operators for the online supply of goods or provision of services.

SEP provisions are included in the definition of "business connection", thereby providing taxing rights to India in respect of digital businesses that operate in India without creating any physical presence in India, which has historically been a key requirement for creating a "permanent establishment" in India.

It is expected that once a consensus-based solution is reached at the global level on Pillar 1, India will withdraw its digital service tax and other similar measures.

India is an active participant in the BEPS 2.0 initiative (Two-Pillar Solution) and is in favour of a consensus-based solution that would allocate appropriate revenue to market jurisdictions.

With respect to Pillar 2, India's endeavour has been to phase out exemptions/deductions. It is expected that the effective tax rate (ETR) will be higher than the agreed global minimum tax rate of 15% since the corporate tax rate in India is generally higher than 15%.

9.5 Entities Bearing the Risk of Another Entity's Operations

The Indian TP regulations do not contain any specific provision permitting – or restricting – an entity in terms of bearing the risk of another entity's operations by guaranteeing the other entity a return. Practically, limited-risk structures are quite prevalent in India and are often used by MNEs in their overall structure. For this, Indian taxpayers generally place reliance on the overall TP principles provided under the Indian

regulations, as well as the OECD TP Guidelines, to determine a suitable business/pricing model for their intra-group transactions based on the detailed review of the functional, asset and risk profile of the parties involved. Furthermore, the arm's length standard is to be followed while deciding remuneration for any entity, including for a limited risk entity.

Experience has also shown that where an MNE group headquartered in India has a limited risk entity overseas, Indian tax authorities may question whether such foreign entity is, in fact, bearing its own risks, and therefore whether it should be entitled to an assured return for its activities. This issue gains more prominence in cases where an Indian entity is not deriving or earning a commensurate value from overseas operations, while continuing to bear the costs and risks of such overseas entity. Furthermore, in terms of comparability analysis for such limited risk structures, the Indian tax authorities may challenge the use of an overseas entity as the tested party, especially in the absence of reliable financial information for foreign comparable companies.

10. Relevance of the United Nations Practical Manual on Transfer Pricing

10.1 Impact of UN Practical Manual on Transfer Pricing

The UN Practical Manual on Transfer Pricing is not specifically referred to in the Indian TP regulations. However, India is an active contributor to the UN Practical Manual and has contributed an entire chapter to the manual on TP practices and challenges in India.

Furthermore, taxpayers and tax authorities in India often rely on the UN Practical Manual for guidance on relevant matters. Similarly, reference to the UN TP manual can also be found in judicial rulings in India.

11. Safe Harbours or Other Unique Rules

11.1 Transfer Pricing Safe Harbours

Indian safe harbour provisions provide circumstances in which the income tax authorities will accept the transfer price declared by the taxpayer, in respect of its eligible international transactions, without conducting in-depth scrutiny of the declared transfer price. Safe harbour rules were first made applicable in India in FY 2012–13. These rules were then revamped and revised in 2017 to make the prescribed margins/prices more reasonable.

The CBDT recently notified changes to these rules (in December 2023) effective from FY 2023–24 onwards. These changes primarily pertain to:

- the international transaction of outbound intra-group loans, wherein amendments have been made to the definition of the term "intra-group loan", resulting in expansion of the scope of the intra-group loans covered under safe harbour rules;
- introduction of different reference rates to be used for foreign currency denominated loans in view of the phasing out of LIBOR; and
- changes in credit ratings to be used for deciding interest spread along with the arm's length interest rate to be used for intra-group loans.

Further, minor changes were also made to the definitions of the terms "operating expense" and "operating revenue" as used in the context of other international transactions.

The safe harbour rules were last notified (on 9 August 2023) for FY 2022–23 and are applicable to the following transactions:

- the provision of software development and/or IT-enabled services;
- the provision of knowledge process outsourcing services;
- contract R&D services relating to software development and generic pharmaceutical drugs;
- the manufacture and exportation of core auto components;
- the manufacture and exportation of non-core auto components;
- providing a corporate guarantee;
- providing an intra-group loan (these have since undergone changes as described above); and
- receipt of low-value adding intra-group services.

Safe harbour rules are yet to be notified for FY 2023–24 and subsequent years.

Apart from the above, India also introduced limited safe harbour provisions for certain categories of specified domestic transactions.

11.2 Rules on Savings Arising From Operating in the Jurisdiction

There are no specific rules in the Indian TP regulations governing allocation of the benefit of location savings/advantages between associated enterprises. However, India as a country offers various location-linked cost savings due to the availability of lower cost skilled and unskilled labour, lower rental costs, etc, and offers other advantages such as access to a large market and a wide customer base.

Therefore, the concept of "location savings" may be one of the aspects analysed by Indian tax authorities during the course of TP audits. Where good quality local comparable companies/transactions are available for the arm's length analysis, which have access to similar location advantages, one may conclude that the benefits of such location savings/advantages are captured in the arm's length price itself.

11.3 Unique Transfer Pricing Rules or Practices

The following is a summary of some key trends, rules and practices witnessed in the Indian TP landscape since the inception of the TP regulations in India in 2001.

Annual TP Documentation Requirement

In India, taxpayers are required to prepare contemporaneous TP documentation or a local file on an annual basis. The underlying economic analysis (or benchmarking analysis) also needs to be performed every year.

Domestic TP Provisions

Certain domestic transactions are also subject to TP provisions in India, provided their aggregate value exceeds INR200 million. This primarily includes:

- the transfer of goods or services between units of an entity claiming or eligible to claim a tax holiday under Indian tax laws; or
- any business transacted between an entity claiming a tax holiday or concession under specified sections of Indian tax laws and a closely connected person.

Use of the Sixth Method or Residual Method for Arm's Length Analysis

The Indian TP regulations prescribe a sixth method, namely "the other method", for arm's length analysis. This is a residual method that allows the use of any reasonable approach for computing the arm's length price, provided it reflects the price that has been charged or paid, or that would have been charged or paid, for the same or a similar uncontrolled transaction between third parties. As a result, taxpayers can explore the use of various data points, such as quotations, valuation reports, standard rate cards, etc, for the purpose of the arm's length analysis using this residual method.

Specialised Officers for TP Audits

TP audits in India are currently being performed only by specialised tax officers – ie, TP officers (TPOs). TPOs are solely responsible for performing TP audits, and regular tax assessing officers are no longer permitted to analyse the arm's length nature of a taxpayer's international or specified domestic transactions.

Deemed International Transactions

Deemed international transactions are also included within the scope of the Indian TP regulations. A deemed international transaction in the context of a taxpayer means a transaction entered into by an enterprise with an unrelated enterprise, where a prior agreement exists between the unrelated enterprise and the AE of the taxpayer; or where the terms of such a transaction are, in substance, determined between such unrelated enterprise and the AE of the taxpayer (where the resident or non-resident status in India of such unrelated enterprise is irrelevant).

Therefore, it becomes important for taxpayers in India to evaluate whether any of their third-party transactions fall within the ambit of Indian TP, necessitating the determination of the arm's length price.

Preference for Use of Indian TP Databases

Indian tax authorities prefer the use of specific Indian TP databases in cases where an Indian entity is selected as the tested party for the arm's length analysis.

Free-of-Cost Transactions

Indian tax authorities generally tend to question free-of-cost transactions, especially any free-of-cost support received from overseas group companies by Indian entities that are remunerated by their counterparts on a cost-plus basis.

Notional Interest on Overdue Balances

Indian authorities generally challenge the credit period that is offered by a taxpayer to its overseas group companies and tend to compute the notional interest on any overdue receivables by treating such outstanding balances as a deemed loan or advance.

Marketing Intangibles

Marketing intangibles have been a key focus area in Indian TP. The Indian tax authorities generally challenge any significant advertising, marketing and promotion (AMP) expenses incurred by an Indian entity, especially where such entity is using marketing intangibles legally owned by an overseas group company. Indian authorities generally expect an Indian entity to be compensated for any benefits accruing to an overseas group company as a result of expenses incurred by the Indian entity, as such expenses are often perceived as being incurred on behalf of the overseas group company. This matter has been highly litigated in India, and is now pending adjudication before the Supreme Court of India.

Intra-Group Services/Royalty Transactions

Indian tax authorities are more likely to question the need and benefit of any outbound payment for intra-group services or royalty transactions. While various rulings have held that the commercial expediency of the taxpayer cannot be challenged by tax authorities, the tax authorities in India still seek detailed documentation/evidence to satisfy the need and benefit tests, along with proof of actual receipt of such services, in respect of such outbound payments.

Evaluation of the Reliability and Correctness of Comparability Analysis

The Indian tax authorities generally perform a detailed review of the taxpayer's arm's length analysis, including the methodology followed for the selection of comparable companies/transactions. This may include an in-depth analysis of the various quantitative and qualitative criteria applied by the taxpayer as part of its economic analysis. Furthermore, the tax authorities often proceed to perform their own independent benchmarking analysis, especially where they are not satisfied with the various filters used by the taxpayer and/or the adequacy and reliability of the comparables used by the taxpayer.

Treatment of Pass-Through Costs

The tax authorities in India generally analyse the cost structure of the taxpayers in detail, especially in the case of limited risk captive entities operating in India, to determine if any costs have been intentionally excluded from the "operating cost" or have been wrongly classified as "pass-through costs", thereby reducing the overall remuneration of such limited risk entity. For example, Indian tax authorities may try to determine if there are any services or resources made available by overseas AEs to the Indian captive entity on a free-of-cost basis, which may have resulted in reduced "operating costs" in India. Similarly, the tax authorities generally tend to include any cost pertaining to the employee stock plans granted by the overseas parent to the employees of the Indian entity, either on a free-of-cost basis or based on subsidised rates.

Financial Transactions

Indian TP regulations are applicable to financial transactions as well, including borrowing, lending, guarantees, etc. The Indian courts have held that loans and guarantees are subject to TP provisions, even when entered into without consideration. Furthermore, in respect of loans, the Indian courts have held that the arm's length interest rate should ideally be determined based on the interest rate applicable to comparable uncontrolled transactions denominated in the same currency as the intercompany loan.

Reliance on Other Regulations

In India, taxpayers and tax authorities often rely on other regulatory provisions prevailing in the country in order to defend their TP analysis. For example, taxpayers often rely on the provisions of foreign exchange management regulations for the purpose of defending the credit period offered to the AEs.

Secondary Adjustment Provisions

The concept of secondary adjustment was introduced in India from FY 2016–17 onwards in cases where the value of the primary TP adjustment exceeds INR10 million. The primary TP adjustment can be made voluntarily by the taxpayer in its return of income, or it can be made by a tax officer during TP audits (if accepted by the taxpayer). Primary TP adjustments also arise on account of APAs or application of safe harbour rules, or from a MAP resolution.

Secondary adjustment is an accounting adjustment in the books of accounts of both the tax-

payer and the AE aimed at reflecting the actual allocation of profits between the taxpayer and its AE, in accordance with the primary TP adjustments based on the arm's length principle. The provisions also require time-bound repatriation of excess money lying with the AE as a result of primary TP adjustments into India. Such repatriation may be done by any of the AEs not resident in India. Failure to repatriate triggers a levy of interest on the amount not repatriated. There is an option available to the taxpayer to pay one-time additional tax of 18% (plus applicable surcharge and cess) on secondary adjustments where the taxpayer is not able to repatriate the excess money to India.

Rules Limiting the Deduction of Interest Paid

In line with the recommendations under Action Plan 4 of the OECD's BEPS Action Plan, India introduced interest limitation rules in 2017. Accordingly, the interest expense of the borrower, being an Indian company or a permanent establishment of a foreign company in India, is deductible to the extent of 30% of EBITDA. Balance interest is allowed to be carried forward for a period of eight subsequent financial years.

The interest limitation rule is not applicable where the amount of interest is INR10 million or less. Borrowers who are in the business of banking or insurance, and borrowings from a permanent establishment of a foreign bank in India, are exempted from the interest limitation rules. The Finance Act 2023 has extended this exemption to non-banking finance companies as well.

12. Co-ordination With Customs Valuation

12.1 Co-ordination Requirements Between Transfer Pricing and Customs Valuation

In India, customs-related matters are administered by the Central Board of Indirect Taxes and Customs (CBIC), while TP matters fall under the purview of the Central Board of Direct Taxes (CBDT).

There is a fundamental difference between the customs valuation and TP regulations. The customs authorities seek to increase the value of imported goods, resulting in higher customs duty liability. The income tax authorities focus on reducing the value of imported goods, as a lower transfer price will result in higher taxable profits in India. However, practically, the customs authorities have been seen take reference from the values adopted under the TP documentation while assessing the valuation under the customs law.

At present, there are no provisions under any law which mandate synchronisation between the valuation adopted by both authorities (ie, the customs authorities and the income tax authorities).

Since both laws are controlled by the central government, the government is aiming to arrive at a consensus between the authorities on the valuation aspect.

To formulate the above synchronisation, in 2007 a joint working group (comprised of senior officers from the income tax and customs departments) recommended certain steps for achieving co-operation between the customs and TP laws/departments. The field officers from both

departments were asked to make their respective databases regarding related party/associated enterprises available to each other on a "need to know" basis. Practically, not much traction was seen in this area.

Furthermore, in 2020, to begin a new era of co-operation and synergy between the CBDT and CBIC, a memorandum of understanding (MoU) was signed to facilitate a smoother bilateral exchange of data. This MoU makes it easier to share data and information on both an automatic and regular basis, as well as on request.

13. Controversy Process

13.1 Options and Requirements in Transfer Pricing Controversies

In India, the first level tax officer or assessing officer (AO) has to refer the audit of international/specified domestic transactions to a designated TP officer (TPO). Previously, such cases were picked up for TP scrutiny based on certain monetary thresholds. However, the Indian government later moved to a risk-based approach.

Dispute Channels

A taxpayer required to make a TP adjustment as an outcome of an audit has two channels available for disputing such TP adjustments. The taxpayer may either approach the Dispute Resolution Panel (DRP) or file an appeal before the Commissioner of Income Tax (Appeals), known as CIT(A).

While disputed tax is not required to be paid while approaching the DRP, a partial payment is generally required when an appeal is filed before the CIT(A). However, such payment may be waived by tax authorities depending on the facts of the case.

The Income Tax Appellate Tribunal

Where the taxpayer is not satisfied with the outcome of an appeal, a further appeal may be preferred before the Income Tax Appellate Tribunal (ITAT). While both taxpayers and the revenue authorities may file an appeal before the ITAT against an order passed by the CIT(A), only the taxpayer has the option to appeal against an assessment order passed pursuant to the directions of the DRP.

The ITAT has the power to grant stay to taxpayers from payment of disputed tax for a certain time period. The ITAT is the final fact-finding authority in India, and generally only matters involving a question of law travel to higher courts, namely the jurisdictional high courts and then (if required) the Supreme Court of India.

Constitutional Rights

Taxpayers, in certain cases, can also access their constitutional rights and directly approach either the jurisdictional high courts or the Supreme Court of India in the case of any violation of their rights or against any action taken by the tax authorities which is bad in law.

14. Judicial Precedent

14.1 Judicial Precedent on Transfer Pricing

The TP regulations were introduced in India in 2001. Since then, the country has witnessed litigation on multiple TP issues. As a result, the country has developed a very rich repository of judicial precedents on TP issues. Various TP matters have been analysed by the Indian tax tribunals and courts, providing guidance and precedence on issues such as:

- the interpretation of TP provisions;
- the powers of the tax authorities;

- the scope of various terms, such as international transactions and associated enterprise;
- comparability factors, including quantitative and qualitative aspects;
- selection of the tested party; and
- penalties, etc.

14.2 Significant Court Rulings

India has witnessed extensive TP litigation over the past two decades. As a result, the country has seen various judicial pronouncements on multiple TP issues. The following is a quick snapshot of some important court rulings on TP controversies in India.

- Aspects related to the arm's length price determination, such as choice of comparable companies, choice of filters used, correctness of application of filters, etc, can fall under the purview of "substantial question of law" and hence can be appealed before the high courts under u/s 260A of the Act. See Hon'ble Supreme Court of India in the case of SAP Labs India Private Limited (CA 8463/2022 ETC).
- Provision of a corporate guarantee to an overseas group company, even without consideration, constitutes an international transaction, and therefore warrants computation of the arm's length price. See the Madras High Court in the case of Redington (India) Limited (TCA Nos 590 and 591 of 2019).
- The arm's length interest rate in respect of intra-group loans denominated in foreign currency should be computed based on the interest rate applicable on comparable uncontrolled transactions denominated in the same currency. See the Delhi High Court in the case of Cotton Naturals (I) Pvt Ltd (ITA No 233/2014).
- TP adjustments on account of excessive advertising, marketing and promotion (AMP) expenses incurred by the Indian taxpayer cannot be made in the absence of any international transaction between such taxpayer and its overseas AE by simply alleging that such expenses were incurred for the benefit of marketing intangibles legally owned by the foreign AE. See the Delhi High Court in the case of Maruti Suzuki India Ltd (ITA No 110/2014 and ITA No 710/2015) and Whirlpool of India Ltd (ITA No 610/2014 and ITA No 228/2015).
- Tax authorities cannot recharacterise a taxpayer's international transaction barring a few exceptional cases. Furthermore, they cannot question a taxpayer's commercial expediency while analysing the arm's length nature of intra-group services availed from an overseas AE. See the Delhi High Court in the case of EKL Appliances Ltd (ITA No 1068/2011 & ITA No 1070/2011).
- Working capital adjustment performed by a taxpayer appropriately takes into account the impact of any delayed realisation of intercompany receivables. Therefore, a separate TP adjustment in the form of interest for an overdue receivable is unwarranted where the principal international transaction has already been demonstrated to be at arm's length after such working capital adjustment. See the Delhi High Court in the case of Kusum Health Care Pvt Ltd (ITA 765/2016).
- No separate adjustment for interest on overdue intercompany receivables is warranted where a uniform credit policy is adopted with AEs and non-AEs. See the Bombay High Court in the case of Indo American Jewellery Ltd (ITA No 1053 of 2012).
- Use of a foreign AE as the tested party is permissible under the Indian TP regulations, where such entity meets the relevant criteria for selection as the tested party. See the

Calcutta High Court in the case of Almatis Alumina Pvt Ltd (ITA No GA/2/2020).

15. Foreign Payment Restrictions

15.1 Restrictions on Outbound Payments Relating to Uncontrolled Transactions

Any outbound payment to unrelated parties needs to be made in accordance with the provisions of the Foreign Exchange Management Act, 1999 (FEMA) and the rules and regulations thereunder.

The provisions with respect to cross-border business expenses are governed by the Foreign Exchange Management (Current Account Transactions) Rules, 2000 rw FED Master Direction No 8/2015-16 (RBI/FED/2016-16/4) dated 1 January 2016, as amended from time-to-time (the "Regulations").

Current account transactions for business purposes are generally permitted under these regulations without any restrictions. However, certain types of transactions may have restrictions and require the prior approval of the central government and/or the Reserve Bank of India (RBI), as the case may be, in accordance with the Regulations.

It may be noted here that remittances exceeding USD10 million per project for any consultancy services in respect of infrastructure projects, and USD1 million per project for other consultancy services, will require the RBI's prior approval. Royalty payments, on the other hand, are freely permitted.

Similarly, for outbound payments with respect to capital account transactions, specific regulations are to be referenced. Under indirect tax laws, the importation of goods/services attracts tax as per respective statutes – ie, the Indian goods and services tax (GST) law and customs laws. However, when making payment towards such imports, no specific restriction has been prescribed.

15.2 Restrictions on Outbound Payments Relating to Controlled Transactions

Any outbound payment to related parties needs to adhere to the arm's length principle. Furthermore, such payments need to be made in accordance with the provisions of the FEMA regulations in India, as mentioned in **15.1 Restrictions on Outbound Payments Relating to Uncontrolled Transactions**.

Under indirect taxes, the importation of goods/services attracts tax as per the respective statutes – ie, Indian GST law and customs laws. However, when making payment towards such imports, no specific restriction has been prescribed.

15.3 Effects of Other Countries' Legal Restrictions

Indian tax law does not have any specific rules regarding the effects of other countries' legal restrictions. Furthermore, there are no provisions under Indian TP regulations allowing the benefit of a corresponding adjustment to taxpayers. However, India has a very strong tax treaty network with multiple countries. Taxpayers may access the MAP route via such tax treaties to get the benefit of such corresponding adjustments, if any, for obtaining necessary dispute resolution. Furthermore, bilateral advance pricing agreements may also be considered to avoid any double taxation issues in future.

16. Transparency and Confidentiality

16.1 Publication of Information on APAs or Transfer Pricing Audit Outcomes

The Indian government regularly issues press releases to provide statistical updates and details of any landmark developments (such as the signing of bilateral APAs, the signing of APAs for new or complex transactions, the number of APAs signed in a financial year, updates on any extensive audits/search and seizure operations without sharing any confidential details, etc). The Indian government has also started publishing an annual report card, capturing various statistical data highlighting the overall progress and key achievements of the Indian APA programme. The last APA annual report was published for FY 2022–23 in September 2023.

However, the Indian government does not publish the final outcomes of any APAs or TP audits, in view of their confidential nature and to protect taxpayers' information.

At the same time, judicial pronouncements made by income tax appellate tribunals, the high courts and the Supreme Court in respect of any TP matters in India are available in the public domain. Such judicial pronouncements generally capture the key details of the overall approach adopted by the taxpayer as well as the lower tax authorities (including the key TP issues involved), resulting in TP adjustments.

16.2 Use of "Secret Comparables"

Indian tax laws grant tax authorities/TPOs the power to seek information from any person in relation to such points or matters that may help them in computing the arm's length price. Tax authorities often use these powers to access non-public financial or other key information (such as the financial data of companies not available in the public domain) in order to support their arm's length conclusions. Furthermore, tax officers are also in a position to use their knowledge of industry practices acquired during the course of audits of other taxpayers operating in a similar industry, while performing the TP audit for a specific taxpayer.

In the past, such information was not shared with taxpayers. However, over the years various tribunals/courts have upheld that such information, if used, should also be shared with taxpayers. The latter can generally seek such details from tax officers during the course of audits.

Trends and Developments

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Introduction

Transfer pricing regulations were introduced in India in 2001. The law has consistently evolved over the last two decades to align Indian transfer pricing law with global best practices, such as with:

- the introduction of an interquartile range;
- safe harbours;
- secondary adjustments; and
- the implementation of India's advance pricing agreement (APA) regime.

While the APA regime has been criticised for its closure timeframe (an average of 44 months for closure of unilateral APAs, and of 59 months for bilateral APAs) and the aggressive positions adopted by the tax administration, the unparalleled certainty offered for up to nine years (once the APA is signed) has meant that the APA programme remains extremely sought after. Ever since the first set of transfer pricing audits took place in India, certainty on their Indian transfer pricing positions has been a cause of concern among multinationals across the globe. A host of multinational enterprises (MNEs) have been in the spotlight for their extant practices and intragroup transactions.

Indian transfer pricing law has several nuances and unique features. The definition of "transaction" is very wide in the law, and includes an arrangement, action or understanding in concert (whether or not such arrangement, action or understanding is formal) or in writing, or intended to be enforceable by legal proceeding. India also has a very wide definition of "associated enterprises", which includes a deeming fiction. Similarly, the definition of "international transaction" is also very wide and includes a deeming fiction.

Current trends and developments pivot around such nuances and wide definitions in the law. Section 92B of the Income Tax Act, 1961 (ITA) specifically mentions business restructurings or reorganisations to be included as international transactions, irrespective of these transactions' impact on profits, and requires reporting of such transactions as part of providing transfer pricing documentation. The ITA does not include guidance clarifying which circumstances entail a restructuring reorganisation, though the UN and OECD transfer pricing guidelines seek to clarify this: the UN guidance refers to a cross-border redeployment of functions, assets and risks, and the OECD guidelines refer to the reorganisation of commercial or financial relations between associated enterprises.

Even though transfer pricing jurisprudence has rapidly evolved (there have been close to 9,500 reported rulings), only a few precedents address the dynamic interplay and change in transfer pricing scenarios. The present article shall illustrate the cornerstone of transfer pricing jurisprudence, before analysing issues related to alternate dispute mechanisms, secondary adjustments, and the ever-expansive realm of the OECD Pillar Two Solution on the transfer pricing ecosystem in India for 2024.

Trends in Jurisprudence

Intra-group services

Intra-group services are widely viewed by the administration as a profit extraction measure, largely entailing no withholding of tax in India. Tax tribunals have been insisting on detailed documentation and satisfaction of five tests (need, benefit, rendition, non-duplication and non-stewardship) before deciding in taxpayers' favour.

Intra-group financing

Intra-group loans and guarantees are also closely scrutinised by tax authorities. Tribunals tend to be largely liberal and accept benchmarking undertaken by taxpayers. In a very recent ruling, the Mumbai Tribunal held that issuance of a comfort letter is tantamount to an international transaction for transfer pricing purposes. Transactions relating to purchase and sale of shares and convertible instruments are also increasingly coming under scrutiny.

Intangibles

Transactions involving intangibles are also being increasingly scrutinised. Advertising, marketing and promotion (AMP) spend agreements are being challenged using DEMPE principles. Tax tribunals, however, are demanding more stringent proof for the application of DEMPE to AMP transactions.

Business restructuring

Business restructuring and deemed international transactions are other areas where taxpayers are seeing more detailed inquiries. In a recent ruling, in the case of Diamond Dimexion [2024] 159 taxmann.com 118 (Mumbai – Trib), the Mumbai Tribunal upheld an addition made by the tax administration towards consideration paid to shareholders pursuant to a merger. The acquirer company had split the consideration into equity, compulsorily convertible debentures (CCDs) and cash. The Tribunal upheld the finding of the tax officer that the taxpayer should have received interest on the CCDs and the cash given, which, according to the officer, was a deemed loan/advance.

In the case of Mckinsey Knowledge Centre Pvt Ltd (Delhi ITAT, ITA No 154/Del/2016), the Delhi Tribunal dealt with business restructuring. Here the taxpayer provided research and information services to Mckinsey & Co Inc, USA, on a fixed-rate remuneration model up to assessment year 2010/11. From assessment year 2010/11 onwards, the remuneration model was changed to the cost-plus model. The issue in question was whether a change in the remuneration model amounted to business restructuring and whether a separate exit charge is required for change in the remuneration model. The Tribunal rejected the Indian Revenue Authority's (IRA) contention that the taxpayers had declared higher profits in previous years to avail themselves of a higher amount of deduction under Section 10A.

The jurisprudence concerning cases of business restructuring and the transfer pricing implications thereof are still evolving in India.

Location savings

Location savings are a pertinent issue for emerging markets like India, as MNEs set up shop in these markets and leverage on low-cost resources available therein. Such relocation to a low-cost jurisdiction has spurred the IRA to argue that a higher return is warranted for Indian operations on account of location savings. The IRA has applied high markups for captive information technology-enabled service/IT/R&D development centres, and has alleged that India offers location-specific advantages to MNEs, such as highly specialised and skilled manpower. In the case of Watson Pharma (Income Tax Appeal No 124 of 2016), the Bombay High Court upheld a tribunal ruling to the effect that, where local comparables are used, there is no locational advantage and hence no location-savings advantage is warranted.

Transfer pricing – an issue of fact or an issue of law?

A dispute arose in the Indian transfer pricing ecosystem as to whether the arm's length pric-

ing (ALP) determination (including choice of comparable companies, choice of filters used, correctness of application of filters, choice of method, etc) would be a factual exercise or a question of law. If the ALP determination is merely a factual exercise, the High Court cannot admit an appeal arising therefrom, unless perversity is demonstrated.

In a notable ruling in Principal Commissioner of Income Tax v Softbrands India Private Limited (ITA No 398/2017), the Karnataka High Court held the ALP determination exercise to be a factual matter, and held that for the matters involving ALP determination, the Income Tax Appellate Tribunal (ITAT) shall be the fact-finding authority and said matters are not appealable before the High Court. This ratio decidendi was challenged before the Hon'ble Supreme/Apex Court.

In SAP Labs India Private Limited v the Income Tax Officer (Civil Appeal No 8463 of 2022), the Supreme Court overruled the *Softbrands* ruling, and held that while determining the ALP the tribunal must follow the guidelines prescribed under domestic income tax law.

One of the immediate implications of this decision would be a surge in litigation concerning such determination, as the taxpayer and IRA can both challenge the adverse finding of the ITAT before the High Court. Coupled with India's secondary adjustment rules (discussed below), this will add to the timeline for settling tax disputes in an already elongated litigation cycle.

Developments

Secondary adjustment

The law on secondary adjustment is once again in the limelight, following the Supreme Court's ruling in *SAP Labs* (discussed above). Additional tax burdens owing to secondary adjustments gives further reasons for taxpayers to continue litigating their transfer pricing positions in India. Indian law requires a taxpayer to undertake secondary adjustment in the following scenarios:

- suo moto voluntary adjustment made by the taxpayer in the tax return;
- adjustment made by the tax officer and accepted by the taxpayer; and
- adjustment resulting from an APA, mutual agreement procedure (MAP) or safe harbour.

The Indian taxpayer's associated enterprise repatriates the excess money (the difference between ALP determined as per primary adjustment and the price at which the transaction is undertaken) within 90 days of the specified date. Failure to do so leads to the excess money (not repatriated to India) being deemed as an advance by the taxpayer to the AE, and an interest rate: SBI base rate (currently about 10%) plus 325 basis points for Indian rupee transactions; or six million LIBOR plus 300 basis points for transactions other than Indian rupee. This is computed on such excess money till the date such failure continues.

If the associated enterprise does not wish to remit the money, the Indian taxpayer has the option of paying additional tax at the rate of 18% tax plus applicable surcharge and cess on such excess money or part thereof (translating to approximately 21%). Where additional income tax is so paid by the taxpayer, the taxpayer will not be required to make secondary adjustments and compute interest from the date of payment of such tax. This implies that the taxpayer would, in any case, be required to compute interest up to the date of payment of such additional tax.

This heavy additional tax burden suggests that taxpayers will likely seek to litigate transfer pricing positions all the way to the Supreme Court.

Revised safe harbour rules for loan transactions

Under the revised safe harbour rules, LIBOR has been substituted as follows:

- for US dollar, six-month term Secured Overnight Financing Rate (SOFR), currently administered by the Chicago Mercantile Exchange (CME), increased by 45 basis points;
- for the euro, six-month Euro Interbank Offered Rate (EURIBOR), currently administered by the European Money Markets Institute;
- for UK pound sterling, six-month term Sterling Overnight Index Average (SONIA), currently administered by ICE Benchmark Administration/Refinitiv, as increased by 30 basis points;
- for Japanese yen, six-month Tokyo Term Risk-Free Rate (TORF), currently benchmarked by QUICK Benchmarks Inc, as increased by ten basis points;
- for Australian dollar, six-month Bank Bill Swap Rates (BBSW), currently administered by the Australian Securities Exchange; and
- for Singapore dollar, six-month Compounded Singapore Overnight Rate Average (SORA), currently administered by the Monetary Authority of Singapore, as increased by 45 basis points.

An additional rate of 150–400 basis points (1.5% to 4%) is added to this, depending on the credit rating of the borrower. The guidance has also been updated for prescribed credit rating agencies. If the loan is given in Indian currency, the interest rate is linked to the SBI base rate, and the additional interest cost can go up to 600 basis points if the taxpayer has no credit rating or has a credit rating of C+ or below (previously, this was 300 basis points).

Power to review transfer pricing orders

In what has only added to the already litigious landscape, the tax administration has been given an additional avenue for creating uncertainty for taxpayers. An order passed by the transfer pricing officer can now be revised by the commissioner; commissioners have started exercising these powers, and at what stage they can do so is the subject of controversy.

Option to file cross-objections

Yet another avenue for generating uncertainty for taxpayers is the powers given to the tax administration to file cross-objections against the findings of the Dispute Resolution Panel (DRP). The DRP was an optional process introduced to prevent the appellate system from becoming clogged with transfer pricing appeals, and to reduce instances of issuing high-pitched demands to taxpayers pursuant to audits.

Orders passed by the DRP have to be mandatorily factored in by the officer, before issuing the final order. The taxpayer is at liberty to appeal the order before the tribunal. However, the tax office has now been given the option to file cross-objections against such order. This could lead to relief given by the DRP being challenged by the tax office, and is completely contrary to the intent behind the DRP's introduction.

Advance Pricing Agreements (APAs)

The APA programme was introduced in India in 2012, with effect from 1 July 2012.

In September 2023, India's Central Board of Direct Taxes released an annual APA report for financial year (FY) 2022–23. In this year, the IRA signed the highest number of APAs (a total of

95). The IRA also signed 32 BAPAs, the most in any financial year to date. A record number of single-day signings in the history of the programme was also reached, with a total of 21 signed APAs on 23 March 2023.

The highest number of signed APAs in FY 2022–23 were in the services sector (26), followed by the information technology (18) and pharmaceuticals (11) sectors. India's leading treaty partners for APA signing were USA (302), China (96), UK (83), France (61), and Germany and Singapore (58).

Owing to the continued trust of treaty partners, out of the 96 BAPAs signed till 31 March 2023, 63 applicants have opted for renewal of the APA to date. Though the APA programme has been successful in enabling a positive economic environment for multinationals doing business in India, the government must remain committed to further increasing the efficacy of the programme. Today, India has an inventory of over 800 pending APA applications.

Mutual Agreement Procedures (MAPs)

As of 12 December 2022, the average time needed to close transfer pricing MAP applications in India stands at 34.54 months for cases started after 1 January 2016.

The number of MAP cases closed in 2022 was substantially higher than the number of new invoked MAP applications. As a result, the total number of MAPs in India's inventory is gradually dropping. The MAP closing inventory has decreased from 740 for FY 2022 to 697 for FY 2023. This has been attributed to the maturing of India's relationships with treaty partners, and to efforts to increase frequency of communication with its treaty partners.

India's Response to Amount B

On February 19th, the OECD/G20 Inclusive Framework on BEPS released a report on Amount B of Pillar One, to explicate a simplified and streamlined (S&S) pricing framework that determines a return on sales for eligible distributors undertaking baseline marketing and distribution activities. While envisioned as being friendly towards taxpayers and compliance administrators, the framework has been criticised due to a lack of definitive edge on key terms and chinks in the methodology being employed.

India has expressly recorded its reservations on the incomplete nature of the OECD/G20 Inclusive Framework report on Amount B, and its dissatisfaction concerns the following five factors:

- the non-inclusion of "low-capacity jurisdictions" and "qualifying jurisdictions" in the definition clause;
- use of operating expense as a cross-check mechanism for determining the minimum/maximum return of the distributor under Amount B, as against the distributor's functional contribution being reflected in the sales made by it, which most developing jurisdictions have been propounding;
- evident lack of geographical market considerations and qualitative screening criteria throughout the report;
- technical design of the pricing methodology employed; and
- the quandary around baseline distributors in the scope of Amount B.

India has been left short-pressed due to this incomplete approach by the OECD, and has declined to make a strong political commitment towards Amount B.

India's Proposal to the UN

India continues to remain actively engaged with the UN, and proposed the following work-streams to the UN:

- nexus rule beyond physical presence – to review Articles 5 and 7;
- revised rules for tax income from services;
- revisiting existing rules for tax income of remote/mobile workers;
- developing rules to address taxability of 'stateless' individuals;
- fostering synergies in domestic tax policies among interested member states;
- standardisation of ALP and development of benchmarks; and
- strengthening rules for taxing offshore indirect transfer – attempting global consensus.

Conclusion

India shall continue to protect its tax base by keeping a close watch on the transfer pricing practices of multinationals. As jurisprudence evolves, so too does tax law. Points of law resolved by the judiciary in favour of taxpayers are tackled by way of introducing largely prospective amendments to the law.

India is also witnessing the benefits of multilateralism, and is actively engaging with both the OECD and the UN. Policymakers continue to play a pivotal role in shaping the transfer pricing landscape, though it would be helpful if policymakers engaged equally with the administration and with taxpayers – currently, engagement is skewed in favour of the administration. However, the intention seems to be to adapt global best practices while not compromising on taxing rights.

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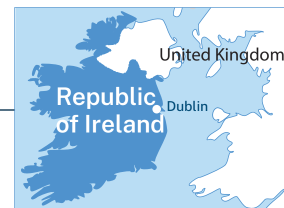

Law and Practice

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Matheson LLP puts its primary focus on serving the Irish legal needs of internationally focused companies and financial institutions doing business in and from Ireland. Matheson has offices in Dublin, Cork, London, New York, Palo Alto and San Francisco. The firm has 800 people working across these six offices, including 121 partners and tax principals, and over 540 legal, tax and digital services professionals. The Matheson tax team is the largest tax practice group among Irish law firms, with over 40 lawyers and tax advisers, and 19 partners and tax principals. The size of the Matheson tax practice has enabled the tax team to specialise, which distinguishes Matheson from the tax departments of other Irish law firms. This ability to specialise has become more important in recent years with global and European tax initiatives having a fundamental impact on both current and future tax laws, increasing the complexity and range of issues that tax advice has to cover.

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1. Rules Governing Transfer Pricing

1.1 Statutes and Regulations

Ireland's transfer pricing rules are set out in Part 35A of the Taxes Consolidation Act 1997 (TCA) (the "TP Rules"). Part 35A was introduced in the Finance Act 2010, and was substantially amended by the Finance Act 2019 and then further amended by the Finance Act 2020, the Finance Act 2021 and the Finance Act 2022. Prior to the Finance Act 2019, transactions agreed before 1 July 2010 were outside the scope of the TP Rules; however, with effect for chargeable periods commencing on or after 1 January 2020, the TP Rules apply to transactions agreed before this date.

The Finance Act 2022 updated the definition of "transfer pricing guidelines" to refer to the 2022 version of the OECD Transfer Pricing Guidelines (the "TP Guidelines"), which incorporates the OECD's Revised Guidance on the Transactional Profit Split Method, Guidance for Tax Administrations on the Application of the Approach to Hard-to-Value Intangibles and Transfer Pricing Guidance on Financial Transactions.

Therefore, with effect from chargeable periods commencing on or after 1 January 2023, the TP Rules provide that the "arm's length amount" is to be determined in accordance with the 2022 version of the TP Guidelines. The TP Rules further provide that any additional guidance published by the OECD will be considered part of the TP Guidelines once designated by the Irish Minister for Finance.

In brief, the TP Rules provide that, subject to certain exemptions between Irish associated persons, the TP Rules require domestic and international transactions between associated persons to be at arm's length. If an associated person has understated income or gains or overstated allowable losses or expenses – ie, the transaction was not at arm's length – the Irish Revenue Commissioners ("Revenue") may make an adjustment for tax purposes.

Revenue issued an updated version of their guidance on the TP Rules in December 2022 to provide clarity to taxpayers on the practical application of the TP Rules. Revenue issued further guidance in December 2023 regarding transfer pricing documentation requests. The guidance issued in December 2023 largely reiterates the existing statutory requirements and the processes set out in the Code of Practice for Revenue Compliance Interventions. However, it highlights the emphasis placed on transfer pricing documentation by Revenue and, from a taxpayer perspective, the importance of preparing robust transfer pricing documentation within the statutory time limits.

The guidance also serves as a reminder that compliance with the TP Rules can form part of Co-Operative Compliance Framework (CCF) annual risk review meetings. Where this is the case, the Revenue team may request a taxpayer's transfer pricing documentation as part of the CCF annual risk review meeting. The CCF is a co-operative framework for larger taxpayers that are typically within the scope of transfer pricing rules. The framework involves the taxpayers engaging regularly with Revenue to manage tax compliance on an ongoing basis.

1.2 Current Regime and Recent Changes

Overview of Recent Changes

Ireland did not have an extensive transfer pricing regime prior to the introduction of the TP Rules as inserted by the Finance Act 2010.

The TP Rules were significantly altered by the Finance Act 2019, which implemented some important changes including:

- extension of the TP Rules to capture non-trading transactions (save for certain Irish-to-Irish transactions) and certain capital transactions (where the market value exceeds EUR25 million);
- removal of grandfathering provisions relating to transactions that occurred prior to 1 July 2010; and
- the introduction of formalised documentation requirements for taxpayers in line with the requirements of the TP Guidelines (eg, a master file and local file in line with the TP Guidelines for certain taxpayers).

On 8 December 2021, Ireland's Minister for Finance signed a statutory instrument to formally incorporate into Irish law the OECD's 2020 guidance on the transfer pricing of financial transactions. Prior to this, the OECD's guidance on financial transactions had not yet been formally incorporated into Ireland's TP Rules. As noted, the OECD's latest edition of its TP Guidelines, issued on 20 January 2022, incorporates all supplemental guidance issued by the OECD subsequent to the 2017 edition of the TP Guidelines, and this is the version to be applied with respect to chargeable periods commencing on or after 1 January 2023.

The Finance Act 2021 introduced into the Irish TP Rules the application of the OECD development mechanisms (ie, the "authorised OECD approach") for the attribution of income to a permanent establishment of a non-resident company operating in Ireland for accounting periods commencing on or after 1 January 2022.

For accounting periods commencing on or after 1 January 2022, income attributable to a permanent establishment of a non-resident company operating in Ireland is to be computed as the amount of income which the permanent establishment would have earned if it were a separate and independent company engaged in the same or similar activities and under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the notionally separate company and the other parts of the non-resident company. In giving effect to the notionally separate company approach, the new rules are to be construed in so far as possible in a way that is consistent with Article 7(2) of the OECD Model and the guidance contained in the OECD Attribution of Profits to Permanent Establishments Report.

The Irish-to-Irish Exemption

The TP Rules apply to all transactions unless the transaction falls within the scope of the Irish-to-Irish transaction exemption. This exemption was introduced in the Finance Act 2019; however, the introduced exemption gave rise to interpretative difficulties regarding its application. A number of amendments to the Irish-to-Irish exemption were included in the Finance Act 2020, though as these also gave rise to interpretative difficulties, they were ultimately never implemented. The Finance Act 2021 addressed the interpretative difficulties for chargeable periods commencing on or after 1 January 2022.

The treatment of Irish-to-Irish transactions has a separate rule as a result of Ireland's dual-rate system. Ireland operates two corporation tax rates:

- a 12.5% rate applies to trading transactions; and
- a 25% rate applies to non-trading transactions.

For example, interest on an intercompany balance could be taxable at 25% as non-trading income in one group company and deductible at 12.5% (or not at all) in another group company. Therefore, the rule for Irish-to-Irish transactions ensures that the TP Rules do not give rise to negative tax arbitrage within the Irish tax system.

Accordingly, for the Irish-to-Irish exemption to be satisfied:

- each party's Irish tax computation must take account of any consideration payable/receivable;
- where there is no consideration, each party's Irish tax computation must take account of the consideration if any were charged;
- the supplier to the transaction (eg, a lender under a loan agreement) must not have entered into the transaction in the course of a trade; and
- neither party to the transaction can be a "Section 110" company (ie, a securitisation company qualifying for treatment under Section 110 of Ireland's tax code).

Where an acquirer to a transaction (eg, a borrower under a loan agreement) cannot satisfy the hypothetical test in the second condition above, there is a further carve-out which examines the activities of the acquirer in the course of entering into the transaction. The carve-out looks at whether such activities give rise to, or are capable of giving rise to, taxable profits, gains or losses (including tax-exempt dividends) for the acquirer, directly or indirectly.

Updated Revenue Guidance was introduced to provide further clarity on the relevant provisions. Helpfully, the Revenue Guidance confirms that, for chargeable periods which commenced on or after 1 January 2020 and before 1 January 2022, Revenue will accept returns which are filed in accordance with the Irish-to-Irish exemption in accordance with the Finance Act 2021. The clarified exemption is a welcome development on the initial iteration of the exemption and should provide greater certainty to taxpayers going forward.

2. Definition of Control/Related Parties

2.1 Application of Transfer Pricing Rules

The TP Rules require domestic and international transactions between associated persons to be at arm's length.

The TP Rules define associated enterprises in line with the TP Guidelines. For the purpose of the TP Rules, two persons will be associated if the other person is (directly or indirectly) participating in the "management, control or capital" of the other, or if the same person is participating in the "management, control or capital" of both persons. This would include parent companies involved in the management, control or capital of their subsidiaries.

The meaning of "control" in terms of the TP Rules is the power of a person to ensure that the affairs of a company are in accordance with the intentions of the person:

- by means of the holding of shares or the possession of voting power in or in relation to that or any other company; or
- by virtue of any powers conferred by the articles of association or another document regulating that or any other company.

A more flexible definition of control is included in Section 432 of the Taxes Consolidation Act,

1997 (TCA), which addresses scenarios whereby a person may exercise control by means other than percentage shareholding. However, this more flexible test does not apply for the purposes of the TP Rules.

In partnerships, it is necessary to "look through" to the rights of the individual partners. "Control" for the purposes of a partnership means a right to a share of more than 50% of the assets or income.

Under the TP Rules, the arm's length amount is the amount of the consideration that independent parties dealing at arm's length would have agreed in relation to the supply and acquisition. The TP Rules state that in computing the profits, gains or losses chargeable to tax, the TP Rules should be construed in accordance with the TP Guidelines, including the interpretation of the arm's length amount.

The TP Rules do not include a definition of "controlled transaction". However, the TP Rules apply to any "arrangement":

- involving the supply and acquisition of goods, services, money, intangible assets or anything else of commercial value;
- where, at the time of supply and acquisition, the person making the supply and the person making the acquisition are associated; and
- where the profits, gains or losses arising from the relevant activities are within the charge to tax in the case of either or both of them.

An arrangement is given a very broad definition and includes any transaction, action, course of action, course of conduct, scheme or plan and any agreement, arrangement of any kind, understanding, promise or undertaking. Moreover, the arrangement may be express or implied, and it does not need to be legally enforceable for it to fall within the provisions of the TP Rules.

3. Methods and Method Selection and Application

3.1 Transfer Pricing Methods

There is no specific list of transfer pricing methods included in the TP Rules. The TP Rules approve the transfer pricing methods applied under the TP Guidelines.

There are two broad categories of methodology approved for use in Ireland in line with the TP Guidelines: traditional transaction methods and transactional profit methods.

The traditional transaction methods approved for use in Ireland are:

- the comparable uncontrolled price (CUP) method;
- the cost-plus method; and
- the resale price method.

The transactional profit methods approved in Ireland are:

- the transactional net margin method; and
- the profit split method.

Revenue is pragmatic in its approach to the transfer pricing method most suitable to be applied to a transaction.

3.2 Unspecified Methods

Methods that are not provided for under the TP Guidelines are generally not accepted by Revenue, although the fact that the TP Guidelines refer to the use of unspecified methods means it is theoretically possible to seek to use such

unspecified methods, provided they can be shown to provide an arm's length amount in line with the OECD arm's length principle. Therefore, global formulary apportionment methods will not be accepted as they are not listed in the TP Guidelines.

There is, as yet, no Irish case law or Revenue guidance that discusses the suitability of particular methodologies.

3.3 Hierarchy of Methods

The TP Rules do not impose a hierarchy of methods, nor has any supplementary guidance been published by Revenue indicating a hierarchy of methods.

3.4 Ranges and Statistical Measures

There are no specific provisions in the TP Rules nor guidance relating to the use of ranges or other statistical measures to be used with the arm's length assessment. In practice, reliance will be placed on the TP Guidelines in relation to the use of ranges and statistical measures.

3.5 Comparability Adjustments

There is no specific requirement for comparability adjustments. There is little established practice in Ireland regarding when comparability adjustments will be sought, but they may be sought in certain circumstances, in line with the guidance in the TP Guidelines. To date, Revenue has not published supplementary guidance for their application in Ireland, and in practice this is looked at on a case-by-case basis.

4. Intangibles

4.1 Notable Rules

The TP Rules do not provide a definition for "intangible property", but intangibles are defined elsewhere in the TCA, where the definition focuses on legally protected intangibles and intangibles for accounting purposes. The TP Rules follow the TP Guidelines, and therefore one should refer to Chapter VI of the TP Guidelines when discussing transfer pricing rules on intangibles in Ireland.

The scope of the TP Rules includes the supply and acquisition of intangibles. The TP Rules do not set out rules that apply to transactions involving intangibles specifically, nor has Revenue provided guidance on transactions involving intangibles in a transfer pricing context.

Ireland recognises the distinction between legal and beneficial ownership of intangibles. This distinction is often set out in contract between the parties. The appropriate pricing of transactions will necessarily involve an examination of these contractual agreements.

The TP Rules do not specify methodologies to be used in relation to intangibles. In practice, Revenue will follow the TP Guidelines – ie, the use of traditional transaction methods and transactional profit methods are acceptable.

4.2 Hard-to-Value Intangibles

The transfer pricing legislation does not specify a valuation method in relation to intangibles. The discounted cash flow, acquisition or capitalised cost method could be used. Revenue, in its guidance, states that robust documentation must be provided to support a valuation of "intangible assets". The TP Rules do not specifically refer to the use of after-the-fact evidence to reprice a transaction that involves hard-to-value intangibles. However, Revenue will follow the guidance set out in Chapter VI of the TP Guidelines, which allows for the use of ex post evidence to

determine an arm's length price in certain circumstances.

DAC 6

The introduction and application of Directive 2018/822 ("DAC 6") means that cross-border arrangements involving hard-to-value intangibles between EU member states, or between EU member states and third countries, must be reported to Revenue and are subject to the automatic exchange of information between tax authorities. An arrangement must be reported within 30 days from the date on which the first step of the arrangement took place. In the case of persons advising on such arrangements, they must report within 30 days from the date on which the advice was given.

For the purposes of DAC 6, the term "hard-to-value intangibles" covers intangibles or rights in intangibles for which, at the time of their transfer between associated persons, no reliable comparables exist, and where, at the time the transaction was entered into, it was difficult for specified reasons to predict the level of ultimate success of the intangible at the time of the transfer.

DAC 6 took effect from 1 July 2020, but applies to arrangements that were first implemented on or after 25 June 2018. Ireland exercised a right to defer reporting obligations, and as a result, reporting to Revenue commenced in January 2021.

4.3 Cost Sharing/Cost Contribution Arrangements

The TP Rules do not specifically legislate for cost contribution arrangements. However, cost sharing and cost contribution arrangements are often encountered in practice. The TP Rules are aligned with the TP Guidelines, and therefore the interpretation of cost sharing and cost contribution arrangements in the context of the TP Rules will be in line with the TP Guidelines. There is, as yet, no case law in Ireland discussing this issue.

5. Affirmative Adjustments

5.1 Rules on Affirmative Transfer Pricing Adjustments

A taxpayer may make a transfer pricing-related adjustment after filing a tax return. The rules around making such an adjustment depend on the context in which the adjustment is made.

Self-Correction

If the adjustment is made prior to a Revenue compliance intervention, the taxpayer may seek to "self-correct without penalty" provided that the correction is made within 12 months of the due date for the relevant return and a payment of the additional tax accompanies the correction. A taxpayer will not be able to self-correct without penalty if Revenue has contacted the taxpayer in relation to any type of Revenue compliance intervention or where the self-correction relates to an instance of deliberate behaviour that featured in a period prior to the period to which the self-correction relates.

A taxpayer may also seek to correct an innocent error that is not deliberate in nature where the error cannot be attributed to the taxpayer failing to take reasonable care to comply with their tax obligations. Similarly, Revenue may also allow a technical adjustment, which arises due to differences in the interpretation or application of the Irish tax rules. Revenue will not allow a technical adjustment where the issue relates to a matter that is well established in case law/precedent.

Qualifying Disclosures

A taxpayer may also make a "qualifying disclosure" to Revenue. A qualifying disclosure is made in writing and must include a payment of tax and any interest owed. Any penalties owing will usually be agreed between the taxpayer and Revenue. A qualifying disclosure may be prompted or unprompted.

A prompted disclosure is a disclosure that is made following notification of a Revenue audit but before the audit commences, whereas an unprompted disclosure is one that is made by a taxpayer before any notification of an investigation or audit is received.

The quantum of any penalty payable to Revenue following a qualifying disclosure depends on:

- the nature of the disclosure (ie, prompted or unprompted);
- the category of behaviour (careless or deliberate);
- the level of co-operation by the taxpayer with Revenue; and
- whether the taxpayer had made any previous disclosures.

Transfer Pricing Adjustment in Another Jurisdiction

While a taxpayer may amend tax returns, a taxpayer may not automatically take a deduction for an expense that arises as a result of a transfer pricing adjustment in another jurisdiction. Instead, a taxpayer must rely on any reliefs that may be available pursuant to the relevant double tax treaty, such as a mutual agreement procedure (MAP) or a correlative adjustment.

6. Cross-Border Information Sharing

6.1 Sharing Taxpayer Information

Treaties Aligned With the OECD Model Tax Treaty

All tax treaties into which Ireland enters contain a provision through which the contracting countries agree to exchange information. Some tax treaties into which Ireland has entered are aligned with the OECD Model Tax Treaty, which includes provisions on the exchange of information between tax authorities for the purposes of each states' domestic laws. In addition, Ireland has entered into information exchange agreements with certain states.

The Convention on Mutual Administrative Assistance in Tax Matters

Ireland has also ratified the Convention on Mutual Administrative Assistance in Tax Matters, which contains articles on the exchange of information in tax matters between signatory states.

EU Directives

The EU Directive on Mutual Assistance for the Exchange of Information (2011/16) and the EU Directive on Mutual Assistance for the Recovery of Claims Relating to Taxes, Duties and Other Measures (2010/24) are applicable in Ireland and provide for the exchange of information and mutual assistance between member states in relation to taxation. The Directives have been used increasingly for exchange of information in the EU in recent years.

DAC 6

DAC 6 also provides for the automatic exchange of information on arrangements that are potentially aggressive, both between member states and between member states and third-party countries. Certain categories of transactions

that involve transfer pricing are caught within the DAC 6 reporting requirements, namely:

- arrangements involving safe harbour rules;
- arrangements involving the transfer of hard-to-value intangibles (see **4.2 Hard-to-Value Intangibles**); and
- arrangements that involve intra-group cross-border transfer of functions, risks and/or assets, where the projected annual earnings before interest and taxes of the transferor(s) within the three-year period after transfer are less than 50% of the projected amount if the transfer had not been made.

DAC 6 took effect in Ireland on 1 July 2020 under Part 33 of the TCA, but the reporting obligations were deferred until January 2021 for commencement.

Ireland has also implemented Directive 2021/514 ("DAC 7"), which provides for automatic exchange of information relating to certain platform operators.

Other Platforms for Exchanging Information

Ireland also exchanges information on country-by-country (CbC) reports, advance pricing agreements (APAs) and financial account information under the Foreign Account Tax Compliance Act and the Common Reporting Standard.

Furthermore, Ireland is subject to international agreements on the exchange of CbC reports pursuant to the Multilateral Convention on Mutual Administrative Assistance in Tax Matters and the Multilateral Competent Authority Agreement for exchanges of CbC reports ("CbC MCAA"). The CbC MCAA provides for the automatic exchange of information of CbC reports of multinational enterprise (MNE) groups between signatory states in which the MNE groups operate. Ireland has activated 77 bilateral relationships under the CbC MCAA or exchanges under EU Council Directive (2016/881/EU) and bilateral competent authority agreements.

The OECD Global Forum on Transparency and Exchange of Information for Tax Purposes published a peer review report in 2017 on Ireland's exchange of information processes. The report showed that there is satisfaction with the quality and timeliness of the information provided by Ireland under these processes. Ireland is rated "compliant" in terms of the exchange of information between tax authorities.

The Finance Act 2022 transposed the provisions of DAC 7 that facilitate information-sharing in the context of a new legal framework for joint audits. The Finance Act 2023 further supplemented the transposition of DAC 7 by implementing legislation to regulate the conducting of joint audits. Accordingly, given the multi-jurisdictional nature of transfer pricing disputes, joint audits are expected to become more common in the coming years.

7. Advance Pricing Agreements (APAs)

7.1 Programmes Allowing for Rulings Regarding Transfer Pricing

Ireland's bilateral APA programme has been effective since 1 July 2016. The formalised APA programme provides certainty and clarity to taxpayers when applying for and operating under a bilateral APA. Revenue has also published and updated guidelines on bilateral APAs.

Bilateral APAs are, in practice, more common than multilateral APAs. Revenue has confirmed that it will not enter into unilateral APAs.

There has been a significant uptake in Ireland's APA programme in recent years. Revenue's annual report notes that, in 2022, the Irish competent authority received 12 APA requests and four APAs were concluded following negotiations with the competent authorities of other countries.

7.2 Administration of Programmes

Revenue administers the programme for APAs in Ireland. In its role of the competent authority, Revenue emphasises its importance in relation to APAs.

7.3 Co-ordination Between the APA Process and Mutual Agreement Procedures

There is co-ordination between the APA process and MAPs. Access to the APA programme is subject to the MAP terms in the applicable double tax treaty.

In relation to the negotiation of APAs, Revenue adheres to the best practice set out in Communication 2007/71 on Guidelines for Advance Pricing Agreements within the EU and the accompanying report.

7.4 Limits on Taxpayers/Transactions Eligible for an APA

The types of taxpayers who can apply for an APA are limited to a company that is tax resident in Ireland or a permanent establishment of a non-resident country.

Revenue will, in practice, only accept a request for an APA for transactions in which:

- a significant amount of Irish tax is potentially at issue;
- a fundamental principle is being considered; or
- the transaction is complex or involves a high likelihood of double taxation arising in the absence of an APA.

7.5 APA Application Deadlines

A taxpayer's APA request should be submitted before an audit process begins, and in advance of the first accounting period to be covered by the APA. However, Revenue, in its guidance, states that it will agree to an APA that covers a prior accounting period (a "roll-back period").

7.6 APA User Fees

There is no fee payable for applying for or concluding an APA.

7.7 Duration of APA Cover

An APA will be granted for a specific period, typically for three to five years. The APA period cannot exceed five years (excluding roll-back periods).

7.8 Retroactive Effect for APAs

Where APAs have been sought for transactions that are already occurring, roll-back periods may be applied by Revenue.

8. Penalties and Documentation

8.1 Transfer Pricing Penalties and Defences

The TP Rules provide that taxpayers must prepare transfer pricing documentation. There is currently no requirement to file transfer pricing documentation with Revenue. However, the TP Rules contain provisions for penalties that apply where a taxpayer fails to provide Revenue with transfer pricing documentation following a request from Revenue.

A penalty of EUR4,000 will apply where a taxpayer fails to provide Revenue with its transfer pricing documentation within 30 days of a written request by Revenue. If the taxpayer is of such a size that it is required to prepare a local file, the penalty is increased from EUR4,000 to EUR25,000 plus EUR100 for each day the failure continues. The increased penalty applies to failure to provide any of the transfer pricing documentation, as opposed to a failure to provide the local file specifically.

In the event of a transfer pricing adjustment, this will not give rise to other tax-geared penalties contained in the TCA where:

- the taxpayer has prepared the files within the time limit;
- the taxpayer has provided the files to Revenue within the time limit; and
- a reasonable effort was made to ensure the files were accurate.

8.2 Taxpayer Obligations Under the OECD Transfer Pricing Guidelines

The TP Rules require the preparation of a master file and local file in accordance with the TP Guidelines for taxpayers meeting certain thresholds. The requirement under the TCA to submit a CbC report applies to Irish-headquartered MNEs or MNE groups with annual consolidated group revenue of EUR750 million or more.

9. Alignment With OECD Transfer Pricing Guidelines

9.1 Alignment and Differences

Ireland's TP Rules are closely aligned with the TP Guidelines. The TP Rules explicitly state that they are to be construed in accordance with the TP Guidelines. Moreover, the Minister for Finance may designate that the TP Rules be construed in accordance with further OECD guidance.

9.2 Arm's Length Principle

Ireland's TP Rules fully apply the arm's length principle in accordance with the TP Guidelines and do not recognise the use of a formulary approach, for example.

9.3 Impact of the Base Erosion and Profit Shifting (BEPS) Project

Ireland is fully engaged in the Base Erosion and Profit Shifting (BEPS) project, which has clearly influenced many of the changes in the Irish tax and transfer pricing landscape in recent years.

The TP Rules align with the requirements set out in the TP Guidelines, as amended by the work of the BEPS project.

CbC reporting requirements under BEPS Action 13 form one of the four BEPS minimum standards. Ireland enacted CbC reporting regulations (SI No 629 of 2015) to implement the recommendations as set out in the BEPS Action 13 Final Report.

The TP Rules have introduced the requirement for taxpayers to prepare and maintain a master file and local file, as recommended under BEPS Action 13.

Ireland has committed to implementing the BEPS Action 14 Final Report: Making Dispute Resolution Mechanisms More Effective minimum standard, and to having this standard reviewed by other member states. Ireland's peer-reviewed report on this matter was published in August 2018. Moreover, Ireland, as a member of the EU, is subject to the EU Dispute Resolution Directive (Council Directive (EU) 2017/1852). The Directive was transposed into Irish law in 2019

and provides taxpayers with the right to request a so-called EU MAP between member states. A taxpayer has three years in which to request a MAP and, if initiated, all other related MAPs (ie, one commenced under the relevant double taxation agreement, or DTA) must be concluded.

9.4 Impact of BEPS 2.0

Ireland supports the OECD's Pillar One and Pillar Two proposals and has been an active participant in tax reform discussions. In 2021, Ireland held a public consultation on the OECD proposals to seek stakeholder input prior to ultimately signing up to the OECD Inclusive Framework agreement in October 2021.

As with most jurisdictions, the OECD's Pillar One and Pillar Two proposals will significantly impact on the Irish tax and transfer pricing landscape.

Amount A under Pillar One proposes a divergence from normal application of the arm's length principle under the TP Rules, and Amount B under Pillar One is intended to simplify and streamline the arm's length principle based on the guidance provided in the TP Guidelines. While Pillar One Amount A technical work continues, overall, Pillar One is likely to see a reduction in Irish corporation tax receipts through a realignment of taxing rights. It is expected that the volume of disputes will increase as a result of Pillar One, which may put strain on Irish competent authority resources.

In February 2024, the OECD Inclusive Framework published a report on Amount B under Pillar One. This report provides a simplified approach to transfer pricing rules, with a particular focus on low-capacity jurisdictions. Ireland has not publicly confirmed the proposed approach to the adoption of the Amount B rules.

Finance (No 2) Act 2023 implemented the Pillar Two framework in Ireland by transposing the EU Minimum Tax Directive (Council Directive (EU) 2022/2523) into Irish law. The Finance Act provides that the Irish Pillar Two legislation shall be construed to ensure that effect be given to the OECD Model Rules and OECD Pillar Two guidance. The OECD's December 2023 Administrative Guidance was not included in the Finance (No 2) Act 2023 as signed into law on 18 December 2023, but was subsequently brought into effect by Ministerial Order dated 20 December 2023. Ireland has not yet published detailed guidance on the Pillar Two rules, but has issued high level notes for guidance regarding the Pillar Two provisions contained in the Finance (No 2) Act 2023. The move to a global minimum effective tax rate of 15% is a step towards greater tax certainty, which is broadly welcomed by multinational taxpayers in Ireland. As part of the negotiations, Ireland received assurances that the 12.5% headline corporation tax rate can remain in force for companies below the Pillar Two threshold of EUR750 million revenue.

Ireland intends to ensure that the use of research and development (R&D) tax credits can continue to support innovation and growth in compliance with the OECD framework, and the Finance Act 2022 introduced changes to the R&D tax credit regime to ensure its effectiveness. The Finance (No 2) Act 2023 introduced further changes, including increasing the R&D tax credit rate from 25% to 30% with a view to maintaining the level of support provided by the credit to many businesses in operating in Ireland. It is expected that the complex computation and compliance framework under Pillar Two will put a strain on taxpayer resources, particularly given the extent of existing documentation and compliance obligations under the TP Rules.

There continues to be a lot of uncertainty around the legal and technical implementation of Pillar One and Pillar Two. Therefore, the practical impact on the Irish TP Rules remains to be seen. In the meantime, multinational taxpayers in Ireland are closely following the OECD implementation to consider and model the impact on their transfer pricing policies.

9.5 Entities Bearing the Risk of Another Entity's Operations

The TP Rules do not attempt to deal with specific areas of discussion on the application of the arm's length principle. Rather, the TP Rules incorporate the TP Guidelines, and questions regarding the appropriate allocation of risk will be determined based on the application of the TP Guidelines to the particular scenario. This includes a review of the contractual terms underpinning the arrangement, such as guaranteeing a return for a particular entity in an arrangement.

10. Relevance of the United Nations Practical Manual on Transfer Pricing

10.1 Impact of UN Practical Manual on Transfer Pricing

The TP Rules do not rely on or reference the United Nations Practical Manual on Transfer Pricing.

11. Safe Harbours or Other Unique Rules

11.1 Transfer Pricing Safe Harbours

The TP Rules do not specifically provide for any safe harbours. However, as the TP Guidelines are explicitly incorporated into the TP Rules, Chapter VII of the TP Guidelines on "low value intra-group services" also forms part of the TP Rules. In this context, Revenue follows the guidance contained in Chapter VII of the TP Guidelines when determining an arm's length charge for such services. Revenue notes in its guidance that it will accept a mark-up of 5% of the cost base of a low-value intra-group service without requiring a taxpayer to carry out a benchmarking study to support the rate.

DAC 6 contains the requirement that arrangements involving the use of unilateral safe harbour rules are reportable and subject to automatic exchange of information. DAC 6 has been implemented in Ireland and arrangements from 1 July 2020 are reportable. Revenue has published guidance on the implementation of DAC 6 in Ireland.

11.2 Rules on Savings Arising From Operating in the Jurisdiction

The TP Rules do not specifically refer to location savings and there is no Revenue guidance or established practice in this regard.

11.3 Unique Transfer Pricing Rules or Practices

As set out previously, the TP Rules provide that certain arrangements between associated Irish entities should not be subject to the TP Rules. The Finance Act 2022 provided for a clearer application to certain qualifying loan arrangements between Irish suppliers and acquirers (see **1.2 Current Regime and Recent Changes** for recent developments regarding this exemption).

The Finance Act 2019 provided for small and medium-sized enterprises (SMEs) to be brought within the scope of the TP Rules. However, the relevant legislative provisions remain subject to commencement by the Minister for Finance, which has not yet occurred. In this regard, SMEs

are not currently within the scope of the TP Rules and there is no indication that the rules will be applied to SMEs in the immediate future.

12. Co-ordination With Customs Valuation

12.1 Co-ordination Requirements Between Transfer Pricing and Customs Valuation

The TP Rules do not give a definition for customs duty, and there is no general legislation or guidance from Revenue on the co-ordination between transfer pricing and customs valuation. Therefore, the TP Rules apply in the same manner as they do to other related-party transactions.

Customs duty is based primarily on the value of the goods as well as the origin and type of goods. The value of the goods will usually be determined by the transaction value – ie, the invoice price plus cost of transport, insurance and other payments to be made. If the transaction value is not available, Revenue provides a hierarchy of other valuation methods.

A transfer pricing adjustment may present facts that affect a valuation for customs duty purposes, and in those cases the customs authorities should be notified.

Revenue is ultimately responsible for tax and customs duty in Ireland, and therefore, where issues arise, Revenue may make further enquiries.

13. Controversy Process

13.1 Options and Requirements in Transfer Pricing Controversies

The Transfer Pricing Unit

Revenue has established a "transfer pricing unit" (TPU). The TPU will conduct reviews of taxpayers' transfer pricing by way of a compliance intervention.

Risk-Based Reviews/Checks

Prior to 2022, an "aspect query" was a form of compliance intervention used to target a specific risk reported on Revenue's risk review system. For all compliance interventions notified after 1 May 2022, the aspect query framework has been replaced with risk reviews, which are focused interventions to examine a risk or a small number of risks on a return. Risk reviews and audits must be carried out in accordance with Revenue's updated Code of Practice for Revenue Compliance Interventions, which took effect on 1 May 2022. Transfer pricing audits are "Level 2" compliance interventions conducted in compliance with the Code of Practice for Revenue Compliance Interventions and comprise risk-based reviews/checks on data provided by taxpayers in their tax returns. These risk-based reviews/checks can range from Revenue's examination of a single issue within a return to a comprehensive tax audit.

The Tax Appeals Commission

An appeal against a transfer pricing adjustment is made in the same manner as appeals against other tax assessments. An appeal is made to the Tax Appeals Commission (TAC) against the assessment under the relevant provisions of the TCA. TAC decisions are final unless the case is stated to the High Court on a point of law. Cases cannot be brought before the High Court on questions of fact.

Appeals from the High Court are made to the Court of Appeal, and from there to the Supreme Court. At the time of writing, there have been no published decisions of the TAC focusing specifically on the application of the TP Rules (and, therefore, no decisions from the higher courts either). Matheson acted for the taxpayer in Ireland's first transfer pricing appeal heard by the TAC. The determination in that case, which was successful for the taxpayer, will be publicly available in the coming months.

A taxpayer does not have to pay the disputed tax before making an appeal to the TAC. However, if the taxpayer does not pay the tax and subsequently loses the appeal, they will be subject to interest, and possible penalties, on a late payment.

Judicial Review

There may also be parallel avenues of litigation associated with transfer pricing enquiries through seeking judicial review in the High Court.

14. Judicial Precedent

14.1 Judicial Precedent on Transfer Pricing

No transfer pricing-specific dispute has been determined by the TAC or the Irish courts as yet, and therefore there is no developed domestic judicial precedent system on transfer pricing. However, as noted, the first determination regarding a transfer pricing appeal will be published in the coming months. In addition, the TPU is actively involved in transfer pricing audits, a number of which are under appeal at the TAC, and it is inevitable that a case will come before the courts in due course.

14.2 Significant Court Rulings

There are no significant court rulings on transfer pricing in Ireland.

15. Foreign Payment Restrictions

15.1 Restrictions on Outbound Payments Relating to Uncontrolled Transactions

The TP Rules do not restrict outbound payments relating to uncontrolled transactions.

However, other provisions of the TCA provide that payments such as royalties or interest may be subject to Irish withholding tax (WHT) unless an exemption is available. The TCA provides for broad exemptions from WHT, such as:

- when the payments are between group members; or
- when the payments are made to a recipient that is resident in a jurisdiction with which Ireland has concluded a double tax treaty.

Moreover, some of Ireland's double tax treaties provide that no WHT, or a reduced rate of WHT, applies to certain payments.

While not a TP measure, the Finance (No 2) Act 2023 also introduced new defensive measures on the tax treatment of distributions (including dividends), royalties and interest payments to recipients in zero-tax jurisdictions and jurisdictions included on the EU's list of non-cooperative jurisdictions. The new rules limit the availability of domestic WHT exemptions where payments are made to entities in the such jurisdictions.

15.2 Restrictions on Outbound Payments Relating to Controlled Transactions

The TP Rules apply in the normal manner to outbound payments between associated entities, and the same WHT considerations as detailed in **15.1 Restrictions on Outbound Payments Relating to Uncontrolled Transactions** also apply.

15.3 Effects of Other Countries' Legal Restrictions

A taxpayer will be denied a deduction for any payments made to a connected person resident outside Ireland in the context of a transfer pricing adjustment made to the connected person's profits. This rule applies both to payments to double tax treaty jurisdictions and payments to non-double tax treaty jurisdictions. A deduction will only be allowed where relief is obtained under the relevant DTA.

16. Transparency and Confidentiality

16.1 Publication of Information on APAs or Transfer Pricing Audit Outcomes

Information submitted to Revenue in connection with an APA or transfer pricing audit is treated as confidential. Revenue publishes certain aggregated statistics in its annual report on APAs, and also provides statistics to the European Commission on APAs in Ireland. This information may be made public by the European Commission, but reported in such a way that it does not identify the taxpayer. Revenue's annual report also contains aggregated statistical information on the number of transfer pricing audits conducted, and the outcomes. Revenue noted in its 2022 annual report that 51 transfer pricing audits had been initiated between 2015 and the end of 2022, 25 of which have been finalised. At the time of this update, the 2023 figures have not yet been released.

16.2 Use of "Secret Comparables"

Revenue will apply the general guidance in the TP Guidelines in determining the appropriate use of comparables. In practice, Revenue would not support the use of secret comparables, which aligns with the TP Guidelines.

Trends and Developments

Contributed by:
Catherine O'Meara, Anna Crowley and Joe Duffy
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Matheson LLP puts its primary focus on serving the Irish legal needs of internationally focused companies and financial institutions doing business in and from Ireland. Matheson has offices in Dublin, Cork, London, New York, Palo Alto and San Francisco. The firm has 800 people working across these six offices, including 121 partners and tax principals, and over 540 legal, tax and digital services professionals. The Matheson tax team is the largest tax practice group among Irish law firms, with over 40 lawyers and tax advisers, and 19 partners and tax principals. The size of the Matheson tax practice has enabled the tax team to specialise, which distinguishes Matheson from the tax departments of other Irish law firms. This ability to specialise has become more important in recent years with global and European tax initiatives having a fundamental impact on both current and future tax laws, increasing the complexity and range of issues that tax advice has to cover.

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Transfer Pricing Audit Landscape in Ireland

During the past year, the Revenue Commissioners ("Revenue") has continued to actively audit multinational enterprises (MNEs) in Ireland. With effect from 1 May 2022, Revenue is engaging in transfer pricing (TP) compliance interventions under the new Code of Practice for Compliance Interventions, which places a greater emphasis on collaborative compliance. The new framework has three graduated compliance levels: Level 1, Level 2 and Level 3.

Revenue is technologically sophisticated and has made significant investments in software with advanced data analytics capability. Taxpayers are selected for compliance intervention based on the presence of various risk indicators. In light of data analytics technology, Revenue's TP audits have been more focused and strategic in recent years.

In terms of trends, Revenue's TP audit focus is varied, and ranges from reviewing wider group TP policies and broader transactions to specific transactions focused on targeted areas. Given that the Organisation for Economic Co-operation and Development (OECD's) 2020 guidance on the TP of financial transactions was formally incorporated into Irish TP rules in 2021, the arm's length nature of financial transactions involving MNEs is now being closely examined by Revenue. It is expected that documentation of and support for TP policies applied to financial transactions will form an audit trend in the coming years.

Revenue's annual report contains aggregated statistical information on the number of conducted TP audits, and the outcomes. In its most recently available annual report, Revenue noted that 51 TP compliance interventions were initiated in the period from 2015 to the end of 2022.

During 2023, Matheson acted for a multinational taxpayer in the first Irish TP appeal heard by the Tax Appeals Commission (Tax Court) in Ireland. The taxpayer successfully won the appeal, and the assessments were set aside. The determination has not yet been publicly released; however, this landmark case is a significant development for Irish TP, and, given the nature and range of the issues considered, the determination will be of relevance to most multinational companies. Prior to this determination, no TP-specific appeal had been heard by the Tax Appeals Commission or the Irish courts since TP rules were first introduced in Ireland in 2010.

Currently, there are a number of TP assessments under appeal at the Tax Appeals Commission, with the likelihood of further appeals being heard by the Tax Appeals Commission in the near future.

The Importance of Robust TP Documentation

Updated Revenue Guidance

There has been a renewed focus on the importance and quality of TP documentation. On 18 December 2023, Revenue published new guidance on "Requests for Transfer Pricing Documentation" (the "Guidance"). The Guidance largely reiterates the existing statutory requirements and processes set out in the Code of Practice for Revenue Compliance Interventions. However, the publication of specific guidance by Revenue demonstrates the emphasis placed on TP documentation and, from a taxpayer perspective, the importance of preparing robust TP documentation within the statutory time limits.

The Guidance details the operational policy of Revenue's TP Audit Branches in the Large Corporates Division for requesting TP documentation from taxpayers as part of the risk assessment/appraisal process. It also sets out how TP

documentation requests fit within Revenue's compliance intervention framework, noting that TP documentation requested during a Revenue appraisal constitutes a "Level 1" compliance intervention (the lowest level of the compliance intervention framework). The Guidance also notes that a taxpayer's master file and local file will always be requested when a "Level 2" TP intervention is initiated (which can be a risk review or audit).

The Guidance includes a reminder of TP documentation obligations, and notes the requirement for taxpayers to have prepared their TP documentation no later than the date on which the tax return for the chargeable period is due to be filed. On that basis, the Guidance notes the expectation that the master file and local file should already be prepared and readily available upon request from Revenue. Importantly, a recent development is that the corporation tax return (CT1) in Ireland now contains mandatory questions regarding TP documentation. Taxpayers must confirm whether the company qualifies for an SME exemption and whether the company is required to prepare a local file and master file.

The Guidance highlights the role a taxpayer's master file and local file play in assisting Revenue's TP Audit Branches, to help better identify TP risks and facilitate more targeted risk-based TP interventions in being opened. The Guidance notes that the taxpayer's TP documentation informs Revenue's decision as to whether there is sufficient risk to proceed to audit or risk review. The Guidance also summarises a non-exhaustive list of the information generally reviewed by the TP Audit Branch for TP risk appraisals. This list includes information such as:

- financial statements;
- corporation tax returns and computations;
- payroll information for company employees filed with Revenue;
- country-by-country (CbC) reports;
- information on cross-border transactions submitted as part of the mandatory disclosure regime;
- intellectual property registries; and
- company websites.

The Guidance also provides a reminder that compliance with the TP rules can form part of co-operative compliance framework (CCF) annual risk review meetings. Where this is the case, the Revenue team may request a taxpayer's TP documentation as part of the CCF annual risk review meeting. CCF is a co-operative framework for larger taxpayers that typically fall within the scope of TP rules.

Finally, the Tax and Duty Manual (TDM) reiterates the relevant statutory penalties for non-compliance with the TP documentation requirements, and notes the importance of TP documentation in seeking protection from tax-geared penalties. In the event of a TP adjustment, tax-geared penalties will generally not be applied where:

- the taxpayer has prepared the files within the time limit;
- the taxpayer has provided the files to Revenue within the time limit; and
- a reasonable effort was made to ensure the files were accurate.

The Finance Act 2022 transposed the provisions of DAC 7, which facilitate information-sharing in the context of a new legal framework for joint audits. The Finance Act 2023 further supplemented the transposition of DAC 7 by implementing legislation to regulate the conducting of joint audits. Accordingly, given the multi-jurisdictional nature of TP disputes, joint audits

are expected to become more common in the coming years.

CbC tax reporting

In light of the interaction of CbC tax reporting with Pillar Two safe harbours, there has also been a renewed focus on the quality of CbC reports. CbC reporting requirements apply to MNE groups with consolidated group revenue of EUR750 million or more in the preceding fiscal year. CbC reports provide a breakdown of revenue, profits, taxes and other indicators of economic activities for each jurisdiction in which the MNE group operates.

The OECD has implemented the "Transitional CbCR Safe Harbour" as a temporary safe harbour to ease the administrative burden for MNEs. The CbCR Safe Harbour has been incorporated into Ireland's Pillar Two legislation, which came into effect for accounting periods commencing on 31 December 2023. As the operation of MNE TP policies and TP adjustments can impact on the application of the CbCR Safe Harbour, MNEs seeking to rely on the CbCR Safe Harbour should review their existing CbC reports, processes and source data to ensure that they are qualified for purposes of the CbCR Safe Harbour.

Separately, on 22 June 2023, public CbC reporting requirements took effect in Ireland with the entry into force of the EU (Disclosure of income tax information by certain undertakings and branches) Regulations (the "Regulations"). The Regulations require in-scope MNEs to publicly disclose corporate tax information. In addition, non-EU multinationals with subsidiaries and branches in the EU must comply with the same reporting obligations as EU multinational undertakings. Where the information is not available, the subsidiary or branch must request the information from the ultimate parent or standalone company. The application of the regulations begins in the first financial year on or after 22 June 2024, with 2025 as the first potential year for reporting, to be published in 2026. An in-scope undertaking must publish the tax report on its own website, unless it makes the report available to the public on the website of the Companies Registration Office (CRO) in Ireland, in which case the company must reference this on its own website and provide information on where the report can be found.

Potential Impact of OECD and EU Developments on Irish TP

Several important tax policy developments have emerged from the OECD and the EU during the past year, which will have a significant impact on TP and the application of the arm's length principle.

Pillar Two

The Finance (No 2) Act 2023 implemented the OECD's Pillar Two framework in Ireland by transposing the EU Minimum Tax Directive (Council Directive (EU) 2022/2523) into Irish law. The Act provides that the Irish Pillar Two legislation must be construed to ensure that effect be given to the OECD Model Rules and OECD Pillar Two guidance.

The arm's length principle plays a key role in the application of the Pillar Two rules, and it is essential that taxpayers are able to support the arm's length nature of intra-group arrangements. The Irish Pillar Two rules require certain adjustments where transactions between constituent entities of an MNE group are not consistent with the arm's length principle. It is therefore essential that MNE groups within the scope of the Irish Pillar Two rules consider the impact of the Pillar Two rules on TP policies and ensure that the

arm's length nature of arrangements can be supported.

Pillar One – Amount B

In February 2024, the OECD Inclusive Framework published a report on Amount B under Pillar One. This report provides a simplified approach to TP rules regarding certain baseline distribution activities, with a particular focus on low-capacity jurisdictions. Ireland has not publicly confirmed the proposed approach to the adoption of the Amount B rules; however, the introduction of simplified rules and documentation regarding baseline distribution activities would be widely welcomed by taxpayers in Ireland.

EU TP Directive

On 12 September 2023, the EU Commission issued a proposal for a Directive on TP (the "EU TPD"). If implemented, the EU TPD is not expected to materially affect how TP applies to Irish taxpayers in practice, as the proposal is based on the same OECD principles that form the basis for the existing Irish rules.

The Irish TP rules formally incorporate the arm's length principle and the OECD TP guidelines into Irish law. Therefore, the implementation of the EU TPD should reflect the principles underpinning Ireland's existing TP rules. However, the proposed EU framework for applying TP rules would broaden the scope of Irish TP rules if the EU TPD was implemented as proposed.

Achieving Certainty in an Uncertain Tax Landscape

The growing advance pricing agreement (APA) trend continues, as taxpayers continue to seek certainty amid the unsettled world of international tax reform. This is particularly the case given the implementation of Pillar Two in many jurisdictions. Revenue's 2022 annual report noted that the Irish competent authority received 12 APA requests and that four APAs were concluded following negotiations with the competent authorities of other countries.

ITALY

Law and Practice

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Maisto e Associati was established in 1991 as an independent Italian tax law firm with offices in Milan, Rome and London. Over the years, the firm has grown consistently and now has over 60 professionals, including 13 partners and three of counsel, with consolidated experience in managing complex domestic and multi-jurisdictional cases. It has a long tradition of transfer pricing work, with a dedicated team that has a depth of expertise in assisting multinational groups with reference to all issues connected to transfer pricing. Maisto e Associati has an outstanding track record in the negotiation of unilateral and bilateral advance pricing agreements, requests for unilateral recognition of the downward adjustment of the income of a resident company following a transfer pricing adjustment carried out by the fiscal administration of another state, competent authorities procedures for the management of tax disputes concerning the adjustment of the profits of associated companies, and assistance on transfer pricing audits.

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MAISTO E ASSOCIATI

1. Rules Governing Transfer Pricing

1.1 Statutes and Regulations

Transfer pricing is governed by Article 110(7) of Presidential Decree, 22 December 1986, No 917 (the "Consolidated Law on Income Taxes", also referred to as the Income Tax Code or ITC), which provides that the prices for intercompany cross-border transactions have to be determined on the basis of the arm's length principle (ie, based on the conditions and prices that would have been agreed between independent parties acting on an arm's length basis and in comparable circumstances) to the extent that this gives rise to an increase in taxable income.

Special rules are provided for downward adjustments. Pursuant to Article 31-quater of Presidential Decree 22 December 1973, No 600 ("Presidential Decree No 600/1973"), and related implementing regulations issued by the Italian Revenue Agency (IRA) on 30 May 2018, a downward adjustment is allowed under the following circumstances:

- as a result of the implementation of an agreement reached by competent authorities pursuant to a double tax treaty (DTT), to the Convention on the elimination of double taxation in connection with the adjustments of profits of associated enterprises resident in a member state of the European Union (90/436/EEC) and to Council Directive 2017/1852 of 10 October 2017 on tax dispute resolution mechanisms in the European Union;
- as a result of a joint audit carried out as part of international administrative co-operation; and
- upon request of the taxpayer, following a final upward adjustment, complying with the arm's length principle carried out by a state with which a DTT is in force and that allows an effective exchange of information.

General guidelines for the correct application of the arm's length principle set out by Article 110(7) of the ITC have been issued in the Decree of the Ministry of Economy and Finance, on 14 May 2018 (the "Ministerial Decree"), aligning the Italian regulations with current international best practices.

1.2 Current Regime and Recent Changes

Following the 1971 tax reform, transfer pricing was regulated by a specific provision (Articles 53, last paragraph, letter (b) and 56(2) of Presidential Decree, 29 September 1973, No 597 ("Decree No 597/1973")), separately for expenses and revenues.

The IRA issued comprehensive guidelines on transfer pricing for the first time in 1980 with Circular No 32/9/2267 of 22 September 1980 (the "1980 Circular"). The 1980 Circular was largely based on the OECD report, "Transfer Pricing and Multinationals" of 1979, and has been, for a very long time, the sole source for interpreting the Italian transfer pricing rules.

At the end of 1980, the provisions contained in Articles 53 and 56 of Decree No 597/1973 were repealed and replaced by Article 75, last paragraph, of Presidential Decree, 30 December 1980, No 897. Further guidelines were issued by the IRA with Circular No 42 of 12 December 1981 (the "1981 Circular"), dealing with the concept of control. Subsequently, Article 75 was transposed into Article 110(7) of the ITC, which provided that the price for intercompany cross-border transactions had to be determined on the basis of the "normal" value of goods and services, as defined by Article 9(3) of the ITC, which reads as follows:

"Normal value [...] means the price or consideration applied on average for goods or services of the same kind or similar, at arm's length conditions and at the same market level, at the time and place where goods and services are purchased or rendered or, in the absence of this, at the nearest time and place. For the determination of normal value, reference is made as far as possible to price lists or tariffs of the person rendering the goods or services or, in the absence of this, to official lists, considering usual discounts. [...]".

Alignment With OECD Transfer Pricing Guidelines

In 2017, in order to better align the Italian transfer pricing regulations with international standards, Article 110(7) was amended by Law Decree, 24 April 2017, No 50 converted, with amendments, by Law No 96 of 21 June 2017: the reference to the "normal" value concept was replaced by the reference to the arm's length principle. Therefore, the new Article 110(7) of the ITC explicitly incorporates the arm's length principle set forth by both Article 9 of the OECD, Model Tax Convention on Income and on Capital, Condensed Version 2017, and the OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations of January 2022 (OECD Guidelines).

On 14 May 2018, a Ministerial Decree was published, setting out general guidance for the correct application of the arm's length principle in line with international best practices making explicit reference to the OECD Guidelines and to the OECD Final Report on Base Erosion and Profit Shifting (BEPS) Actions 8–10 as well.

Furthermore, pursuant to Article 8 of the Ministerial Decree, on 23 November 2020, the Director of the IRA issued Regulation 2020/0360494 (the "2020 TP DOC Regulation"), in replacement of the previous 2010 regulations, updating the transfer pricing documentation eligibility requirements to benefit from the penalty protection regime and aligning the same with the OECD Guidelines as amended following the OECD Final Report on BEPS Actions 13.

It is also worth noting that the Ministerial Decree contains a final clause under Article 9 that explicitly enables the IRA to issue further implementing measures, considering the OECD Guidelines as amended, from time to time.

2. Definition of Control/Related Parties

2.1 Application of Transfer Pricing Rules

Transfer pricing rules apply with respect to cross-border transactions carried out between an Italian resident enterprise and non-resident companies that are linked by a direct or indirect "control" relationship. Indeed, Article 110(7) of the ITC applies to cross-border transactions occurring between Italian and non-resident enterprises that: "directly or indirectly control the Italian enterprise, or are controlled by it, or are controlled by the same company controlling the Italian enterprise". However, Article 110(7) of the ITC does not provide a definition of "control".

The definition of "associated enterprises" is provided by Article 2, letter a), of the Ministerial Decree, as follows: "an enterprise resident in the Italian territory as well as non-resident companies where: (i) one of them participates directly or indirectly in the management, control or capital of the other, or (ii) the same person participates directly or indirectly in the management, control or capital of both enterprises".

What Constitutes Control?

Article 2, letter b), of the Ministerial Decree clarifies that "participation in the management, control or capital" means (i) a participation of more than 50% in the capital, voting rights or profits of another enterprise; or (ii) the dominant influence over the management of another enterprise, based on equity or contractual bounds. In this respect, it should be noted that Article 110(7) of the ITC merely refers to the concept of "control", which was already present in the wording of Article 110(7) before the amendments introduced by Law Decree of 24 April 2017, No 50. In this regard, the 1980 Circular had specified that the concept of "control" must be characterised as "all instances of potential or effective economic influence". According to the 1980 Circular, the rationale of such interpretation lies in the fact that price differentials in commercial transactions often have their fundamental basis in the power of one party to strongly influence the will of the other party, thus altering the terms of the transaction. Such power can be effective without its possessor necessarily being a majority shareholder.

On this point, the Ministerial Decree seems to follow the same approach of the 1980 Circular, confirming that the concept of "participation in the management, control or capital" includes a "dominant influence" on the management of another enterprise based on constraints other than mere capital control, even if it introduced a reference to contractual bounds. Also, the 1981 Circular reaffirmed that the concept of control is strictly related to the actual existence of a "dominant influence". In the light of this, apart from voting rights, some other factors were identified, such as:

- the exclusive sale of products manufactured by the other enterprise;
- the use of the capital, products and technical co-operation of the other enterprise, including joint ventures;
- the right of the other enterprise to appoint members of the board of directors of the enterprise;
- the existence of members of the board of directors in common;
- the existence of family relationships between the parties; and
- in general, all the cases in which a potential or actual influence on business decisions is exercised.

Further guidance should be provided with reference to the notion of "dominant influence".

3. Methods and Method Selection and Application

3.1 Transfer Pricing Methods

The transfer pricing methods to be used for the evaluation of a controlled transaction on the basis of the arm's length principle are provided by Article 4(2) of the Ministerial Decree, in accordance with those listed in the OECD Guidelines: (i) the comparable uncontrolled price (CUP) method, (ii) the resale price method (RPM), (iii) the cost-plus method (CPM), (iv) the transactional net margin method (TNMM), and (v) the transactional profit split method (PSM).

It is worth mentioning that, based on the 1979 OECD Guidelines, the 1980 Circular had already referred to such methods for the evaluation of a controlled transaction. The practice of the IRA shows that the guidelines provided by the 1980 Circular on transfer pricing methods have been frequently considered together with the OECD developments in this regard (namely the OECD Guidelines as updated from time to time). It is

also worth noting that the Italian Ministry of Finance has translated into Italian and published the OECD Guidelines, first in 2013 and then in 2017, implicitly endorsing their adoption.

3.2 Unspecified Methods

Article 4(5) of the Ministerial Decree, following the OECD Guidelines, allows taxpayers to apply an unspecified method, other than the methods listed in Article 4(2) of the same Ministerial Decree, provided that they demonstrate that (i) none of the specified methods can be applied in a reliable manner, and (ii) the different method produces a result consistent with the one which independent enterprises would obtain in carrying out comparable uncontrolled transactions.

3.3 Hierarchy of Methods

The "most appropriate method" rule for the selection of the method is explicitly adopted by Article 4(1) of the Ministerial Decree as provided by the OECD Guidelines. Accordingly, Article 4(1) states that the most appropriate method should be selected based on:

- the strengths and weaknesses of each method depending on the circumstances of the case;
- the appropriateness of the method considered in view of the economically relevant characteristics of the controlled transaction;
- the availability of reliable information, in particular in relation to comparable uncontrolled transactions; and
- the degree of comparability between the controlled transaction and the uncontrolled transaction.

Furthermore, in line with the OECD Guidelines, Article 4(3) also states that traditional methods (CUP, CPM or RPM) have to be preferred, where a traditional method and a transactional method (TNMM or PSM) can be applied in an equally reliable manner. Additionally, Article 4(3) provides that the CUP method is deemed to be preferable where it and any of the other above-mentioned methods can be applied in an equally reliable manner. Lastly, Article 4(4) specifies that it is not necessary to apply more than one method to assess the arm's length nature of a controlled transaction.

3.4 Ranges and Statistical Measures

Article 6 of the Ministerial Decree deals with the arm's length range – ie, the range of figures related to a number of uncontrolled transactions each of which is equally comparable to the controlled transaction. In accordance with the OECD Guidelines, it is expressly provided that a controlled transaction is deemed to be at arm's length if the related financial indicator falls within the above-mentioned arm's length range.

Furthermore, it is worth mentioning that according to Article 6(3), if the financial indicator of a controlled transaction does not fall within the arm's length range, the IRA and the *Guardia di Finanza* (in the following, jointly referred to as "Tax Auditors") are allowed to make an adjustment in order to bring it within the range. The IRA, with Circular Letter No 16/E (the "Circular Letter"), issued on 24 May 2022 provided instructions regarding the correct definition and use of "arm's length range".

Lastly, in accordance with the OECD Guidelines, Article 6(3) states that, in the case of a transfer pricing adjustment by the Tax Auditors, the taxpayer has the right to demonstrate that the controlled transaction complies with the arm's length principle. In this case, the Tax Auditors can disregard the taxpayer's arguments, providing adequate explanation.

3.5 Comparability Adjustments

According to Article 3 of the Ministerial Decree, in the case of differences in comparability that affect a financial indicator, comparability adjustments can be made if it is possible to reduce such differences in a reliable manner.

4. Intangibles

4.1 Notable Rules

Italian laws do not provide for notable rules specifically relating to the transfer pricing of intangibles. The arm's length principle applies.

4.2 Hard-to-Value Intangibles

Italian laws do not provide for any special transfer pricing rules regarding hard-to-value intangibles. The arm's length principle and the OECD guidance on hard-to-value intangibles apply.

4.3 Cost Sharing/Cost Contribution Arrangements

Cost sharing/cost contribution arrangements are generally recognised in Italy (reference to them is expressly made in the 1980 Circular), even if no special transfer pricing rules apply to such arrangements. The arm's length principle applies.

5. Affirmative Adjustments

5.1 Rules on Affirmative Transfer Pricing Adjustments

Italian laws provide that a taxpayer is allowed to make an affirmative transfer pricing adjustment after the filing of a tax return, and before a tax audit starts, by submitting an amended tax return and paying the higher taxes resulting from the upward adjustment, related interest and reduced penalties through the *ravvedimento operoso* (active repentance) programme.

In the event that a taxpayer adopts the penalty protection regime (for further details see **8.1 Transfer Pricing Penalties and Defences**), that taxpayer is allowed to make an upward adjustment as per the above, also amending the transfer pricing documentation.

6. Cross-Border Information Sharing

6.1 Sharing Taxpayer Information

The Italian exchange of information framework is characterised by a wide and complex landscape of instruments available to the Tax Auditors, through which they can share information with, or gather information from, other jurisdictions. Very briefly, regarding transfer pricing matters, exchange of information can be based on DTTs, tax information exchange agreements (TIEA), and EU Directives executed/implemented by Italy.

DTTs

Italy has a wide treaty network, largely based on the OECD Model Tax Convention on Income and Capital of 1969, generally compliant with Article 26 of the OECD Model Convention. As a general rule, under DTTs, contracting states are obliged to exchange not only necessary information, but also pieces of information that can be "foreseeably relevant", with the only limitations being those applicable to generalised requests for information, of a banking or financial nature, and not concerning specific taxpayers (so-called fishing expeditions). The exchange of information can occur upon request, automatically or spontaneously.

TIEAs

Furthermore, Italy has concluded several TIEAs with states other than those with whom it has a DTT in force. Based on such agreements, exchange of information can occur only upon request; the pieces of information to be exchanged are those foreseeably relevant for the assessment and collection of taxes.

EU Directives

Italy has implemented, inter alia, the following EU Directives.

- Directive 2015/2376/EU (DAC3), which provides for the automatic exchange of tax rulings and advance pricing agreements (APAs); however, bilateral or multilateral APAs concluded with third countries are excluded if the agreement reached does not allow its disclosure. These agreements may be subject to spontaneous exchange, if allowed and where the competent authority of the third country authorises the disclosure.
- Directive 2016/881/EU (DAC4), which provides for the automatic exchange of reporting documents of multinational companies (ie, country-by country reporting).
- Directive 2018/822/EU (DAC6), which provides for the automatic exchange of information regarding cross-border aggressive tax planning mandatorily communicated by Italian intermediaries (such as, lawyers, tax accountants, notaries, financial institutions and the like) or taxpayers.
- Directive 2021/514/EU (DAC7), which provides for the automatic exchange of information regarding platform operators with respect to sellers in the sharing and digital economy and adds, inter alia, some rules regarding the timeline and the subject of the information to be communicated with respect to tax rulings and APAs.

7. Advance Pricing Agreements (APAs)

7.1 Programmes Allowing for Rulings Regarding Transfer Pricing

In Italy there is APA programme allowing taxpayers with international activities to, inter alia, determine in advance with the IRA the methods and criteria used to set their transfer pricing policies. Specifically, Italian taxpayers falling within the provision laid down by Article 110 (7) of the ITC can access APAs. APAs can be (i) unilateral, when they involve only the taxpayer and the IRA; or (ii) bilateral or multilateral, when they involve the taxpayer, its foreign counterparty(ies), the IRA and one or more foreign tax authorities.

APA Procedure

The unilateral APA procedure is regulated by Article 31-ter of the Presidential Decree No 600/1973 and by its implementing regulations issued by the IRA Director on 16 March 2016 (2016 Regulations). For the bilateral and multilateral APA procedure, the governing provision is laid down by the relevant DTT and in particular by the rule corresponding to Article 25(3) of the OECD Model Convention on Income and on Capital, which provides for mutual agreement procedures (MAPs) between the tax authorities of the contracting states aimed at avoiding double taxation.

The APA procedure is concluded (i) in the case of unilateral APAs, with the execution of a binding agreement by and between the IRA and the Italian taxpayer; or (ii) in the case of a bilateral or multilateral APAs, with the execution of a binding agreement by and between the IRA and one or more foreign tax authorities, as well as of a corresponding binding agreement by and between the IRA and the Italian taxpayer mirroring the

transfer pricing method and criteria agreed upon between the tax authorities.

During the effectiveness of the APA, the Tax Auditors are prevented from auditing the transactions covered by the APA. The office in charge of the administration of the programme has the power to assess if the taxpayer complied with the terms and conditions set out by the APA and if no changes occurred in the factual and legal circumstances founding the APA. Both unilateral and bilateral/multilateral APAs can be renewed upon request of the taxpayer.

7.2 Administration of Programmes

The APA programme is administered by the IRA. Specifically, unilateral APAs are administered by the Revenue Agency – Large Taxpayer Central Directorate – Audit Sector – Advanced Agreement Office (*Agenzia delle Entrate, Direzione Centrale Grandi Contribuenti, Settore Controlli, Ufficio Accordi Preventivi*); while bilateral and multilateral APAs are administered by the Revenue Agency – Large Taxpayer Central Directorate – Audit Sector – Resolution and Prevention of International Tax Disputes Office (*Agenzia delle Entrate, Direzione Centrale Grandi Contribuenti, Settore Controlli, Ufficio Risoluzione e Prevenzione Controversie Internazionali*).

7.3 Co-ordination Between the APA Process and Mutual Agreement Procedures

Italian laws do not provide for automatic co-ordination between the APA process and mutual agreement procedures (MAPs). Nevertheless, consistency is normally secured because the same office is in charge of both MAPs and bilateral/multilateral APAs.

7.4 Limits on Taxpayers/Transactions Eligible for an APA

There are no limits on which taxpayers and/or transactions are eligible for an APA. Indeed, an APA application can be submitted by all Italian taxpayers regardless of the size of the activity performed and of the kind of the intercompany transaction to be covered, provided that the provisions laid down by Article 110(7) of the ITC apply.

7.5 APA Application Deadlines

Italian laws do not provide for a deadline to file an APA application even if the date of filing can be relevant for the purposes of the application of roll-back mechanisms for bilateral and multilateral APAs.

A mandatory deadline is provided for the submission of the APA renewal application. Indeed, pursuant to Article 10 of the 2016 Regulations, taxpayers willing to renew a unilateral APA, must submit the renewal application 90 days before the end of the fiscal year in which the APA's validity expires. The same deadline should also apply to the agreement executed by and between the IRA and the taxpayer following a bilateral or multilateral APA.

7.6 APA User Fees

APA user fees are only necessary for the submission of bilateral and multilateral APA applications starting from 1 January 2021. The admissibility of the application is subject to the payment of a fee equal to:

- EUR10,000, where the overall turnover of the group, to which the applicant belongs, is less than EUR100 million;
- EUR30,000, where the overall turnover of the group, to which the applicant belongs, is

between EUR100 million and EUR750 million; and
- EUR50,000, where the overall turnover of the group, to which the applicant belongs, exceeds EUR750 million.

The above-mentioned fees are halved for the request of an APA renewal.

Specific regulations were issued by the Revenue Agency's Director (Reference No 2021/297428) on 2 November 2021, in order to provide implementing measures for the payment of the fees due for the request of a renewal. Such specific regulations also clarified (i) that for the determination of the overall turnover of the group, reference should be made to the latest consolidated balance sheet available at the date of submission of the application; and (ii) that in the event of the submission of several requests for bilateral or multilateral APAs with different states, the applicant shall pay the fee, as determined by the rules listed above, for each bilateral application or for each foreign country involved.

No fees are required for unilateral APAs.

7.7 Duration of APA Cover

The conclusion of a unilateral APA binds the parties for five years starting from the fiscal year in which it is signed, provided that no changes occur to the factual or legal conditions which constitute the premise on which the clauses of the agreement are based. As for bilateral or multilateral APAs, these are binding according to the agreements reached with the foreign tax authorities and starting from the fiscal year in which the application was submitted. The duration of bilateral or multilateral APAs is agreed by the contracting competent authorities, and the tendency of the IRA is to propose a duration no longer than five years, aligned with the maturity of unilateral APAs.

7.8 Retroactive Effect for APAs

Unilateral APAs can have retroactive effect ("roll-back") for one or more fiscal years preceding the effectiveness of the APA still open to tax assessment, if the following conditions are met: (i) the factual and legal circumstances on which the APA is based also existed in previous fiscal years, and (ii) no tax audits (access, inspections and verifications) covering previous fiscal years to be covered by the APA have been started.

As for the retroactive effect of bilateral and multilateral APAs, in addition to the above-mentioned conditions, it is also necessary to (i) submit a request for retroactive effect in the APA application, and (ii) obtain the consent of the relevant foreign tax authority(ies) to extend the effects of the APA to the previous fiscal years still open to tax assessment.

In both cases, if, from the retroactive effect of the APAs, upward adjustments are due, the taxpayer can spontaneously correct these using the *ravvedimento operoso* programme (as discussed in **5.1 Rules on Affirmative Transfer Pricing Adjustments**) and by the submission of an amended tax return. No penalties apply to the higher taxes arising from the upward adjustment.

8. Penalties and Documentation

8.1 Transfer Pricing Penalties and Defences

Administrative Tax Penalties

Italy has no specific transfer pricing penalties. However, administrative tax penalties generally also apply in the case of transfer pricing claims.

In particular, a transfer pricing claim may give rise to the application of the administrative penalties provided for by Legislative Decree 18 December 1997, No 471 ("Legislative Decree No 471/1997") (i) for an incorrect corporate tax return pursuant to Article 1(2); or (ii) if the transfer pricing adjustment also triggers a failure to apply withholding taxes, for an incorrect withholding tax agent return pursuant to Article 2(2), each of which range between 90% and 180% of the higher corporate taxes/higher withholding taxes assessed as a consequence of the upward adjustment. Repeated violations can lead to further increases in the penalties. It should, however, be noted that a draft legislative decree that will reorganise the existing tax penalty regime, making the punishments more proportionate, is currently under discussion.

Defences and exemptions

With respect to administrative penalties there are a number of potentially applicable exempting cases, including – in particular – where the violation deriving from incorrect estimates gives rise to a differential not exceeding 5% of the declared amount (Article 6(1) of Legislative Decree No 472/1997). Such exempting cases are, however, seldom recognised by the IRA.

Documentation requirements for penalty protection

More specifically, Article 26 of Decree-Law, 31 May 2010, No 78, converted into law with amendments by Article 1 of Law 30 July 2010, No 122, introduced into the Italian legal system a penalty protection rule for taxpayers that comply with certain transfer pricing documentation requirements for their intra-group transactions subject to transfer pricing rules.

Specifically, it is provided pursuant to Articles 1(6) and 2(4-ter) of Legislative Decree No 471/1997 that no penalties apply if the taxpayer delivers documentation that is appropriate to allow control over the compliance of the prices charged with the arm's length principle, as determined in the 2020 TP DOC Regulation and as clarified by the Circular letter No 15 of 26 November 2021 ("Circular No 15/2021"). This is a replacement of the previous 2010 regulations that is substantially aligned with BEPS Action 13. In particular, penalties do not apply if the following conditions are met:

- the taxpayer has communicated to the IRA through the relevant corporate tax return that it has prepared transfer pricing documentation;
- the taxpayer delivers, within 20 days from the Tax Auditors' request, transfer pricing documentation drafted in accordance with the template structure set out by the 2020 TP DOC Regulation;
- the information reported in the delivered documentation is fully consistent with the underlying commercial reality; and
- the documentation delivered in the course of an audit is complete and consistent with the provisions endorsed by the 2020 TP DOC Regulation (for further details see **8.2 Taxpayer Obligations Under the OECD Transfer Pricing Guidelines**).

On this point, Article 8 of the Ministerial Decree reiterates that transfer pricing documentation will be appropriate to allow for penalty protection whenever that documentation provides auditors with the information necessary for an accurate analysis of the transfer prices, regardless of the choice of method or the selection of the tested party or comparables. This protection will apply, as clarified by Circular No 15/2021, even if the transfer pricing documentation contains omis-

sions or partial inaccuracies, provided that these do not hamper the IRA's tax audit.

Criminal Tax Penalties

Furthermore, in addition to the above-mentioned administrative tax penalties, upward transfer pricing adjustments may – under certain circumstances – compel tax officers to refer the assessment to the public prosecutors to explore possible criminal tax law implications if certain thresholds are exceeded.

In particular, Article 4 of Legislative Decree, 10 March 2000, No 74 provides for the imprisonment, from two to four and a half years, of anyone who, with the aim of evading tax, files an incorrect tax return whereby both of the following thresholds are exceeded: (i) the non-paid tax exceeds EUR100,000, and (ii) the upward adjustments exceed 10% of the positive elements indicated in the tax return or EUR2 million.

Defences and exemptions

However, under Article 4(1-bis) of the Legislative Decree, 10 March 2000, No 74, no criminal relevance is given to:

- undeclared income deriving from improper classification or evaluation of positive or negative items of income that are real and properly disclosed in the accounts or in other documentation relevant for tax purposes;
- wrong timing accrual;
- non-deductibility of real costs; or
- issues not related to the business activity of the taxpayer.

Therefore, based on the above-mentioned Article 4(1-bis), it is often argued that transfer pricing adjustments should be considered not relevant for criminal purposes if at least one of the above-mentioned conditions is met (especially in the cases where the taxpayer prepared TP Documentation).

8.2 Taxpayer Obligations Under the OECD Transfer Pricing Guidelines

Italian laws follow the three-tiered approach recommended by BEPS Action 13 and the OECD Guidelines (ie, master file, local file and country-by-country reporting).

Master File and Local File

As mentioned in **8.1 Transfer Pricing Penalties and Defences**, a specific penalty protection regime has been introduced in 2010 whereby, should the Tax Auditors raise a transfer pricing claim, no penalties are levied if the taxpayer complies with specific documentation requirements and had timely filed a specific communication to the IRA within the corporate tax return on the availability of such documentation.

The 2020 TP DOC Regulation, which repealed the 2010 regulation, requires transfer pricing documentation that consists of a master file and a local file. Therefore, Italian taxpayers (including permanent establishments of non-Italian resident entities), wishing to benefit from the penalty protection regime, are obliged to prepare on a yearly basis both the master file and the local file.

As to the master file, the 2020 TP DOC Regulation provides that this file has to contain information regarding the group, following the structure set out in paragraph 2.2, which substantially mirrors BEPS Action 13 and the OECD Guidelines; taxpayers are allowed to draft more than one master file if the group carries out several activities that are different from each other and regulated by specific transfer pricing policies. The Circular No 15/2021 clarified that taxpayers may also submit the master file prepared by

the direct or indirect controlling entity, concerning the group as a whole or the individual division in which it operates, provided that such a document is (i) structured in the manner, and (ii) contains the information required by Annex I to Chapter V of the OECD Guidelines. However, where such document has a different structure or contains less information than that which can be inferred from the structure set out in paragraph 2.2, it must be supplemented by the taxpayer with a document linking the structure or with one or more appendices.

With regard to the local file, the 2020 TP DOC Regulation provides that this file has to contain information regarding the local entity and its intra-group transactions, and must be drafted following the structure set out in paragraph 2.3, which substantially mirrors BEPS Action 13 and the OECD Guidelines. Circular No 15/2021 clarified that a taxpayer may submit transfer pricing documentation with respect to a part of the intercompany transactions carried out. A simplification is provided for small and medium-sized enterprises (taxpayers with an annual turnover not exceeding EUR50 million that are not, directly or indirectly, controlled by, or in control of, entities exceeding the mentioned annual turnover): they can opt to update the benchmark analysis of the local file every three years (instead of annually), provided that (i) the comparability analysis has been performed using publicly available information sources; and (ii) the five comparability factors (characteristics of property or services, functions, assets and risks, contractual terms, economic circumstances, and business strategies) have not substantially changed.

Lastly, the 2020 TP DOC Regulation also sets out the content and the structure of the documentation to be followed by the taxpayers for applying the simplified approach for intra-group low value-adding services.

It is worth mentioning that Circular No 15/2021 clarified that taxpayers, in the case of doubts about the content that needs to be included in the master file and local file, may refer to the OECD Guidelines.

In order to benefit from the penalty protection, both the master and local files must be:

- prepared on a yearly basis, following the structure indicated in the 2020 TP DOC Regulation;
- drafted in Italian (however, it is permissible to have the master file in English);
- signed by the taxpayer’s legal representative or by a delegate using a digital signature with time stamp to be affixed within the date of the submission of the tax return; and
- submitted in an electronic format and delivered within 20 days from the Tax Auditors’ request.

As stated above, the existence of the transfer pricing documentation must be communicated to the IRA in the corporate tax return.

Circular No 15/2021 clarified that, in the event the taxpayer opts to submit the transfer pricing documentation only for a part of the intercompany transactions carried out, the above penalty protection will apply only with respect to the transactions described.

Country-by-Country Reporting

With Law 28 December 2015, No 208 (Finance Act 2016), Italy introduced country-by-country reporting (CbCR) obligations in accordance with Action 13 of the OECD BEPS project. On 8 March 2017, the Decree of the Italian Ministry

of Finance implementing the CbCR obligations (the "CbCR Decree") was published. The law introduced a CbCR obligation for MNE groups to deliver a comprehensive report to the IRA reflecting their activities and taxes paid in each country where the group operates (eg, revenues, profits before tax and corporate income tax paid).

Under the CbCR Decree, CbCR obligations may only apply to Italian-resident companies that belong to an MNE group whose consolidated revenues are not lower than EUR750 million (or a corresponding amount in the local foreign currency). An MNE group means a plurality (group) of enterprises, resident in different jurisdictions (or having permanent establishments in different jurisdictions), that are linked by a control or ownership relationship and are obliged to draft consolidated financial statements according to domestic accounting principles (or that would be obliged if the shares of any of the enterprises were traded on a regulated market).

The following entities are obliged to file CbCR under the CbCR Decree.

- The Italian resident parent company of an MNE group (the "Parent") – ie, the company obliged to draft consolidated financial statements according to its accounting principles and which is not controlled, whether directly or indirectly, by other enterprises of the MNE group.
- Italian resident subsidiaries of an MNE group (the "Subsidiary"), if:
  (a) the non-resident parent company is not obliged to file CbCR in its state of residence; or
  (b) there is no qualifying automatic exchange of information (AEoI) agreement for CbCR purposes between Italy and the state of residence of the non-resident parent company; or
  (c) the IRA has notified the Italian resident Subsidiary that the state of residence of the Parent suspended the AEoI or repeatedly omitted to transmit the CbCR files to the IRA.

Even if there is no qualifying AEoI agreement, an Italian Subsidiary is, in any case, exempted from filing the CbCR in the following circumstances:

- the MNE group has more than one subsidiary in the EU and designates another subsidiary to file the CbCR, provided that such subsidiary receives all the information needed to prepare the filing;
- the MNE group voluntarily appoints a surrogate parent company to file the CbCR in its state of residence, provided that if the surrogate parent company is resident in a non-EU state, additional requirements must be met (eg, it must be resident in a state with mandatory CbCR rules and with a qualifying AEoI agreement with Italy); or
- the Parent voluntarily files CbCR with the tax authorities of its state of residence, subject to certain additional conditions (eg, the foreign state should enact CbCR legislation by the deadline for filing the first CbCR under the CbCR Decree).

9. Alignment With OECD Transfer Pricing Guidelines

9.1 Alignment and Differences

As discussed in **1. Rules Governing Transfer Pricing**, Italian transfer pricing regulations are substantially aligned with BEPS Action 13 and OECD Guidelines. Therefore, there are no notable differences to be highlighted.

9.2 Arm's Length Principle

Italian transfer pricing rules consistently apply the arm's length principle under all circumstances.

9.3 Impact of the Base Erosion and Profit Shifting (BEPS) Project

As discussed in **1. Rules Governing Transfer Pricing**, Italian transfer pricing regulations have been amended in order to better align the rules with the best international practices (ie, OECD Guidelines as amended following the BEPS project).

9.4 Impact of BEPS 2.0

Italy has been contributing to the collective effort to redefine international tax rules for the digital economy since its inception in the OECD. Indeed, it participated in the discussions that led the OECD and the G20 to adopt the first report on the taxation of the digital economy, consisting of Action 1 (Tax Challenges arising from the digitalisation) of the action plan, developed by the OECD to counter the phenomena of base erosion and profits shifting (BEPS).

Italy chaired for the first time in 2021 the G20, a privileged discussion forum for the world's major economies, which has supported the work carried out so far at the OECD. Under, the Italian Presidency of the G20, on 8 October 2021 a historic agreement was reached between 136 countries of the OECD/G20 Inclusive Framework on a two-pillar solution of reforming the international tax rules, to be implemented in 2023.

In support of this agreement, Italy (and other countries, such as Austria, France, Spain and the United Kingdom) and the United States signed on 21 October 2021 a transitional agreement to move from the current system of taxation of digital services to a new multilateral solution: the United States has to stop the trade measures against Italy and the other signing countries and the latter will have to allow a certain method to credit the digital services tax paid against the Pillar One liability in order to avoid double taxation, once the Pillar One rules are implemented. Furthermore, Italian legislation on a digital services tax already sets out the repealing of the digital services tax once the political agreement on digital economy taxation is implemented.

Generally, it is expected that these initiatives could have an impact on domestic legislation, which could be subject to amendments when the work on the two-pillar solution is complete and the Council Directive (EU) 2022/2523 of December 14 2022, on ensuring a global minimum level of taxation for multinational enterprise groups and large-scale domestic groups in the Union is implemented. Said Council Directive has been incorporated into Italian legislation through the Legislative Decree of 27 December 2023, No 209. The implementing Ministerial Decrees have not been published yet.

9.5 Entities Bearing the Risk of Another Entity's Operations

As a general rule, Italy applies the OECD Guidelines on risks, recognising a return to the entity actually assuming them, taking also into account through a functional analysis how related parties involved in a controlled transaction operate in relation to the assumption and management of the specific, economically significant risks, identifying in particular who performs control functions and risks mitigation functions, who bears the consequences arising from the risk outcomes and who has the financial capacity to assume the risk.

10. Relevance of the United Nations Practical Manual on Transfer Pricing

10.1 Impact of UN Practical Manual on Transfer Pricing

As discussed in **1. Rules Governing Transfer Pricing**, Italian transfer pricing regulations have been aligned with international best practices (ie, the OECD Guidelines as amended following the BEPS project). There is no reference in Italian legislation or administrative guidance to the UN Practical Manual on Transfer Pricing.

11. Safe Harbours or Other Unique Rules

11.1 Transfer Pricing Safe Harbours

Special rules for low value-adding intercompany services are provided by Article 7 of the Ministerial Decree. This provision, mirroring the OECD Guidelines, provides for a simplified approach to assessing the consistency with the arm's length principle of certain qualified services. These are services which (i) are of a supportive nature, (ii) are not part of the core business activity of the group, (iii) do not require the use of unique and valuable intangibles and do not lead to the creation of the same, and (iv) do not involve the assumption or control of substantial or significant risk by, or give rise to the creation of significant risk for, the service provider.

In accordance with the OECD Guidelines, the remuneration of the above-mentioned services is deemed to be arm's length if a mark-up of 5% is applied on the direct and indirect costs borne for the performance of the same services. Therefore, if the simplified approach is applied, a specific benchmark to test the arm's length value is not required. However, in order to apply such a simplified approach, the taxpayer must draft specific documentation in accordance with the detailed content set out by the 2020 TP DOC Regulation.

11.2 Rules on Savings Arising From Operating in the Jurisdiction

Italian laws do not provide for specific rules governing savings arising from operating in Italy; in line with the general OECD recommendations, savings arising from operating in Italy should be taken into account in the functional analysis as they are an economic characteristic of the market.

11.3 Unique Transfer Pricing Rules or Practices

Italian laws provide notable unique rules applicable to the determination of the transfer pricing applicable to online advertising sales and ancillary services rendered by Italian taxpayers to related foreign parties. Specifically, Article 1(177) of Law 27 December 2013, No 147, provides that in determining the pricing of online advertising sales and ancillary services, taxpayers must use profit indicators other than those applicable to costs incurred for carrying out the activity (essentially, the CPM and TNMM based on costs). The use of profit indicators based on costs is allowed only if an APA is reached with the IRA.

12. Co-ordination With Customs Valuation

12.1 Co-ordination Requirements Between Transfer Pricing and Customs Valuation

There are no specific rules requiring co-ordination between transfer pricing and customs valuations; it is worth mentioning that the Italian

Customs and Duty Agency provided high level guidance in Circular 6 November 2015, No 16 regarding customs valuation of the transactions between related parties.

13. Controversy Process

13.1 Options and Requirements in Transfer Pricing Controversies

Italian laws do not provide for a specific controversy process for transfer pricing matters. Accordingly, general rules apply.

Administrative Tax Assessment

As a rule, in the case of a tax audit (which can be performed both by the IRA and the *Guardia di Finanza*), the tax auditors serve the taxpayer with a tax audit report (the "Report"), that describes the outcome of the audit activity and the findings of the auditors. The Report is not enforceable against the taxpayers and does not contain a request for payment of higher taxes and/or penalties.

To raise an enforceable claim against the taxpayer, the IRA issues a tax assessment notice (the *Guardia di Finanza* are not entitled to issue tax assessments). Note that, in certain cases, a tax assessment notice could be issued also in the absence of previous audit activity.

Before the tax assessment notice is served, the taxpayer has the following options:

- to accept wholly or partially the findings of the Report, spontaneously correct the violations by paying the amount due (higher tax and interest) and the applicable minimum penalty (if any) reduced to 20% (*ravvedimento operoso*), and submit amended tax returns;
- to file observations/comments to the competent Office of the IRA (the law provides a 60-day freezing period after the issue of the Report during which the IRA cannot issue a tax assessment notice to give the taxpayer time to provide observations); and/or
- to submit a formal application to start discussion with the competent Office to redetermine the findings in a settlement procedure.

Based on the Report and taking into account the discussion with, and the observations of, the taxpayer, the competent Office may withdraw/amend the claims or issue the formal tax assessment notice.

Once the formal tax assessment notice is served to the taxpayer, the latter has the following options.

- Within 60 days from the service date, subject to extension for the summer period, (the "Appeal Deadline"), to submit a formal settlement application to the competent Office, which allows the taxpayer and the IRA to discuss the content of the tax assessment notice and to negotiate a reduction/withdrawal of the adjustments raised (note that such alternative is not available if a settlement phase had already taken place before the issue of the tax assessment notice); this application suspends the Appeal Deadline by 90 days. In the case of a settlement, penalties, if any, are reduced to ⅓ of the minimum applicable. If the negotiation fails, the taxpayer can still appeal before the competent First Instance Tax Court no later than the extended Appeal Deadline.
- Within the Appeal Deadline, file the appeal against the tax assessment notice before the competent First Instance Tax Court.

- Accept the claim and pay the relevant amounts within the 60 days; in this case the penalties are reduced to ⅓ of the amount charged in the tax assessment notice.

The taxpayer is entitled, before filing the appeal, to pay ⅓ of the penalties indicated in the tax assessment notice, if any, thus reducing the risk of negative litigation. However, if the taxpayer prevails in Court, the penalties paid will not be reimbursed.

It is worth mentioning that the Legislative Decree of 11 February 2024, No 13, in relation to deeds served by the tax authorities from 30 April 2024, provides (among the other things):

- the possibility of accepting (with or without conditions) the content of the Report with a reduction of penalties to 1/6 ; or
- the issuance of a draft tax assessment before the final tax assessment, on the basis of which the taxpayer, within 30 days, may file a settlement application or additional observations.

Where the taxpayer files for a settlement application on the draft tax assessment, if a settlement is not reached, the final tax assessment will be served; in this case the taxpayer cannot file any other settlement application out of court. Where the taxpayer files further observations, the taxpayer may file a settlement application on the final tax assessment issued by the IRA within 15 days from the service of the same. This application will suspend the appeal deadline by 30 days.

Furthermore, in the event the taxpayer does not submit a settlement application but only submits observations, this would always be without prejudice to the possibility of the parties initiating, by mutual agreement, the settlement procedure, where the prerequisites for a settlement emerge as a result of the observations.

Tax Litigation Procedure

The First Instance Tax Court schedules a hearing; the taxpayer is entitled to file additional documentation and briefs before the Court within certain time limits.

Pending the appeal, the taxpayer is still in a position to negotiate a settlement with the competent IRA Office, which must be concluded within the date scheduled for the first hearing before the First Instance Tax Court. If the negotiation is successful, the penalties, if any, are reduced to 40% of the minimum applicable.

The decision issued by the First Instance Tax Court may be appealed both by the IRA Office and by the taxpayer before the competent Second Instance Tax Court. Pending the second instance procedure, the taxpayer may further negotiate a settlement (if the negotiation is successful, the penalties, if any, are reduced to 50% of the minimum applicable). The decision issued by the Second Instance Tax Court may be appealed by both parties before the Supreme Court but only for reasons based on violation of legal provisions (ie, generally, factual circumstances and amounts cannot be challenged). Starting from 2024, pending the Supreme Court litigation, the taxpayer may further negotiate a settlement (if the negotiation is successful, the penalties, if any, are reduced to 60% of the minimum applicable amounts). It is possible that the Supreme Court, rather than issuing a final judgment, will refer the case back to a different chamber of the Tax Court that issued the decision (generally the Second Instance Tax Court), so that the litigation process can continue.

Provisional Collection Pending Litigation

The tax assessment notice containing a transfer pricing claim is enforceable (ie, the taxpayer has to pay on a provisional basis, as a rule, ⅓ of the higher taxes assessed and interest pending tax litigation within the Appeal Deadline, as possibly extended if a settlement application is filed).

Under motivated and exceptional circumstances, the IRA can decide on provisional collection for the full amount of the assessment.

If the taxpayer does not pay within the abovementioned deadline, the IRA will instruct the collection agent to start the collection procedure (the collection procedure cannot generally be started in the 30 days following the filing of the appeal). After this 30-day period, a "grace" period of 180 days is in any case granted under law to all taxpayers. The suspension is not granted in the case of precautionary measures (eg, seizure of assets) and when the IRA Office claims that the collection is at risk.

After the First Instance Tax Court decision, to the extent unfavourable for the taxpayer, the collection agent can collect up to ⅔ of the higher taxes and penalties as determined by the decision, plus interest. After the Second Instance Tax Court decision, to the extent unfavourable for the taxpayer, the Collection Agent may request 100% of the taxes and penalties as determined by the decision, plus interest.

The taxpayer can also ask for a suspension of the collection according to the following procedures.

- Based on the administrative proceeding, the IRA Office is entitled, at its discretion, to totally or partially postpone the collection, upon written request of the taxpayer (possibly by requesting guarantees); this remedy will remain in force until the judgment of the First Instance Tax Court.
- Under the judicial proceeding, the taxpayer can request the postponement directly from the First Instance Tax Court; this request can be filed together with the appeal as well as after it, but no later than the first hearing on the merit – the postponement is granted at the discretion of the Court if the judges conclude that:
  - (a) there is fumus boni iuris (ie, the arguments of the appeal are well grounded prima facie); and
  - (b) there is periculum in mora (ie, there is a well-founded risk that the taxpayer may suffer from financial detriment as a consequence of the provisional collection).

The hearing on the postponement will be scheduled by the court within 30 days from the request. The decision on the postponement can be appealed within 15 days from its issuance.

14. Judicial Precedent

14.1 Judicial Precedent on Transfer Pricing

Italy has a well-developed legal system that puts taxpayers in the position to prevent domestic transfer pricing disputes, through unilateral or bilateral/multilateral APAs, and to resolve them out of court through competent authorities procedures (MAPs and arbitration procedures), that can ensure elimination of double taxation, or settlement procedures that allow taxpayers to significantly reduce penalties (where taxpayers did not have proper transfer pricing documentation).

As a result, in many cases, transfer pricing claims are solved out of court. Especially, in recent

years there has been a trend to start competent authority procedures instead of court proceedings, particularly where there are no penalties. This is the reason why the number of court rulings on transfer pricing matters is quite limited in comparison with the overall number of transfer pricing challenges.

14.2 Significant Court Rulings

In the last decade one of the most notable transfer pricing topics discussed before Italian courts has concerned the procedural ramifications of Article 110(7) of the ITC and, in particular, whether the initial burden of proof lies on the taxpayer, which will have to demonstrate that its transfer pricing policy is in line with the arm's length principle, or on the IRA, which will have to demonstrate effective non-compliance with the arm's length principle and the low level of taxation in the state of residence of the related party involved in the controlled transaction. According to the several Supreme Court decisions, the burden of proof in transfer pricing primarily lies on the IRA (see, for example, the Decisions of the Supreme Court, 13 October 2006, No 22023 and 16 May 2007, No 11226). In such decisions, the Supreme Court has stated that the taxpayer is not required to prove the accuracy of transfer prices applied, unless the tax authorities have themselves first provided proof of effective non-compliance with the arm's length principle and the low level of taxation in the state of the related counterpart. Hence, it is up to the IRA to demonstrate that the conditions applied in the controlled transactions are not at arm's length.

However, in recent years, the Supreme Court has overturned this position. Indeed, the Supreme Court has stated that, in transfer pricing disputes, the burden of proof initially lies on the taxpayer, which will have to demonstrate that its transfer pricing is in line with the arm's length principle while it secondarily shifts to the IRA, which does not have to demonstrate the low level of taxation in the related counterparty state, but still has to demonstrate the reasons why the taxpayer's reasoning is not valid (see, for example, Supreme Court decisions No 6656 of 6 April 2016; No 20805 of 6 September 2017; No 5645 of 2 March 2020; No 5646 of 3 March 2020; No 11837 of 18 June 2020; No 21828 of 9 October 2020; No 22695 of 19 October 2020; No 230 of 12 January 2021, No 1232 of 21 January 2021, No 2908 of 31 January 2022, No 26695 of 12 September 2022 and No 36275 of 13 December 2022).

15. Foreign Payment Restrictions

15.1 Restrictions on Outbound Payments Relating to Uncontrolled Transactions

Outbound payments (eg, royalties) relating to uncontrolled transactions are not restricted by Italian laws and/or by IRA practices.

15.2 Restrictions on Outbound Payments Relating to Controlled Transactions

Outbound payments (eg, royalties) relating to controlled transactions are not restricted by Italian laws and/or by IRA practices.

15.3 Effects of Other Countries' Legal Restrictions

Italian laws do not have rules regarding the effects of other countries' legal restrictions.

16. Transparency and Confidentiality

16.1 Publication of Information on APAs or Transfer Pricing Audit Outcomes

Except for the publication of statistics in compliance with international standards, the IRA does not publish any information regarding APAs or transfer pricing audit outcomes.

16.2 Use of "Secret Comparables"

Use of secret comparables is not explicitly prohibited by Italian law. However, as stated, the OECD Guidelines are consistently applied by the IRA. Therefore, it may be reasonably held that the use of secret comparables would be permitted only if the IRA were to disclose such data to the taxpayer so as to allow the exercise of a proper right of defence.

Trends and Developments

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Gatti Pavesi Bianchi Ludovici is a full-service law and tax firm with 170 professionals in offices in Milan, Rome and London. The firm advises and assists national and international clients with high-level expertise in all areas of civil, commercial and corporate law, and in national and international taxation, offering cutting-edge innovative and sophisticated solutions both in corporate and structured finance transactions and in complex litigation matters. Gatti Pavesi Bianchi Ludovici has a dedicated transfer pricing team that offers advice to multinational enterprises on the selection of transfer pricing methodology; aids with the drafting of transfer pricing documentation and the negotiation of advance pricing agreements with the relevant tax authorities, both in Italy and abroad; and provides assistance in tax optimisation of supply chain models, and in litigation and mutual agreement procedures for the elimination of international double taxation.

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Recent Developments in the Transfer Pricing Treatment of Cash Pooling Structures in Italy

Introduction

The Italian transfer pricing framework is aligned with Article 9 of the OECD Model Tax Convention on Income and Capital and with international best practices. As stated by Article 9 of the Ministerial Decree of 14 May 2018, the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the "OECD Guidelines"), as periodically updated, are considered to be the relevant guidance when applying the arm's length principle. The 2022 update of the OECD Guidelines – which contains a new Chapter X "Transfer pricing aspects of financial transactions" – has, accordingly, been fully implemented.

There is no specific administrative guidance regarding transfer pricing aspects of financial transactions in Italy, but in recent years the tax administration has officially expressed its view on the nature and the tax consequences of different types of financial operations (such as, for example, leveraged buyouts or cash poolings).

The transfer pricing treatment of one specific financial operation – cash pooling – is analysed in the following, both in light of the Italian Revenue Agency (IRA) position and as decided on in some relevant court decisions issued during 2023 and at the beginning of 2024.

The IRA's position on cash pooling

The IRA has issued some interpretative guidance on the nature and characteristics of the two basic types of cash pooling arrangements: physical pooling (with a target balance, usually zero) and notional cash pooling.

Circular Letter No 21/E, issued on 3 June 2015, provided significant clarifications relating to zero-balance system cash pooling agreements. With reference to the cash moved within a group on the basis of this type of agreement, the IRA stated that a loan cannot be identified, as the characteristics of the contract (ie, daily credit and debit balancing of the group companies' accounts and their automatic transfer to the centralised account of the parent company, no obligation to return the sums transferred, and the accrual of interest income or expense exclusively on that account) do not allow for the possibility of using these sums in order to carry out potentially elusive transactions.

This position was already expressed in resolution No 58/E issued on 27 February 2002 and confirmed also in ruling No 834/2021 and ruling No 396/2022. The latter ruling specifically put the cash pooling agreement within the category of "atypical contracts" (pursuant to the Italian Civil Code) and described it as an agreement entered into autonomously by all the group companies with the parent company (treasury centre) aimed at the management of a centralised account into which the balances of the bank accounts of each company are transferred. Zero-balance cash pooling agreements stipulated between group companies are characterised by reciprocal credits and debits that originate from the daily transfer of the bank balance of the subsidiary to the parent company. As a result, the balance of the bank account held by the subsidiary is always zero, as it is always transferred to the parent company. The IRA has stated that the existence of characteristics such as the absence of the obligation to repay the remittances receivable, their reciprocity, the write-off and unavailability of the balance of the account until the closing of the same, determines that such agreements cannot be regarded as intercompany loans. In conclusion, in this specific case it is deemed that the waiver of credits arising from a zero-

balance cash pooling agreement made by the parent company in favour of its subsidiary cannot be considered a waiver of financial receivables and, therefore, cannot be assimilated to a cash contribution.

References to notional cash pooling arrangements date back to resolution No 194/E issued on 8 October 2003. The notional cash pooling does not provide for any possibility of repayment of the sums transferred to the account, except at the periodic closing ("netting"), and the surplus of the group companies is reciprocal and unavailable until the closing of the account. Indeed, in this type of operation there is no actual "netting" of the accounts of the participating companies, but only a "virtual" netting of the balances of these bank accounts, as the balances are considered, for the purposes of calculating interest, as a single balance of all the accounts participating in the cash pooling. Those characteristics therefore clearly differentiate this type of agreement from the physical zero-balance cash pooling system: the notional cash pooling constitutes a system of interest offsetting among the group companies. In this specific case, the operation is qualified as an "interest offsetting contract". This offsetting enables the company holding an account that is part of the notional cash pooling agreement to have its account debited, thereby benefiting from a form of financing, albeit indirect. The functioning of the notional cash pooling agreements is then considered to be attributable to a loan transaction.

Cash pooling in some recent Italian tax litigation

The most recent judicial decisions of the Supreme Court dealing with zero-balance cash pooling arrangements were published in 2023 and at the beginning of 2024.

Two core issues are at the heart of the Supreme Court decisions: (i) the qualification of the transaction (and re-qualification of the contract), and (ii) the principle that a zero-balance cash pooling arrangement is not per se a loan transaction and that the burden of proof lies with the tax authorities.

Judgments No 998 and No 1001, both issued on 10 January 2024, refer to different tax periods of the same case. The judgments deal with a zero-balance cash pooling agreement between an Italian company and its foreign parent company. The cash pooling agreement was about the management of a centralised treasury function in favour of all the group companies, in which each company transferred all sums receivable and received the clearing of sums payable at the end of the day in such a way that the accounting balance of each subsidiary was always equal to zero. The findings of the tax audit carried out by the Italian Tax Police showed that:

- the monthly interest rate was set at Euribor +/- 50 basis points depending on whether a negative or positive balance was transferred to the cash pooling;
- the parent company had never paid any withholding tax on the interest income, and it had never charged any commission for the treasury service provided;
- the Italian company had only transferred positive balances and never used the intra-group credit;
- the Italian company did not transfer the balances every day, but rather owned them and used them slowly – only when the parent company needed the funds was the balance transferred; and
- the Italian company maintained a capacity of sums in its account that allowed it to operate independently.

The Tax Police recharacterised the contract from a cash pooling agreement to a simulated loan agreement between the foreign parent company and the Italian subsidiary in order to satisfy the liquidity needs of the former. According to the Tax Police, this implies that the interest rate applied by the company was not at arm's length, thus allowing it to identify a different interest rate to be applied by using the so called *Rendistato* interest rate, which is the weighted average yield on a basket of government securities published by the Bank of Italy. These findings were confirmed by the IRA in the tax assessment.

The Supreme Court agreed with the IRA on the recharacterisation of the agreement as a loan, but in its opinion the elements supporting this recharacterisation led to a different scenario, lacking the elusive and "unprofitable" feature: the case had to be considered under the transfer pricing framework (Article 110 paragraph 7 of the Income Tax Code). By simply applying a different rate (the *Rendistato* interest rate, not commonly used in this type of agreement), the IRA had not demonstrated that the interest rate applied by the company was not at arm's length. In fact, they did not correctly apply the burden of proof mechanism that, in transfer pricing cases, requires the IRA to prove that the interest rate applied in the intercompany transaction was not at arm's length. The recharacterisation of the agreement and the application of the *Rendistato* interest rate do not meet the burden of proof, since this particular interest rate is not a common applicable rate between independent parties and also because the interest rate applied by the company was indeed at arm's length.

The Supreme Court thus rejected the IRA appeal.

Another relevant judgment is No 23587 of 23 August 2023. In this case, the IRA disputed the payment of interest income received by an Italian company from its parent company by recharacterising the cash pooling agreement in force between the two companies as a financing agreement and thus recalculating the interest rate to be applied.

Starting from the definition of a centralised current account, in line with settled Italian case law, the Supreme Court in this judgment defined the cash pooling contract as an agreement that regulates the management of the cash between two or more companies, excluding or limiting the need to access bank credit for the parties of the agreement. The Supreme Court agreed with the taxpayer that that agreement cannot be classified as a loan agreement since it has all the typical features of a cash pooling agreement and, moreover, it has no elusive purposes. The Supreme Court granted the company's appeal because the second instance Tax Court did not explain its reasoning, and it was therefore not possible to verify the correctness of the reasoning followed by the judge in forming their decision. In particular, the Tax Court identified only a generic financing function in the cash pooling agreement without distinguishing between the two types of financing arrangements on the basis of the statement that "there is no mutual obligation of repaying by the closing date of the account" while it was also stated in the IRA's guidance that the possibility of characterising a loan agreement in a case of a zero-balance cash pooling arrangement is excluded.

Another 2023 domestic case, judgment No 39139 of 23 June 2023, concerns the case of fraudulent bankruptcy by misappropriation, implemented by the transfer of funds through a cash pooling agreement. The prosecution considered that the transfer of sums, which took place every day to transfer the funds to a cen-

tralised account, constituted the misappropriating event of the offence of bankruptcy.

According to settled case law, to exclude the misappropriating nature of the transfer of funds it is necessary to prove the functioning of the mechanism envisaged by the cash pooling agreement and to show that there was a prior formalising of the contract, thus demonstrating the synallagmatic nature of the agreement. In this way, the misappropriating conduct constituting the offence of fraudulent bankruptcy by misappropriation is not realised. Following this case law, the Supreme Court ruled that in order to avoid the commission of the fraudulent bankruptcy by misappropriation, there must be a prior contractual settlement between the parties for the configuration of a cash pooling agreement and the mechanism put in place must not be aimed at transferring funds for purely unlawful purposes, but at ensuring that the companies in the pool take some benefits from that contractual scheme.

Conclusion

The IRA, complying with the OECD Guidelines with regard to physical zero-balance cash pooling, has clearly indicated the characteristics of the transaction so that it can be accurately delineated in order to avoid its recharacterisation as a loan transaction.

The above-mentioned Italian judgments issued in 2023 and 2024 give evidence of the Supreme Court's sensitivity in applying transfer pricing principles in a manner consistent with the OECD Guidelines, including in respect of financial transactions.

In particular, the Supreme Court's judgments pointed out that transactions should be formalised through contracts and that an alignment between the contractual terms of the transaction and the conduct of the parties must be verified.

LUXEMBOURG

Law and Practice

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ATOZ Tax Advisers was founded in 2004 and is a high-end independent advisory firm based in Luxembourg, offering a comprehensive and integrated range of direct and indirect tax solutions as well as transfer pricing, corporate and aviation finance and tax litigation services to both local and international clients. ATOZ has a team of carefully selected professionals who possess extensive experience in serving the local market as well as multinational corporations. Its entire team works together to ensure consistently high standards of client service from beginning to end. Confirmed experts in their respective fields, its partners share a common and rigorous approach of researching and understanding the facts before drawing conclusions. They lead each engagement with a steadfast commitment to objectivity and the highest professional, legal, regulatory and ethical standards.

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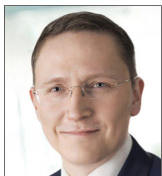

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1. Rules Governing Transfer Pricing

1.1 Statutes and Regulations

Opening Comments

Luxembourg tax legislation does not provide for any integrated transfer pricing legislation. Instead, according to different tax provisions and concepts applicable under Luxembourg domestic tax law, transfer pricing adjustments can be made in order to restate arm's length conditions.

Luxembourg Tax Law and Administrative Guidelines

Article 56 of the Luxembourg Income Tax Law (LITL)

Article 56 of the LITL formalises the application of the arm's length principle under Luxembourg tax law in accordance with Article 9 of the OECD Model Tax Convention and provides a legal basis for transfer pricing adjustments (upward and downward adjustments) when associated enterprises deviate from the arm's length standard.

Article 56bis of the LITL

Article 56bis of the LITL formalises the authoritative nature of the OECD Transfer Pricing Guidelines. It provides definitions of several terms that are relevant in a transfer pricing context (eg, controlled transaction, comparable uncontrolled transaction, arm's length price) and guiding principles in relation to the application of the arm's length principle which closely follow some of the key paragraphs of Chapter I (Arm's length principle) of the OECD Transfer Pricing Guidelines. It clarifies that the arm's length principle has to be met whenever a Luxembourg company enters into a controlled transaction with an affiliate. This requires a calculation of the taxable income that may reasonably be expected if the parties are dealing with one another at arm's length. It does this by contrasting the choices made and the outcomes achieved by the taxpayer with those that would have resulted from market forces.

Article 56bis explicitly addresses transactions that may not be observed between independent enterprises. It provides that the fact that a specific transaction cannot be observed between independent enterprises does not mean that a transaction does not adhere to the arm's length standard. This is a provision of great importance as related parties may, in practice, enter into transactions that are not undertaken by independent enterprises. Article 56bis of the LITL introduces the concept of the comparability analysis through a replication of some of the guidance provided in the OECD Transfer Pricing Guidelines. Article 56bis of the LITL also deals with circumstances in which a transaction, as structured by a taxpayer, may be disregarded because there is a lack of valid commercial rationality, and a third party would not have entered into a specific transaction. Nevertheless, the non-recognition of a transaction should only occur in very exceptional situations.

Circular 56/1 – 56bis/1 of the Luxembourg tax Authorities (LTA) on the tax treatment of intra-group financing activities

The Circular of the LTA, dated 27 December 2016, provides guidance on the practical application of the arm's length principle to intra-group financing activities. It also details some specific formal requirements applicable to financing companies when requesting an APA.

Concepts of hidden dividend distributions and hidden capital contributions and their interaction with Article 56 of the LITL

The concepts of hidden dividend distributions (Article 164 (3) of the LITL) and hidden capital contributions (Article 18 (1) of the LITL) also play

an important role in ensuring that associated enterprises adhere to the arm's length standard.

According to Article 164 (3) of the LITL, hidden dividend distributions arise when a shareholder partner or interested party receives advantages directly or indirectly from a company that a third party would not have received. Article 164 (3) of the LITL states that such profit distributions have to be included in the company's taxable income, meaning that they are not deductible for tax purposes and may be subject to withholding tax if no exemption applies.

A hidden capital contribution refers to an advantage shifted by a shareholder to a company. While the concept is not defined in Luxembourg tax law, hidden capital contributions bear the following characteristics in accordance with the relevant case law:

- a shareholder or a related party of the shareholder;
- grants, motivated by the shareholding relationship; and
- an advantage to a company that may be reflected in the balance sheet – ie, either an increase in assets or a decrease in liabilities (insofar as the shareholder does not receive an arm's length compensation), and the contribution is not a regular contribution (pursuant to Luxembourg commercial law).

In principle, contributions increase the net equity in the receiving company's balance sheet. The object of a hidden capital contribution should therefore directly relate to balance sheet items, namely an increase in assets or a decrease in liabilities. In contrast, any advantage (including free services) shifted by the company to its shareholder(s) should be classified as a hidden dividend distribution. Consequently, the scope of hidden capital contributions and that of hidden dividend distributions do not mirror each other, though both concepts share the same objective, namely the separation of the realm of the company from its shareholders.

Article 56 of the LITL and the concepts of hidden dividend distributions and hidden capital contributions operate independently of one another and may apply concurrently. In case of an overlap, however, the concepts of hidden dividend distributions and hidden capital contributions should take precedence over Article 56 of the LITL. This is because the only tax consequence of Article 56 of the LITL is an adjustment of the taxable income of the company (in order to restate arm's length conditions), whereas the concepts of hidden dividend distributions and hidden capital contributions may require additional tax adjustments at the level of the company and the shareholder.

Transfer pricing documentation

Duty of co-operation of taxpayers – since the introduction of Section 3 of paragraph 171 of the Luxembourg General Tax Law (LGTL), the duty of co-operation of taxpayers set out in paragraph 1 thereof has been expressly extended to transactions between associated enterprises. This means that transfer pricing documentation is identified in Luxembourg tax law as information which taxpayers should provide to the LTA upon request in order to support the positions they take in their tax returns.

Country-by-country reporting – the law of 23 December 2016 implemented the provisions of EU Directive 2016/881 of 25 May 2016 into Luxembourg law which extended administrative co-operation in tax matters to country-by-country (CbC) reporting. MNE groups with a consolidated revenue exceeding EUR750 million are

required to prepare a CbC report. The entity of the group in charge of the reporting is either the Luxembourg resident ultimate parent entity of the MNE group or, in certain circumstances, any other reporting entity (a Luxembourg subsidiary or a Luxembourg permanent establishment) as defined in Annex 2 of the law. The CbC report follows the OECD recommendations provided in Chapter V of the OECD Transfer Pricing Guidelines.

Article 164ter of the LITL – transfer pricing aspects of the Controlled Foreign Company (CFC) rule

Article 164ter of the LITL, which implemented the CFC rules of the EU Directive 2016/1164 into Luxembourg tax law with effect as from 1 January 2019, includes some transfer pricing-related aspects. This is because Luxembourg is one of the few EU member states which decided to opt for the transactional approach when introducing the CFC rules. Article 164ter of the LITL provides that a Luxembourg corporate taxpayer or a Luxembourg permanent establishment (PE) of a non-Luxembourg tax resident entity will be taxed on the non-distributed income of an entity or PE which qualifies as a CFC, provided that the non-distributed income arises from non-genuine arrangements which have been put in place for the essential purpose of obtaining a tax advantage. An arrangement or a series thereof will be regarded as non-genuine if the entity or PE does not own the assets or has not undertaken the risks that generated all or part of its income if it were not controlled by a Luxembourg corporate taxpayer when the significant people functions, which are relevant to those assets and risks, are carried out and are instrumental in generating the CFC's income. While no further clarification is provided on the concept of significant people functions and the interaction between the Luxembourg transfer pricing rules and the CFCs rules, in Circular 164ter/1 of 17 June 2022, the tax authorities are imposing an additional documentation requirement, not required by the law, according to which a transfer pricing analysis following the OECD Transfer Pricing Guidelines has to be performed for each of the CFCs of the taxpayer and has to be updated on an annual basis. Based on the circular, even though the taxpayer does not assume any people function generating the CFC's income, transfer pricing documentation needs to be available and updated on an annual basis.

Luxembourg Double Tax Treaty Network

Almost all Luxembourg double tax treaties are based on the OECD Model Tax convention and thus include the arm's length principle, as further defined in the OECD Transfer Pricing Guidelines.

OECD Transfer Pricing Guidelines

As a member of the OECD, Luxembourg adheres to the organisation's Transfer Pricing Guidelines which reflect the consensus of OECD member countries towards the application of the arm's length principle, as provided in Article 9 (1) of the OECD Model Tax Convention. Since the Luxembourg legislation does not provide for any integrated transfer pricing legislation, the OECD Transfer Pricing Guidelines play an extremely important role for Luxembourg taxpayers, when analysing their transactions from a transfer pricing point of view. Reference to these guidelines is made in both the parliamentary documents (such as the ones related to the draft laws introducing Article 56 and Article 56bis of the LITL) and in Circular 56/1 – 56bis/1 of the LTA on the tax treatment of intra-group financing activities.

1.2 Current Regime and Recent Changes

Over the past few years, transfer pricing and the need for related documentation have become increasingly important in Luxembourg. Before

2011, Luxembourg domestic tax law did not provide any specific transfer pricing rules or documentation requirements. On 28 January 2011, the LTA issued the first circular dealing with transfer pricing, Circular 164/2, which provided guidance on how Luxembourg companies performing financing activities should determine their arm's length margin. This circular already explicitly referred to the OECD Transfer Pricing Guidelines.

The law of 19 December 2014 amended Article 56 of the LITL in order to formalise the application of the arm's length principle and provided a legal basis for transfer pricing adjustments when associated enterprises do not meet the arm's length standard. The same law also amended Paragraph 171 of the LGTL in order to explicitly extend the duty of co-operation of taxpayers to transactions between associated enterprises, reflecting the increasing importance of transfer pricing documentation.

The law of 23 December 2016 introduced Article 56bis of the LITL which provided, for the first time, definitions and guiding principles in relation to the application of the arm's length principle. These definitions and guiding principles are in line with the OECD Transfer Pricing Guidelines. In order to reflect the changes introduced by Article 56bis of the LITL, on 27 December 2016, the LTA released a new circular, Circular 56/1 – 56bis/1, on the tax treatment of intra-group financing activities, which provides guidance on the practical application of the arm's length principle to intra-group financing activities and repealed and replaced the former Circular of 28 January 2011 with effect from 1 January 2017.

Further changes are in the pipeline with draft law No 8186, presented to Parliament on 28 March 2023, which would introduce a new procedure for requesting an advanced bilateral or multilateral agreement on transfer pricing pursuant to the double tax treaties concluded by Luxembourg and additional transfer pricing documentation requirements (master file and local file, in line with Action 13 of the BEPS Action Plan).

2. Definition of Control/Related Parties

2.1 Application of Transfer Pricing Rules

The scope of Article 56 of the LITL is limited to transactions between associated enterprises and does not apply to transactions between individual shareholders and Luxembourg companies. Article 56 of the LITL further applies to both cross-border transactions and transactions between Luxembourg companies.

Article 56 of the LITL defines "associated enterprise" in accordance with Article 9 (1) of the OECD Model Tax Convention, namely:

- an enterprise which participates directly or indirectly in the management, control, or capital of another enterprise; or
- the same persons participate directly or indirectly in the management, control or capital of two enterprises.

Thus, Article 56 of the LITL includes a flexible definition, which is not defined further (neither in the related parliamentary documents, nor in the related Circular 56-56bis of the LTA).

As far as the concepts of hidden dividend distributions and hidden capital contributions are concerned, they apply not only to shareholders but also to related parties of the shareholder.

"Associated enterprise" is also defined in other provisions of Luxembourg tax law, such as the CFC rules of Article 164ter of the LITL and the anti-hybrid rules of Article 168ter of the LITL, which, for some of them, include more technical control criteria of 50% or 25%, as the case may be.

3. Methods and Method Selection and Application

3.1 Transfer Pricing Methods

The Luxembourg transfer pricing provisions of Luxembourg tax law do not include any specific lists of transfer pricing methods to be applied. However, paragraph 6 of Article 56bis of the LITL defines general principles to be followed in respect of the transfer pricing method to be used: the methods to be used to determine the appropriate comparable price must take into account identified comparability factors and must be consistent with the nature of the transaction precisely defined. The price thus identified, by comparing the precisely defined transaction with comparable transactions on the open market, will be the arm's length price applicable to the transaction under analysis, in order to comply with the arm's length principle. The choice of comparison method must be the one that provides the best possible approximation of the arm's length price.

The parliamentary documents related to the draft law which introduced Article 56bis of the LITL state that paragraph 6 of Article 56bis L.I.R. implements Chapters II and III of the OECD Transfer Pricing Guidelines into Luxembourg tax legislation. Chapters II and III set out the various techniques and methods to be used, the transaction having been analysed in accordance with the instructions in Chapter I of the OECD Transfer Pricing Guidelines, in order to determine the arm's length price. Thus, reference first has to be made to the five methods, as defined in the guidelines, that can be used to establish whether a controlled transaction adheres to the arm's length standard and which are divided into two groups, namely the traditional transaction methods and the transactional profit methods. However, in addition to these five methods, as stated in the commentary to the draft law introducing Article 56bis of the LITL, the OECD Transfer Pricing Guidelines also allow any other method to be applied, as long as it enables a price to be set that satisfies the arm's length principle. In such case the taxpayer will have to evidence why this other method is the most appropriate method.

3.2 Unspecified Methods

As a principle, the most appropriate method has to be applied, using either one of the methods defined in the OECD Transfer Pricing Guidelines or any other method which enables a price to be established that is in line with the arm's length principle.

3.3 Hierarchy of Methods

Since the Luxembourg legislation only refers to the OECD Transfer Pricing Guidelines without specifying the different methods, the only principle which should be followed is that the most appropriate method should be applied, meaning there is no hierarchy of methods. In practice the most commonly used method is the comparable uncontrolled price (CUP) method, mainly for a wide range of financial transactions and license fees. However, other methods such as the cost-plus method (for low value-adding services) as well as the profit split method (eg, for highly integrated fund management activities) are regularly relevant in practice as well.

3.4 Ranges and Statistical Measures

The Luxembourg legislation does not require the use of ranges or statistical measures. However, since the LTA follow the OECD Transfer Pricing Guidelines, reference has to be made to these in this respect.

3.5 Comparability Adjustments

Based on paragraph 4 of Article 56bis of the LITL, transactions are sufficiently comparable when there are no material differences between the transactions being compared that could have a significant methodological influence on the determination of the price, or when reasonably reliable adjustments can be made to eliminate the impact on price determination. Thus, comparability adjustments have to be reliable and reasonable and may be performed ("in accordance with internationally recognised standards", as Circular 56-56bis states) if they are necessary to improve the reliability and quality of the comparability analysis.

4. Intangibles

4.1 Notable Rules

Luxembourg tax legislation does not include any specific rules relating to the transfer pricing of intangibles. Thus, reference has to be made to Chapter VI of the OECD Transfer Pricing Guidelines in this respect. However, Circular 50ter/1 of 28 June 2019 dealing with the Luxembourg intellectual property regime (ie, 80% corporate income tax and municipal tax exemption of the net qualifying income and capital gains derived from eligible IP assets and 100% exemption of qualifying IP assets for net wealth tax purposes) specifies that the arm's length principle defined in Article 56 and Article 56bis of the LITL apply in case of application of the IP regime.

4.2 Hard-to-Value Intangibles

Luxembourg tax legislation does not include any specific rules relating to hard-to-value intangibles (HTVI), so the OECD Transfer Pricing Guidelines have to be followed in this respect. Based on the Luxembourg questionnaire on the Implementation of the HTVI Approach included in the Luxembourg country profile released by the OECD, even though the HTVI approach defined in Chapter VI is to be considered as not implemented in domestic legislation, the general provisions of Chapters I-III can be used for audit purposes with regard to transactions on intangibles.

Attention should be paid to the fact that arrangements involving the transfer of HTVI between associated enterprises belong to the transfer pricing arrangements which may have to be reported under the Luxembourg Law of 25 March 2020 implementing EU Directive 2018/822/EU (so-called "DAC6"), as amended, regarding reportable cross-border arrangements. HTVI are defined in Part 2 of the Annex to the law of 25 March 2020, which deals with the "hallmarks" (ie, characteristics or features of a cross-border arrangement that indicate a potential risk of tax avoidance) as follows: "Intangibles or rights in intangibles for which, at the time of their transfer between associated enterprises, (a) no reliable comparables exist and (b) at the time the transaction was entered into, the projections of future cash flows or income expected to be derived from the transferred intangible, or the assumptions used in valuing the intangible, are highly uncertain, making it difficult to predict the level of ultimate success of the intangible at the time of the transfer."

4.3 Cost Sharing/Cost Contribution Arrangements

Luxembourg tax legislation does not include any specific rules relating to cost sharing or cost contribution arrangements. Therefore, the guidance included in the OECD Transfer Pricing Guidelines in this respect (ie, Chapter VIII) has to be followed.

5. Affirmative Adjustments

5.1 Rules on Affirmative Transfer Pricing Adjustments

While both upward and downward adjustments may be made in application of the arm's length principle, according to the LGTL, amended tax returns may only be filed (or may even have to be filed) by taxpayers under certain limited conditions and circumstances.

- As long as no tax assessment has been released, the taxpayer has the possibility to file an amended tax return, reflecting the adjustment, no matter whether the adjustment is positive for the taxpayer or not. Based on paragraph 85 of the LGTL, the tax authorities will have to assess the taxpayer based on the newly filed tax return.
- Once a tax assessment has been released, based on paragraph 94 of LGTL, at the taxpayer's request, the tax office may amend the tax assessment, but only to the extent that the deadline for challenging this tax assessment (ie, three months by means of a so-called *réclamation*) has not elapsed.
- Once the three month-deadline for challenging the tax assessment has elapsed, the tax authorities have no obligation to take the amended tax return into consideration, even if it includes a correct adjustment – ie, even in case the initial tax assessment (which did not take this adjustment into consideration) was wrong.
- Finally, every time a tax assessment has been issued based on a wrong tax return and the mistake made in the tax return lowered the tax due by the taxpayer, there is an obligation for the taxpayer to file an amended tax return reflecting the adjustment. This obligation remains as long as the statute of limitations of five years has not elapsed.

6. Cross-Border Information Sharing

6.1 Sharing Taxpayer Information

There is a multitude of legal instruments for exchanging information on Luxembourg taxpayers with foreign tax authorities. The exchange can take place upon request, automatically or spontaneously.

Exchange of Information Upon Request

As far as exchange of information upon request is concerned, it can mainly take place either on the grounds of the double tax treaty (Luxembourg has an extensive tax treaty network and almost all tax treaties include a provision on exchange of information in line with Article 26 of the OECD Model Tax Convention) concluded by Luxembourg with the jurisdiction of the foreign requesting authority or based on EU Directive 2011/16/EU of 15 February 2011 on administrative co-operation in the field of taxation (so-called "DAC") if the exchange is requested by an authority of another EU member state. The procedure for exchanging information on request in these cases, as well as under the law of 26 May 2014 approving the Convention on Mutual Administrative Assistance in Tax Matters, is governed by the Law of 25 November 2014. In order to avoid so-called "fishing expeditions",

only "foreseeably relevant" information can be exchanged. In 2023, the Luxembourg authorities received 911 requests from other jurisdictions, compared to 1189 requests in 2021 and 1038 requests in 2022. Thus, the number of requests has been decreasing since 2021, which is most probably due to the fact that foreign authorities already receive an ever-increasing amount of information automatically.

Automatic Exchange of Information

The scope of information to be exchanged on a mandatory and automatic basis has been increasing consistently over the past few years through several amendments of the DAC, each of them having been implemented into Luxembourg law.

The most important scope extensions for transfer pricing purposes are as follows.

- Advance Pricing Agreements (APAs) – EU Directive 2015/2376 (DAC3), implemented by the Law of 23 July 2016, which extended the automatic exchange to tax rulings and APAs.
- CbC reporting – EU Directive 2016/881 (DAC4), implemented by the law of 23 December 2016, which extended the automatic exchange to CbC reports.
- Cross-border arrangements – DAC6, implemented by the Law of 25 March 2020, which introduced mandatory disclosure rules for intermediaries on certain reportable cross-border arrangements. The following cross-border transfer pricing arrangements are covered: arrangements which involve the use of unilateral safe harbour rules (hallmark E1) and arrangements involving the transfer of Hard-to-Value Intangibles (hallmark E2), as well as arrangements involving intragroup cross-border transfers of functions and/or risks and/or assets, if the projected annual earnings before interest and taxes (EBIT), during the three-year period after the transfer, of the transferor(s) are less than 50% of the projected annual EBIT of such transferor(s) if the transfer had not taken place.

Spontaneous Exchange of Information

The LTA may also exchange information spontaneously with other jurisdictions based on the DAC (in an EU context) or based on the Convention on Mutual Administrative Assistance in Tax Matters (which 147 jurisdictions have signed as of today). Information can only be exchanged if the LTA have grounds for supposing that there may be a loss of tax in the other jurisdiction.

Circular 56/1 – 56bis/1 of the LTA on the tax treatment of intra-group financing activities states that companies which opted for the simplification measure that may apply to Luxembourg companies acting as mere intermediaries will be subject to spontaneous exchanges of information.

7. Advance Pricing Agreements (APAs)

7.1 Programmes Allowing for Rulings Regarding Transfer Pricing

Unilateral APAs – with effect as from 2015, Luxembourg has formalised its procedure applicable to tax rulings, including those related to transfer pricing (unilateral APAs). This procedure is included in paragraph 29a of the LGTL, as well as in Grand Ducal Regulation of 23 December 2014. On top of the requirements applicable under the procedure of paragraph 29a, Luxembourg companies performing intra-group financing activities have to provide additional information listed in Circular 56/1 – 56bis/1 of the LTA dated 27 December 2016.

Bilateral or Multilateral APAs – based on the legal provisions currently in force, no formal programme has been implemented by Luxembourg for bilateral and multilateral APAs and Luxembourg considers that these can be concluded by its competent authority based on the first sentence of Article 25(3) of the OECD Model Tax Convention. Circular L.G. – Conv. D.I. No 601 of the LTA dated 11 March 2021 provides guidance in this respect.

Draft law No 8186 introduces a new procedure (new paragraph 29c of the LGTL and related Grand-Ducal Regulation) for requesting an advanced bilateral or multilateral agreement on transfer pricing pursuant to the double tax treaties concluded by Luxembourg. However, it is uncertain at this stage whether this draft law will ever become law since the draft provision on bilateral and multilateral APAs belongs to a broader piece of draft legislation which has been giving rise to discussions and criticism over the legislative process on many of its aspects.

Still, Luxembourg taxpayers are able to request bilateral or multilateral agreements in transfer pricing based on the EU Arbitration Convention, the law of 20 December 2019 implementing EU Directive 2017/1852 of 10 October 2017 on tax dispute resolution mechanisms in the EU, or based on a double tax treaty.

7.2 Administration of Programmes

APA requests have to be sent to the head of the tax office in charge of the taxpayer. However, if the APA request deals with company taxation issues, the request will first be submitted for opinion to the advance tax clearance commission (*Commission des décisions anticipées*).

Based on Circular L.G. – Conv. D.I. No 601 of the LTA dated 11 March 2021, transfer pricing mutual agreement procedures (MAP) requests have to be sent to the economic division of the LTA (which is the authority in charge of transfer pricing cases) or to the *Comité de Direction* of the LTA, which is in charge of all MAP cases.

7.3 Co-ordination Between the APA Process and Mutual Agreement Procedures

While there is no provision dealing with this question, in practice, there should be co-ordination between the APA process and the MAP, even though the competent authorities administrating the two are not the same. Co-ordination between the MAP procedure and other procedures (such as a legal procedure before the administrative courts) is also covered in Circular L.G. – Conv. D.I. No 601 of the LTA dated 11 March 2021.

7.4 Limits on Taxpayers/Transactions Eligible for an APA

An APA can be requested by any type of taxpayer and can deal with any type of transaction.

7.5 APA Application Deadlines

Unilateral APA requests have to be filed before the transaction takes place. As far as bilateral and multilateral APAs are concerned, they generally have to be requested within three years starting from the first notification of the action resulting (i) in taxation not in accordance with the provisions of the covered tax agreement, (ii) in the question in dispute or (iii) in double taxation, depending on whether the request is made during a MAP initiated based on a double tax treaty, based on the law implementing the EU Directive on tax dispute resolution mechanisms in the EU, or based on the EU Arbitration Convention.

7.6 APA User Fees

In the same was as any other advance tax clearance dealing with company taxation issues, uni-

lateral APAs are subject to a fee which is determined by the LTA upon receipt of the request and ranges between EUR3,000 and EUR10,000, depending on the complexity and the amount of work required. In practice, in transfer pricing matters, the fee very often reaches EUR10,000. The fee is payable within one month.

Based on the legislation in force, no fee applies to bilateral or multilateral APAs. However, should draft law No 8186 (introducing a new procedure for requesting an advanced bilateral or multilateral agreement on transfer pricing pursuant to the double tax treaties) become law in its current form, a fee ranging between EUR10,000 and EUR20,000 (depending on the level of complexity and the amount of work required) would apply.

7.7 Duration of APA Cover

The APA is valid for a time period of maximum five tax years and has a binding effect on the tax authorities, except in the following situations: (i) the situation or operations described are not accurate, (ii) the situation or operations performed differ from the ones described in the APA request, or (iii) it appears that the APA is not, or no longer, in line with Luxembourg, EU or international tax law.

7.8 Retroactive Effect for APAs

Given that unilateral APA requests have to be filed before the transaction they relate to takes place, in principle, there is no possible retroactive effect.

8. Penalties and Documentation

8.1 Transfer Pricing Penalties and Defences

Luxembourg legislation does not provide for penalties which are transfer pricing specific or which are linked to the preparation and maintaining of transfer pricing documentation. If a transaction has been priced in such a way that it does not reflect the arm's length principle, the tax authorities will perform an adjustment based on Article 56 of the LITL.

However, penalties might apply in the context of mandatory reporting requirements, which include transfer pricing data, such as under the CbC reporting requirements, where the LTA may levy, on a discretionary basis, a fine of up to EUR250,000 in cases of non-filing, late filing or incomplete or incorrect filing of the CbC report, as well as in cases of non-compliance with the filing rules. The same level of penalties also applies in case of breach of the reporting requirements under the law implementing DAC6, which also covers transactions which are transfer pricing related.

As far as transfer pricing documentation is concerned, based on paragraph 171 of the LGTL, it only has to be provided to the tax authorities upon request and there is no general obligation to prepare such documentation. However, given that taxpayers have to be in the position to justify the positions they take in their tax returns, including when they enter into transactions with related parties, they have to be in the position to present, upon request, documentation illustrating how the arm's length price of these transactions was determined. Therefore, from a practical point of view, even if it is not required by the law, taxpayers should prepare their transfer pricing documentation upfront.

Finally, the general administrative penalties which apply in any other tax matters – ie, in case of late filing of the tax returns, late payment of the tax due or in case of fraud, might also apply.

8.2 Taxpayer Obligations Under the OECD Transfer Pricing Guidelines

There is a requirement to file CbC reports, based on the the law of 23 December 2016 implementing EU Directive 2016/881 of 25 May 2016. This obligation applies to MNE groups with a consolidated revenue exceeding EUR750 million, whereby the entity of the group in charge of the reporting is generally the ultimate parent entity of the group. Luxembourg entities that are members of an MNE group are also required to notify the LTA of the identity and tax residence of the reporting entity (whether this reporting entity is the Luxembourg entity itself or any other entity of the group).

Based on the legislation currently in force, there is no requirement to prepare a master file or a local file, as defined in Action 13 of the BEPS Action Plan. However, a draft law (No 8186) complements paragraph 171 of the LGTL, adding that associated enterprises are required to present, on request, documentation justifying the transfer pricing policy they applied. The scope, content and extent of the documentation referred to in this new draft provision is laid down in a draft Grand-Ducal regulation which refers to the local file and the master file and details their content, in line with the standards defined in Action 13 of the BEPS Action plan. Thus, as soon as this draft law is in force, master files and local files will have to be prepared by taxpayers and will have to be provided to the tax authorities upon request.

9. Alignment With OECD Transfer Pricing Guidelines

9.1 Alignment and Differences

Since Luxembourg legislation does not provide for any integrated transfer pricing legislation, the OECD Transfer Pricing Guidelines play an extremely important role for Luxembourg taxpayers when analysing their transactions from a transfer pricing point of view and for tax authorities to assess the transfer pricing policy of taxpayers. Reference to these guidelines is made in the parliamentary documents related to the Luxembourg transfer pricing legislation, as well as in the related guidance of the LTA. Therefore, the position of the LTA should be fully aligned with the OECD guidelines and taxpayers should use these guidelines as a reference.

9.2 Arm's Length Principle

Luxembourg tax law follows the arm's length principle.

9.3 Impact of the Base Erosion and Profit Shifting (BEPS) Project

The development of the Luxembourg transfer pricing legislation as from 2015 is the direct impact of the outcome of the BEPS project in transfer pricing matters. As such, the BEPS project has impacted Luxembourg legislation significantly. The wording of Article 56bis of the LITL closely follows some of the key paragraphs of Chapter I (Arm's length principle) of the OECD Transfer Pricing Guidelines, which were updated in order to reflect the outcome of Actions 8-10 of the BEPS Action Plan.

9.4 Impact of BEPS 2.0

Luxembourg has implemented the EU Pillar Two directive by means of the law of 22 December 2023, so the Pillar Two rules of the Directive are now in force in Luxembourg.

As far as Pillar One is concerned, its impact will mainly depend on the scope of exclusions for the financial services industry.

9.5 Entities Bearing the Risk of Another Entity's Operations

A Luxembourg entity may bear the risk of another entity's operations, to the extent that the transaction is concluded under arm's length conditions providing the risk-bearing entity with an arm's length remuneration. Explicit guarantees in financial transactions have to be remunerated in line with Chapter X of the OECD Transfer Pricing Guidelines.

10. Relevance of the United Nations Practical Manual on Transfer Pricing

10.1 Impact of UN Practical Manual on Transfer Pricing

While the UN Practical Manual on Transfer Pricing may be used as a source of information (reference is even made to it in the commentary to draft law 6722 introducing Article 56 of the LITL), in practice, it is not relevant since Luxembourg closely follows the OECD Transfer Pricing Guidelines.

11. Safe Harbours or Other Unique Rules

11.1 Transfer Pricing Safe Harbours

Luxembourg tax law does not include any transfer pricing related safe harbours. However, as far as Luxembourg companies performing intra-group financing activities are concerned, Circular 56/1 – 56bis/1 provides for the following simplification measure for Luxembourg companies acting as mere intermediaries – ie, on-lending funds received without bearing any significant risks: transactions entered into by these companies are deemed to comply with the arm's length principle if the analysed entity realises a minimum return of 2% after tax on the amount of the financing volume. In practice, this simplification measure is never applied as the 2% after-tax margin is significantly higher than the arm's length remuneration for such activity.

Attention should be paid to the fact that arrangements involving the use of unilateral safe harbour rules belong to the specific arrangements concerning transfer pricing which may have to be reported under the Luxembourg Law of 25 March 2020 implementing DAC6 regarding reportable cross-border arrangements. However, given that Circular 56/1 – 56bis/1 of the LTA on the tax treatment of intra-group financing activities states that companies which opt for the simplification measure that may apply to Luxembourg companies acting as mere intermediaries will already be subject to spontaneous exchanges of information, reporting under DAC6 in this specific situation would mean that the information would be exchanged twice (once under the spontaneous information exchange and once under the automatic exchange of DAC6).

11.2 Rules on Savings Arising From Operating in the Jurisdiction

Luxembourg does not have any specific rules governing savings that arise from operating in Luxembourg.

11.3 Unique Transfer Pricing Rules or Practices

Luxembourg does not have any notable unique rules or practices applicable in the transfer pricing context.

12. Co-ordination With Customs Valuation

12.1 Co-ordination Requirements Between Transfer Pricing and Customs Valuation

While there is no specific provision in Luxembourg law in respect of the arm's length value for customs duty purposes, Article 70-3 (d) of the Union Customs Code applies the arm's length principle in order to determine the customs value, stating that the transaction value shall apply provided that "the buyer and seller are not related or the relationship did not influence the price".

The law of 19 December 2008 provides a legal framework for the exchange of information between the different LTA – ie, the direct tax authorities (*Administration des contribution Directes*), the indirect tax authorities (*Administration de l'Enregistrement, des Domaines et de la TVA*) and the customs and excise duties administration (*Administration des Douanes et Accises*), as well as with other public authorities, such as the supervisory authority of the financial sector (*Commission de Surveillance du Secteur Financier*). However, in practice, to date, the use of transfer pricing documentation for customs duty purposes is uncommon.

13. Controversy Process

13.1 Options and Requirements in Transfer Pricing Controversies

There is no dedicated procedure applicable to transfer pricing matters, meaning that the same procedure as for any other direct tax matters applies when it comes to transfer pricing audits or to legal proceedings.

In a first step, the tax authorities may consider performing a tax audit which can take the form of either a general information request or a more formal tax audit, including several steps. In practice, we are seeing an increasing number of tax audits (in the form of a general information request) performed, especially when it comes to intra-group financing transactions. The tax audit is performed by the local inspector in charge of the taxpayer. Besides the statute of limitations (of five years in principle), there is no timeline for performing a tax audit and the tax authorities set the deadline for the taxpayer to provide the information requested (generally two to four weeks). The taxpayer has the obligation to provide the information requested and must answer any additional questions the tax authorities may ask during the audit process. In practice, the tax authorities request the transfer pricing documentation supporting the intra-group transactions performed by the taxpayer as well as the related agreements. They often also request information related to substance.

Once the audit is completed, the tax authorities will release a tax assessment (or a revised tax assessment if the taxpayer has already been taxed automatically based on its tax return in a first place, as it is the case for companies, in principle). If the tax assessment differs from the position taken in the tax return, the tax authorities will first have to send a notification to the taxpayer explaining that they will deviate from the position taken in the tax returns and briefly explain the rationale behind this deviation. The taxpayer is able to take position on the envisaged deviation. Then, the tax assessment is released. The taxpayer then has three months to challenge the tax assessment before the Director of the direct tax authorities. Even though the tax assessment is challenged, the tax fixed in the tax assessment must be paid. The Director can

then either issue a new tax assessment, reject the claim of the taxpayer or even remain silent. If the Director remains silent, the appeal is deemed to be rejected after six months. As soon as the appeal is rejected or deemed to be rejected, the taxpayer has the possibility to appeal against the decision (or deemed decision) of the Director of the tax authorities before the Administrative Tribunal (first instance in direct tax matters). The taxpayer can appeal against the decision of the Administrative Court (second instance in direct tax matters) within 40 days following the notification of the decision. The decision of the Administrative Court is final and cannot be appealed as the Administrative Court is the highest instance in direct tax matters.

Draft law No 8186 aims to simplify and modernise the rules governing the direct tax procedure in Luxembourg and amends, among others, some aspects of the formal conditions to challenge tax assessments.

14. Judicial Precedent

14.1 Judicial Precedent on Transfer Pricing

Luxembourg does not recognise the rule of precedent so the Luxembourg courts are not bound by decisions handed down in other cases, even when these cases are very similar. Still, decisions of the Director of the tax authorities very often make reference to the case law of the administrative courts, which is generally followed by the tax authorities.

14.2 Significant Court Rulings

Besides the rulings of the administrative courts regarding hidden dividend distributions and hidden capital contributions which are very numerous, the Luxembourg case law in transfer pricing matters is rather limited. There is some case law on the computation of interest rates on financing activities, but their relevance is reduced since these rulings concern tax years prior to 2015, so before Luxembourg introduced its transfer pricing legislation. There is, however, some recent case law on intra-group financing transactions and the qualification (as debt v equity) of the related instruments, including, in particular, one case regarding the qualification of an interest-free loan.

Administrative Court No 48125C, 23 November 2023 and Administrative Tribunal No 44902, 23 September 2022 – Interest-Free Loan (IFL)

On 23 November 2023, the Luxembourg Administrative Court held a decision in a case concerning an IFL which was granted by a Luxembourg company to its wholly-owned Luxembourg subsidiary. The case involved a company resident in the Cayman Islands (CayCo) that invested via a Luxembourg investment platform into (distressed) debt owed by third parties. CayCo financed its Luxembourg subsidiary (LuxParentCo) by a mixture of equity and a profit-participating loan (PPL). LuxParentCo used the funds received to finance its Luxembourg subsidiary ("LuxSubsidiary", the taxpayer) by a mixture of equity and (mainly) an IFL. LuxSubsidiary (the borrower) invested the funds received from LuxParentCo (the lender) mainly into distressed debt instruments.

In its corporate tax return, in accordance with Article 56 of the LITL, LuxSubsidiary performed a downward adjustment in relation to the IFL in order to account for deemed interest expenses that would have been due at arm's length. LuxParentCo recognised deemed interest income in its corporate tax return (corresponding to the amount of the deemed interest expenses reflect-

ed in the corporate tax return of LuxSubsidiary). The upward adjustment was also performed in accordance with Article 56 of the LITL.

Both the LTA and the Administrative Tribunal denied the downward adjustment on the grounds that the IFL was to be considered as an equity instrument. The equity qualification by the tax authorities and the Tribunal was mainly based on the fact that the IFL included a limited recourse clause providing for no or limited risk in case of default. One additional element was that the loan was only formalised several months after the cash had been made available, so, according to the Administrative Tribunal, the intention of the parties was to make a hidden capital contribution.

The Administrative Court overturned the judgment of the Tribunal and recalled that the classification of a financing instrument follows the economic approach (so-called *wirtschaftliche Betrachtungsweise*). This approach involves, for tax purposes, the economic reality prevailing over the legal form (also referred to as the "substance over form" principle). The Administrative Court performed an overall analysis of the transaction and an analysis of all relevant features of the IFL. Since most of the relevant features of the IFL were debt features, the Administrative Court classified the loan as a debt instrument. As the subject matter of the case was the classification of the IFL as debt or equity and the Administrative Court is limited by the grounds on which it has been involved, it could not itself review the downward (and upward) adjustment in principle (ie, notional interest) and the arm's length nature of the notional interest rate declared by the borrower. However, the Administrative Court stated that it is led to hold that it was wrong to recharacterise the IFL as equity and to refuse to admit the amount put forward as notional interest. Hence, the Administrative Court re-established long-standing principles with respect to the classification of financial instruments as debt or equity (ie, economic approach, substance over form).

15. Foreign Payment Restrictions

15.1 Restrictions on Outbound Payments Relating to Uncontrolled Transactions

The Luxembourg legislation does not include any restrictions on payments relating to uncontrolled transactions. There are only restrictions on the tax deduction of payments, which, in certain cases, like in the case of the interest limitation rules of the EU Anti Tax Avoidance Directive (ATAD), also apply to payments to third parties.

15.2 Restrictions on Outbound Payments Relating to Controlled Transactions

Luxembourg legislation does not restrict the possibility to make payments relating to controlled transactions. However, certain limitations exist on the possibility to deduct such payments from a tax point of view. This is the case, for example, of interest and royalty payments made to entities located in a jurisdiction considered as non-co-operative, based on the list released and updated twice a year by the EU Council. Restrictions may also apply when the anti-hybrid rules of the ATAD, as implemented into Luxembourg law, apply. Finally, restrictions will apply to the part of the remuneration which exceeds the arm's length price or when a payment is requalified into a hidden distribution. In such case, withholding tax might also apply on the payment.

15.3 Effects of Other Countries' Legal Restrictions

In Luxembourg, there are no specific rules regarding the effects of other countries' legal restrictions.

16. Transparency and Confidentiality

16.1 Publication of Information on APAs or Transfer Pricing Audit Outcomes

According to the Grand-Ducal Regulation of 23 December 2014 (related to paragraph 29a of the LGTL), advance tax agreements, including those covering transfer pricing aspects – ie, unilateral APAs – are published in a summarised and anonymised form in the annual report of the direct tax authorities. However, in practice, the information published only includes the number of decisions taken on APA requests and whether the decision was positive or negative. Luxembourg taxpayers usually do not rely on the APA procedure but rather on the preparation of robust transfer pricing documentation supporting the positions they take in their tax returns. The very low number of APAs (one single APA in 2023 based on the 2023 annual report of the direct tax authorities) illustrates this quite well.

As far as bilateral MAPs are concerned, the annual report of the direct tax authorities also indicates the number of MAPs launched and closed during the year, including those related to transfer pricing. However, no information is included on the content, outcome, etc. Finally, in line with its commitment under Action 14 of the BEPS Action plan ("Making Dispute Resolution Mechanisms More Effective"), Luxembourg provides data and statistics to the OECD on its MAP procedure on a regular basis, including on bilateral APAs. This information is then analysed and published in the form of a peer review report by the OECD.

16.2 Use of "Secret Comparables"

Luxembourg does not use secret comparables for transfer pricing assessment purposes.

Trends and Developments

Contributed by:
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Loyens & Loeff is a European independent, full-service business law firm providing integrated legal and tax advice with specialists in Dutch, Belgian, Luxembourg and Swiss law. The firm's Luxembourg transfer pricing team assists clients regarding documentation, planning and strategy, and dispute resolution. More specifically, it helps clients to assess their documentation against stringent new requirements. The team also assist clients' tax departments on the formulation of sustainable transfer pricing strategies in line with their business whilst maintaining tax efficiency. Finally, it helps clients accelerate litigation procedures and prevent double taxation. The transfer pricing team also regularly assists its clients with audits and resolves (international) transfer pricing disputes both at an administrative and court level. The team is part of a fully integrated firm with home markets in Benelux and Switzerland, and offices in all major financial centers, including London, New York, Paris and Tokyo.

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Introduction

As transfer pricing (TP) continues to be a hot topic domestically, at EU level and in the international scene, from Luxembourg and European Union (EU) legislation to domestic and EU case law, in this article we analyse the main TP-related developments that took place during 2023.

Public Country-by-Country Reporting

Background and timeline

Bill No 8158 transposing the provisions of directive 2021/2101 on public country-by-country reporting (CbCR) into Luxembourg domestic law was published on 22 August 2023, in the Memorial A of the Official Gazette under number 532 (the "Law"). As part of EU's initiatives to enhance corporate and tax transparency and public scrutiny, public CbCR is a global action requiring multinational enterprises (MNEs) to publicly disclose data of their tax activities to different stakeholders.

Scope of application

Who should disclose?

The Law provides for four categories of companies that are required to publish and provide certain information. These include EU-based MNEs and non-EU based MNEs conducting a business activity in Luxembourg through a subsidiary or a branch with a consolidated annual turnover at the balance sheet date of at least EUR750 million for each of the last two consecutive years.

The in-scope entities shall be covered by the EU accounting directive and should be organised under the following legal forms:

- Luxembourg public limited company (S.A.);
- Luxembourg partnership limited by shares (S.C.A.);
- Luxembourg private limited liability company (S.à r.l.); and
- Luxembourg partnerships (S.N.C. and S.C.S.), provided their direct or indirect partners, who are indefinitely liable, are organised as limited companies or similar.

Thus, any entity organised under another legal form (such as special limited partnerships – *Société en Commandite Spéciale* – SCSp) falls outside the scope of the Law.

Carve-out for banks

Considering that groups engaged in the banking sector are already required to publish a CbCR pursuant to the Capital Requirements Directive IV, the Law avoids the double reporting in this sector, by providing a general carve-out, subject to conditions.

What information to disclose?

The public CbCR for the financial year concerned should include, among others, a list of all subsidiaries included in the consolidated accounts, a brief description of the nature of their activities, the number of full-time equivalent employees, the turnover, the amount of profit or loss before tax and the amount of corporate income tax and withholding tax paid.

Omission from disclosure

Luxembourg chose to permit in-scope entities to defer, under certain conditions, the disclosure of commercially sensitive information. In cases where the disclosure of one or more of the required pieces of information would constitute a serious prejudice to the commercial position of the reporting entity, their temporary omission is allowed. Any omission shall be clearly indicated in the CbCR and accompanied by an explanation. Nevertheless, any omitted information shall be published in a subsequent CbCR within a maximum period of five years from the date of its initial omission.

To date there is no administrative guidance as to which information is considered commercially sensitive capable of constituting a serious prejudice to the commercial position of the reporting entity. It remains to be seen whether the Luxembourg Tax Administration (LTA) will issue a guidance and the Luxembourg courts will take position in their judgements.

How to disclose?

In-scope entities shall file and publish the public CbCR with the Luxembourg Trade Register (RCS) and make available its content in one of the official EU languages on their website free of charge for a minimum period of five consecutive years. Entities are exempt from publication on their website provided that the CbCR is accessible to the public free of charge. The entities shall also inform the public by including on their website the reasons for the exemption and by making reference to the RCS website.

Sanctions

Failure to comply with the provisions of the Law may lead to fines of between EUR500 and EUR25,000. A distinction is drawn between the responsibility of the administrative, management and supervisory bodies of UPEs and standalone undertakings, which are required to prepare and publish the public CbCR in accordance with the Law, and the responsibility of the administrative, management and supervisory bodies of subsidiary undertakings and branches, which are expected simply to ensure, to the best of their knowledge and ability, that the public CbCR is prepared and published.

Auditor’s statement

Statutory auditor(s) or approved audit firm(s) auditing financial statements shall state in their audit report whether the taxpayer was required by the Law to publish a public CbCR for the financial year preceding the financial year being audited and whether the public CbCR was indeed prepared and published.

Entry into force

The Law will be applicable to financial years starting on or after 22 June 2024. The public CbCR shall be published within 12 months of the closing of the financial year for which it is drawn up. For entities whose financial year follows the calendar year, the reporting obligation will only start with respect to the financial year 2025 and the public CbCR shall be published by 31 December 2026 at the latest.

Conclusion

The public CbCR will be a supplementary obligation for MNEs besides the existing CbCR reporting that is applicable since 23 December 2016. Given the publication of the information and the managers’ personal liability, a timely review might be necessary to determine whether an adoption of a data capture processes is required.

Master File and Local File Obligations

On 28 March 2023, the Luxembourg government presented a bill of law as well as the related project of grand-ducal regulation (the “Grand-Ducal Regulation”), to reform certain tax administrative and procedural aspects, as well as TP documentation requirements.

The draft Grand-Ducal Regulation on TP documentation provides that there will be a Local File and Master File obligation for Luxembourg “constituent entities” as defined in the Luxembourg CbC law. Therefore, Luxembourg constituent entities that are part of an MNE group having a consolidated revenue exceeding EUR750 million shall prepare a Local File describing the TP analysis of their transactions with related parties.

An additional threshold is also foreseen for the Master File obligation. Luxembourg resident constituent entities with a net turnover of at least EUR100 million or with a balance sheet total of at least EUR400 million, shall prepare a Master File type of documentation.

Both the Local File and the Master File shall be available to the LTA at all times.

The Grand-Ducal Regulation is in line with OECD's BEPS Action 13 and the OECD TP Guidelines for Multinational Enterprises and Tax Administrations (the "OECD Guidelines") and provides a list of information as well as the content of the Local File and the Master, which overall is in line with the OECD Guidelines.

The bill of law has not been voted yet. To date, the legislative proposal has faced much criticism, both from stakeholders and the *Conseil d' Etat*. It remains to be seen whether the proposal will be adopted, or it will undergo any amendments. In any case, the intention to align TP documentation with the BEPS Action 13 Report is set and taxpayers should make sure that all controlled transactions are supported by ad hoc TP documentation.

Advanced Pricing Agreements (APAs)

Under the same legislative proposal, the government also proposed a draft Grand Ducal regulation introducing a new bilateral and multilateral APA (BAPA or MAPA) procedure, based on the provisions of Article 25(3) of the OECD Model Tax Convention. A BAPA or a MAPA is concluded between the competent tax authorities. While it is already possible to request a BAPA or a MAPA, following this draft regulation, the procedure would be formalised and the application would be subject to a fee ranging from EUR10,000 to EUR20,000.

Proposal on a TP Directive

Introduction

As part of the BEFIT package, on 12 September 2023, the European Commission (EC) presented the proposal for a Directive that integrates key TP principles into EU law (the "TP Directive"). The draft TP Directive aims to increase tax certainty, reduce compliance costs, mitigate the risk of double (non) taxation and harmonise TP rules throughout the EU with the adoption of the arm's length principle into EU law and the clarification of the role and status of the OECD Guidelines. To ensure a common application of the arm's length principle, the latest version of the OECD TP Guidelines will be binding when applying it and a common definition of what should be considered a controlled company has been included in the TP Directive.

TP methods

The TP Directive provides the five TP methods already included in the OECD Guidelines. The arm's length prices shall be determined by applying the most appropriate method and any other valuation method or technique can be applied only if it can be demonstrated that (i) none of the approved methods can be reasonably applied, and (ii) such other method produces a result consistent with that which would have been achieved by independent enterprises. Hence, the draft TP Directive is more restrictive than the OECD Guidelines and the current practice in many member states with respect to the obligation to apply the most appropriate TP method and the burden of proof in applying other methods.

Arm's length ranges

Further, the TP Directive contains rules on the application of the comparability analysis and the arm's length ranges. According to the TP Directive, a taxpayer is not subject to adjustment if its

results fall within the interquartile range, unless it can be proven that a different point within this range is justified by the underlying facts and circumstances. If the result of a controlled transaction falls outside the arm's-length range, it shall be adjusted to the median of the range unless it can be proven that another point in the range provides an arm's length price. This contradicts with the OECD Guidelines, which state that any point within the range (ie, not just the interquartile range) is arm's length.

TP documentation

Pursuant to the TP Directive, member states shall ensure that taxpayers avail of sufficient information and analysis to prove that their controlled transactions respect the arm's length principle. The TP documentation requirements will apply to all taxpayers in the absence of a revenue threshold. The EC can also supplement the TP documentation prerequisites by adopting common templates, language requirements, defining the type of taxpayer to abide by these templates and the deadlines to be respected.

TP adjustments

The TP Directive also provides for a mechanism enabling member states to make a corresponding adjustment when a primary adjustment is made in another EU or treaty country. More precisely, member states may not limit the granting of such corresponding adjustments only in the context of a double tax treaty or a mutual assistance procedure (MAP). Pursuant to the TP Directive, member states will have at their disposal a "fast-track" procedure when there is no doubt that the primary adjustment is well founded, or in case such adjustment results from a joint audit. Such "fast-track" procedure shall be concluded within 180 days, without the need to open a MAP. Compared to MAPs, a term of 180 days would be a tremendous improvement. Hence, this fast-track procedure is a very welcome but also ambitious development.

In the absence of a primary adjustment, member states are allowed to perform a downward adjustment provided that an amount equal to the downward adjustment shall be included in the profit of the associated enterprise in the other jurisdiction and that such downward adjustment shall be communicated to the tax authorities of the other jurisdiction.

The TP Directive also provides strict conditions under which EU member states should recognise a compensating adjustment, which is initiated by the taxpayer and differs from the price that is actually charged between the associated enterprises.

Entry into force

If passed, member states shall adopt and publish the necessary laws to comply with the TP Directive by 31 December 2025 at the latest, which shall apply as from 1 January 2026.

On 14 November 2023, it was proposed to amend the TP Directive, among others, by shortening the deadline for its adoption to 31 December 2024 and subsequently its entry into force to 1 January 2025 instead of 2026 (the "Draft Report"). The Draft Report was adopted by the European Parliament's Economic and Monetary Affairs Committee on 22 February 2024. The European Parliament's plenary will vote on the Draft Report on 11 April 2024, which will then pass to the European Council for consideration. However, the European Parliament's opinion is not binding for the European Council.

It remains to be seen how member states will respond to the content of the TP Directive. Provided the TP Directive has formally been

approved, member states would have to include the provisions of the TP Directive in their domestic legislation, and both tax authorities and taxpayers may have to adjust their TP practices, which may impact their support to the TP Directive.

Case Law

In 2023, there has been further progress in the judicial review of significant cases involving tax rulings dealing with TP matters.

Interest-free loans case law

Administrative Court No 48125C of 23 November 2023

In 2016, a Luxembourg company financed its subsidiary with an interest-free loan (IFL). The involved companies imputed notional interest applying TP rules, leading to a deduction at borrower level and a corresponding income at the level of the lender. The LTA initially denied the deduction and requalified the IFL into equity. LTA's decision was confirmed by the administrative tribunal but was annulled on appeal on 23 November 2023.

Case law in recent years has consistently listed a range of criteria, largely derived from parliamentary documents and doctrine, to classify a financial instrument for Luxembourg tax purposes, but also the need for a holistic assessment of the transaction and its economic circumstances, stressing that no single feature of the loan is determining. The transaction should rather be analysed according to its economic conditions (substance over form). In the case at hand, the court applied these criteria to an IFL granted to a debtor by its sole shareholder. The key takeaways are the following.

- Considering that the formalities of loan documentation are more flexible than those of a capital increase, documenting a loan after the funding, although not ideal, can be acceptable. As such, a delay in documenting the funding, while not desirable is not indicative of equity or debt classification.
- When the debt-to-equity ratio is lower than the maximum 99/1 debt-to-equity ratio prevailing based on the circular on intragroup financing activities that was applicable until 2017, the borrower shall not be considered as having a disproportionate debt-to-equity ratio. Moreover, to assess the debt-to-equity ratio, only the actual drawdowns should be considered rather than the total commitment under a facility. Note that nowadays the debt-to-equity ratio should be substantiated.
- The criteria of the absence of a right to participate in profits and liquidation proceeds and the absence of voting rights need to be assessed in respect of the lender's capacity, by examining the terms and conditions of the financial instrument. These criteria shall not be considered met just because of the mere fact that the lender is also the borrower's shareholder.
- A maturity of eight to ten years shall not be considered so long that it would be indicative of equity classification, while actual (p)repayments on the IFL confirm the debt nature of the instrument.
- The limited recourse clause transfers risk to the lender but does not annul ex ante the repayment obligation. As such, the limited recourse clause shall not be a feature to support the equity classification of the IFL.
- Considering that a bank would typically ask for its loans to rank senior to shareholder debt, the subordination of shareholder loans to third-party debt shall not be held as an equity feature, where such subordination is standard.

This decision offers valuable clarifications regarding the classification of financial instruments as debt or equity and is pertinent for evaluating the tax implications not only of IFLs but also various other financial instruments used in Luxembourg. It also offers useful guidance for analysing specific criteria which remained largely open to interpretation.

Administrative Court No 48127C of 21 September 2023 and No 47754C of 14 November 2023

In its decision 48127C of 21 September 2023, the Administrative Court of Appeal criticised LTA's position in its attempt to reverse the burden of proof regarding the level of interest rates (that should be) charged on interest free shareholder loans. The LTA referred to its 1998 circular that basically prescribes an interest rate of 5% to shareholders' current accounts. However, the court found that the mere demonstration of the existence of a hidden distribution of profits (due to the shareholder loan in the case at hand being interest free) should not entail a reversal of the burden of proof as otherwise, the LTA would be free to impose any interest rate, however unreasonable. In cases of hidden distribution of profits, to determine whether the transaction was carried out in accordance with the arm's length principle, the LTA shall accurately define the transaction it intends to requalify and also has the burden of determining the amount of hidden distribution, and cannot merely refer to the rate stated in the 1998 circular, which is not binding on taxpayers. The court applied the interest rate sustained by transfer pricing analyses submitted by the taxpayer, that it analysed as adequate.

Similarly to the above, the Court confirmed these principles for an interest-bearing loan in its decision No 47754C.

Administrative Court No 48281C of 26 September 2023

The Administrative Court, in its decision No 48281C of 26 September 2023, dealt with payments under a total return swap (TRS) paid by a Luxembourg corporate taxpayer (the "LuxCo") to its non-resident individual shareholder (the "Individual"). LuxCo's subsidiary in fiscal unity (the "Subsidiary") distributed to Russia and Kazakhstan pharmaceutical products manufactured in France through Russian and Kazakh related entities, respectively. The group's beneficial owner was the Individual. The Subsidiary's role in the chain was administrative, involving the receipt of orders from the Russian and Kazakh companies and their transmission to the manufacturer, as well as the import of the pharmaceuticals into the aforementioned countries. This particular distribution activity that had a high margin for the Subsidiary was not possible without the central role performed by the Individual.

The TRS on the one hand entitled the Individual to 85% of the net profits of the Subsidiary, and on the other hand LuxCo to a small annual amount and possibility to borrow interest free. LuxCo claimed that the TRS arrangement was at arm's length, remunerating the Individual for his central role and leaving the Subsidiary/fiscal unity with a return that was commensurate or in excess of usual margin as a low-risk distributor.

The court recognised that the margin made by the Subsidiary on the distribution activity seemed high in light of the functions it performed. However, the overall margin on the distribution activity realised by the three related entities in Luxembourg, Russia and Kazakhstan should be allocated among them in an arm's length manner, and not between them and the Individual, that was not employed by and had not entered into any services agreement with these entities.

Instead, the Individual benefitted in an indirect way from the high margin activity of the group, namely as shareholder. Absent any indication of the Russian and Kazakh margin being challenged in Russia and Kazakhstan, there should be no reason to doubt the remaining margin realised by the Subsidiary. The obligations of LuxCo under the TRS being in no proportion with its entitlements under the TRS, the court sided with the LTA and confirmed the latter's treatment of the payments to the Individual as hidden dividends.

Transfer pricing-related state aid case law

Amazon case law

The case concerned the arm's length nature of royalties paid by a Luxembourg operating company (the "LuxOpCo") to a Luxembourg partnership for the use of certain intangibles.

In a tax ruling issued in 2003, the LTA confirmed the arm's length nature of the deductible royalty payments. LuxOpCo provided supporting TP analysis determining its arm's length remuneration for the provision of the royalties. The EC argued that LuxOpCo's tax base was unduly reduced and made its own calculation to determine the appropriate amount of the royalty charge using a different TP method, thus arriving at a lower royalty charge. The General Court then annulled the EC's decision.

The CJEU, with its decision No 985/2023 of 14 December 2023, confirmed the General Court's conclusions, albeit on different grounds. In line with its landmark Fiat judgment of November 2022, the CJEU repeated that in the absence of EU harmonisation, taxation remains within the authority of member states, which shall exercise their discretion within the framework of EU rules, including those regarding state aid. CJEU stressed member states' exclusive right to choose their own tax policy and their own standards, and that the OECD Guidelines are not legally binding if not incorporated into domestic law.

As such, CJEU ruled that the OECD Guidelines could not form part of the "reference framework", leading to the annulment of the EC's decision due to an error of law. The CJEU finally noticed that, although the General Court also relied on a wrong reference framework, it results in a correct outcome. The CJEU, thus, ruled in final instance and dismissed EC's decision.

Impact on other cases and taxpayers

The Fiat and Amazon judgments confirmed that the EC, under the legal framework, is not entitled to enforce the non-binding OECD Guidelines to the extent they are not implemented in national law. Instead, it should focus on the arm's length principle as implemented in the domestic law of the member states. Note that Luxembourg has implemented part of the OECD Guidelines in article 56bis of the LIR.

The TP Directive discussed above may come to fill in the gap of the binding nature of the OECD Guidelines.

Developments on TP-related audits

Over the past few years, TP has become the main point of attention in Luxembourg taxation. The decrease of tax rulings and APAs has resulted in an increased scrutiny on behalf of the LTA, which has started more systematically questioning taxpayers' intercompany transactions and the application of the arm's length principle.

While in most cases the LTA limits itself in requesting the supporting TP documentation for intragroup financing activities, cash pooling and services, some tax inspectors have not hesitated

to review in detail and challenge the methodology applied and the underlying calculations performed.

Experience shows that the LTA can challenge easier taxpayers' intercompany transactions when no TP documentation is prepared. In an environment where more and more tax scrutiny is observed, taxpayers should make sure that all controlled transactions are duly documented and supported by ad hoc TP documentation.

MEXICO

Law and Practice

Contributed by:
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Chevez, Ruiz, Zamarripa was founded in 1981 and is the leading firm in Mexico for advisory, consulting, transfer pricing and tax litigation. It is a one-stop shop providing a comprehensive, specialised and high-quality multidisciplinary service in the anti-corruption, anti-money laundering, administrative and regulatory, corporate, M&A, finance and banking, labour law, and IP sectors. Chevez Ruiz Zamarripa believes that transfer pricing analyses require an interdisciplinary vision in order to identify and structure the commercial and financial relationship within a multinational enterprise, going beyond mere tax compliance. The transfer pricing team is comprised of experts with economics, tax and legal expertise with advanced financial, economic and accounting analysis techniques, which – together with vast international experience and a deep knowledge of the characteristics of the Mexican business environment – guarantees high added value services for its clients.

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1. Rules Governing Transfer Pricing

1.1 Statutes and Regulations

In Mexico, the provisions related to the transfer pricing regime are included in the Income Tax Law (ITL) and the Federal Tax Code (FTC), as well as regulations of the ITL and miscellaneous tax rules.

In general, taxpayers that carry out transactions with related parties, either resident in Mexico or abroad, are required to determine their taxable income and deductions in accordance with the arm's length standard.

Through a tax audit, tax authorities may challenge the taxable income or authorised deductions of the taxpayer derived from related-party transactions.

The Mexican transfer pricing regime includes provisions that establish the definition of related parties, transfer pricing methods and their applicable hierarchy, what could be considered as a comparable company or transaction, comparability adjustments and business cycle considerations, and information that could be used for interpretation purposes, among other concepts.

In addition, the ITL establishes the requirements for compliance with contemporaneous transfer pricing documentation, which must be prepared on an annual basis by the taxpayer. In general, there is no obligation to file contemporaneous transfer pricing documentation before the tax authorities; however, it should be submitted upon request through a tax audit process.

The requirement to maintain contemporaneous transfer pricing documentation does not apply to taxpayers whose income, in the immediately preceding fiscal year, did not exceed MXN13 million (approximately USD733,000) and taxpayers whose income from the provision of professional services did not exceed MXN3 million (approximately USD170,000).

Three-Tier Transfer Pricing Documentation

In addition to the obligation to maintain contemporaneous transfer pricing documentation, there is an obligation to file a local file, master file and country-by-country reports.

These provisions duplicate transfer pricing obligations for taxpayers.

This three-tier transfer pricing documentation requirement is implemented in Mexico as

informative tax returns which includes the obligation to file similar information as proposed in Action 13 of the Base Erosion and Profit Shifting project issued by the OECD (the "BEPS project") consisting of a local file, master file and country-by-country report.

Regarding transfer pricing adjustments, in general there are not detailed tax provisions, but Miscellaneous Tax Rules (MTR) have included guidelines for transfer pricing adjustments and the documentation to be prepared and filed for the applicability of the amendments of the taxable income and/or deductions derived from transfer pricing adjustments.

The FTC incorporates rules for taxpayers and tax advisors for the disclosure of reportable schemes. The schemes that must be reported are those that generate or may generate, directly or indirectly, a tax benefit for the taxpayer in Mexico. For transactions between related parties, the FTC states the following as reportable:

- transfer of hard-to-value intangibles;
- restructures without consideration or if, as a result of said restructuring, the operating profit is lowered by more than 20%;
- transactions without consideration;
- transactions without the use of reliable comparables; and
- mutual agreement procedures (MAPs) or advance pricing agreements (APAs) obtained by a foreign-based related party regarding a transaction with a Mexican taxpayer.

1.2 Current Regime and Recent Changes

Mexican tax legislation considers transfer pricing provisions for recognising the arm's length principle as the benchmark for related party transactions.

Significant updates were considered in the years 2001, 2002 and 2006, with the implementation of a transactional approach versus a global approach, recognition of the OECD Guidelines for Multinational Enterprises and Tax Administrations as established in 1995 as a basis for interpretation, and its updates (the "OECD Transfer Pricing Guidelines") as long as they are consistent with the ITL provisions, and a hierarchy for the application of transfer pricing methods.

In 2016, an update to the ITL was carried out to include the three-tiered obligation established by BEPS (local file, master file and country-by-country reporting) for taxpayers who, in general, in the immediately preceding fiscal year had declared in their annual tax returns, taxable income equal to or exceeding MXN1,016,759,000 (approximately USD57 million) – which is adjusted annually considering inflation – and had carried out transactions with related parties. This obligation is in addition to the annual transfer pricing contemporaneous documentation.

As per the 2022 ITL, if the taxpayer has these obligations, the local informative return must be submitted on May 15th of the following year, whereas the master informative return and country-by-country report have to be submitted no later than December 31st of the following year.

From 2016 and until the ITL of 2021, the local informative returns had to be filed before the tax authorities, no later than December 31st of the immediately following year. Therefore, the update for the 2022 ITL resulted in important challenges for taxpayers and transfer pricing advisers in Mexico, since this update speeds up the filing process of this tax return by more than seven months, and the fact that the comparable information is limited at such date.

2. Definition of Control/Related Parties

2.1 Application of Transfer Pricing Rules

The ITL states that two or more persons or entities are related parties when one of them participates directly or indirectly in the management, control or capital of the other, when a person or group of persons participates directly or indirectly in the management, control or capital of those persons, or when there is a link between them according to customs regulations.

The ITL does not consider a minimum percentage of capital ownership for two or more persons to be considered as related parties; the definition of related party is therefore very broad.

In addition, transfer pricing benchmarking considers a transactional approach, and no threshold amount is contemplated.

In this sense, all related party transactions that derive income or a deduction for the Mexican entity should be analysed in compliance with the arm's length principle as per Mexican tax provisions.

3. Methods and Method Selection and Application

3.1 Transfer Pricing Methods

The ITL establishes six transfer pricing methods that could be used for analysing intercompany transactions, which in the order established therein are the following:

- the comparable uncontrolled price method (CUP);
- the resale price method (RPM);
- the cost-plus method (PLM);
- the profit split method (PSM);
- the residual profit split method (RPSM); and
- the transactional net margin method (TNMM).

Unlike the OECD Guidelines, which consider the residual analysis as part of the transactional profit split method, the Mexican ITL establishes these as separate transfer pricing methods (PSM and RPSM), and therefore their applicability must be considered individually.

3.2 Unspecified Methods

The Mexican ITL does not consider the application of unspecified methods, and only the six transfer pricing methods included in Article 180 of the law should be used for analysing intercompany transactions.

3.3 Hierarchy of Methods

According to the ITL, the CUP should, if possible, be used when analysing related party transactions. If the CUP is not applicable, any other method may be applied on the following basis:

- it is demonstrated that the CUP is not applicable in order to analyse the related party transaction, according to the OECD Guidelines; and
- it is demonstrated that the method applied is the most appropriate one to analyse the related party transaction in accordance with the available information and the OECD Guidelines, giving preference to the RPM and CPLM.

Additionally, the ITL establishes that, if applying the RPM, CPLM or TNMM, both the selling price and the costs associated with such transaction should be established under the arm's length standard. It would be necessary to prove that the method applied is the best method or the

most reliable based on the available information, giving preference to the RPM and CPLM.

3.4 Ranges and Statistical Measures

As established in the ITL, from the application of any of the transfer pricing methods specified in the law, when two or more comparables exist, a range of prices, consideration amounts, or profit margins could be obtained. These ranges should be adjusted by means of the interquartile method, the method agreed in a mutual agreement procedure as included in tax treaties to which Mexico is a signatory, or the authorised method as per the rules issued by the Mexican tax authorities.

If the taxpayer is not within the adjusted range, then the arm's length price, consideration amount or profit margin would be the median of the range.

3.5 Comparability Adjustments

As stated in the ITL, transactions or companies are considered comparables when there are no differences that significantly affect the prices, consideration amounts or profit margins as per the transfer pricing methods established in the law, and if differences exist, where these are eliminated with reasonable adjustments. For determining these differences, the ITL establishes that, among others, the following elements should be considered.

- Characteristics of the transactions including:
  - (a) for financial transactions, elements such as principal amount, term, guarantees, solvency of the debtor and interest rate;
  - (b) for the provision of services, elements such as the nature of the service and if the service involves experience or technical know-how;
  - (c) in relation to the use, enjoyment or sale of tangible assets, elements such as the physical characteristics, quality, and availability of the asset;
  - (d) in relation to the exploitation or transfer of an intangible asset, elements such as if the intangible consists in a patent, trade mark, trade name or transfer of technology, as well as its duration and protection grade; and
  - (e) in the sale of shares, elements such as the updated equity of the issuing entity, present value of the margins or free cash flows, or the stock market quotation for public entities.
- Functions and activities, including the assets used and risks assumed in the transaction, of each entity involved in the transaction.
- Terms and conditions of the intercompany agreement.
- Economic circumstances.
- Business strategies, including those related to market penetration, maintenance, or expansion.

In addition, general transfer pricing practice in Mexico considers adjustments to reflect differences in the relative levels of accounts receivable and accounts payable, as well as inventories and property, plant and equipment.

Recently, it has been a common practice by the tax authorities in Mexico to apply a country risk adjustment in audit processes, which is performed when there are differences in the existing economic circumstances of the market/country in which the tested party and the comparables' operation takes place.

As part of this country risk adjustment, the Emerging Markets Bond Index (EMBI) could be considered as a factor to compute the applicable country risk adjustment. This kind of adjustment

triggers a higher profit margin for the comparables and therefore a higher interquartile range.

4. Intangibles

4.1 Notable Rules

As established in the ITL, transactions related to the exploitation or transfer of intangible assets must be in compliance with the arm's length principle. For this type of transaction, elements such as the type of asset (patent, trade mark, trade name or transfer of technology, among others), the duration, and the degree of protection of the intangible must be considered.

The RPSM is the transfer pricing method included in the ITL, that should generally be used to analyse intercompany transactions where significant or relevant intangible assets are used by the related parties.

In general, the RPSM consists of a two-step method, where a global profit is obtained and through step one, the "routine" profitability of the related parties involved is determined, which includes the application of any other of the transfer pricing methods for obtaining the minimum profit that each company must obtain. Step two will determine the residual profit, obtained by subtracting the routine profit from the global profit, which will be distributed between the related parties considering, among other things, the relevant intangible assets used by each related party.

The tax authorities have issued non-binding criteria related to royalty payments, through which it was established as a wrongful practice for royalties to be paid to foreign-based related parties for the licensing of an intangible asset that was originally owned by a Mexican entity, and for which no transfer price was established or, where the transfer price was below the market price. Furthermore, these non-binding criteria establish that Mexican entities should not consider as a deductible item the investments derived from the purchase of intangibles assets acquired from foreign-based related parties, even if a third party in Mexico is involved in the purchase of that intangible asset. The exception being if the intangible assets had been acquired earlier by the foreign-based related party from a third party and it proves the payment regarding the acquisition cost.

4.2 Hard-to-Value Intangibles

The provisions regarding intangible assets including in the ITL are limited and no broad guidelines are established. As mentioned, the OECD Guidelines are a source for interpretation; therefore they may be used for the application of these intangibles since no specific or special rules are considered in Mexican provisions.

The updated OECD Guidelines recognise hard-to-value intangibles as part of Chapter VI "Special considerations for intangibles", and further considerations are established in Annex II to Chapter VI, which provides guidance for tax administrations to apply regarding these intangibles.

As part of the analysis for hard-to-value intangibles, the OECD Guidelines recommend that tax administrations should consider the application of the ex-ante and ex-post approaches, which will minimise the information asymmetry that this type of asset entails.

As mentioned, starting in 2020, the tax authorities incorporated a new section in the FTC related to reportable schemes; specifically, Section VI of Article 199 of the FTC requires taxpayers

to disclose information related to intercompany transactions related to the transfer of hard-to-value intangibles.

The tax authorities have also issued non-binding criteria related to intangible property, which established that a taxpayer in the transfer pricing analysis should not consider companies as comparables in cases where there are significant differences due to unique and valuable contributions or when these unique and valuable contributions are not recognised correctly.

4.3 Cost Sharing/Cost Contribution Arrangements

Regarding cost sharing, Mexican tax provisions establish that expenses from transactions with foreign-based related parties that are assigned on a pro-rata basis, are considered a non-deductible item.

As an exemption, there is a miscellaneous tax rule which establishes that the aforementioned tax provision should not be applicable if the taxpayer complies with the requirements included therein. The requirements include, among other elements, the following:

- the expense should be considered as strictly indispensable for the Mexican entity considering its business activities;
- regarding the foreign-based related party, it must be an entity that is resident for tax purposes in a country with which Mexico has an agreement for the exchange of information;
- proving that the services related to the expenses were rendered;
- for related parties, complying with transfer pricing provisions; and
- demonstrating a reasonable relation between the expense and the benefit obtained or expected to be obtained by the Mexican entity.

These documentation requirements are hard to comply with on a post-transaction basis, therefore it is strongly recommended that prior to establishing these types of agreements, Mexican residents should be aware of the documentation requirements to prepare a defence file in time.

5. Affirmative Adjustments

5.1 Rules on Affirmative Transfer Pricing Adjustments

As stated in the ITL, the tax authorities audit faculties are for tax years ended. Mexico considers a calendar tax year to start on January 1st and end on December 31st, therefore transfer pricing provisions are applicable on an annual basis.

Regarding transfer pricing adjustments performed, the specific rules are established in the MTR.

Types of Transfer Pricing Adjustments

Transfer pricing adjustments can be real (accounting and tax effects) or virtual (only tax effects) and are categorised as the following.

- Voluntary or compensatory: adjustment performed by the taxpayer prior to the annual tax return (March 31st) or May 15th for entities that obtain the accounting reporting opinion (*dictamen fiscal*).
- Primary: adjustment that derives from the audit process carried out by the tax authorities on the taxpayer.
- Corresponding national: adjustment that derives from the audit process carried out by the tax authorities on the related party in

Mexico for which the intercompany transaction was carried out with the taxpayer.
- Corresponding foreign: adjustment derives from the audit process carried out by the foreign tax authorities on the foreign-based related party for which the intercompany transaction was carried out with the taxpayer.
- Secondary: Adjustment to a contribution, derived from the transfer pricing adjustment, which is generally characterised as a presumed dividend.

Requirements for Tax-Deducting Adjustments

MTR establishes the list of requirements for adjustments that reduce their taxable income to be deductible, which includes the following.

- To obtain and keep documentation that supports that, previous to the adjustment, the taxpayer determined that the intercompany transaction was not in compliance with the arm's length principle according to the ITL transfer pricing provisions.
- To obtain and keep a statement signed by the elaborator of the original transfer pricing documentation, explaining why the transaction was not originally agreed in compliance with the arm's length principle.
- To obtain and keep a statement signed by the elaborator of the documentation, explaining the consistency or inconsistency in the application of transfer pricing methodologies and the search for comparable companies/transactions, in relation to the adjusted transaction corresponding, as minimum, to the immediately preceding fiscal year.
- To obtain and keep all documentation through which it can be verified that, with the transfer pricing adjustment, it can be concluded that the transaction was agreed in compliance with the arm's length principle.
- A digital tax return (*Comprobante Fiscal Digital por Internet*, or CFDI) or tax receipt regarding the original intercompany transaction.
- For real adjustments, a CFDI or tax receipt regarding the transfer pricing adjustment which must comply with certain specific requirements.
- For deductible items from the purchase of merchandise through importation, keep all documentation related to the related value-added tax (IVA) and the special tax for products and services (IEPS).
- Proof that the related party with whom the adjusted transaction was carried out, has accrued the corresponding adjustment and that the adjustment does not derive in a taxable income for a tax haven; such proof can consist of a statement under oath of the legal representative of the related party, translated into Spanish, confirming that the corresponding adjustment was performed and that the accrued income was not taxed in a tax haven.

As an important item related to transfer pricing adjustments, it should be noted that, under a non-binding criterion published by the Mexican tax authorities, taxpayers should not perform any modification to prices, amounts of consideration, or profit margins that are already within the interquartile range.

This criterion is particularly relevant in situations where Mexican taxpayers intend to decrease the transfer pricing results (for instance, from the upper to the median of the arm's length results) and consequently decrease the taxable basis.

6. Cross-Border Information Sharing

6.1 Sharing Taxpayer Information

Since 1992, Mexico has entered into several Double Taxation Treaties with the more than 60 jurisdictions, based on the OECD's and UN's Model Tax Conventions.

In addition to Double Taxation Treaties, Mexico has entered into Tax Information Exchange Agreements with the purpose of these promoting international co-operation in tax matters through the exchange of information. In general, these Tax Information Exchange Agreements align with the model developed by the OECD Global Forum Working Group on Effective Exchange of Information.

Mexico is also a member of the Convention on Mutual Administrative Assistance in Tax Matters, which entered into force as of September 2012. This Convention intends to facilitate international co-operation, through the exchange of information, including automatic exchanges, and the recovery of foreign tax claims in order to address tax evasion and avoidance issues. As part of this Convention, as of 2014, Mexico is also part of the Multilateral Competent Authority Agreement, through which the Mexican tax authorities receive and share the financial information of taxpayers with the other jurisdictions that are part of this agreement.

7. Advance Pricing Agreements (APAs)

7.1 Programmes Allowing for Rulings Regarding Transfer Pricing

Article 34-A of the FTC establishes that taxpayers may submit all related documentation, data, and information for requesting a consultation regarding the transfer pricing methodology for intercompany transaction(s) to the tax authorities in order to obtain an advanced pricing agreement (APA).

The validity of the APA is subject to the compliance with requests that prove that the intercompany transaction in this procedure is established considering prices, consideration amounts or profit margins that would have been established by third parties in comparable transactions.

7.2 Administration of Programmes

The APA should be requested before the Central Administration of the Transfer Pricing Audit Administration of the Large Taxpayers General Administration, which is the main administration that administers the APA programme.

7.3 Co-ordination Between the APA Process and Mutual Agreement Procedures

APAs are valid for the fiscal year in which they are requested, the immediately preceding year, and for up to three fiscal years following the one in which they are requested.

APAs may be valid for a longer period when they derive from a mutual agreement procedure (MAP) in accordance with an international convention to which Mexico is a signatory.

MAPs are also administered by the Central Administration of the Transfer Pricing Audit Administration of Large Taxpayers General Administration.

7.4 Limits on Taxpayers/Transactions Eligible for an APA

Mexican tax provisions do not establish a list of specific transactions or taxpayers that could be subject to an APA.

In this sense, subject to the compliance with the requested information in procedure sheet 102/CFF, there are no limits on a taxpayer requesting an APA for an intercompany transaction.

7.5 APA Application Deadlines

There is no specific filing date for the application of an APA.

Once the application for an APA has been submitted by the taxpayer, procedure sheet 102/CFF establishes eight months for the tax authorities to issue a response, including a potential request for further documentation from the taxpayer.

7.6 APA User Fees

The applicable user fee for the request of an APA in 2024, is MXN310,247 (approximately USD17,485), and the annual APA review post-resolution MXN62,049 (approximately USD3,497).

7.7 Duration of APA Cover

As mentioned in **7.3 Co-ordination Between the APA Process and Mutual Agreement Procedures**, an APA may be valid for the fiscal year in which it is requested, the immediately preceding year, and for up to three fiscal years following the one in which it is requested; this is a total of five years.

An APA may be valid for a longer period when they derive from a MAP in accordance with an international treaty to which Mexico is a signatory.

7.8 Retroactive Effect for APAs

An APA can have retroactive effect of up to one year (see **7.7 Duration of APA Cover**). In addition, bilateral and multilateral APAs are subject to agreement between the competent tax authorities and therefore a wider period for retroactive effects could be negotiated.

8. Penalties and Documentation

8.1 Transfer Pricing Penalties and Defences

Regarding penalties, failure to submit or submission with errors of the annual transfer pricing informative return established in Article 76 Section X of the ITL would entail a penalty, in FY 2024, of between MXN99,590 and MXN199,190 (approximately USD5,600 to USD11,200). This informative return requests certain information from the contemporaneous transfer pricing report (ie, transactions analysed, related parties and transaction amounts, transfer pricing method applied, among others).

In connection with the transfer pricing informative returns (local file, master file and country-by-country) established in Article 76-A of the ITL, the penalty for failure to submit, submission with errors, incongruence or submission in a different form than stated in the tax provisions is, in FY 2024, between MXN199,630 and MXN284,220 (approximately USD11,200 to USD16,000).

In addition, the government will not engage in contracts with taxpayers that failed to submit the tax returns established in the ITL.

On the other hand, if the Mexican tax authorities conclude that a company underpaid taxes in Mexico as a result of non-arm's length transfer prices, the penalty could consist of a monthly

interest rate payment equal to the government published rate, plus surcharges and penalties that range from 55–75% of the re-evaluated and unpaid tax. These penalties are applied after the taxpayer is audited and in case of an existing error or tax payment omission.

If determined by the tax authorities through their audit faculties, there is no specific defence mechanism for transfer pricing penalties, and more likely than not the taxpayer will be required to submit without errors the corresponding tax return.

There is an administrative mechanism that a taxpayer could apply to consider the reduction of the penalties by 100%, which is stated in Article 70-A of the FTC; however, the taxpayer must be reviewed through an audit process by the tax authorities to have this reduction considered.

8.2 Taxpayer Obligations Under the OECD Transfer Pricing Guidelines

Article 76-A of the ITL establishes that taxpayers who, in the immediately preceding fiscal year, had declared in their annual tax returns taxable income equal to or exceeding a certain amount established in Article 32-H of the FTC (MXN1,016,759,000 for FY 2024; approximately USD57 million), and have carried out transactions with related parties, must file the following informative returns.

- Master information return of related parties, which must include information regarding the multinational business group.
- Local informative return of related parties, which must include the organisational structure, strategic and business activities, as well as the information regarding operations with related parties.
- Country-by-country informative return of the business multinational group.

In this regard, it is established that a country-by-country informative return must be filed by taxpayers when they are within any of the following categories.

- Multinational holding companies, which shall be understood as the companies meeting the following requirements:
  - (a) resident in Mexico;
  - (b) with subsidiary companies defined in terms of the financial information standards, or else, permanent establishments residing or located abroad, as the case may be;
  - (c) not subsidiaries of any other company residing abroad;
  - (d) bound to prepare, file and disclose the consolidated financial statements in terms of the financial information standards;
  - (e) which report, in their consolidated financial statements, income for entities residing in other countries or jurisdictions; and
  - (f) which have obtained in the immediately preceding fiscal year consolidated income for accounting effects equivalent to or exceeding MXN12 billion (this amount may be amended by the Mexican Federal Congress for the relevant fiscal year in the Federal Income Law).
- Legal entities residing in Mexico or abroad with a permanent establishment in the country, that have been appointed by the holding company of the multinational business group residing abroad as parties responsible for providing the country-by-country informative return.

9. Alignment With OECD Transfer Pricing Guidelines

9.1 Alignment and Differences

The ITL considers as a source for interpretation the OECD Transfer Pricing Guidelines and, in general, Mexico's transfer pricing provisions are closely aligned with these guidelines.

A difference would be that unlike to the OECD Transfer Pricing Guidelines, which consider the residual analysis as part of the transactional profit split method, the Mexican ITL establishes these as separate transfer pricing methods (PSM and RPSM), and therefore considers six transfer pricing methods.

In addition, there is a specific Article in the ITL that considers as a non-deductible item all expenses from foreign-based related parties that are assigned to a Mexican entity considered on a pro-rata basis. There are certain requirements for the documentation that a Mexican entity can prepare and obtain to have this type of expense considered deductible, which are described in detail in **4.3 Cost Sharing/Cost Contribution Arrangements**.

Furthermore, the ITL contemplates a hierarchy for the application of transfer pricing methods, which differs from the OECD Transfer Pricing Guidelines in considering the most applicable method for the intercompany transaction analysis.

9.2 Arm's Length Principle

Mexico's transfer pricing regime is aligned with the arm's length principle as established in the OECD Transfer Pricing Guidelines, and it is the basis of analysis when reviewing whether an intercompany transaction complies with what would have been established with or between independent third parties in comparable transactions.

9.3 Impact of the Base Erosion and Profit Shifting (BEPS) Project

Mexican transfer pricing provisions consider the OECD's BEPS project recommendations from Actions 8–10 regarding more detailed and robust functional analyses for intercompany transactions, as well as thorough detail regarding supporting documentation to review materiality issues.

In addition, Article 76-A established to align with Action Plan 13 regarding the submission of annual tax returns which somewhat resemble the OECD's recommendations for a local file, master file and country-by-country report.

Furthermore, in connection with BEPS project Action 4, the ITL has implemented measures that limit interest deductions that exceed 30% of EBITDA, which applies only to taxpayers with interest expenses exceeding MXN20 million in a given fiscal year.

9.4 Impact of BEPS 2.0

As of April 2022, Mexico has only implemented certain provisions related to the VAT Law, which address the taxation of digital services for such tax.

9.5 Entities Bearing the Risk of Another Entity's Operations

Mexico's tax legislation and transfer pricing practice does not forbid entities to bear the risk of another entity's operations by guaranteeing the other entity a return.

However, in cases where a Mexican entity guarantees the interest payments of a related party (whether foreign or domestic), thus assuming the

credit risk of the lender, these interest payments should be treated as dividends from a tax perspective.

10. Relevance of the United Nations Practical Manual on Transfer Pricing

10.1 Impact of UN Practical Manual on Transfer Pricing

Mexican legislation does not consider the UN Practical Manual on Transfer Pricing as a source for interpretation of transfer pricing practice.

Mexican tax provisions consider only the OECD Transfer Pricing Guidelines as a source for interpretation of transfer pricing practice.

11. Safe Harbours or Other Unique Rules

11.1 Transfer Pricing Safe Harbours

The use of safe-harbour rules is limited to a targeted sector, which is the Maquiladora industry.

The safe-harbour mechanism, established in the ITL for this industry, consists in determining the tax profit base as the maximum value that results from applying 6.9% on the total value of the assets and 6.5% on the total amount of costs and expenses.

Articles 181 and 182 list the specific computational characteristics that must be considered for determining the total value of the assets and the total amount of costs and expenses.

In addition, Maquiladora entities that apply these safe-harbour rules, must submit annually a tax return with the corresponding computations.

From 2021, the FTC has established a new faculty for the tax authorities to publish information regarding reference parameters with respect to profit levels, deductible concepts or effective tax rates, based on the industry in which the taxpayer operates.

11.2 Rules on Savings Arising From Operating in the Jurisdiction

Mexican tax provisions do not consider any rules governing savings that apply to transfer pricing and related party transactions.

11.3 Unique Transfer Pricing Rules or Practices

Mexican tax provisions consider specific rules for transfer pricing adjustments which have been discussed in detail in **5.1 Rules on Affirmative Transfer Pricing Adjustments**.

In addition, there is a restriction regarding expenses arising from transactions with foreign-based related parties that assign the expenses on a pro-rata basis, which are considered a non-deductible item. There are certain requirements regarding the documentation that a Mexican entity can prepare and obtain to have this type of expense considered as deductible, which are described in detail in **4.3 Cost Sharing/Cost Contribution Arrangements**.

12. Co-ordination With Customs Valuation

12.1 Co-ordination Requirements Between Transfer Pricing and Customs Valuation

Transfer pricing provisions included in the ITL are only applicable for purposes of this law, and only for income tax purposes.

Mexican Customs Law establishes the taxes to be considered for the determination of customs value in import and export transactions. The Customs Law considers specific methods for determining the customs value, which are different to transfer pricing methodologies.

In general, there is no co-ordination between transfer pricing documentation and customs valuations, since generally transfer pricing documentation will not be valid for customs purposes and vice versa.

13. Controversy Process

13.1 Options and Requirements in Transfer Pricing Controversies

Mexican tax provisions consider a five-year statute of limitation.

The audit process starts once the taxpayer receives a ruling from the tax authorities, which in general will require information and documentation to be submitted by the taxpayer, stating the initiation of a tax audit.

The tax authorities have up to two years to notify the taxpayer of an Observations Ruling, which will include the specifics of their qualification of the facts or of the omissions in the information provided by the taxpayer through the audit process.

Once this Observations Ruling is notified, as an alternative tax resolution mechanism, the taxpayer has 20 business days to request a conclusive agreement procedure before the Mexican Taxpayer's Ombudsman (PRODECON). This resource consists in holding discussions with the tax authorities through the assistance of PRODECON, to reach an agreement before a tax assessment is issued. If no agreement is reached in this procedure or a partial agreement is negotiated, then the audit process will continue its course until a tax assessment is determined.

Once the tax authorities have determined their tax assessment, taxpayers are entitled to challenge these results through the following options.

Administrative Appeal (Recurso de Revocación) Before the Legal Department of the Mexican Tax Authorities

Once the tax assessment is notified to a taxpayer, they will have 30 business days to file for an administrative appeal. This defence mechanism provides taxpayers with a final instance to provide additional information to that already provided through the audit process.

It is important to mention that, for the duration of this defence mechanism, the taxpayer will not have to secure the amounts determined in the tax assessment.

In general, if the audit process derives from transfer pricing implications, which include intercompany transactions from foreign-based related parties that are resident for tax purposes to countries to which Mexico has a tax treaty, a MAP can be requested. If initiated, the MAP will suspend the administrative appeal process until its termination.

If no agreement is reached in the MAP, the administrative appeal will continue its term process.

If the taxpayer obtains an unfavourable result through the administrative appeal, this can be appealed before the Tax Court.

Nullity Petition (Juicio Contencioso Administrativo Federal) Before the Tax Court

Taxpayers can proceed to a nullity petition after the tax assessment is notified, and as a general recommendation, if the administrative appeal resolution obtained is partially or totally unfavourable. After this resolution, taxpayers have up to 30 business days to file the nullity petition.

Taxpayers that begin this process need to secure the amounts derived from the tax assessment, including the principal amount plus all corresponding extras such as the update adjustment, surcharges, and penalties.

If the resolution of the nullity petition is partially or totally unfavourable, the taxpayer can dispute this resolution through an amparo complaint.

Amparo Before the Collegiate Circuit Court

After the taxpayers get a partial or total unfavourable resolution by the tax court regarding the tax assessment, they have 15 business days to file for an amparo.

It is important to emphasise that this resource proceeds only against a final decision made by a court that goes against any of the following:

- the applicability of the law to the case;
- the interpretation of laws; and
- the general principles of Mexican law in the absence of an applicable law.

If the resolution obtained by the taxpayers is an unfavourable one, they can dispute it through an extraordinary appeal before the Supreme Court of Justice.

Extraordinary Appeal Before the Supreme Court of Justice

An extraordinary appeal needs to be verified and accepted by the President of the Supreme Court. For the filing to be admitted by the President of the Court it must comply with certain requirements. For instance, that the filing made by the taxpayer to the Collegiate Circuit Court includes a proposal on the constitutionality of an interpretation, rule, or human right included in an international treaty, or the resolution made by the Collegiate Circuit Court includes a pronouncement of this nature.

Furthermore, the President of the Supreme Court will verify that the requirements of importance or transcendence are met, which means that if the resolution appealed by the taxpayer implies the omission or contradiction of a judgment upheld by the Supreme Court of Justice relevant to a constitutional matter, or if there is an issue of constitutionality that could result in the creation of a new criteria of relevance, the appeal is likely to be admitted.

14. Judicial Precedent

14.1 Judicial Precedent on Transfer Pricing

There are few judicial precedents on transfer pricing matters in Mexico.

In general, such precedents consider the formalities behind the transfer pricing provisions as established in the ITL rather than substantive controversies.

14.2 Significant Court Rulings

The following are some of the relevant judicial precedents on transfer pricing matters in Mexico.

One of the most relevant court rulings was issued in August 2013, in which the Federal Court of Fiscal and Administrative Justice issued an isolated ruling that established that in accordance with the OECD Transfer Pricing Guidelines, the tax authorities may ignore the self-characterisation of an intercompany transaction carried out between related parties and recharacterise it according to its economic substance (August 2013 – Court precedent No VII-P-2aS-353).

In June 2014, in an isolated ruling, the Supreme Court of Justice ruled that expenses assigned on a pro-rata basis carried out between related parties could be considered as a deductible item, provided that several conditions were met (June 2014 – Court precedent No 2a. LIV/2014 (10a)). This precedent contributed to the publication of the requirements included in Rule 3.3.1.27. of the MTR regarding the information that must be complied by a Mexican entity to consider the expenses assigned on a pro-rata basis, as deductible, which are explained in detail in **11.3 Unique Transfer Pricing Rules or Practices**.

Finally, in February 2018, in an isolated ruling, a Collegiate Circuit Court ruled that the tax invoices issued in connection with transfer pricing adjustments must correspond to the tax year in which the transfer pricing adjustments were effectively performed (February 2018 – Court precedent No I.1o.A.190 A (10a.)).

15. Foreign Payment Restrictions

15.1 Restrictions on Outbound Payments Relating to Uncontrolled Transactions

The ITL closely aligns with the OECD Transfer Pricing Guidelines and treats them as a source of interpretation.

Currently, the only uncontrolled transactions subject to restriction are expenses that are assigned on a pro-rata basis, as explained in **4.3 Cost Sharing/Cost Contribution Arrangements**, which in general are considered as a non-deductible item unless several requirements are complied with.

In addition, payments made to an individual or entity subject to a preferential tax regime (REFIPRE per its acronym in Spanish) which will be subject to a withholding tax rate of 40% with no deductions allowed. This would apply regardless of whether the transaction is controlled or uncontrolled.

A jurisdiction is considered as REFIPRE if the income is subject to an effective income tax rate lower than 75% of the Mexican income tax rate, which is 30%. Therefore, a jurisdiction with an income tax rate below 22.5% would be considered as a REFIPRE. This applies even if Mexico has a tax treaty in force with such jurisdiction.

Furthermore, since 2020, deductions have not been allowed from transactions considered as hybrid mechanisms, which occur when a payment, person, legal entity, income or an asset's owner is recharacterised and, therefore results in a tax mismatch. In this sense, if a transaction results in a deduction for the taxpayer in Mexico and the related party does not recognise the transaction as subject to income tax in the foreign jurisdiction, a hybrid mechanism would be present. This would apply regardless of whether the transaction is controlled or uncontrolled.

15.2 Restrictions on Outbound Payments Relating to Controlled Transactions

As of today, Mexican transfer pricing provisions limit payments made to an individual or entity

subject to a REFIPRE; these will be subject to a withholding tax rate of 40% with no deductions allowed. As mentioned in **15.1 Restrictions on Outbound Payments Relating to Uncontrolled Transactions**, this would apply regardless of whether the transaction is controlled or uncontrolled.

15.3 Effects of Other Countries' Legal Restrictions

As of today, Mexican transfer pricing provisions do not have any restrictions regarding the effects of other countries' legal restrictions.

16. Transparency and Confidentiality

16.1 Publication of Information on APAs or Transfer Pricing Audit Outcomes

In Mexico, there are no publications regarding APAs or transfer pricing audit outcomes.

The OECD periodically publishes the APA and MAP statistics of its member countries.

16.2 Use of "Secret Comparables"

Any information to which the tax authorities have access may be used in an audit process, which mainly consists of public information. However, the tax authorities have used secret comparables in certain audit processes, which are case specific.

Trends and Developments

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Sánchez DeVanny is a Mexican legal consulting firm with international expertise, which specialises in providing holistic and innovative solutions to resolve clients' needs, and understands their industries from the inside out. The firm practises law with social responsibility – by exercising legal practice with transparency, ethics and inclusion – and forms lasting relationships with clients that go beyond a simple contract for temporary services. Sánchez DeVanny has served clients who have placed their trust in the talent and experience of the firm's lawyers since its foundation in 1996. The team combines experience with creativity in order to build solutions for clients, because it is easier to innovate successfully when there is an understanding of how to do things correctly.

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Navigating Transfer Pricing in Mexico

In the ever-evolving landscape of international business, the concept of transfer pricing has emerged as a crucial element for multinational enterprises. Transfer pricing has become a vital practice for accurately reflecting the value of transactions and ensuring fair allocation of profits among different jurisdictions. However, navigating the complexities of transfer pricing can be challenging, particularly for businesses operating in countries like Mexico, where stringent regulations and tax compliance requirements are enforced.

Significance of transfer pricing in Mexico

Mexico, as a key player in the global economy, has recognised the importance of transfer pricing regulations in ensuring fair taxation and preventing tax evasion. These regulations serve as a critical tool for promoting transparency and accountability in intercompany transactions within multinational enterprises operating in Mexico.

Mexico's tax authority, the Tax Administration Service (SAT), plays a pivotal role in overseeing adherence to transfer pricing regulations. The SAT diligently monitors transfer pricing practices to ensure compliance with the law and to prevent any potential misuse or manipulation of transfer pricing arrangements. As a result, businesses operating in Mexico are subject to rigorous scrutiny and enforcement measures by the SAT.

Failure to comply with transfer pricing requirements can have severe consequences for businesses. Non-compliance may lead to substantial penalties, audits, and potential disputes with tax authorities, which can adversely affect a company's financial standing and reputation, as will be further specified further on in this article.

The transfer pricing regulations in Mexico are designed to be in alignment with international standards, reflecting the country's commitment to promoting consistency and harmonisation in transfer pricing practices. These regulations are primarily articulated in Article 76-A of the Mexican Income Tax Law (MITL) and its accompanying regulations, providing clear guidelines and frameworks for businesses to follow in their transfer pricing activities. By adhering to these regulations, businesses can ensure compliance with both domestic and international standards.

Alignment with international standards

Mexico's commitment to aligning its transfer pricing regulations with international standards, particularly those established by the Organization for Economic Co-operation and Development (OECD), is evident through its proactive adoption of the Base Erosion and Profit Shifting (BEPS) initiative.

Since 1995, Mexico has implemented significant reforms to the Mexican Income Tax Law (MITL) with the aim of establishing consistent transfer pricing provisions. Amendments made in 1997 integrated the arm's length principle and methods outlined in the OECD transfer pricing guidelines. Subsequent revisions in 2002 mandated adherence to OECD transfer pricing guidelines, provided they do not contradict core principles and methodologies within the MITL.

Dedicated transfer pricing provisions for the import-export *maquiladora* industry were introduced in 1994 and have undergone multiple revisions since. Between 2014 and 2021, Mexican tax regulations stipulated that foreign principals in *maquila* structures could comply with Mexican transfer pricing regulations and avoid establishing a Permanent Establishment (PE) under certain conditions, including obtaining an Advance

Pricing Agreement (APA). However, the 2022 tax reform eliminated the APA option. Now, PE relief is contingent upon *maquiladoras* meeting safe harbour rule criteria.

One significant aspect of the BEPS initiative relevant to transfer pricing is Action 13, which aims to enhance transparency through country-by-country reporting (CbCR) requirements and the incorporation of a local file and master file. Multinational enterprises are mandated to provide detailed information on their global operations to tax authorities, enabling effective assessment of transfer pricing risks and enforcement actions, including by Mexico's SAT.

As part of its commitment, Mexican tax authorities established an international tax division to oversee treaty application and administration, accumulating valuable experience in international tax matters over time. The expertise of Mexican tax authorities in competent authority matters primarily involves transfer pricing adjustments, bilateral APAs, and facilitating information exchange between jurisdictions. While some double taxation cases undergo Mutual Agreement Procedure (MAP) proceedings, particularly with the United States, such cases remain relatively low compared to other jurisdictions.

Current regime

In Mexico, income tax is self-assessed, meaning taxpayers bear the responsibility of correctly applying tax provisions, including those related to transfer pricing. This necessitates adherence to transfer pricing regulations and the assessment of transactions with related parties to ensure they are conducted at arm's length.

The obligation to uphold evidentiary transfer pricing documentation does not extend to taxpayers whose earnings in the preceding fiscal year were below MXN13 million (about USD760,000, taking into consideration the average exchange rate of 1 USD to 17.08 MXN as of this date in 2024), or to those whose income from professional services did not surpass MXN3 million (about USD175,000).

It is important to mention that the Federal Tax Code (FTC) integrates rules for taxpayers and tax advisors regarding the disclosure of reportable schemes. These schemes entail transactions that directly or indirectly generate a tax benefit for the taxpayer in Mexico. Among the reportable transactions involving related parties, the FTC identifies:

- transfer of hard-to-value intangibles;
- restructures resulting in a decrease in operating profit by more than 20% or without consideration;
- transactions lacking consideration or reliable comparable; and
- MAPs or APAs obtained by a foreign-based related party concerning a transaction with a Mexican taxpayer.

If prices negotiated with related parties don't meet this standard, taxpayers can adjust their taxable income by correcting income or expenses accordingly. Non-compliance with transfer pricing regulations obliges taxpayers to self-assess adjustments as income, with corresponding adjustments made to related party income.

These adjustments must be completed no later than March 31st of the subsequent calendar year for taxpayers who forego auditing their financials. Alternatively, taxpayers may opt to submit an audit report of their financials for tax purposes by May 15th of the following calendar year.

Moreover, if a foreign competent authority intervenes, resulting in an adjustment based on transfer pricing principles and an income tax treaty application, the Mexican competent authority must first approve the adjustment before the Mexican taxpayer can file the corresponding supplementary tax return. In such cases, taxpayers must fulfil formal obligations, including submitting necessary notifications to Mexican tax authorities in line with Mexican Treasury Regulations (MTR).

Key Components of Transfer Pricing in Mexico

Transfer pricing methods

Various transfer pricing methods can be used to determine appropriate transfer prices for related-party transactions. These methods include:

- comparable uncontrolled price method;
- resale price method;
- cost-plus method;
- profit split method;
- residual profit split method; and
- transactional net margin method.

The selection of the most appropriate method depends on the nature of the transaction and the availability of comparable data.

Documentation requirements

Businesses operating in Mexico must maintain comprehensive documentation to support their transfer pricing policies. This documentation typically includes detailed analyses of related-party transactions, comparability studies, and economic analyses demonstrating compliance with the arm's length principle. Adequate documentation is essential for defending transfer pricing practices.

Rule 3.9.1.3 of the MTR for 2024 outlines the requirements for adjustments that reduce taxable income to be deductible. These requirements include the following.

- Maintaining documentation demonstrating that, prior to the adjustment, the taxpayer determined that the intercompany transaction did not comply with the arm's length principle as per the MITL transfer pricing provisions.
- Obtaining and retaining a statement signed by the creator of the original transfer pricing documentation, explaining why the transaction did not originally adhere to the arm's length principle.
- Obtaining and retaining a statement signed by the creator of the documentation, detailing the consistency or inconsistency in the application of transfer pricing methodologies and the search for comparable companies/transactions, pertaining to the adjusted transaction for at least the immediately preceding fiscal year.
- Maintaining all documentation confirming that, with the transfer pricing adjustment, it can be concluded that the transaction was in compliance with the arm's length principle.
- Providing a digital tax return (*Comprobante Fiscal Digital por Internet*, or CFDI) or tax receipt for the original intercompany transaction.
- For real adjustments, presenting a CFDI or tax receipt for the transfer pricing adjustment that meets specific requirements.
- For deductible items from the purchase of merchandise through importation, retaining all documentation related to the related value-added tax (IVA) and the special tax for products and services (IEPS).
- Providing evidence that the related party with whom the adjusted transaction was conducted has recorded the corresponding

adjustment and that the adjustment does not result in taxable income for a tax haven. Such evidence may include a sworn statement from the legal representative of the related party, translated into Spanish, confirming the performance of the corresponding adjustment and the non-taxation of the accrued income in a tax haven.

The MTR stipulates that audits may lead to primary adjustments, entailing the modification, for tax purposes, of price, consideration amount, or profit margin to reflect that the transaction with a related national or foreign party was negotiated as it would have been with or among independent parties in comparable transactions. While the option of primary adjustments is provided for in current Mexican regulations, there is an increasing trend towards outright rejection of deductions by the Tax Authority, citing not only incomplete or erroneous analysis but also lack of evidence or arguments. Therefore, it is crucial not only to conduct a thorough analysis but also to gather the necessary evidence to support the transaction and avoid complete deduction rejection during a review.

Recent Experience (Vis-à-Vis Mexican Tax Authorities)

In recent years, several developments have shaped the transfer pricing landscape in Mexico and have implications for businesses operating in the country; in particular there has been an increased scrutiny from Tax Authorities.

The SAT has intensified its focus on transfer pricing compliance, leading to a rise in transfer pricing audits and enforcement actions, therefore forcing businesses to ensure that their transfer pricing policies are robust and supported by comprehensive documentation to mitigate the risk of non-compliance.

Risk assessment and planning

Conducting a comprehensive risk assessment is essential for businesses to identify potential transfer pricing risks and develop effective strategies to mitigate them. Factors such as the nature of the industry, the complexity of intercompany transactions, and changes in regulatory frameworks should be carefully considered when developing transfer pricing policies.

In addition to potential transfer pricing risks, it is important to consider the following issues.

Classification of payments for services

Operations involving the rendering of services between related parties have been identified as high-risk operations by the SAT. This includes ensuring their correct classification for withholding purposes and the tax recognition of the operations (such as services that could qualify as royalties for the transfer of intangibles). Additionally, scrutiny is placed on supporting the effective materiality of the service and justifying it based on business purposes (including the strict indispensability of the service and the benefits it could represent).

Pro-rata expenses

Regarding cost-sharing arrangements, Mexican tax law deems expenses allocated on a pro-rata basis to foreign-based related parties as non-deductible, unless specific requirements are met. These requirements include demonstrating the indispensability of the expense to the Mexican entity's business activities, compliance with transfer pricing provisions, and establishing a reasonable relationship between the expense and the benefit obtained by the Mexican entity. Nevertheless, in practice it is hard to meet those requirements.

Review of intercompany financing and netting operations

The payment of interest on intercompany loans has also been identified as a high-risk operation by the SAT. The SAT has been reluctant to accept that loans between related parties are adequately supported solely by transfer pricing studies. Therefore, additional support from various factors is likely required. Among these factors, precise studies must include an analysis of the debtor's solvency to justify the need for the loan (credit risks). Additionally, they must consider arm's length principles such as special interest in the terms of payment of principal and interest, as well as reasonable interest rates. Furthermore, compliance with thin capitalisation rules is necessary, or, if applicable, a favourable resolution authorising a higher level of indebtedness. Additionally, the law has incorporated limitation to the interest deductions in similar terms to those included under BEPS Action Plan 4, related to a deduction up to 30% of the EBITDA of the company.

In cases concerning transfer pricing-related attribution of profits issues, the competent authority reserves the right to conduct inquiries that extend beyond the specific transaction or transactions under review. This expanded investigation may be deemed necessary by the SAT, to gain a comprehensive understanding of all pertinent factors influencing the decision to grant relief.

Advance pricing agreements

APAs offer businesses the opportunity to proactively engage with tax authorities to establish transfer pricing methodologies for specific transactions or business operations. By obtaining APAs, businesses can achieve greater certainty regarding their transfer pricing arrangements and minimise the risk of disputes with tax authorities.

In Mexico, APAs are established through rulings under domestic legislation. While there isn't a formal "agreement" signed by both parties, the ruling results from negotiations between the Mexican taxpayer and the Mexican tax authorities.

The Central Administrator for Transfer Pricing Audits, housed within the Large Taxpayers' General Administration of the SAT, oversees negotiations for both unilateral and bilateral APAs. For bilateral APAs, which involve negotiations among the taxpayer, the Mexican competent authority, and the competent authority of a treaty country, this unit leads discussions when the application is reviewed with the foreign tax authority.

Taxpayers seeking an APA must pay a fee prior to filing the request. Additionally, they must pay an annual fee to cover an annual review by the tax authorities of the filed annual report. The APA process in Mexico requires comprehensive information regarding the transactions and operations to be covered. This includes the following.

- Detailed descriptions.
  - (a) A thorough overview of the functions and activities carried out by the taxpayer and its Mexican and foreign related parties involved in contractual or business relationships with the taxpayer. This description should include information about the assets and risks associated with each party.
  - (b) Proposed transfer pricing methodologies, outlining the criteria and all elements considered for evaluating each method. Additionally, the taxpayer must specify the financial and tax obligations for the fiscal years covered by the APA under the proposed transfer pricing methodologies.

- Comparable transactions and entities: Information on comparable transactions and entities, highlighting reasonable adjustments made to eliminate differences as per Article 179, paragraph 3 of the MITL (comparability analysis).
- Audit and MAP information: A statement regarding ongoing transfer pricing audits involving the taxpayer or its Mexican and foreign related parties, specifying the stage of the audits, if applicable. Additionally, disclosure is required if any party is engaged in a transfer pricing-related MAP and the current stage of that procedure. If a formal resolution or decision has been reached either under a MAP or in court, documentation regarding that resolution must be provided.
- Additional information: Any other relevant information and documentation requested by the tax authorities to complete the APA process effectively.

Overall, the APA process in Mexico necessitates detailed information and documentation to ensure transparency and compliance with transfer pricing regulations.

Intangible assets

In Mexico, the tax authorities consider several factors when evaluating transactions involving intangible assets to ensure compliance with the arm's length principle. These factors include the nature of the asset (such as patents, trade marks, trade names, or technology transfers), its duration, and the level of protection afforded to the intangible.

Regarding hard-to-value intangibles, Mexican tax provisions lack specific guidelines, thus the OECD Guidelines serve as a reference for interpretation. Tax administrations are recommended to apply ex-ante and ex-post approaches to minimise information asymmetry related to these assets. Starting in 2020, taxpayers are required to disclose information on intercompany transactions involving hard-to-value intangibles.

Regarding the Development, Enhancement, Maintenance, Protection and Exploitation (DEMPE) functions, the Mexican Tax Authority can use the term by reference to the OECD Transfer Pricing Guidelines, which are applicable in Mexico to interpret the domestic transfer pricing rules. Under this scenario, the Mexican Tax Authority could seek to attribute this functions to Mexican taxpayers in order to increase the profitability of the company in Mexico.

Intangible assets, such as patents, trade marks, and proprietary technologies, are increasingly becoming the primary drivers of value creation in modern businesses. Unlike tangible assets, the value of intangibles often lies in their ability to generate future income streams, making their management and valuation complex, particularly in the context of cross-border transactions.

DEMPE activities encompass a range of functions undertaken by multinational enterprises to create, improve, safeguard, and utilise intangible assets effectively across different jurisdictions. These activities include research and development efforts, ongoing enhancements to existing intangibles, routine maintenance to preserve their value, legal protection through intellectual property rights, and strategic exploitation to derive commercial benefits.

Legal ownership of an intangible does not guarantee rights to the total profits generated from its exploitation. If the legal owner of an intangible does not perform relevant functions, use relevant assets, or assume relevant risks, there is no justification for them to participate partially

or fully in the profits generated by the intangible. It is necessary to conduct exhaustive analyses to identify both the economic and legal ownership of an intangible within the group of multinational enterprises. If compensation is warranted, it should be paid to the parties contributing to the development, enhancement, maintenance, protection, and exploitation of the intangible.

From a transfer pricing perspective, the allocation of profits associated with intangible assets is a matter of great importance for tax authorities and multinational enterprises alike. The OECD's Transfer Pricing Guidelines provide a framework for assessing the arm's length nature of transactions involving intangibles, emphasising the need for aligning profits with the value creation activities undertaken by the parties involved.

DEMPE analysis plays a crucial role in determining the contribution of each affiliated entity within a multinational enterprise to the development, enhancement, maintenance, protection, and exploitation of intangible assets. This analysis informs the allocation of profits in accordance with the functions performed, risks assumed, and assets employed by each entity, ensuring that transfer pricing arrangements reflect economic substance and commercial realities.

However, applying DEMPE principles in practice can be challenging, as it requires a thorough understanding of the specific functions, assets, and risks associated with each intangible asset, as well as the ability to accurately quantify the contributions made by different entities within the multinational enterprise. Moreover, tax authorities worldwide are increasingly scrutinising transfer pricing arrangements involving intangibles, heightening the importance of robust DEMPE analysis to support the arm's length nature of such transactions.

Marketing, promotion and advertising expenses

On 11 May 2019, the Second Section of the Superior Chamber of the Federal Tax Court issued two rulings on the deductibility of expenses related to non-exclusive licence agreements for brand use. The first ruling deemed "marketing expenses" strictly indispensable for merchandising activities, making them deductible regardless of brand ownership.

Conversely, the second ruling found "promotion and advertising expenses" non-deductible as they lack a direct link to merchandising activities and instead focus on brand positioning. These decisions establish absolute rules, impacting taxpayers paying royalties for brand use and advertising costs, despite their non-binding nature.

Under this scenario, it is important to note that companies conducting royalty payments abroad, deducting them and expending on marketing and advertisement, and promotion expenses in the country, the Mexican Tax Authority takes the position that those expenses (marketing and advertisement, and promotion) are not deductible, because they consider that those expenses do not meet the strictly indispensable requirement provided under Domestic Law. The argument of the Mexican Tax Authority considers that to the expenses (marketing and advertisement, and promotion) incurred increments the value of the Brand held by the foreign entity and therefore it is the foreign entity is the one that should bear the expense.

Transfer Pricing Audits

Transfer pricing audits conducted by the SAT have become increasingly common in Mexico. Businesses should be prepared to respond to audit inquiries promptly and provide compre-

hensive documentation to support their transfer pricing policies.

In Mexico, transfer pricing rules allow for adjustments to tax liabilities based on the arm's length principle as previously mentioned. However, when transactions lack compensating payments between involved parties, the actual transaction prices can distort their economic positions. To rectify this distortion, "secondary adjustments" may be made to restore parties to their proper economic positions, reflecting arm's length pricing.

It's important to understand that the Mexican Income Tax Law neither mandates nor prohibits secondary adjustments. Thus, it's at the discretion of taxpayers whether to implement them. In some instances, Mexican tax authorities may require secondary adjustments as part of the conditions for an APA.

Mexican tax regulations impose a five-year statute of limitations, with the audit process commencing upon receipt of a notice from tax authorities, typically necessitating the submission of various information and documentation by the taxpayer, signalling the onset of a tax audit. It's worth noting that audits could be initiated by a different department of the SAT, not necessarily by the transfer pricing department. However, these audits can involve pricing components, even in domestic transactions between related parties.

Current trends in the review of intangibles reveal instances where audits involving the sale of intangible assets are reclassified by the Tax Authority as business transfers. Furthermore, the Tax Authority's scrutiny of valuations encompasses the majority of analysis components, such as discount rates, comparables, and assumptions for projections, among other potentially subjective elements contingent upon professional judgement.

MAP

The MAP article within Mexico's tax treaties is pivotal for the country's transfer pricing programme, as it authorises the negotiation of bilateral APAs. As anticipated, Mexico has ratified the Multilateral Instrument (MLI), which will instigate the amendment of its covered tax agreements. This amendment process includes the adoption of minimum standards to ensure the availability and accessibility of the MAP, aligning with OECD standards.

The responsibility of the competent authorities is to assess cases brought before them to determine whether taxation aligns with the provisions of the tax treaty. If they find discrepancies, they can either unilaterally resolve the issue or seek a bilateral resolution, aiming to prevent taxation that deviates from the treaty.

To date, Mexico hasn't pursued the elimination of double taxation through the MAP in cases not covered by a treaty. However, upon the MLI taking effect for covered tax agreements, paragraph 3 of Article 16 of the MLI will compel Mexico's competent authority to engage in consultations with other jurisdictions to address and resolve disputes regarding double taxation in cases not covered by the tax treaty.

General anti-abuse rule

Mexican Law adopted a Domestic General Anti-Avoidance Rule, (Article 5-A of the FTC), which grants tax authorities the power to recharacterise tax treatment and attribute different tax effects to legal acts lacking a business reason, thus generating undue tax benefits.

In general terms, this article grants the tax authorities, within the framework of the exercise of their verification faculties, the faculty to recharacterise the tax treatment and/or to attribute different tax effects to those legal acts that, in their judgement, lack a business reason, thus generating a tax benefit – direct or indirect – undue and/or different from the reasonably expected economic benefit.

In this regard, it is specified that the application of such GAAR is not absolute, but is subject to a specific procedure regulated by Article 5-A of the FTC, which requires obtaining a favourable opinion from a collegiate body integrated by officials of the Ministry of Finance and Public Credit and the SAT; such opinion must be obtained within a term of two months, counted from the presentation of the case before such collegiate body. In case of a negative response or if no response is obtained within such term – tacit refusal – the GAAR may not be applied.

Furthermore, according to criterion IX-P-2aS-147, the tax authority in Mexico is empowered to disregard the formal characterisation of a transaction between related parties and recharacterise it based on its economic substance, in line with the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. This criterion establishes that tax authorities may recharacterise a transaction when its economic substance differs from its form, or when, even if the form and substance coincide, the agreements regarding the transaction differ from those that would have been adopted by independent companies acting rationally from a commercial standpoint.

In such cases, the tax authority can determine the taxable income and authorised deductions of the involved taxpayers considering the prices and amounts of consideration that would have been used by independent parties in comparable transactions, disregarding the contractual transaction and determining the economic substance of the underlying transaction actually carried out.

In August 2013, the Federal Court of Fiscal and Administrative Justice issued a precedent (ruling No VII-P-2aS-353), establishing that in accordance with the OECD Transfer Pricing Guidelines, tax authorities have the authority to disregard the self-characterisation of intercompany transactions between related parties and instead recharacterise them based on their economic substance.

Penalties

Failure to file or submitting inaccurate annual transfer pricing informative returns, as stipulated in Article 76 Section X of the Mexican Income Tax Law (MITL), results in penalties. These penalties range from MXN99,590 to MXN199,190, according to Article 82 Section XVII of the Federal Tax Code (FTC) for the fiscal year 2024.

Likewise, penalties apply for non-compliance, errors, incongruences, or deviations from specified requirements in tax provisions for transfer pricing informative returns such as the local file, master file, and CbCR, outlined in Article 76-A of the MITL. These penalties range from MXN199,630 to MXN284,2200, according to FTC Article 82 Section XVII.

Additionally, failure to submit tax returns established in the MITL disqualifies taxpayers from engaging in government contracts.

However, taxpayers may apply for a 100% reduction in penalties through an administrative mechanism outlined in Article 70-A of the FTC. This reduction is contingent upon undergoing an

audit process by tax authorities for consideration.

What's Coming Next

Transfer pricing plays a critical role in the tax compliance and regulatory landscape for businesses operating in Mexico. By understanding the importance of transfer pricing regulations, conducting thorough risk assessments, and implementing effective compliance strategies, businesses can navigate the complexities of transfer pricing and mitigate potential risks. Staying abreast of current issues and regulatory developments in the transfer pricing landscape is essential for businesses seeking to establish a successful presence in Mexico while ensuring compliance with tax laws and regulations.

Through proactive engagement with tax authorities, adoption of best practices, and strategic planning, businesses can optimise their transfer pricing arrangements and contribute to sustainable growth and profitability in the Mexican market.

There is an increase in transfer pricing audits to MNE groups with presence in Mexico, and this trend is expected to continue during this year, considering that 2024 is also an electoral year. There also is the possibility for change within the Tax Administration Service Offices, which means that some of the personnel who currently attend the opened audits might not be there by the end of the audit.

NETHERLANDS

Law and Practice

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Taxand Netherlands is an Amsterdam-based independent advisory firm offering a full range of tax advisory and compliance services (including VAT, wage tax, M&A, international and European tax law, corporate income tax, real estate and transfer pricing). Its focus is on tax disputes and transactions, nationally and internationally. The firm consists of over 25 seasoned tax professionals and is part of Taxand Global, a network with tax law firms in nearly 50 countries. This allows it to offer high-quality and integrated tax advice worldwide. The transfer pricing team at Taxand Netherlands helps clients to prepare and maintain appropriate transfer pricing documentation, including benchmark studies. The team also assists clients with business restructurings, (bilateral) advance pricing agreements with the tax authorities, and transfer pricing audits or disputes.

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1. Rules Governing Transfer Pricing

1.1 Statutes and Regulations

The arm's length principle and the Dutch transfer pricing documentation requirements are codified in Article 8b of the Dutch Corporate Income Tax Act (DCITA). For multinational enterprises (MNEs) with an annual consolidated revenue below EUR50 million, the documentation is free of form, but should be appropriate to substantiate the arm's length character of the pricing. Master file and local file documentation and country-by-country reporting (CbCR) requirements are codified in Article 29b–29h of the DCITA. Master file/local file documentation is applicable to multinationals with a consolidated annual turnover exceeding EUR50 million, whereas CbCR requirements have a revenue threshold of EUR750 million. Local files should be updated on an annual basis, while benchmark studies should be updated once every three years, assuming there are no relevant changes to the business model.

In addition, the state secretary of finance has issued several decrees that involve transfer pricing. The most relevant of these are:

- Stcrt No 2023, 2621, providing guidance on Article 8bd of the DCITA;
- Stcrt No 2023, 25745, on rulings with an international character;
- Stcrt No 2022, 16685, on the application of the arm's length principle and the OECD Transfer Pricing Guidelines;
- Stcrt No 2022, 16683 providing guidance on how the Dutch Tax Authority (DTA) attributes profits to permanent establishments;
- Stcrt No 2020, 32689, on mutual agreement procedures (MAPs);
- Stcrt No 2019, 66184, which provides guidance on penalties with respect to CbCR; and
- Stcrt No 2015, 47457, providing guidance on the transfer pricing documentation requirements.

The decree Stcrt No 2019, 13003, providing guidance on the renewed advance pricing agreement (APA) practice of the DTA was amended with the decree Stcrt No 2023, 25745 in December 2023.

The decrees are not laws – nevertheless they are binding for the tax authorities. Furthermore, Dutch transfer pricing legislation is based on the OECD Transfer Pricing (TP) Guidelines.

1.2 Current Regime and Recent Changes

Before 2002, the arm's length principle was not explicitly included in the DCITA. It was understood, however, that it was already applicable through general principles regarding profit determination, which were enacted in Article 8 of the DCITA.

The arm's length principle was only enacted in Dutch law in 2002. Until then, some perceived there was insufficient clarity on how to apply the arm's length principle, as also concluded in the decision of the Court of Appeal's-Hertogenbosch on 20 June 2000. At that time, there was also international pressure on the Netherlands to clarify its position. Due to these developments, the arm's length principle was codified in Article 8b of the DCITA in 2002.

In decree Stcrt No 2015/47457, further guidance was provided with regard to the contents of transfer pricing documentation. This concerns the contents of the master file, local file and the CbCR. The requirements are applicable for fiscal years starting 1 January 2016 onwards. With these documentation requirements, the Netherlands implemented the outcome of Action Plan

13 of the OECD BEPS project commissioned by the G20.

In 2023, a decree on rulings with an international character was published. This decree, among other things, ensures that in situations where there is a so-called triangular case in a bilateral or multilateral APA, a critical assumption can be included that takes into account transfer pricing adjustments from countries that are not involved in the bilateral or multilateral APA.

Furthermore, a decree concerning MAPs published in 2020 includes the adoption of a minimum international standard for dispute resolution in Action Plan 14 of the OECD BEPS project.

The latest Dutch TP Decree (Stcrt No 2022, 16685) was published on 1 July 2022. This update of the decree addresses the impact of the COVID-19 pandemic. The most significant adjustments in the decree are Section 2 on government support measures, Section 6 on intragroup services, and Section 9 on financial transactions. Furthermore, there are some textual changes in the terminology in order to align with the OECD TP Guidelines and Dutch law and regulation.

Lastly, there is also an updated decree regarding Article 8bd of the DCITA, which provides further guidance on this article with regard to practical matters.

Transfer Pricing Mismatches Legislation

Since 1 January 2022, new legislation has come into force in the Netherlands to target transfer pricing mismatches, introducing new Articles (8ba, 8bb, 8bc, 8bd and 35) to the DCITA. The purpose of the legislation is to eliminate transfer pricing mismatches that arise as a result of a different foreign application of the arm's length principle, which results in double non-taxation.

Currently the arm's length principle is applied in the Netherlands (Article 8b, DCITA). The foreign treatment of transactions has, in principle, been irrelevant to the Dutch position, although since mid-2019 it has no longer been possible to obtain rulings when a tax benefit exists because of an international mismatch. This does not, however, impact the positions taken in the corporate income tax return without a ruling.

With the new articles it is no longer possible to deduct additional costs or to incur additional depreciation on an asset in the Netherlands if the actual commercial price was different (lower in the case of depreciation or costs incurred, and higher in the case of income) and the tax adjustment is not followed in the involved foreign jurisdiction; ie, there is no pick-up. The transfer pricing mismatches legislation therefore applies where a tax to commercial difference is taken into account that exists because of a different foreign application of the arm's length principle in a transaction. The new legislation targets, among other things, so-called informal capital or deemed dividend structures.

Examples

Two main examples are summarised below.

- A Dutch company obtains a loan from a foreign-affiliated company with an agreed interest rate of 0%. An arm's length interest rate would be 5%. Based on Dutch legislation (or the DCITA) the arm's length interest rate should be deducted for tax purposes. With the new legislation, the possibility of deduction depends on whether the foreign legislation requires a corresponding adjustment; ie, including the arm's length interest of

5% as taxable income. If this is not the case, the 5% interest may no longer be deducted in the Netherlands. Conversely, this also applies to loans from a Dutch company to a foreign affiliate – where the arm's length interest is higher than the commercial interest charged, the foreign affiliate will be able to deduct the arm's length interest for tax purposes.
- A Dutch company acquires an asset (eg, an intangible asset) for a price of 75, while an arm's length price would have been 200. Based on the existing legislation, the asset should be booked on the tax balance sheet for an amount of 200 and depreciated accordingly. While with the proposed legislation, this depends on whether the arm's length price is reported as taxable income. If the foreign country only taxes 75 as income, the Dutch company should book the asset on its tax balance sheet for the same amount and may only depreciate the asset accordingly if appropriate. Regarding this example, the legislation can also affect transactions that have already taken place, as well as taxable income in the Netherlands from 2022 onwards. This relates to assets that have been acquired from affiliated companies since mid-2019, that were depreciated in 2022 and afterwards, in this way matching the changes to the Dutch ruling practice.

The legislation does not take into account at what rate the income is taxed in the foreign country, a zero rate could therefore avoid application of the legislation.

2. Definition of Control/Related Parties

2.1 Application of Transfer Pricing Rules

Associated Enterprises in Dutch Tax Law

Transfer pricing is only relevant for transactions between associated enterprises. In Dutch tax law, the term "associated enterprise" is defined in Article 8b(1) and (2) of the DCITA. Parliamentary history indicates that the definition of the term "associated enterprise" in Article 9 of the OECD Model Convention was followed.

Pursuant to Article 8b of the DCITA, an enterprise is an associated enterprise if:

- it participates, directly or indirectly, in the management, control or capital of another enterprise; or
- the same taxpayer participates, directly or indirectly, in the management, control or capital of two enterprises.

The degree of participation in the management, control or capital are not elaborated in the DCITA. In the explanatory memorandum to the legislative proposal it is specified that the shareholder, supervisor and/or director have sufficient control to be able to exert influence with regard to the determination of the prices for transactions that take place between the entities involved. It is intended that the term "associated enterprises" be interpreted broadly, for which reason there is no percentage threshold. As a result, it is relatively easy to be in scope.

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3. Methods and Method Selection and Application

3.1 Transfer Pricing Methods

Chapter II of the OECD Guidelines discusses the three traditional transaction methods – the comparable uncontrolled price (CUP) method, the resale price method and the cost-plus method – and the two transactional-profit methods – the profit-split method and the transactional net margin method (TNMM). Depending on the circumstances, a choice should be made from one of these five acceptable methods.

According to the Dutch TP Decree (Stcrt No 2022-16685), the DTA will always start its transfer pricing analysis from the perspective of the method used by the taxpayer. The taxpayer is, in principle, free to choose any transfer pricing method, provided that the chosen method leads to an arm's length outcome for the specific transaction in view of the relevant facts and circumstances. Furthermore, the taxpayer is not obliged to use multiple methods. The taxpayer has to substantiate their choice of method. The TP Decree does acknowledge that a CUP is often difficult to find and that therefore the TNMM will be applied in many cases, while the OECD TP Guidelines include a preference for the CUP method.

3.2 Unspecified Methods

In principle, a taxpayer has to choose one of the five acceptable OECD methods discussed in **3.1 Transfer Pricing Methods**. It is up to the taxpayer to select an appropriate method. In the parliamentary history, a reference has been made to paragraph 2.9 of the OECD TP Guidelines, where it is stated that the taxpayer can also apply a method other than the five acceptable OECD methods, if this is deemed more appropriate.

3.3 Hierarchy of Methods

There is no strict hierarchy of methods in the Netherlands. However, if comparable market prices are available, the CUP method may be the most direct and most reliable way of determining the transfer price and may therefore be preferable to the other methods. The CUP method is often applied to determine interest rates or commodity prices. Since a CUP is often unavailable due to a lack of sufficiently comparable data, in practice the TNMM is the most frequently used transfer pricing method.

3.4 Ranges and Statistical Measures

The DTA recognises that in some cases, an exact transfer price cannot be determined and that transfer pricing is not an exact science. It is common in practice to apply the median of a benchmark of identified comparables for the pricing of transactions. One would only use the lower quartile or upper quartile of the range if economic arguments supported this position.

In establishing the range, a distinction must be made between accurate and less accurate comparables. When the comparables possess a high degree of comparability, then the range is composed of all these quantities. When less accurate comparables are used because of a lack of more appropriate ones, it may be necessary to increase the reliability of the comparables with the aid of statistical methods. An example is the "interquartile range" approach.

Once the range has been established, it is necessary to assess whether the fee for the transaction under review falls within the established range. If the fee falls within the range, no adjustment should be made. In the event that the fee falls outside the range and the taxpayer is unable to explain the deviation with sufficient documentation, an adjustment may be necessary.

3.5 Comparability Adjustments

The Netherlands requires comparability adjustments if necessary. The Netherlands follows the OECD TP Guidelines and applies the OECD approved methods. In paragraphs 3.47 and following, the comparability adjustments are discussed. Paragraph 3.50 elaborates that comparability adjustments should only be considered if they are expected to increase the reliability of the results of a benchmark study.

4. Intangibles

4.1 Notable Rules

According to the state secretary, based on the resale price method, the cost-plus method or the TNMM method, the value of intangible assets can be calculated by determination of the arm's length remuneration for the least complex entities. The residual profit should then be divided between the entrepreneurial functions, among which are included the IP.

Depending on the facts and circumstances, the various development, enhancement, maintenance, protection and exploitation (DEMPE) functions will have to be weighted in relation to their relative importance. In general, the development and enhancement functions will be given greater weight in assessing the relative contributions to the value of the intangible asset concerned.

The TP Decree (Stcrt No 2022-16685) also covers the purchase of shares in an unrelated company followed by a business restructuring and the determination of a fee for the use of intangible assets. If the value of the transferred intangible assets is determined, the value of the intangible assets for both the seller and buyer should be taken into account, thus applying the two-sided approach.

4.2 Hard-to-Value Intangibles

If it appears that there are large deviations between the actuals after an IP transaction and the five-year forecasts that formed the basis for the price determination at the time of the transaction, and these deviations (by more than 20%) cannot be explained by new facts and circumstances, the DTA may, according to the TP Decree, retrospectively reassess the transfer price that was determined at the time of the transaction.

4.3 Cost Sharing/Cost Contribution Arrangements

For cost-sharing or cost contribution arrangements (CCAs), the arm's length principle as elaborated in the OECD Guidelines and, in particular, Chapter VIII of the OECD Guidelines should be followed. Under the arm's length principle, remuneration should be related to the functions performed (taking into account the risks incurred and assets used). This means that the level of remuneration of the participants in a CCA may not differ (substantially) from the remuneration that the companies concerned would receive if they were co-operating outside a CCA context. This means, for example, that a participant in a CCA that assumes risks must also exercise control over these risks and have the financial capacity to bear the negative impact of these risks.

A participant in a CCA, which only provides financing for the CCA and only exercises control over risks related to that financing and not the risks related to other activities within the CCA, is generally only entitled to an arm's length fee for the financing, taking into account the financing risk.

5. Affirmative Adjustments

5.1 Rules on Affirmative Transfer Pricing Adjustments

The taxpayer can supplement or amend a corporate income tax return as long as no final assessment has been imposed. If the taxpayer has already received a final assessment, the taxpayer can only pursue adjustments by filing an objection within six weeks or requesting an ex officio reduction within five years after fiscal year-end if the assessment is already final (*ambtshalve vermindering*). If the requested adjustment is based on a foreign transfer pricing adjustment, a request for a corresponding adjustment or a MAP can be filed.

In general, the tax inspector has three years to impose a final tax assessment after the end of the fiscal year. If the extension ruling for consultants is used, which allows an extension for filing the corporate income tax return until the following fiscal year, the inspector will have an additional year to impose the final tax assessment. The tax inspector can impose an additional tax assessment until five years after the end of the fiscal year if the taxpayer acts in bad faith or "new facts" appear.

6. Cross-Border Information Sharing

6.1 Sharing Taxpayer Information

Ruling Exchanges

APAs, advance tax rulings (ATRs) and innovation box rulings are exchanged with the tax authorities in the jurisdictions in which the involved parties are tax resident.

DAC6

Cross-border structures that fulfil certain hallmarks must be reported and subsequently exchanged with other EU countries. The TP hallmarks in DAC6 are the hallmarks under E, which are:

- E.1 – cross-border arrangements that rely on a unilateral safe-harbour rule;
- E.2 – arrangements that involve hard-to-value intangibles; and
- E.3 – intragroup cross-border transfers of assets, functions and risks where the projected annual EBIT – during the three years after the transfer – amounts to less than 50% without the transaction.

Bilateral Approach

The Netherlands has been actively concluding Tax Information Exchange Agreements (TIEAs). On a bilateral level, the Netherlands is concluding TIEAs specifically aimed at the exchange of information and is including provisions in accordance with Article 26 of the OECD Model Convention. Since 2009, around 28 TIEAs have been concluded.

Domestic Law

Based on the International Assistance (Levying of Taxes) Act (*Wet op de internationale bijstandsverlening bij de heffing van belastingen*, or WIBB), information is provided to foreign competent authorities upon request if there is a financial services company that does not have sufficient substance in the Netherlands. No exchange of information will be applicable if the financial services company fulfils the substance requirements. Spontaneous exchange of information is also possible if that exchange may lead to specific tax consequences in foreign countries (eg, a withholding tax reduction that would otherwise not have been granted).

7. Advance Pricing Agreements (APAs)

7.1 Programmes Allowing for Rulings Regarding Transfer Pricing

The Netherlands has a programme that allows APAs. The rules and procedures for obtaining an APA are set out in the Decree of 28 June 2019, Stcrt No 2019/13003 for rulings with an international character and its latest amendment – Decree of 19 December 2023, Stcrt No 2023, 25745. Bilateral and multilateral APA programmes are also implemented in the Netherlands through the above-mentioned decrees.

The DTA aims to issue a decision on an APA request between six and eight weeks after it has been provided with all the relevant information. Obviously, the time span from start to finish depends on the complexity of the case.

7.2 Administration of Programmes

The DTA and, especially, the International Tax Certainty Team administer the APA programme, which concerns agreements on the pricing of intercompany transactions for future years. If a taxpayer wishes to obtain an APA, a request has to be filed with the local competent tax inspector and the International Tax Certainty Team. The International Tax Certainty Team carries out the procedure in consultation with the local competent tax inspector. Before requesting the APA, there is the possibility of a pre-filing meeting with the DTA. During this pre-filing meeting, the necessary information and the elements that are important in the specific case for the assessment of the APA request are discussed.

Regarding settlement agreements and current and prior-year TP issues, the co-ordination of transfer pricing within the DTA is in the hands of the Transfer Pricing Co-ordination Group. Tax inspectors within the DTA have to seek (binding) advice from a member of the Transfer Pricing Co-ordination Group when dealing with transfer pricing matters. This creates a unity of policy and application of the transfer pricing rules.

7.3 Co-ordination Between the APA Process and Mutual Agreement Procedures

In practice there is co-ordination between the APA process and MAPs, however MAPs are the competency of the Ministry of Finance and the DTA while APAs are co-ordinated through the DTA. Furthermore, in the new decree concerning the MAP, it is stipulated that the information to be included in a request for a bilateral APA or a multilateral APA is the same as the information to be provided in a request for a unilateral APA. If a request for a bilateral APA is filed, it is necessary to also file a request for a unilateral APA at the same time.

7.4 Limits on Taxpayers/Transactions Eligible for an APA

According to the Decree of 28 June 2019, Stcrt No 2019/13003, three requirements have to be met in order to obtain an APA:

- sufficient economic nexus in the Netherlands relating to the transactions involved;
- no transactions that involve designated low-tax jurisdictions or jurisdictions that are on the EU blacklist; and
- the saving of Dutch or foreign tax is not the sole or decisive motive for performing the (legal) act(s) or transaction(s).

An APA request must contain relevant information and substantiate the TP methods applied. According to the amendment of the decree in 2023, the following information has to be included in an APA request:

- the master file, as referred to in Section 29g of the DCITA for qualifying MNEs;
- relevant financial information, information about the products and a functional analysis;
- a description of the proposed transfer pricing methodology, including comparability analysis;
- assumptions supporting the APA request;
- a description of the contractual terms, business strategy and market conditions;
- the financial years for which the security is requested;
- confirmation that none of the directors of the company is on the EU blacklist; and
- a draft standard form for the exchange of cross-border information exchanges.

If a taxpayer does not provide the required information, an APA request can be denied.

7.5 APA Application Deadlines
In the Netherlands, there is no formal deadline for submitting an APA request. However, it is not possible to include fiscal years for which a tax return has already been filed under an APA.

7.6 APA User Fees
No filing fees have to be paid for requesting and/or obtaining an APA.

7.7 Duration of APA Cover
The taxpayer shall, first of all, indicate the period for which the APA is requested. In principle, the ruling will be valid for a maximum of five fiscal years. If the facts and circumstances justify an exception – for example, in the case of long-term contracts – a maximum term of ten financial years may be applied, with at least an interim review after five years.

7.8 Retroactive Effect for APAs
An APA can have limited retroactive effect upon request, provided that the facts and circumstances have not changed since the period for which the taxpayer is requesting an APA and that the retroactive effect does not result in a lower taxable profit which is ultimately not taxed anywhere. For multilateral or bilateral APAs a roll-back is possible if all the countries involved agree that it is the correct application of the arm's length principle and if they process this application accordingly. Again, it may not lead to profit that remains untaxed.

8. Penalties and Documentation

8.1 Transfer Pricing Penalties and Defences
In practice, the DTA does not usually impose penalties in transfer pricing cases. Under the law it may, however, decide to impose penalties for not having the required TP documentation available when due, or for non-compliance with CbCR obligations.

TP Documentation
For intentionally not having the documentation ready when required, imprisonment for up to six months or a fine of up to EUR20,250 can be imposed. The fine can be higher when not having the documentation leads to under-levied tax for a higher amount. It is, however, unlikely that the tax authorities will impose imprisonment.

For non-standardised TP documentation for small and medium-sized enterprises (consolidated annual revenue below EUR50 million), the obligations are less strict. The DTA's policy is to grant the taxpayer a reasonable period of time to hand in appropriate TP documentation. The reasonable period of time is generally four to six

weeks. Master file/local file documentation, on the other hand, is in principle due upon request, if the applicable corporate income tax return filing deadlines have passed.

Country-by-Country Reporting

Based on Article 29h(1) of the DCITA, the taxpayer may receive an administrative fine for deliberate or grossly negligent failure to comply with the obligation to submit a country-by-country (CbC) report or to file a notification that another group entity will file the report. The administrative fine will not exceed the amount of the sixth category (*Wetboek van Strafrecht*) as referred to in Article 23(4) of the Dutch Penal Code (ie, EUR870,000).

The administrative fine is imposed by means of a fine decision. Pursuant to the General Administrative Law Act (*Algemene wet bestuursrecht*), objections against such a decision can be submitted to the DTA. Following the objection, a new decision is taken. An appeal against this decision can be filed with the administrative court.

8.2 Taxpayer Obligations Under the OECD Transfer Pricing Guidelines

Specific transfer pricing documentation may be required depending on the annual consolidated revenue of the MNE. The Netherlands requires a master file, as well as a local file for MNEs with a consolidated annual revenue of EUR50 million or more, and a CbC report and notifications for MNEs with a consolidated annual revenue of EUR750 million or more. Both have been introduced starting in FY 2016. The Netherlands has implemented the master file/local file and CbCR requirements in accordance with the OECD/G20 BEPS Action Plan 13.

9. Alignment With OECD Transfer Pricing Guidelines

9.1 Alignment and Differences

In January 2022, the OECD Transfer Pricing Guidelines were updated. This update includes the addition of Chapter X to the Guidelines on transfer pricing aspects of financial transactions. In addition, a section on hard-to-value intangibles has been added.

In June 2022, the Dutch Decree Stcrt No 2022/16685 was updated as follows:

- The section on government policy has been expanded, with a discussion on government aid measures (COVID-19 pandemic).
- Several new sections on financial transaction have been adjusted. There is more focus on substance and the application of the comparable uncontrolled price method. The paragraphs regarding guarantees and captives have also been rewritten.
- There is now a section regarding cash pools.
- There is now a section regarding financial service entities.
- Adjustments have been made to the policy on intra-group services.
- Some textual changes in line with OECD TP Guidelines have been made.

The adjustments are a consequence of international developments, such as the new OECD TP Guidelines and OECD publications on the treatment of government subsidies. Since the OECD Guidelines provide an internationally accepted interpretation of the arm's length principle, the secretary of finance considers the OECD Guidelines to be an appropriate explanation and clarification of the principle described in Article 8b of the DCITA.

Case Law

The Netherlands does have some specific case law regarding financial transactions, which involves a landmark case from 1988 (27 January 1988, No 23 919). The main conclusions were that intercompany loans can only be recharacterised as equity if they possess specific features, either being a loss-financing loan, a profit-participating loan or sham loan. Those definitions have been precisely defined in case law. There seem to be relevant differences between this case law and the new Chapter 10 of the OECD TP Guidelines. The new transfer pricing decree recognises this difference and it notes that if a taxpayer requests advance certainty on the application of the arm's length principle, the OECD TP Guidelines will be taken as the starting point.

New Decree

Lastly, a new decree has removed the approved policy to charge only the relevant actual costs in the case of low-value added services. This is replaced by a brief reference to the OECD TP Guidelines, in which the option to re-charge on a cost basis can still be applied. This probably implies that the DTA will have a less flexible stance on remunerating low-value added services on a cost basis.

9.2 Arm's Length Principle

The arm's length principle is the leading principle for transfer pricing purposes. The principle is also codified in Dutch tax law. There are no circumstances in which another principle would be applicable. In parliamentary history it is stipulated that, in the Netherlands, taxable profit is determined on the basis of the arm's length principle in accordance with the interpretation agreed within the OECD.

9.3 Impact of the Base Erosion and Profit Shifting (BEPS) Project

The Dutch interpretation of the arm's length principle has not changed significantly following the BEPS project, as indicated in the TP Decree. The documentation standards have, however, become more extensive. The TP team of the DTA has grown over time and there has therefore been an increase of TP audits or questionnaires.

9.4 Impact of BEPS 2.0

The Netherlands has consistently supported the Pillar One and Pillar Two proposals and continues to support their swift implementation. It is expected that the Pillar One and Pillar Two rules will result in an increased administrative burden for taxpayers that fall under the scope of Pillar One and Pillar Two. Besides, the interaction between the Pillar One and Pillar Two systems and double tax treaties is unclear, which could lead to uncertainty for taxpayers. The complexity and the different possible interpretations of the Pillar One and Pillar Two rules could lead to discussions with the DTA. This remains uncertain, however, since final international agreement has not been reached and it therefore needs close monitoring.

9.5 Entities Bearing the Risk of Another Entity's Operations

It is allowed for group companies to provide guarantees (eg, for bank loans). The pricing of the guarantees should be in line with the arm's length principle and thus also with the accurate delineation of the transaction.

10. Relevance of the United Nations Practical Manual on Transfer Pricing

10.1 Impact of UN Practical Manual on Transfer Pricing

Dutch TP legislation and decrees do not officially refer to the UN Practical Manual on Transfer Pricing. The UN Manual is, however, also based on the arm's length principle and has the goal of making transfer pricing more understandable in practice. The DTA will therefore generally be open to explanations that are based on the UN Manual.

11. Safe Harbours or Other Unique Rules

11.1 Transfer Pricing Safe Harbours

Low-value-adding services are a safe harbour. A mark-up of 5% may be applied for specific services without the generally required comparability study. The low-value-adding services doctrine of the OECD is referred to in the Dutch TP Decree. It thus applies to intercompany services that:

- are of a supportive nature;
- are not part of the core business of the MNE group (ie, not creating the profit-earning activities or contributing to the economically significant activities of the MNE group);
- do not require the use of unique and valuable intangibles and do not lead to the creation of unique and valuable intangibles; and
- do not involve the assumption or control of substantial or significant risk by the service provider and do not give rise to the creation of significant risk for the service provider.

There is also a safe harbour for back-to-back financial transactions that are conducted by limited risk intra-group service providers. The equity at risk relating to these transactions should be at least 1% of the loan volume or EUR2 million. This serves as a de facto safe harbour, although benchmark studies are required to determine the pricing. This specific policy is currently being investigated by the government. The proposed European Anti-Tax Avoidance Directive III ("ATAD 3"), which targets misuse of shell companies, may speed up this process.

11.2 Rules on Savings Arising From Operating in the Jurisdiction

The OECD Transfer Pricing Guidelines considers location savings as a comparability factor. The Netherlands follows the OECD Transfer Pricing Guidelines for the application of the arm's length principle and also the guidance concerning location savings. There are no specific domestic rules.

11.3 Unique Transfer Pricing Rules or Practices

Since the Netherlands follows the OECD Transfer Pricing Guidelines, no other unique rules are applicable in the transfer pricing context. Although one should take into account the recently introduced transfer pricing mismatch legislation that is covered in **1.2 Current Regime and Recent Changes**.

12. Co-ordination With Customs Valuation

12.1 Co-ordination Requirements Between Transfer Pricing and Customs Valuation

While there is not operational co-ordination between the Dutch customs authorities and the

DTA, since these are separate organisations, they co-operate closely if required on a case-by-case basis.

13. Controversy Process

13.1 Options and Requirements in Transfer Pricing Controversies

Controversy Process

In the event of a tax controversy, the DTA initially attempts to enter into discussions. A taxpayer will be given the opportunity to explain how the transfer pricing works and to provide additional relevant information.

Court proceedings only occur if no common ground can be found during these discussions and if the case is considered sufficiently important for the DTA from both a technical and a financial perspective.

In principle, a transfer pricing dispute does not differ from any other dispute between tax authorities and taxpayers. Eventually, the inspector will or will not make a correction and this can be challenged in an objection to the DTA and in subsequent appeal proceedings.

After the taxpayer has objected to the DTA, the taxpayer can make an appeal before the district court. After the district court has issued a judgment, an appeal can be initiated with the Court of Appeal and then with the Dutch Supreme Court.

Since transfer pricing discussions are often complex and extensive, such procedures tend to take a long time. It is also important to note that the judges involved are generally not transfer pricing specialists and it is difficult to predict the outcome of proceedings. Since transfer pricing is not an exact science, the burden of proof is relatively important.

MAPs and Arbitration

On the basis of a tax treaty, a MAP is (usually) possible between tax authorities with the aim of eliminating double taxation (Stcrt No 2020/32689). Although a MAP between countries based on a bilateral tax treaty will often lead to a result whereby no double taxation remains, this is certainly not guaranteed. This can therefore lead to double taxation taking place. Currently, there is a trend towards including a mandatory arbitration clause in tax treaties to ensure that double taxation is avoided in all cases (eg, the EU Arbitration Convention and the arbitration provisions in the Multilateral Instrument).

14. Judicial Precedent

14.1 Judicial Precedent on Transfer Pricing

There is not much litigation in the area of transfer pricing since most disputes are settled without going to court. The DTA usually only institutes legal proceedings in cases where the parties cannot agree from a theoretical perspective and where the financial impact is significant.

14.2 Significant Court Rulings

Supreme Court 8 May 1957, No 12 931, BNB 1957/208

For the purpose of determining the parent company's profit, transactions with subsidiaries must be reported as if they had taken place with a third party. The taxpayer argued that profit should only be reported as soon as a transaction with third parties had taken place, but the Supreme Court rejected this reasoning. Internal transactions thus cannot be delayed until external transactions have taken place, but should

be accounted for in accordance with the arm's length principle.

Court of Appeal's Gravenhage 13 June 1984, No 87/84, BNB 1986/13

The Court of Appeal considered a 10% mark-up on services purchased from an Irish group company reasonable. It had been considered customary to determine the compensation for the services rendered in relation to the costs incurred. What the taxpayer paid over and above this 10% was part of the taxpayer's profit.

Supreme Court 28 June 2002, No 36 446, BNB 2002/343

The Supreme Court ruled that the burden of proof that the taxpayer had not been dealing at arm's length rested with the tax inspector and that the tax inspector did not meet this burden of proof. The Supreme Court also referred to the OECD Guidelines for the application of the arm's length principle and transfer pricing methods. The case was about a car importer of an international car brand that incurred a loss relating to import and sales of its most-sold car. However, over the total of goods imported and sold, the car importer remained profitable. The potential existence of offsetting transactions was acknowledged. The tax inspector unsuccessfully claimed that the purchase price of the most-sold car was too high.

Court of Appeal Amsterdam 20 August 2003, No 01/04083, V-N 2004/30.16

This case concerned a flow-through company with nearly risk-free intra-group borrowing and lending activity. According to the court, a cost-plus surcharge of 10% was appropriate in this case. The Ministry of Finance did not file an appeal in cassation but published that according to APA practice, the compensation should be related to the loan amount. For loan amounts below EUR100 million, this can be partly determined on a cost-plus basis.

Court Arnhem 7 March 2007, No AWB 06/288, V-N 2007/35.6

The court ruled on transfer prices between the taxpayer and its Chinese affiliate. The tax inspector succeeded in proving that the transfer prices were not arm's length in so far as the compensation for the limited procurement activities of the Chinese affiliate exceeded a cost-plus mark-up of 10%.

Supreme Court 25 November 2011, No 08/05323

The Supreme Court ruled that if the interest rate on a loan between related parties was not determined in accordance with the arm's length principle, an interest rate that complies with this principle must be used to calculate the taxable profit. If it is not possible to find an interest rate for which a third party would be willing to provide the loan under the same conditions and the loan thus de facto becomes a profit-sharing loan, the loan will be labelled non-businesslike (*onzakelijk*). Such a loan cannot be depreciated for tax purposes.

Court of Appeal's-Gravenhage 13 March 2020, No 17/00714, V-N 2020/25.9

The taxpayer operates an entrepreneurial zinc smelter, being part of an international group. In 2010, it was decided to transfer the group's headquarter to Switzerland, accompanied by a gradual transfer of functions amongst which was central procurement. At some point the taxpayer qualified its Dutch activities as toll manufacturing while the tax authorities took the position that more high-value-adding functions were still involved. The Court of Appeal ruled that the profit-split method should be considered an appropriate method to determine the compensation

for the business restructuring and therefore agreed with additional assessments imposed by the tax authorities. After the decision of the Court of Appeal, partly in favour of the tax payer, the parties settled on the arm's length amount for the compensation.

15. Foreign Payment Restrictions

15.1 Restrictions on Outbound Payments Relating to Uncontrolled Transactions

There are no restrictions on outbound payments related to uncontrolled transactions.

15.2 Restrictions on Outbound Payments Relating to Controlled Transactions

There are no restrictions on outbound payments related to controlled transactions. However, as per 2021, Dutch tax law includes a new conditional withholding tax of 25.8% on intra-group interest and royalty payments to entities in selected low-tax jurisdictions.

15.3 Effects of Other Countries' Legal Restrictions

There are no specific domestic rules regarding the effects of other countries' legal restrictions.

16. Transparency and Confidentiality

16.1 Publication of Information on APAs or Transfer Pricing Audit Outcomes

A summary will be published for each APA with an international character. This summary will include a brief explanation of the facts and circumstances and – as far as is relevant – of the main conclusions from transfer pricing reports or other documents, an analysis of the requested tax ruling based on the relevant laws and regulations, and the conclusion on the basis of which the APA was granted.

A summary will also be published when the ruling request did not result in a ruling. The summary will then include an explanation of why the ruling was not concluded.

The summary will be anonymised in such a way that it cannot be traced back to an individual taxpayer.

The outcome of TP audits is confidential and will not be published.

16.2 Use of "Secret Comparables"

In principle, the DTA does not use secret comparables to substantiate pricing adjustments. They may, however, use secret comparables in their TP risk assessment if doing so is considered appropriate and necessary.

Trends and Developments

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Loyens & Loeff is a leading legal and tax partner for those doing business in or from the firm's home markets of the Netherlands, Belgium, Luxembourg and Switzerland. The firm has 1,000 advisers based in its offices in the Benelux countries and Switzerland, as well as in key financial centres around the world. The lawyers in this full-service practice have both sector-specific experience and a thorough understanding of the market. The Loyens & Loeff transfer pricing team provides a hands-on and tailor-made approach to transfer pricing. The team of around 30 tax lawyers and economists is able to provide integrated solutions on all relevant transfer pricing issues. The team offers advice on strategy, quantitative transfer pricing, dispute resolution and documentation, and has particular expertise in pricing shareholder loans using economic modelling.

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Introduction

The Dutch transfer pricing landscape was impacted by various developments in 2023 and early 2024. Amongst others, these developments consist of clarifications around the transfer pricing mismatch legislation that was introduced in 2022 and case law addressing several transfer pricing topics. This article will furthermore address both European and broader international developments impacting the Dutch transfer pricing landscape, including the transfer pricing impact of Pillar Two, the proposal for an EU directive on transfer pricing, and Amount B.

Transfer Pricing Mismatch Legislation

As of 1 January 2022, the Netherlands has legislation in its Dutch Corporate Income Tax Act (CITA) that aims to eliminate double non-taxation through transfer pricing mismatches. The legislation requires Dutch taxpayers to ensure that intercompany transactions are priced at arm's length and correctly documented. Otherwise, this new legislation could potentially result in adverse Dutch corporate income tax (CIT) consequences.

The legislation includes three main elements:

- Article 8bb CITA allows no downward adjustment of the Dutch taxable profit without a corresponding upward adjustment;
- Article 8bc CITA allows no adjustment in the Dutch tax basis to the arm's length value for asset and liability transfers to the extent that no corresponding adjustment is taken into account in the transferor's profit tax base; and
- Article 8bd is applicable to contributions, distributions, and (de)mergers, pursuant to which the Dutch CIT base is at maximum (for assets) or at minimum (for liabilities) the value included in the transferor's tax base.

Also, the legislation contains a transitional rule that applies to asset transfers that took place between 1 July 2019 and 1 January 2022 and that would have been affected by the transfer pricing mismatch legislation, had the legislation been in force at the time. In that case, the transitional rule limits the depreciation amount to be taken into account by a Dutch taxpayer going forward (ie, from the financial years starting on or after 1 January 2022).

In practice, the (non-)applicability of Article 8bd CITA led to much uncertainty for taxpayers. On 24 January 2023, the Dutch State Secretary of Finance (the "State Secretary") issued a decree clarifying that capital contributions and distributions to a Dutch entity by an entity that is not subject to a profit tax are not affected by this provision, provided that the fair market value is included in the related civil law documentation and annual accounts. For certain situations and entities, the decree provides a comparable "fallback" position to that envisioned in Articles 8bb and 8bc of the CITA, meaning that the contractually agreed or imposed price (even if not at arm's length) would be used for Dutch CIT purposes if there is no corresponding adjustment. The clarification by the State Secretary reduces uncertainties, especially concerning pension funds and other exempt entities.

In addition, two helpful knowledge group positions ("KG Positions") were published in June 2023. These KG Positions clarify the Dutch Tax Authorities' (DTA's) interpretation of the scope of the transfer pricing mismatch legislation in respect of contributions. The KG Positions were published as part of the DTA's recent policy to externally publish the views of its internal knowledge groups.

These KG Positions concern the contribution of impaired loan receivables against the issuance of shares. The DTA's knowledge group takes the position that these situations do not fall within the scope of Article 8bd of the CITA, even though there is a difference in value reported in the hands of the transferor and in the hands of the transferee. Both KG Positions confirm that there is no transfer of an asset within the meaning of Article 8bd of the CITA and that Dutch taxpayers therefore do not realise a taxable profit in relation to the debt release under the transfer pricing mismatch rules. The KG Positions provide a welcome clarification of the DTA's view on the scope of the rules, specifically in respect of contributions of an (impaired) receivable. Even though no general guidance is provided on the scope of Article 8bd of the CITA and the KG Positions in principle only apply to the specific cases at hand, the DTA's reasoning provides helpful arguments supporting the non-applicability of Article 8bd of the CITA in similar situations, such as for contributions involving entities that are disregarded for US tax purposes and tax-exempt entities. Nevertheless, the (non-)applicability of the transfer pricing mismatch rules remains peculiar, and specific situations might call for obtaining an advance tax ruling to provide the certainty taxpayers desire.

The Transfer Pricing Decree

On 1 July 2022, the State Secretary published the new Transfer Pricing Decree (the "TP Decree"), taking effect as of 2 July 2022. The TP Decree represents the views of the State Secretary (and, by extension, of the Dutch Ministry of Finance and DTA) on the interpretation of transfer pricing provisions, where taxpayers can still take deviating positions within the confines of Dutch legislation and case law. The TP Decree replaced the previous TP Decree from 2018, to be more aligned with the terminology of the 2022 OECD Transfer Pricing Guidelines (TPG). The main changes concerned the new guidance on financial transactions (ie, loans and guarantees) and the treatment of financial service companies (SCs).

Financial transactions

The updated section on financial transactions in the TP Decree has been aligned with the content of Chapter X of the TPG on financial transactions. This section emphasises, amongst other things, that it should first be determined whether a prima facie loan should be considered a loan for transfer pricing purposes. If adjusting the interest rate and/or other conditions of the loan transaction is not sufficient to make the transaction at arm's length, part of the loan may be reclassified to equity for transfer pricing purposes. The State Secretary believes that an arm's length interest charge should then be determined only for the remainder of the loan. However, a partial reclassification of a loan into equity, as now included in the TP Decree, contradicts the existing case law of the Dutch Supreme Court and it remains to be seen whether the view of the State Secretary will actually hold before court.

Financial service companies

The TP Decree further addresses the treatment of SCs. An SC is a company that predominantly (ie, more than 70%) receives and on-pays royalties, interest and lease payments within the group. The SC generally has limited risk either through the loan agreement or through a guarantee from the parent company. In the TP Decree, the State Secretary stresses that the arm's length remuneration of SCs must be aligned with the control over the credit risks and financial capacity to bear the potential negative consequences when such risks materialise.

On 12 February 2024, an independent working group of Dutch officials and external counsels (the "Working Group") published an extensive building blocks report containing policy recommendations to improve the Dutch tax system, amongst which is the recommended replacement of the current safe harbour rules for SCs. By virtue of the CITA, interest and royalties received and on-paid within the group by Dutch SCs are excluded from the Dutch taxable base if the SC does not incur real risk with respect to its conduit activities. This means, inter alia, that foreign withholding taxes are not creditable against Dutch CIT due. The CITA currently contains a safe harbour based on which SCs are deemed to incur a real risk if their equity equals at least (i) 1% of the outstanding loans or (ii) EUR2 million. The Working Group's policy recommendation suggests abolishing this safe harbour and replacing it with an open norm in line with the TP Decree. This would entail that a company must have sufficient control and financial capacity to manage its risks to (i) be allowed to credit withholding taxes, and (ii) account for the received and on-paid interest or royalties in its Dutch CIT base. It remains to be seen whether this recommendation will be followed by a new Dutch government and implemented in Dutch tax legislation.

Recent Relevant Dutch Case Law on Transfer Pricing

There has been an increase in litigation concerning transfer pricing in the Netherlands in the last few years. One of the recent Dutch court cases on transfer pricing addressed the use of implicit support for the purpose of determining a multinational entity's (MNE's) credit rating and the burden of proof in transfer pricing. The DTA disallowed a significant part of the deducted interest expenses and fully disallowed the deduction of commitment fees by a Dutch BV (private limited company), both in respect of certain intercompany loan facilities ("Facilities"). The interest rates for the Facilities were determined based on the credit rating of the BV, being the borrower under the Facilities. The DTA argued that the arm's length interest rates should have been lower due to the existence of implicit support from the parent company, which would enhance the BV's credit rating. The BV successfully challenged the claim of the DTA by providing statements from former bank employees, confirming that third-party lenders generally do not take into account implicit support when setting interest rates. In view of this case, it seems that the DTA cannot just assume the existence of implicit support without further substantiation.

The DTA also argued that the burden of proof had to shift to the taxpayer since the BV had not prepared contemporaneous transfer pricing documentation concerning the Facilities. Instead, the BV had prepared such documentation only after the DTA requested it to provide substantiation of the intercompany pricing. The court ruled that the DTA failed to prove that the BV's transfer pricing documentation contained errors that should have resulted in the conclusion that the BV had filed an incorrect CIT return. The fact that the BV prepared its transfer pricing documentation at a later stage (ie, only after the DTA's request) did not change this outcome.

In another case brought before the court, the DTA had relied, for its assessment, on internally prepared documents that were not necessarily prepared for tax purposes. Such documents included internal presentations, board minutes and external communication. The court considered that the content of these internal documents was relevant for assessing whether or not "something of value" had been transferred between affiliated entities, irrespective of how

such deemed transfer was contractually documented. In particular, these documents were used to substantiate that the taxpayer involved had been aware of an intercompany transfer of functions, assets and/or risks, as well as that such transfer involved material value for the parties involved.

Amongst other things, recent Dutch case law again stresses the importance for taxpayers of having adequate and preferably contemporaneous transfer pricing documentation in place. However, based on recent case law, it may also be possible to meet the transfer pricing documentation requirements even if the documentation was not prepared contemporaneously, provided that the documentation is appropriate, non-contradictory, and sufficiently comprehensive to substantiate the arm's length nature of the transaction.

Further Dutch transfer pricing litigation is anticipated, including the appeal of some of the above-mentioned cases, in the coming period.

Dispute Resolution and Prevention

The number of tax audits has increased substantially over the last few years in the Netherlands. These tax audits often focus on financial transactions, business restructurings (ie, including the onshoring of intellectual property), and the general transfer pricing policies of MNEs. Also in view of the above-mentioned increase in litigation, alternative dispute resolution and prevention has become even more relevant.

To avoid discussions, taxpayers may consider entering into a (bilateral) advance pricing agreement (APA). In view of some of the developments already mentioned, a bilateral APA is generally preferred over a unilateral APA. Although there is no obligation for the competent authorities to reach an agreement on a bilateral APA, successful outcomes are in most cases reached by the Dutch competent authority.

Internationally, discussions with tax auditors may lead to a mutual agreement procedure (MAP). The increasing number of MAPs is expected to persist, as transfer pricing discussions arise more frequently and more MAPs are expected. MAPs remain an attractive cross-border mechanism to resolve double taxation that often results from a unilateral correction by a tax authority, where the Dutch competent authorities reach a resolution in most cases even without mandatory binding arbitration.

International Developments Impacting the Dutch Transfer Pricing Landscape

The proposal for an EU Directive on Transfer Pricing

On 12 September 2023, the European Commission released a legislative proposal for a Council Directive that integrates key TP principles into EU law (the "TP Proposal"). The TP Proposal seeks to harmonise TP norms within the EU through the incorporation of the arm's length principle into EU law and the clarification of the role and status of the TPG. To ensure a common application of the arm's length principle, the 2022 version of the TPG will be binding when applying the arm's length principle in EU member states. If adopted unanimously in the EU Council, member states must apply the provisions as of 1 January 2026.

The TP Proposal differs somewhat from current Dutch tax legislation and regulations. Examples of these differences include the following.

- The definition of "associated enterprises" under the TP Proposal includes permanent establishments and natural persons. This is a

broader definition than currently relied on by certain member states, including the Netherlands. The definition contains a quantitative threshold of 25%, whereas Dutch tax legislation is currently based on an open norm based on Article 9 of the OECD Model Tax Convention.
- According to the TP Proposal, the arm's length range must be determined using the interquartile range. If a result falls outside the interquartile range, tax authorities must make an adjustment to the median. This rule is more stringent than current Dutch tax law, where the use of the interquartile range is not imposed and there is no obligation to adjust to the median.
- The TP Proposal requires taxpayers to have sufficient transfer pricing documentation available. The European Commission will further specify the documentation requirements at a later stage, but documentation comparable to a Local File may be required. Since the TP Proposal does not contain a revenue threshold, these documentation requirements could result in an additional compliance burden for taxpayers that currently do not fall within the scope of the Local File obligations.

The State Secretary informed the Dutch Parliament that the Netherlands would prefer the TP Proposal to be, as much as possible, in line with the TPG. Divergence from the TPG can lead to the arm's length principle being applied differently within the EU compared to outside it. In addition, the State Secretary stated that the TP Proposal seems to hold member states responsible for ensuring that transactions are in line with the arm's length principle. Instead, the Netherlands would prefer the TP Proposal to mandate that taxpayers themselves have the primary responsibility to ensure that cross-border transactions are entered into in accordance with the arm's length principle. In view of these Dutch reservations and those of other member states, it remains to be seen whether the TP Proposal will be implemented in its current form.

Transfer pricing aspects of Pillar Two

The Dutch domestic Pillar Two legislation has entered into force as of 1 January 2024. Pillar Two introduces the Global Anti-Base Erosion (GloBE) Rules, which seek to enforce a global minimum CIT at an effective rate of 15%, calculated on a jurisdiction-by-jurisdiction basis. Pillar Two applies to MNEs meeting the consolidated group revenue requirement of EUR750 million per year.

Pillar Two includes a specific provision on arm's length pricing that applies to in-scope MNE groups. This transfer pricing provision stipulates that transactions should be valued at arm's length prices, including transactions between non-Dutch entities and between a permanent establishment and the head office. Furthermore, the Pillar Two legislation contains specific provisions prescribing when adjustments in accordance with the arm's length principle can be booked and to exclude them if they result in double non-taxation. Where possible, making year-end adjustments not accounted for in previous consolidated annual financial statements, as well as other adjustments in later years, should be avoided. Adjustments that may take place in a later year might have an adverse Pillar Two effect due to the transaction not being correctly priced in the year of the review.

Where the Dutch transfer pricing mismatch legislation already places emphasis on consistent pricing within the group, this has become even more relevant now that Pillar Two has entered into force. The Pillar Two legislation requires taxpayers to ensure alignment between financials

and tax accounts in accordance with the arm's length principle. However, specific local transfer pricing rules (eg, the transfer pricing mismatch rules or the "non-businesslike loan" case law in the Netherlands) may make such alignment difficult. It remains to be seen whether the proposed TP Proposal can provide the desired harmonisation within the EU in this respect.

Pillar One – Amounts A & B

Pillar One's Amount A seeks to create a new taxing right for market jurisdictions, independent of the physical presence requirement and determined using a formulaic approach. Although a final agreement was nearly reached, the Multilateral Convention (MLC) text released on 11 October 2023 is not open for signatures yet. The Dutch State Secretary informed the Dutch Parliament that, even though the Netherlands remains in favour of an international agreement on Pillar One by means of an MLC, alternatives should be considered if a global agreement becomes less feasible. In this regard, the Netherlands would then prefer a European solution over a unilateral digital services tax.

On 19 February 2024, the OECD Inclusive Framework (IF) published the Pillar One Amount B Report. This Report provides guidance on an optional application of a simplified and streamlined approach ("S&S Approach") to baseline marketing and distribution activities. The S&S Approach provides a pricing framework that includes a three-step process to determine a return on sales for in-scope distributors. No minimum revenue threshold is applicable for the S&S Approach. Jurisdictions can choose to apply the S&S Approach for fiscal years beginning on or after 1 January 2025. The Report has been incorporated in the TPG as an Annex to Chapter IV. It remains to be seen how the S&S Approach will be further implemented in Dutch tax law and regulation. This could be effected through an update of the current TP Decree if the S&S Approach would be optional, whereas a mandatory application would require a change of law.

BEFIT

On 12 September 2023, the European Commission proposed a Council Directive on Business in Europe: Framework for Income Taxation (the "BEFIT Proposal"). The BEFIT Proposal contains a common CIT framework for groups active in the EU. If adopted within the timeframe envisaged by the Commission, member states must implement the BEFIT proposal by 1 January 2028 and apply its provisions as of 1 July 2028.

The BEFIT Proposal stipulates that in the first seven fiscal years following its implementation, transactions between entities that are subject to the BEFIT rules (ie, intra-BEFIT group transactions) are considered at arm's length if they are considered to be in "a low-risk zone". The "low-risk zone" would cover the expense incurred/income earned by a BEFIT group member from an intra-BEFIT group transaction that increases by less than 10% compared to the average amount of the income or expense in the previous three fiscal years. If this threshold is exceeded, the transaction is presumed not to be consistent with the arm's length principle, unless the BEFIT group member can provide evidence that the relevant intra-BEFIT group transaction was priced at arm's length.

The State Secretary informed the Dutch Parliament that the Netherlands expects BEFIT to increase compliance costs for tax authorities as well as for taxpayers, which would undermine BEFIT's goal of decreasing the administrative burden for tax authorities and taxpayers. As BEFIT will have a major administrative impact

for MNEs with a European footprint, it remains highly uncertain if, and when, member states will reach an agreement on its adoption.

Concluding Remarks

There have been many important transfer pricing developments in the Netherlands in 2023 and early 2024. The transfer pricing mismatch rules remain an attention point for Dutch taxpayers, where the published DTA's views on the scope of the rules provide welcome clarification. In addition, the introduction of Pillar Two, as of 2024, has made consistent pricing within the group and avoiding adjustments in later years even more important. Further, developments in recent Dutch case law increasingly require taxpayers to have comprehensive and, preferably, contemporaneous transfer pricing documentation. Taxpayers are, furthermore, recommended to closely monitor the various European and broader international developments affecting the Dutch transfer pricing landscape, including developments around the TP Proposal and the implementation of the S&S approach (ie, formerly known as Pillar One's Amount B).

PERU

Law and Practice

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+Value was established in 2017 through a strategic partnership between REM, Peru's leading law firm, and Tania Quispe, and is a boutique firm specialising in tax and transfer pricing consultancy. With a diverse team comprising economists, accountants and lawyers proficient in tax litigation, it provides comprehensive high-value-added services tailored to clients' needs. Tania Quispe and Martín Ramos, both former heads of the Peruvian Tax Administration, enrich +Value's experience in the public sector. With a unique approach that involves case reviews by multidisciplinary specialists, +Value ensures effective risk management and strategy planning. Competing in the high-end corporate segment, it stands out against the "Big Four" firms.

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1. Rules Governing Transfer Pricing

1.1 Statutes and Regulations

In Peru, the provisions related to transfer pricing regulations are ruled by Article 32-A of the Peruvian Income Tax Law (PITL) and by Chapter XIX of its Regulations.

Through these regulations, the following relevant aspects have been addressed:

- the definition of related parties;
- the criteria for applying adjustments to the value agreed upon by the parties;
- the conditions for determining the comparability of transactions;
- the methods to be used;
- the guidelines for enter into advance price agreements;
- sworn declarations; and
- other formal obligations that taxpayers must comply with, as well as specific regulation regarding the treatment of intra-group services.

It should be noted that, for the interpretation of the aforementioned regulations, the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, approved by the Organisation for Economic Co-operation and Development (OECD), are applied, as long as they do not oppose the provisions approved in Peruvian legislation.

1.2 Current Regime and Recent Changes

Transfer pricing regulations in Peru entered into force in 2001, following the amendment of Article 32 of the PITL in October 2000 by Law No 27356. These regulations incorporated the OECD Guidelines and directives that had been adopted by various countries in the region since 1997.

Thus, for tax purposes, Peruvian legislation incorporates the application of the transfer pricing methods for transactions between related parties. In addition, it has been established that transactions with non-co-operative countries or territories with low or no taxation are subject to the same consideration. Aspects related to the market value of the services, the transfer pricing methods to be applied, the definition of related parties and the definition of non-co-operative countries or territories with low or no taxation were specified in Supreme Decree No 045-2001-EF of 16 March 2001, which amended the Income Tax Law Regulations (ITLR).

However, one of the most significant changes to the Peruvian transfer pricing regime was the incorporation of Article 32-A into the ITL by Decree-Law No 945 of 23 December 2003. The legal provisions contained in this Article form the basis of the current Peruvian tax regime. Similarly, Chapter XIX of the ITL was incorporated into the ITL by Supreme Decree No 190-2005-EF of 30 December 2005, which entered into force on 1 January 2006.

In this way, regulations covered various aspects including related to the scope of application of the standard, the provisions for the application of adjustments (primary, correlative and secondary), the elements or circumstances to be taken into account for the comparability analysis, the transfer pricing methods, the determination of the interquartile range and the calculation of the median, the necessary documentation to support the prices, the rules on advance pricing agreements and the minimum information to be included as part of the Transfer Pricing Technical Report.

Regarding formal obligations, the parameters for having or not having a Transfer Pric-

ing Technical Report were first established in October 2006 by Superintendency Resolution No 167-2006-SUNAT, depending on the level of income and the amount of related party and non-co-operative countries or territories with low or no taxation transactions. Subsequently, on 30 May 2013, Superintendency Resolution No 175-2013/SUNAT was published, which also established the conditions for taxpayers to file the annual Transfer Pricing Informative Return through PDT No 3560.

However, in order to adapt local regulations to the new standard generated from the 15 Actions of the OECD BEPS project, the Decree-Law No 1312 entered into force on 1 January 2017, representing a significant change in the field of transfer pricing in Peru. This legal norm modifies the guidelines regarding Transfer Pricing Returns and compliance, establishing the criteria currently in force (see **1.1 Statutes and Regulations**). It also mandates submission deadlines for each obligation. In the same vein, Superintendency Resolution 014-2018/SUNAT of January 2018 established, among other things, the means for filing the Local File: Virtual Form No 3560, currently in use.

It is important to add that Decree-Law No 1312 also established the necessary conditions for the deduction of costs or expenses related to intra-group services, such as compliance with the Benefit Test and the provision of documentation and information to demonstrate the actual provision of the service, the nature of the service, the real need for the service, the costs and expenses incurred by the service provider, as well as reasonable criteria for their allocation.

Finally, the most recent amendments to the transfer pricing rules concern the treatment of imports and exports (Legislative Decrees Nos 1381 and 1537) and the rules applicable to exported or imported goods with a known price on the international market (Supreme Decree No 327-2022-EF).

2. Definition of Control/Related Parties

2.1 Application of Transfer Pricing Rules

Peruvian transfer pricing rules are applicable to:

- transactions carried out by taxpayers with their related parties;
- transactions carried out from, to or through non-co-operative countries or territories with low or no taxation; or
- transactions carried out with subjects whose income/gains from such transactions are subject to a preferential tax regime.

Consequently, it is necessary to have the relevant information, documentation and/or analysis that supports that, for tax purposes, the value assigned to goods, services and other benefits reflects the market value, in accordance with the arm's length principle.

Under Article 32-A of the PITL, two or more individuals, companies, or entities are considered related parties when one of them participates directly or indirectly in the administration, control or capital of the other; or when the same person or group of persons participate/s directly or indirectly in the management, control or capital of several individuals, companies or entities. Related-party status also applies when a transaction involves intermediary parties aimed at concealing a transaction between related parties.

Additionally, Article 24 of the ITLR regulates the assumptions and criteria for establishing related

party relationships. For example, here are some situations in which two or more individuals, companies or entities are considered related parties.

- When a natural or legal person owns more than 30% of the capital of another legal entity, directly or through a third party.
- When more than 30% of the capital of two or more legal entities belongs to the same natural or legal person, directly or through a third party.
- When more than 30% of the capital of two or more legal entities belongs to common partners of them.
- When there is a business collaboration contract with independent accounting, in which case the contract will be considered linked to those contracting parties that participate directly or through a third party, in more than 30% of the contract assets.
- When there is a joint venture contract, in which one of the partners, directly or indirectly, participates in more than 30% in the results or profits of one or more businesses of the partner, in which case it will be considered that there is a link between the partner and each of his/her associates.
- When there is the existence of permanent establishments, applicable to non-resident companies with establishments in the country or resident companies with establishments abroad.
- When the exercise of dominant influence over management decisions, indicating control over other entities' management bodies.
- When there is a significant proportion of transactions between the parties – this is the case when 80% or more of a party's transactions involve related parties, constituting at least 30% of the counterparty's transactions.

3. Methods and Method Selection and Application

3.1 Transfer Pricing Methods

The PITL establishes that transaction prices agreed upon in transactions – subject to transfer pricing rules – will be determined in accordance with any of the following accepted international methods, considering the most appropriate method to reflect the economic reality of the operation:

- Comparable Uncontrolled Price Method (CUPM);
- Resale Price Method (RPM);
- Cost Plus Method (CPM);
- Profit Split Method (PSM);
- Residual Profit Split Method (RPSM); and
- Transactional Net Margin Method (TNMM).

It should be noted that, unlike the OECD Guidelines, which consider residual profit split analysis as part of the profit split method, the PITL treats them as independent transfer pricing methods.

3.2 Unspecified Methods

PITL considers the application of "other methods" when, due to the nature and characteristics of the activities and transactions, it is not appropriate to apply any of the previously mentioned methods. In this regard, it should be added that PITL also indicated that the application of the "other methods" would be carried out in accordance with what is outlined in the PITL Regulations. However, given that to date the referred Regulations have not yet established these provisions, it is currently not possible to apply methods other than those indicated in **3.1 Transfer Pricing Methods**.

3.3 Hierarchy of Methods

PITL states that, in order to establish the most appropriate transfer pricing method, the following must be considered.

- The one that is most compatible with the line of business, business or commercial structure of the company or entity.
- The one that has the best quality and quantity of information available for its adequate application and justification.
- The one that contemplates the most adequate degree of comparability between parties, transactions and functions.
- The one that requires the lowest level of adjustments in order to eliminate the existing differences between the comparable facts and situations.

It should be added that, for purposes of applying the most appropriate transfer pricing method, the concepts of costs of goods and services, production costs, gross profit, expenses and assets will be determined based on the provisions of the International Accounting Standards, provided that they do not oppose the provisions of the PITL. Therefore, Peruvian regulations have not established a hierarchy of methods.

Notwithstanding the foregoing, the PITL indicates that in export or import operations of goods (listed in Annex 2 of the PITL Regulations) with known quotation in the international market, local market or destination market, including those of derivative financial instruments, or with prices that are fixed taking as a reference the quotations of the indicated markets, the market value is determined on the basis of such quotation values. In these cases, the method to be used is the CUPM; however, the PITL adds that, in case the taxpayer uses a different method for the analysis of the transactions, the corresponding supporting documentation must be submitted to the tax administration, as well as the economic, financial and technical reasons justifying its use.

3.4 Ranges and Statistical Measures

The PITL Regulations establish that, for determining the price, consideration amount, or profit margin that would have prevailed among independent parties in comparable transactions and resulting from the application of any of the previously mentioned methods, a range of prices, consideration amounts, or profit margins should be obtained when there are two or more comparable transactions.

It should be noted that if the value agreed upon by the related parties falls within this range, it will be considered as agreed upon at market value. On the contrary, if the agreed value falls outside this range and, as a result, a lower income tax is determined in the country for the respective fiscal year, the market value will be the median of that range. The range will be calculated using the interquartile method.

Finally, concerning the application of the CUPM, if the transactions exhibit a high level of comparability, the range will establish the minimum value at the lowest of the prices or consideration amounts of the comparable operations and the maximum value at the highest of these. For this purpose, the prices or consideration amounts of the comparable transactions are considered to have a high level of comparability if the coefficient of variation applied to the values of the comparable transactions does not exceed 3%.

3.5 Comparability Adjustments

The PITL Regulations establishes that it is possible to eliminate differences (through reasonable adjustments) between the transactions being

compared or between the characteristics of the parties conducting them or the functions they perform.

To achieve this, consideration must be given, among others, to the following elements, as applicable:

- payment terms;
- quantity negotiated;
- advertising and publicity;
- intermediary costs;
- packaging;
- freight;
- insurance; and
- physical and content nature.

4. Intangibles

4.1 Notable Rules

The PITL has not established specific or special rules for intangible assets; however, Peruvian regulations rely on the OECD Guidelines and the final report of Actions 8-10 of the BEPS Plan as sources of interpretation for the treatment of such operations.

Notwithstanding the above, the Regulations stipulate that in order to conduct a proper comparability analysis, certain criteria reflecting the economic reality must be considered. Therefore, in the case of transactions related to the transfer or use of intangible assets, factors such as the contractual typology of the intangible, identification and characteristics, duration, degree of protection, and expected benefits of its use should be taken into account.

Additionally, concerning the application of the most appropriate valuation method, the Regulations provide guidelines for determining transfer prices associated with intangible assets.

- Regarding the application of the CUPM, it is indicated that it is not suitable for transactions involving the definitive transfer or use of significant intangible assets, nor when the involved intangible products or assets are not comparable in nature or quality.
- Additionally, with regard to the RPSM, it is underscored as an approach for transactions within closely integrated intercompany operations, particularly when significant intangible assets are present, rendering segregation impractical and imprecise.

4.2 Hard-to-Value Intangibles

The PITL does not have a specific or special rule for the treatment of hard-to-value intangibles. As mentioned before, Peruvian regulations use the OECD TP Guidelines as a source of interpretation.

4.3 Cost Sharing/Cost Contribution Arrangements

The PITL lacks a specific or specialised provision for Cost Sharing Agreements concerning intangibles among related parties. However, Article 117 of the Regulations mandates that the Master File must at a minimum include a group policy on intangibles, which encompasses a listing of significant agreements on intangibles entered into between related parties, particularly cost sharing agreements.

5. Affirmative Adjustments

5.1 Rules on Affirmative Transfer Pricing Adjustments

Taxpayers are allowed to submit substitute and/or rectifying declarations for the informative returns:

- Local File;
- Master File; and
- Country-by-Country Report (CbCR).

Regarding the Local File, pursuant to Superintendence Resolution No 014-2018/SUNAT, the taxpayer required to submit the referred return may substitute and/or rectify it. This requires re-entering all the required information in Virtual Form No 3560; said declaration renders the last one submitted null and void.

Similarly, under Superintendence Resolution No 163-2018/SUNAT, taxpayers have the option to submit rectifying returns for the Master File. This process involves entering all the required information in Virtual Form No 3561, including data they do not intend to replace or rectify. Additionally, this rectifying return supersedes any previously submitted ones. Likewise, entities obligated to submit the CbCR return may substitute and/or rectify it by re-entering all the required information in the IR Automatic Exchange of Information (AEOI) system, including data they do not wish to substitute or rectify. However, it is important to note that if, as a result of an audit procedure, the taxpayer accepted the adjustments imposed by SUNAT, and these adjustments are linked to the aforementioned informative sworn statements, they can no longer be modified or rectified.

6. Cross-Border Information Sharing

6.1 Sharing Taxpayer Information

Currently, Peru has entered into Double Taxation Treaties (DTTs) with the following countries: Chile, Canada, Brazil, Mexico, South Korea, Switzerland, Portugal and Japan, all of which include clauses for information exchange.

Moreover, Peru is a member of the Convention on Mutual Administrative Assistance in Tax Matters, which involves 147 jurisdictions. Additionally, Peru is a participant in the Global Forum on Transparency and Exchange of Information for Tax Purposes of the OECD.

Regarding information exchange related to transfer pricing, Peru has activated agreements for automatic exchange of information concerning CbCR. As of March 2024, Peru can receive CbCR information from 75 jurisdictions worldwide and can send such information to 94 jurisdictions worldwide.

7. Advance Pricing Agreements (APAs)

7.1 Programmes Allowing for Rulings Regarding Transfer Pricing

The PITL stipulates that the Peruvian tax administration may enter into Advance Pricing Agreements (APAs) with taxpayers domiciled in the country, whereby the valuation of various transactions falling within the scope of transfer pricing rules is determined based on the methods and criteria previously mentioned. Furthermore, the PITL specifies that the Peruvian tax administration may also conclude APAs with other tax administrations of countries with which Peru has entered into an international agreement

to avoid double taxation. It is worth reiterating that, currently, Peru has signed DTTs with: Chile, Canada, Brazil, Mexico, South Korea, Switzerland, Portugal and Japan. Additionally, Peru is a party to Decision 578 of the Andean Community (CAN), establishing the Regime to prevent double taxation and prevent tax evasion among member countries: Bolivia, Colombia, Ecuador and Peru. However, to date, Peru has not yet signed any APAs.

7.2 Administration of Programmes

APAs are administered by the Peruvian tax authority (SUNAT). In relation to the conclusion of APAs with taxpayers domiciled in the country, the Regulations of the PITL have governed the following important aspects: the features of APAs, the presentation and content of the proposal, the period for evaluating the proposal, the acceptance or rejection of the proposal, the execution and duration of the advance pricing agreements, the modification and invalidation of the APA, the auditing authority, the submission of an annual report, and other relevant matters.

7.3 Co-ordination Between the APA Process and Mutual Agreement Procedures

With regard to the conclusion of APAs with tax authorities of countries with which Peru has entered into Double Taxation Treaties (DTTs), the PITL Regulations have indicated that this will be carried out within the framework of the amicable procedures provided for therein. Furthermore, it is worth noting that SUNAT has published a Guide to the Mutual Agreement Procedure (MAP) established in agreements to avoid double taxation and prevent tax evasion and avoidance in relation to income tax and assets.

In this regard, the MAP is a procedure that is carried out when the taxpayer considers that the measures taken by one or both contracting states imply, or may imply, taxation that is not in accordance with the provisions of the DTT or encounter difficulties and doubts arising from the interpretation or application of a DTT, regardless of the remedies provided for in the domestic law of those contracting states. Now, among the matters that may be submitted to a MAP are transfer pricing adjustments.

7.4 Limits on Taxpayers/Transactions Eligible for an APA

With respect to the execution of APAs with taxpayers domiciled in the country, the Regulations of the PITL have outlined that these are civil law agreements entered into between the Tax Administration (SUNAT) and taxpayers domiciled in Peru engaging in transactions with related parties. These agreements cover transactions conducted to, from, or with entities located in non-co-operative or low- or no-tax jurisdictions, or transactions involving entities subject to a preferential tax regime.

However, the Regulations also specify that the proposal will not be approved if it is demonstrated that the taxpayer or any related parties involved in the transactions to be covered by the APA, or their representatives acting as such (in the case of legal entities), have an outstanding conviction for tax or customs offences. Additionally, while there are no established limits regarding the transactions, the Regulations have provided guidelines for the approval or rejection of the proposal to enter into APAs. Furthermore, it has been stipulated that these agreements will apply to the ongoing taxable year at the time of approval and for the subsequent three taxable years. Regarding the conclusion of APAs with tax administrations, the PITL has restricted them to countries with which Peru has entered

into international agreements to avoid double taxation.

7.5 APA Application Deadlines

The PITL specifies that SUNAT may enter into APAs with taxpayers domiciled in Peru to establish the valuation of transactions within the scope of transfer pricing rules, utilising the established methods and criteria. Pursuant to Superintendence Resolution No 377-2013/SUNAT, SUNAT has outlined various provisions for the execution of APAs between domiciled taxpayers and SUNAT. These provisions detail the format, deadlines, and conditions for holding preliminary meetings, submitting the supporting information and documentation for the APA proposal, including any modifications to the proposal, the procedures and requirements for formalising APAs, and the submission of the annual report.

The Resolution mandates that a taxpayer interested in initiating an APA and engaging in preliminary meetings with SUNAT must declare their intention before submitting their proposal. If a taxpayer deems the meetings unnecessary, they may submit their proposal along with the required information and/or documentation directly. Additionally, the Resolution specifies the minimum information that the declaration of intent must contain. Taxpayers are required to submit their proposal within 90 business days following the last meeting. If this period elapses and the taxpayer remains interested in proceeding with an APA with SUNAT, they must reaffirm their intention and either schedule new preliminary meetings or submit the proposal directly. Finally, SUNAT has a 24-month period from the date of the proposal's submission to approve or reject it, which can be extended by an additional 12 months.

7.6 APA User Fees

Peruvian legislation has not established fees for taxpayers to enter into APAs with SUNAT.

7.7 Duration of APA Cover

The PITL Regulations stipulate that APAs shall be applicable to the taxable year in which they are approved and for the next three taxable years thereafter.

7.8 Retroactive Effect for APAs

Peruvian legislation does not grant APAs retroactive effect. It should be noted that APAs contain a clause permitting their modification or annulment in instances where significant changes in a company's operations or economic circumstances severely affect the reliability of the methodology employed, in such a way that third parties would have deemed these changes significant for the determination of their prices. In this context, any modification or decision to annul the APAs will take effect from the taxable year in which the proposal for modification was submitted.

In line with this, regarding the termination of APAs, the PITL Regulations stipulate that SUNAT has the authority, under certain conditions, to unilaterally invalidate these agreements. Nonetheless, transactions between related parties should be valued in accordance with the general provisions outlined in Article 32-A of the PITL, effective from the date the agreement is deemed null and void.

8. Penalties and Documentation

8.1 Transfer Pricing Penalties and Defences

There are various specific penalties and fines for infractions related to transfer pricing, against

which taxpayers may file appeals (if they disagree), within the established deadlines. Such infractions can be divided into three categories.

Infractions related to the obligation of permitting oversight by the tax authority, reporting to, and appearing before it:

For example, the infraction specified under numeral 27 of Article 177 of the Tax Code concerns not submitting the documentation and information that supports the Local File, Master File, and/or Country-by-Country Reporting as demanded in the specified manner, within the designated timeframe, and according to the required conditions. The defence strategy in this scenario is focused on proving that the taxpayer has complied with the tax authority's documentation requests in accordance with the regulatory stipulations.

Infractions related to the obligation of filing declarations and communications:

For example, the infraction identified in numeral 2 of Article 176 of the Tax Code pertains to the failure to submit reports within the prescribed deadlines. The defence strategy in this context is designed to establish that the taxpayer is not required to present said reports. Moreover, the infraction delineated in numeral 4 of Article 176 concerns the submission of reports either incompletely or inaccurately reflecting the truth. The defence strategy here aims to prove that the reports submitted comply fully with all prescribed guidelines and accurately depict the taxpayer's operational realities.

Infractions related to the fulfilment of tax obligations:

For example, the infraction specified in numeral 1 of Article 178 of the Tax Code relates to the declaration of false figures or data. The defence strategy in this scenario is aimed at clarifying that the reports have no bearing on the determination and payment of the taxpayer's tax liabilities. Despite what has been mentioned, in Peru, there is a Graduated Penalty Relief System, through which taxpayers can obtain reductions for the tax infractions they have committed. For this purpose, each penalty and/or infraction is associated with a procedure through which taxpayers can rectify them. It is important to note that, depending on the timing of such rectification, different levels of reduction apply. For instance, in the case of the infraction outlined in numeral 4 of Article 176 of the Tax Code, taxpayers will be eligible for a 100% reduction of the penalty if they resubmit the reports (including any previously omitted information) before receiving any notification from SUNAT regarding the said infraction.

8.2 Taxpayer Obligations Under the OECD Transfer Pricing Guidelines

In Peru, taxpayers are required to prepare all the files and reports contemplated in the OECD Transfer Pricing Guidelines. This obligation became effective on 1 January 2017, with the enforcement of the Legislative Decree No 1312 (for more details, review **1.2 Current Regime and Recent Changes**).

Regarding the formal requirements to be submitted by those taxpayers subject to transfer pricing rules, these were implemented in accordance with Action 13 of the BEPS project. Peruvian legal framework establishes different thresholds for reporting requirements based on the documentation to be submitted. These thresholds take as reference the tax units that correspond to the value in soles established by the Peruvian

state for the determination of taxes, infractions, penalties and fines and other tax aspects.

In the case of the Local File Informative Return, this requirement corresponds to taxpayers whose income in the fiscal year is greater than 2,300 tax units. This return should detail transactions that generate taxable income as well as those considered as part of the deductible cost or expense in the income tax (IR) calculation.

Regarding the Master Report Informative Return, it is required to be submitted by taxpayers who are part of an economic group with accrued income in the fiscal year exceeding 20,000 tax units and controlled transactions over tax units. This report should contain, among other elements, the transfer pricing policies related to intangibles, information on the group's financing methods, its financial and fiscal position, the organisational structure of the group, and a description of the business operations involving the group and its members.

Finally, regarding the CbCR Informative Return, provided that the revenue accrued by a taxpayer's multinational group is equal or greater than PEN2.7 billion in the fiscal year before the reporting fiscal year, the following entities are legally required to submit the return:

- the parent entity of the multinational group if it is based in Peru;
- the taxpayer that is a member of the multinational group when:
  - (a) it has been appointed by the group as the surrogate parent entity;
  - (b) the ultimate parent entity of the group is not required to file the CbCR in its country of residence;
  - (c) the CbCR is submitted to the country of residence of the ultimate parent entity, but Peru has not established procedures for the automatic exchange of CbCR with that jurisdiction; and
  - (d) the ultimate parent entity has submitted the CbCR, and even though Peru has an information exchange mechanism with that jurisdiction, there has been systematic failure to exchange information, according to SUNAT.

This return must contain, among others, information regarding how the income, taxes paid and business activities of each entity belonging to the multinational group are distributed on a global level.

9. Alignment With OECD Transfer Pricing Guidelines

9.1 Alignment and Differences

The legal provisions, complementary rules and regulations established by the Tax Administration are closely aligned with the provisions of the OECD Guidelines on transfer pricing, which are an interpretative source in Peru. However, there are some differences in the local application related to valuation methods and formal transfer pricing obligations, which are as follows:

In the case of valuation methods, the Guidelines consider the RPSM as part of the PSM while the PITL considers them as different methods; therefore, the Guidelines develop five methods and the PITL develops six methods.

It is essential to highlight that, in the absence of specific regulations for these scenarios, the PITL introduces the flexibility to adopt alternative valuation methods not outlined in the OECD Guidelines. This provision applies when assessing controlled transactions that are challenging

to value due to their unique facts and circumstances, which hinder direct comparison with market benchmarks. Such transactions might include, for example, the buying and selling of fixed assets or the sale or transfer of intangible assets. This approach ensures a more nuanced and effective valuation process for complex transactions.

About formal obligations, the main differences with respect to the OECD Guidelines are the following.

- Local File Informative Return – the taxpayer must present a functional and economic analysis of the operations that exceed a materiality amount (2.5 Tax Units). Likewise, they report on the amounts and dates effectively collected and/or paid of the intercompany operations. Finally, they must include a Benefit Test analysis for the service operations received.
- Master File Informative Return – must have a chart illustrating the legal structure, legal corporate structure of each subsidiary, as well as a detailed table of such structure, ie, including name or corporate name, tax identification number, country or jurisdiction and percentage of shareholders capital participation.
- Country-by-Country Report Informative Return – there are no differences related to the information required; however, the Administration requests that the information follows a certain order, prior to its declaration. Therefore, the taxpayer responsible for the declaration must make an adaptation to the XML file or it will not be accepted by the Administration's system.

9.2 Arm's Length Principle

The transfer pricing regime in Peru is aligned with the arm's length principle established in the OECD TP Guidelines.

9.3 Impact of the Base Erosion and Profit Shifting (BEPS) Project

In order to prevent and avoid tax avoidance between related companies, the Tax Administration has been implementing in the legislation some actions of the BEPS Project on transfer pricing, which are the following.

In consideration of the Actions 6 and 14, related to avoid the abuse of Double Taxation Agreements (DTA), the TIPL incorporates in its negotiation models the indicated in these actions in order to be more effective and to have a procedure to solve controversies arising from their application. Regarding this last point, the Tax Administration issued an orientation guide for the taxpayer and other interested parties regarding the Mutual Agreement Procedures that establishes rules, guidelines and procedures according to the minimum standard requested in Action 14.

According to the Action 10, related to the treatment of intra-group services, whereby the Tax Administration has incorporated some proposals in its regulations for purposes of testing the deductibility of the expense. This can be found in Legislative Decree 1312.

Finally, according to the Action 13, referring to formal obligations on transfer pricing, PITL follows the three levels of documentation suggested by the OECD's BEPS Project. This can also be found in the aforementioned Decree.

9.4 Impact of BEPS 2.0

Currently in Peru, Pillars 1 and 2 have not yet been considered as priority state policies by the Executive Branch or by the Legislative Branch. In that sense, in the short term there are still no initiatives linked to them. However, in the next few years, these Pillars will be developed, with greater emphasis on Pillar 2.

9.5 Entities Bearing the Risk of Another Entity's Operations

PITL legislation have not implemented a restriction regarding taxpayers assuming the operational risks of other entities to ensure a guaranteed return. In general, any transaction subject to transfer pricing rules must comply with the correct allocation of market value, the application of the most appropriate method, the profit test (if applicable), among other established obligations. Assessing the variance in risk assumption is crucial for determining the level of comparability between controlled and uncontrolled transactions.

10. Relevance of the United Nations Practical Manual on Transfer Pricing

10.1 Impact of UN Practical Manual on Transfer Pricing

The United Nations Practical Manual on Transfer Pricing for Developing Countries does impact transfer pricing matters in Peru. However, it is crucial to note that this impact is not exerted in a rigid manner but rather through training sessions in which SUNAT participates. An instance of this is Peru's engagement in the "Tax Inspectors Without Borders" (TIWB) initiative through SUNAT. This initiative is a collaboration between the OECD and the United Nations Development Programme (UNDP).

11. Safe Harbours or Other Unique Rules

11.1 Transfer Pricing Safe Harbours

Peruvian regulations have not regulated specific provisions on this point.

11.2 Rules on Savings Arising From Operating in the Jurisdiction

Peruvian regulations have not regulated specific provisions on this point.

11.3 Unique Transfer Pricing Rules or Practices

Peruvian transfer pricing rules consider specific provisions for the deduction of costs and expenses derived from operations with related parties for services. Subsection i) of Article 32-A of the PITL, as well as Article 118-A of the PITL Regulations, indicate that the services provided to the taxpayer by its related parties must meet the benefit test and provide the requested documentation and information, in order to be able to deduct said costs and expenses for the determination of the tax. With respect to the documentation and information provided, it must demonstrate the effective provision of the service, the nature of the service, the real need for the service, the costs and expenses incurred by the service provider, as well as the reasonable criteria for assigning them.

12. Co-ordination With Customs Valuation

12.1 Co-ordination Requirements Between Transfer Pricing and Customs Valuation

While the CUPM includes rules applicable to the export or import of certain goods with recognised market quotations internationally, locally,

or in the destination market, or those that determine their prices based on market quotations and may be associated with customs regulations, as of now, there is no Peruvian legislation or official guidance that connects transfer pricing with customs valuation. Therefore, the market value determined through transfer pricing methods is independent from the customs value, and vice versa.

13. Controversy Process

13.1 Options and Requirements in Transfer Pricing Controversies

Transfer pricing audits in Peru are conducted by SUNAT through a tax audit procedure. After this procedure is completed, if a taxpayer disagrees with the outcome, they have the right to file a claim with SUNAT against the results of the audit. If the taxpayer remains dissatisfied with the resolution of their claim, they may escalate the matter by filing an appeal with the Tax Court. The Tax Court then issues a decision to resolve the dispute, marking the end of the contentious tax procedure.

Should either party disagree with the Tax Court's decision, they can initiate an administrative litigation process by filing a lawsuit against the decision. This process may include an appeal and potentially culminate in a cassation appeal to the Supreme Court, assuming the case meets the criteria for admissibility.

This highlights that disputes over transfer pricing rules can involve multiple stages of legal challenge. It is also important to note that the payment of the disputed tax debt is not required during the contentious tax procedure if the appeals are submitted within the prescribed timeframe. Otherwise, the taxpayer must make the necessary payment or provide a bank guarantee.

14. Judicial Precedent

14.1 Judicial Precedent on Transfer Pricing

Transfer pricing audits have significantly increased since 2016, leading to very few cases progressing from the Tax Court to the Judicial branch. As a result, there are limited judicial precedents concerning transfer pricing rules.

14.2 Significant Court Rulings

Currently, there are two notable cassation decisions in the transfer pricing field.

- Cassation No 17824-2023, concerning the audit period for transfer pricing regulations. While the causes for suspension of the audit period refer only to the auditing of internal taxes, the Supreme Court indicated that this suspension also applies to transfer pricing regulations.
- Cassation No 19941-2023, related to the adjustment to market value concerning the application of the functional currency. The Supreme Court noted that the currency used in the Transfer Pricing Reports of the analysed company must be the same as that used to express the financial statements for determining margins and ratios applying the TNMM, which in this case is US dollars (functional currency).

15. Foreign Payment Restrictions

15.1 Restrictions on Outbound Payments Relating to Uncontrolled Transactions

Regarding the nature of the transaction, there is no restriction on the payment made; however, certain formalities must be complied with for its execution. Indeed, Article 3 of Law No 28194 (Law against Evasion and for the Formalization of the Economy) stipulates that obligations fulfilled through the payment of sums exceeding PEN2,000 or USD500 must be paid using payment methods (deposits into accounts, drafts, and fund transfers, among others).

15.2 Restrictions on Outbound Payments Relating to Controlled Transactions

There is no restriction on payments abroad additional to that indicated in **15.1 Restrictions on Outbound Payments Relating to Uncontrolled Transactions**.

15.3 Effects of Other Countries' Legal Restrictions

Article 32-A of the PITL mandates the application of transfer pricing rules:

- to transactions conducted by taxpayers with their related parties;
- to transactions carried out from, to, or through non-co-operative countries or territories or those with low or no taxation; or
- to transactions conducted with entities whose income, earnings, or profits arising from such transactions are subject to a preferential tax regime.

For the purposes of applying these rules, Annex 1 of the PITL Regulations establishes a list of countries or territories deemed as non-co-operative or of low or no taxation.

16. Transparency and Confidentiality

16.1 Publication of Information on APAs or Transfer Pricing Audit Outcomes

The information that is published pertains to that contained in the resolutions issued by the Tax Court when resolving a dispute arising from audits conducted by SUNAT on taxpayers. These resolutions include the background, the subject matter of the dispute, and the position established by the Tax Court.

16.2 Use of "Secret Comparables"

Peruvian transfer pricing rules does not provide specific regulation regarding the use of "secret comparables". However, it is important to highlight that subsection h) of Article 32-A of the PITL indicates that for the interpretation of transfer pricing rules, the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, approved by the OECD Council, are applicable. These guidelines do not advocate the use of such information for transfer pricing comparability purposes ("secret comparables"), unless the required information can be disclosed to taxpayers within the confines of national confidentiality laws.

PHILIPPINES

Law and Practice

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1. Rules Governing Transfer Pricing

1.1 Statutes and Regulations

The rules governing transfer pricing in the Philippines are based on Section 50 of the National Internal Revenue Code of 1997 (NIRC), which authorises the Commissioner of Internal Revenue ("Commissioner") to "distribute, apportion or allocate gross income or deductions" between or among "organizations, trades or businesses"... "owned or controlled directly or indirectly by the same interests" when necessary to prevent evasion of taxes or to clearly reflect the income of such organisation, trade or business.

The statutory provision is implemented by Revenue Regulations (RR) No 02-13 or the "Transfer Pricing Guidelines" issued by the Secretary of Finance in 2013 with the recommending approval of the Commissioner. RR No 02-13 has the force and effect of law.

Transfer Pricing Regulations

RR No 02-13 provides for:

- the use of the arm's length principle as the standard to determine transfer prices for related-party transactions;
- the methodologies in determining the arm's length price, which are largely based on the OECD Transfer Pricing Guidelines ("OECD TP Guidelines"); and
- the requirement for taxpayers to prepare and retain adequate transfer pricing documentation.

The arm's length principle, as stated in RR No 02-13, requires the transaction with a related party to be made under comparable conditions and circumstances as a transaction with an independent party. If two associated enterprises derive profits at levels above or below the comparable market level solely by reason of the special relationship between them, the profits will be deemed as non-arm's-length. In such a case, the Philippine Bureau of Internal Revenue (BIR) can adjust the taxable profits of the related parties to reflect the true value that would otherwise be derived on an arm's length basis.

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Transfer Pricing Audit Guidelines

In 2019, the BIR published Revenue Audit Memorandum Order (RAMO) No 01-19 or the "Transfer Pricing Audit Guidelines". The audit guidelines detail the procedures and methods used by revenue examiners in transfer pricing audits, and the principles observed in examining specific cases, such as intra-group services, intangible asset transactions and cost contribution arrangements. The audit guidelines provide useful insights to taxpayers conducting a transfer pricing analysis, but the procedures in RAMO No 01-19 are not mandatory for taxpayers.

Since then, the Secretary of Finance and the BIR have also issued various revenue regulations (ie, RR No 19-20, which was amended by RR No 34-20) and revenue memorandum circulars (ie, RMC No 76-20 and RMC No 54-21) on taxpayer disclosure of related-party transactions.

1.2 Current Regime and Recent Changes

The Commissioner's authority to allocate income and deductions among controlled organisations, trades, and businesses under Section 50 of the NIRC can be traced a long way back to Section 44 of the 1939 National Internal Revenue Code. Fundamentally, the wording of the law remains unchanged up to this day.

However, the current transfer pricing regime developed only in the last three decades, in response to a downtrend in revenue collection from related-party groups despite their growth and the increase in related-party transactions globally.

In 1998, the BIR issued RAMO No 01-98 establishing special audit procedures for joint and co-ordinated tax examination of interrelated group of companies. It recognised the use of the arm's length principle as an audit standard for determining prices but did not provide specific details on its application. The manner of application was left to the "best judgment" of the revenue examiner who is permitted to refer to the methods under the OECD TP Guidelines. In several tax controversies up to the early 2000s, although the tax court recognised the use of the arm's length principle as a proper standard, the court found the revenue examiners' methods for determining the arm's length price to be unjustified.

RR No 02-13 issued in 2013 is the first formal regulation adopting the arm's length principle and establishing transfer pricing methods. The regulation is supported by RAMO No 01-19 issued in 2019, both of which remain in force.

2. Definition of Control/Related Parties

2.1 Application of Transfer Pricing Rules

The transfer pricing rules apply to any domestic or cross-border transaction between two or more associated enterprises, known as a "controlled transaction". The regulations also apply, by analogy, to transactions between a permanent establishment and its head office or other related branches, which are treated as separate and distinct enterprises for tax purposes, and to intra-firm transactions. Intra-firm transactions apply to taxpayers with different tax regimes (ie, income tax holiday, 5% gross income tax and regular corporate tax).

Two or more enterprises are associated or related if (i) one participates directly or indirectly in the management, control, or capital of the other, or if (ii) the same persons participate directly or indirectly in the management, control, or capital of the enterprises.

Control refers to any kind of control, direct or indirect, whether or not legally enforceable, and however exercisable or exercised. The regulations do not provide for any percentage or other technical threshold for control. Moreover, control is deemed present if income or deductions have been arbitrarily shifted between two or more enterprises.

3. Methods and Method Selection and Application

3.1 Transfer Pricing Methods

The regulations list the following transfer pricing methods that taxpayers may use:

- Comparable Uncontrolled Price (CUP) Method;
- Resale Price Method (RPM);
- Cost Plus Method (CPM);
- Transactional Net Margin Method (TNMM); and
- Profit Split Method (PSM), which is classified into:
  (a) Contribution Profit Split Method; and
  (b) Residual Profit Split Method.

3.2 Unspecified Methods

Taxpayers may also use other methods not specified by the regulations if they are appropriate to the transaction. Other methods may include methods based on cost approach, market approach, and revenue approach.

3.3 Hierarchy of Methods

The Philippines does not have a hierarchy of methods or preference for any one method. RR No 02-13 provides that the transfer pricing methods that "produce the most reliable results, taking into account the quality of available data and the degree of accuracy of adjustments, should be utilized."

RAMO No 01-19, nonetheless, recognises certain methods to be useful in certain transactions or situations.

- The CUP Method is useful when evaluating related-party transactions of a manufacturer or service provider.
- The RPM is appropriate in a situation where the reseller adds relatively little value to the properties sold, as in the case of a distributor.
- The CPM is useful where semi-finished goods are sold between associated enterprises or where the controlled transaction involves the provision of intra-group services.
- The TNMM is appropriate when the gross profit of the business is not easy to determine such that either CPM, in case of a manufacturer or service-provider, or RPM, in case of a distributor, cannot be used. Since the net margin figure is ordinarily available, the TNMM may be used.
- The PSM is useful in cases involving highly integrated operations or where both parties make unique and highly valuable contributions, so that the testing cannot be done separately. Particularly, the Contribution Profit Split Method is applied when transactions occur between parties that are closely integrated, while the Residual Profit Split Method is applied in cases where both parties have unique and highly valuable contributions (eg, unique or valuable intangible property).

3.4 Ranges and Statistical Measures

The regulations recognise that in some cases, the application of appropriate transfer pricing methods produce a range of figures that are relatively equally reliable, rather than a single figure or specific ratio that may be considered arm's

length. In such cases, the use of ranges to determine an "arm's length range" shall be applied, provided that the comparables are reliable.

If the range includes a sizeable number of observations, such as those extracted from a database, statistical tools that take account of central tendency to narrow the range may be used to determine the arm's length range. RAMO No 01-19 suggests the use of the interquartile range or other percentiles to enhance the reliability of the analysis.

If the relevant conditions of the controlled transaction (eg, price or margin) are within the arm's length range, no adjustment should be made. However, if they are outside the arm's length range determined by the BIR, the taxpayer shall have the opportunity to present its arguments. The taxpayer must establish (i) the applicable arm's length range, which is different from that asserted by the BIR, and (ii) that the conditions of the controlled transaction fall within the arm's length range and satisfy the arm's length principle.

3.5 Comparability Adjustments

The Philippines requires comparability adjustments, if necessary, to improve the reliability of comparables used in determining the arm's length price. These include adjustments for differences in contractual terms, accounting methods, functions performed, and risks assumed.

Comparability adjustments are intended to eliminate the effects of differences that exist between the situations being compared, which could materially affect the condition (eg, price or margin) being examined. These are not performed to correct differences that have no material effect on the comparison.

4. Intangibles

4.1 Notable Rules

Philippine transfer pricing rules recognise two major categories of intangibles: (i) manufacturing intangibles, and (ii) marketing intangibles.

In transfer pricing of intangibles, RR No 02-13 requires the examination of the following characteristics, among others:

- the form of the transaction;
- the type of intangible;
- the duration and degree of protection; and
- the anticipated benefits from the use of the property.

RAMO No 01-19, Chapter VI, also provides general guidelines on the analysis of intangible asset transactions. The transfer price for the utilisation or transfer of an intangible asset must consider the perspectives of the party that delivers (ie, transferor) and the party that receives (ie, transferee) the asset. On one hand, the transferor should obtain greater benefit from the transfer or utilisation of its intangible asset than the costs that it has expended to acquire or protect it. On the other, the transferee should receive a greater benefit than the costs that it must pay for the intangible asset acquired or utilised.

In valuing licences for intangible assets, RAMO No 01-19 identifies the following factors for consideration:

- protection and timeframe;
- exclusiveness;
- geographical coverage;
- useful life of the intangible asset;
- right to develop, revise, and make improvements;

- existence of other intangibles or services inherent in the delivery or utilisation of the intangible asset;
- existence of right to sublicense to third parties; and
- other factors that could influence the value of the licence.

4.2 Hard-to-Value Intangibles

The Philippines does not have special rules on hard-to-value intangibles.

4.3 Cost Sharing/Cost Contribution Arrangements

The Philippines recognises cost contribution arrangements (CCA) for the joint development or acquisition of property and services, and joint development of intangibles. Guidance on the transfer pricing of CCAs is available in RAMO No 01-19, Chapter VII.

In analysing the arm's length nature of the CCA, the following matters should be addressed: (i) the CCA is entered into by the participants with prudent and practical business judgment and a reasonable expectation of benefits; and (ii) the terms of the CCA are agreed upon up-front in accordance with economic substance, which may be judged by reference to circumstances known or reasonably foreseeable at the time of entry into the arrangement. Considerations for the entry or withdrawal of one or more participants, as well as the termination of the CCA, should also be dealt with at arm's length.

5. Affirmative Adjustments

5.1 Rules on Affirmative Transfer Pricing Adjustments

Under Section 6 (A) of the NIRC, any return filed with the BIR, including the Information Return on Transactions with Related Party (BIR Form No 1709), may be modified, changed, or amended within three years from the date of filing, provided that no notice for audit or investigation of such return or of the corresponding taxable period has in the meantime been actually served upon the taxpayer.

6. Cross-Border Information Sharing

6.1 Sharing Taxpayer Information

The Philippines has signed 43 double taxation agreements (DTAs) and the OECD Multilateral Convention on Mutual Assistance in Tax Matters (as amended in 2010). These agreements require the country to share tax information with its tax treaty partners to better implement national tax laws and prevent tax evasion and avoidance.

In 2009, the Philippines also passed Republic Act (RA) No 10021, otherwise known as the "Exchange of Information on Tax Matters Act of 2009". This law affirms the country's commitment to the internationally agreed tax standards for exchanging tax information with its tax treaty partners. This helps fight international tax evasion and avoidance and addresses tax concerns that affect international trade and investment. Since then, various tax regulations have been implemented to clarify the details of RA No 10021 and ensure its implementation. Further, the NIRC, Section 6(F), specifically authorises the Commissioner to inquire into bank deposits and other related information held by financial institutions, of a specific taxpayer or taxpayers, upon a valid request for tax information by a foreign tax authority pursuant to an international convention or agreement to which the Philippines is a signatory or a party of.

All requests for tax information must go through the BIR International Tax Affairs Division, which processes such requests within specific periods.

7. Advance Pricing Agreements (APAs)

7.1 Programmes Allowing for Rulings Regarding Transfer Pricing

The Philippines has yet to issue separate regulations establishing an APA programme. This is expected to cover unilateral, bilateral, and multilateral APAs, which are recognised under existing transfer pricing regulations.

7.2 Administration of Programmes

The APA programme will be administered by the BIR. According to existing transfer pricing regulations, APAs shall be entered into between the taxpayer and the BIR.

7.3 Co-ordination Between the APA Process and Mutual Agreement Procedures

Based on RR No 10-22, which prescribes the guidelines and procedure for requesting Mutual Agreement Procedure (MAP) assistance, the MAP team of the BIR will negotiate bilateral or multilateral APAs with the competent authorities of other jurisdictions through the MAP process.

7.4 Limits on Taxpayers/Transactions Eligible for an APA

The limits on taxpayers or transactions eligible for an APA, if any, are not yet known.

7.5 APA Application Deadlines

The timeline pertaining to an APA application is not yet provided for by existing transfer pricing regulations.

7.6 APA User Fees

Based on RR No 10-22, fees are expected to be charged in relation to the negotiation of bilateral or multilateral APAs. The amount is not yet provided.

7.7 Duration of APA Cover

The duration of APA cover is not yet provided for by existing transfer pricing regulations.

7.8 Retroactive Effect for APAs

Existing regulations do not provide for a retroactive effect of APAs.

8. Penalties and Documentation

8.1 Transfer Pricing Penalties and Defences

Under RR No 34-20, which regulates the submission requirements relating to transfer pricing, non-compliance shall be subject to the penalties provided under the NIRC, Section 250 (Failure to File Certain Information Returns) and Section 266 (Failure to Obey Summons), among other relevant NIRC provisions.

Section 250 of the NIRC imposes a penalty in Philippine pesos of PHP1,000 for each failure to timely file an information return, statement, or list, or keep any record, or supply any information required by the NIRC or the Commissioner, subject to a maximum amount of PHP25,000 per year. To defend against the imposition, a taxpayer must prove that the failure is due to a reasonable cause and not to wilful neglect.

Section 266 of the NIRC imposes a fine of between PHP5,000 to PHP10,000 and imprisonment of between one and two years, upon conviction in a criminal proceeding, of a person who neglects to appear to testify or to produce

books of accounts, records, memoranda or other papers, or to furnish information required under the NIRC, despite having been being duly summoned by the BIR to do so. The substance of the offence is "neglect," which means to omit, fail, or avoid doing something that can be done, or that is required to be done. It can also mean a lack of care or attention in the doing or omission of a given act (Ang v People, C.T.A. EB Crim Case No 095, 2 August 2023). To defend itself, the taxpayer must prove the absence of "neglect" by demonstrating compliance with the BIR-issued subpoena duces tecum (SDT) through (i) appearance at the designated time and date, and (ii) presentation of the required documents. However, substantial compliance with the SDT is enough. The law allows for the possibility that the documents requested may not be available or may not exist. A taxpayer will not be required to produce documents that it cannot submit; otherwise, it would be at the mercy of the BIR, which may require documents that are unavailable or may not exist (BIR v Guevarra, C.T.A. Case No 10298, 15 October 2021).

Documentation Requirements

RR No 34-20 requires certain taxpayers to file an information return on related-party transactions (BIR Form No 1709) together with their annual income tax return. Further, subject to materiality thresholds, they must contemporaneously prepare transfer pricing documentation and submit the same to the BIR within 30 days upon request, in the course of a tax audit. Transfer pricing documentation includes the following information:

- organisational structure;
- nature of the business/industry and market conditions;
- controlled transactions;
- assumptions, strategies and policies;
- cost contribution arrangements;
- comparability, functional and risk analysis;
- selection of the transfer pricing method;
- application of the transfer pricing method;
- background documents; and
- index to documents.

Taxpayers with related-party transactions who are not covered by these requirements shall disclose such non-coverage in the Notes to their Financial Statements.

8.2 Taxpayer Obligations Under the OECD Transfer Pricing Guidelines

The Philippines is not an OECD member country and is not bound by the OECD TP Guidelines. There is no taxpayer requirement to maintain the files and reports (ie, master file, local file, and country-by-country report) under the OECD TP Guidelines.

9. Alignment With OECD Transfer Pricing Guidelines

9.1 Alignment and Differences

Philippine transfer pricing rules are broadly aligned with the OECD TP Guidelines with respect to the arm's length principle, the transfer pricing methodologies, and the conduct of comparability analysis. Specifically, RR No 02-13 refers to the OECD TP Guidelines as basis for the arm's length pricing methodologies established in the regulations, and the OECD Model Tax Convention on Income and on Capital, Article 9, paragraph 1, as the authoritative statement of the arm's length principle.

The regulations, however, do not adopt the OECD's three-tiered approach to transfer pricing documentation. Also, the specific OECD guidelines on intangibles, intra-group services, CCAs,

business restructurings, and financial transactions are not found in the regulations. Instead, RAMO 01-19 offers guiding principles in the BIR's examination of these transactions.

9.2 Arm's Length Principle

Philippine transfer pricing rules are aligned with the arm's length principle.

9.3 Impact of the Base Erosion and Profit Shifting (BEPS) Project

On 8 November 2023, the Philippines joined the OECD/G20 Inclusive Framework on BEPS to combat tax avoidance. The Philippines has pledged to address tax challenges resulting from the digitalisation of the economy by participating in the Two-Pillar Solution (Pillar 2). This initiative aims to reform international taxation regulations and ensure that multinational corporations pay their fair share of taxes wherever they operate. By joining the BEPS inclusive framework, the Philippines will implement four minimum requirements, which include countering harmful tax practices, preventing treaty abuse, transfer pricing documentation, and enhancing dispute resolution. However, the Philippines has not yet domestically implemented the OECD Pillar 2 guidelines by issuing any new laws or regulations.

9.4 Impact of BEPS 2.0

In line with its commitment as a member of the OECD/G20 Inclusive Framework on BEPS, the Philippines is expected to implement BEPS 2.0 (ie, Pillar 2) soon. This will require a re-evaluation of the country's current tax laws. The Philippine government will need to balance the inflow of foreign investments with the tax implications of Pillar 2. As such, the Philippines is expected to create new rules that maximise tax collection under Pillar 2 while maintaining the country as an attractive investment destination.

9.5 Entities Bearing the Risk of Another Entity's Operations

Philippine laws do not provide a mechanism where one entity is allowed to bear the risk of another entity's operations by guaranteeing a return for that entity.

10. Relevance of the United Nations Practical Manual on Transfer Pricing

10.1 Impact of UN Practical Manual on Transfer Pricing

The Philippines has not officially adopted the UN Practical Manual on Transfer Pricing for Developing Countries. However, this Manual is referenced in RR No 02-13, which explains the background of transfer pricing in the Philippines.

11. Safe Harbours or Other Unique Rules

11.1 Transfer Pricing Safe Harbours

Philippine transfer pricing regulations do not provide "safe harbours" as per the OECD TP Guidelines. However, the regulations provide "materiality thresholds". According to Section 3 of RR No 34-20, only certain taxpayers who reach these thresholds must submit transfer pricing documentation and other supporting documents to the BIR as per RR No 02-13.

These taxpayers are:

- (a) large taxpayers;
- (b) taxpayers enjoying tax incentives (ie, Board of Investments-registered and economic zone enterprises enjoying the Income Tax Holiday or are subject to preferential income tax rates);

- (c) taxpayers reporting net operating losses for the current taxable year and the immediately preceding two consecutive taxable years; and
- (d) related parties (as defined in RR No 19-20, Section 3) that have transactions with (a), (b) or (c) above.

Meanwhile, the materiality thresholds are:

- (1) annual gross sales/revenue for the subject taxable period exceeding PHP150 million and the total amount of related-party transactions with foreign and domestic related parties exceeding PHP150 million; or
- (2) related-party transactions:
  (a) in the aggregate amount exceeding PHP60 million within the taxable year, if involving a sale of tangible goods; or
  (b) in the aggregate amount exceeding PHP15 million within the taxable year for payment of interest, utilisation of intangible goods, or other related-party transaction, if involving a service transaction.

If transfer pricing documentation was required to be prepared during the immediately preceding taxable period for exceeding either (1) or (2) above, the covered taxpayers must also submit the transfer pricing documentation and other supporting documents.

Taxpayers who do not meet the specified thresholds are not required to submit transfer pricing documentation, but the BIR may still audit them independently.

11.2 Rules on Savings Arising From Operating in the Jurisdiction

The Philippines does not have specific rules governing savings that arise from operating in the country, like the business restructuring "location savings" under the OECD TP Guidelines. However, Chapter IV of RAMO No 01-19 acknowledges that business restructuring in a multinational group could lead to changes in the nature of the business and profitability of a local (ie, Philippine) entity. If the profits of the local entity decrease, RAMO No 01-19 states that it should be because there is a reduction in the functions performed, assets used, or risks taken (FAR). If these FAR factors are actually transferred, it is considered reasonable for a multinational group to restructure and achieve tax savings. However, if the local entity continues to perform the same functions and bear the same risks, RAMO No 01-19 states that revenue officers should make the necessary adjustments. The tax regulation assumes that in a fair market situation, an independent party will not restructure its business if it leads to negative consequences, especially if it has other options.

11.3 Unique Transfer Pricing Rules or Practices

According to RAMO No 01-19, the following types of activities among members of a multinational corporation group are not considered intra-group services for tax purposes, and any service fees paid in relation to these activities are not allowed as deductions.

- Shareholder activities, such as:
  (a) activities for the reporting needs of the parent company, such as preparation of consolidated financial statements;
  (b) activities relating to the legal status and structure of the parent company, such as overseeing compliance of required annual reports, holding of shareholder meetings, issuance of shares, and management by the oversight board; and
  (c) collection of funds to be used by the parent company to acquire another business

or branch.

- Duplicative services performed by a member of a multinational corporation group that duplicate activities performed by the taxpayer or by a third party.
- Services that provide only incidental benefit to the taxpayer.
- Passive association.
- On-call services, if:
  - (a) the potential for use of the service is very low;
  - (b) the benefit obtained from the service is insignificant or negligible; or
  - (c) the on-call service could be obtained immediately at any time and is available from an independent party without first having to enter into an on-call service agreement.

12. Co-ordination With Customs Valuation

12.1 Co-ordination Requirements Between Transfer Pricing and Customs Valuation

The Philippines does not require co-ordination between transfer pricing assessment and customs valuation. The BIR evaluates related entities' transfer pricing independently of the Philippine Bureau of Customs. However, the BIR ordinarily refers to the Third-Party Matching-Bureau of Customs (TPM-BOC) Data Programme in the course of a tax audit, to verify amounts of importations.

13. Controversy Process

13.1 Options and Requirements in Transfer Pricing Controversies

RR No 02-13 does not provide specific guidelines on resolving transfer pricing-related disputes. However, taxpayers may seek the usual remedies in the context of regular audits through Section 228 of the NIRC.

When the BIR determines that a taxpayer owes taxes (ie, based on incorrect transfer pricing), following the issuance of a notice of informal conference and a preliminary assessment notice, it will issue a formal letter of demand and final assessment notice (FAN) that includes all the necessary information. If the taxpayer disagrees with the assessment, it may file a protest within 30 days of receiving the FAN. The protest can be a request for reconsideration if it is based on existing records without requiring additional evidence. If the protest involves re-evaluating the assessment based on newly discovered or additional evidence, it must be submitted as a request for re-investigation. Supporting documents must be submitted within 60 days of filing the request for re-investigation.

If the protest is denied, the taxpayer may either appeal to the Court of Tax Appeals (CTA) or file an appeal with the office of the Commissioner of Internal Revenue within 30 days of receiving the decision. An appeal to the Commissioner is only available if an authorised representative of the Commissioner issues the denial. If the Commissioner issues the denial, a direct appeal to the CTA is the appropriate remedy.

14. Judicial Precedent

14.1 Judicial Precedent on Transfer Pricing

In the Philippines, only decisions rendered by the Philippine Supreme Court (SC) are considered as judicial precedents or "case law" and are deemed as part of the Philippine legal system. However, the judicial precedent on transfer pricing in the Philippines is not well-developed, and as a result, tax authorities mainly depend on BIR issuances when making transfer pricing assessments. So far, there have only been two SC decisions significantly discussing transfer pricing. The relevant rulings in these decisions are outlined below.

14.2 Significant Court Rulings

Department of Finance v Asia United Bank, G.R. Nos 240163 & 240168-69, 1 December 2021, SC Third Division

"Under Section 50 of the NIRC the said provision, the CIR is authorized to distribute, apportion, or allocate gross income or deductions if [it] determine[s] that such distribution, apportionment, or allocation: (a) is necessary in order to prevent evasion of taxes; or (b) clearly to reflect the income of organizations, trades, or businesses.

... Section 50 is limited only to allocating expense deductions between two or more organizations, trades or business.... [Its] purpose... is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer by determining, according to the standard of an uncontrolled taxpayer, the true net income from the property and business of a controlled taxpayer. If this has not been done and the taxable net incomes are understated, the law grants the CIR the authority to intervene by making distributions, apportionments or allocations of gross income or deductions among the controlled taxpayers to determine the true net income of each controlled taxpayer.

In determining the true net income of a controlled taxpayer in transactions with another controlled taxpayer, the CIR is not restricted to the cases of improper accounting, fraudulent transactions, or distortion or shifting of income and deductions to reduce or avoid tax. Its power extends to cases where, inadvertently or by design, the net income is other than what it would have been had it been an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer. In other words, Section 50 of the NIRC places a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true net income from the property and business of a controlled taxpayer.

Various issuances of the BIR itself illustrate the import of Section 50 of the NIRC. In Revenue Audit Memorandum Order 1-1998, the BIR recognizes that 'the authority for allocating income and expenses between or among related parties' under Section 50 pertains to the 'allocation of income and expenses between or among controlled group of companies, if related taxpayer has not reported its true taxable income.' Moreover, it confirms that Section 50 is intended to place 'a controlled taxpayer in tax parity with an uncontrolled taxpayer by determining the arm's-length price of intercompany transactions.'

RR No 2–2013, which provides the guidelines for the method of income/cost allocation in related-party transactions (ie, transfer pricing), explicitly invokes Section 50 of the NIRC, which authorizes the CIR 'to distribute, apportion or allocate gross income or deductions between or among two or more organizations, trades or businesses (whether or not incorporated and whether or not

organized in the Philippines) owned or controlled directly or indirectly by the same interests, if he determines that such distribution, apportionment or allocation is necessary in order to clearly reflect the income of such organization, trade or business. Thus, the Commissioner is authorized to make transfer pricing adjustments.'

... [T]ransfer pricing is generally defined as the pricing of intra-firm transactions between related parties or associated enterprises. Parties are considered related if they are owned or controlled, directly or indirectly, by the same interests. There is a domestic transfer pricing issue when income is shifted in favor of a related-party with special tax privileges, or when expenses of a related company subject to regular income taxes or in other circumstances, when income and/or expenses are shifted to a related-party in order to minimize tax liabilities. The revenues lost from intra-related transactions can be attributed to the fact that related companies are more interested in their net income as a whole (rather than an individual corporation), as such there is a desire to minimize tax payments by taking advantage of the loopholes in the tax system.

... [T]here is a need to determine the arm's length price only when one organization, trade, or business passes off a cost to a related organization, trade, or business at an amount different from what would have been charged had the transaction been between two unrelated organizations, thereby manipulating the amount of the reported income of the organizations. For this purpose, Section 50 grants authority to the CIR to allocate expense deduction where transactions involving more than one organization, trade, or business are not done at arm's length."

Commissioner of Internal Revenue v American Express International, Inc. (Philippine Branch), G.R. No 152609, 29 June 2005, SC Third Division

"... The business concept of a transfer price allows goods and services to be sold between and among intra-company units at cost or above cost. A branch may be operated as a revenue center, cost center, profit center or investment center, depending upon the policies and accounting system of its parent company. Furthermore, the latter may choose not to make any sale itself, but merely to function as a control center, where most or all of its expenses are allocated to any of its branches.

A 'transfer price' is '[t]he price charged by one segment of an organization for a product or service supplied to another segment of the same organization...' There are three general methods for determining transfer prices; namely, market-based, cost-based, and negotiated. The method chosen must lead each sub-unit manager to make optimal decisions for the organization as a whole, in order to meet the three criteria of goal congruence, managerial effort, and sub-unit autonomy."

15. Foreign Payment Restrictions

15.1 Restrictions on Outbound Payments Relating to Uncontrolled Transactions

There are no specific restrictions on outbound payments related to uncontrolled or controlled transactions in the Philippines, except for the domestic and foreign currency transfer restrictions set by the country's central monetary authority, the *Bangko Sentral ng Pilipinas* (BSP). For outbound transfers or payments of Philippine Pesos, up to PHP50,000 per person is allowed

without prior written authorisation from the BSP. However, BSP written authorisation is required for amounts exceeding the limit, as per Section 4 of the BSP Manual of Regulations on Foreign Exchange Transactions (updated May 2023).

By the same rule, for outbound transfers or payments of US dollars or other foreign currencies, up to USD10,000 (or its equivalent in other foreign currencies) per person is allowed without prior BSP written authorisation. If the amount exceeds this limit, it can still be allowed but must be declared using the appropriate BSP foreign currency declaration form. Further, to service certain outbound payments (eg, interest and loan repayments, and capital repatriation) using foreign currency resources of the Philippine banking system, BSP registration or, in certain cases, approval of the corresponding inward investment must be secured.

From a tax perspective, any outgoing transfers or payments may be subject to final withholding taxes. If the BIR determines that transfer pricing adjustments are necessary in accordance with transfer pricing regulations, the local entity may be assessed for deficiency withholding tax on these transfers or payments.

15.2 Restrictions on Outbound Payments Relating to Controlled Transactions

Refer to **15.1 Restrictions on Outbound Payments Relating to Uncontrolled Transactions**.

15.3 Effects of Other Countries' Legal Restrictions

The Philippines does not have rules regarding the effects of other countries' legal restrictions. It adheres to its own regulations on foreign payment restrictions.

16. Transparency and Confidentiality

16.1 Publication of Information on APAs or Transfer Pricing Audit Outcomes

The Philippine government does not disclose information about APAs or transfer pricing audit (TPA) results. With some exceptions, which do not include APAs and TPA outcomes, Section 270 of the NIRC prohibits the unlawful disclosure of taxpayer information. These include "information about the business, income, or estate of a taxpayer, the secrets, operation, style, or work, or apparatus of any manufacturer or producer, or confidential information about the business of any taxpayer," which may cover APAs and TPA outcomes.

16.2 Use of "Secret Comparables"

The Philippines does not prohibit using "secret comparables" or information available only to the BIR because the same was obtained from other taxpayers' tax filings or audits. The law allows the tax authorities a wide berth in determining arm's length transactions, in accordance with the Commissioner's power to obtain information and make assessments under Sections 5 and 6 of the NIRC. The BIR is not legally obligated to use only local comparables (ie, companies within the Philippines) to determine the arm's length price of controlled transactions. However, the BIR often uses local companies as a benchmark under the reliability requirement for transfer pricing evaluations. Comparables in the Asia-Pacific region may be used at the BIR's option if local comparables are unavailable.

SOUTH AFRICA

Law and Practice

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ENS has offices in Eastern, Southern and Western Africa, with more than 600 specialist practitioners, and a deep expertise and capacity to solve legal, tax, forensics and IP requirements. Its tax team provides a distinct competitive edge by combining unique areas of tax specialisation with extensive African and international experience and an innovative, solution-driven approach. The team offers transfer pricing advisory, transfer pricing documentation, endorsed by the Organization for Economic Co-operation and Development (OECD), and transfer pricing risk management and dispute resolution. The team has assisted in offering transfer pricing advice, including Reserve Bank approval, for a large African manganese mine, and has offered international tax advice regarding a EUR47.5 million joint venture between a local biotechnology firm and German investors to produce COVID-19 tests in Africa.

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1. Rules Governing Transfer Pricing

1.1 Statutes and Regulations

Section 31 of the Income Tax Act, 58 of 1962 (the "South African ITA") contains the main legislative provisions relating to South African transfer pricing rules.

The South African Revenue Service (SARS) issued practice notes on the application of the transfer pricing and thin capitalisation rules to provide more certainty as to the application of the rules.

- SARS issued Practice Note 7 (PN7) on 6 August 1999, offering practical guidance on the arm's length principle outlined in Section 31 of the South African ITA and was further completed by an Addendum published on 29 September 2005.
- In addition, SARS issued Interpretation Note 127 (IN127) on 17 January 2023, which provides guidance on the transfer pricing aspects of intra-group financing arrangements.

South Africa closely follows the guidance contained in the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the "OECD Transfer Pricing Guidelines") in respect of transfer pricing matters in the absence of specific South African guidance.

1.2 Current Regime and Recent Changes

Transfer pricing legislation in South Africa originated in 1995 when SARS acknowledged the need for tackling transfer pricing issues and to prevent profit shifting. Section 31 of the South African ITA was introduced and was augmented by PN7. Subsequently, at various times further amendments were made to Section 31 and other provisions of the South African ITA to align with treaty wording and international practice. For example, in 2011 significant amendments to the transfer pricing rules were introduced. South Africa recently amended its legislation to encompass the international concept of "associated enterprises".

In addition to legislative changes, SARS issued various pronouncements to offer guidance on transfer pricing issues, notably PN7 and IN127.

2. Definition of Control/Related Parties

2.1 Application of Transfer Pricing Rules

South Africa's transfer pricing rules apply to transactions which are "affected transactions" between people who are "connected persons" or "associated enterprises" in relation to each other and which result or will result in any tax benefit being derived by a person that is a party to the affected transaction.

The taxable income or tax payable by any person that derives a tax benefit must be calculated as if that transaction, operation, scheme, agreement or understanding had been entered into on the terms and conditions that would have existed had those persons been independent persons dealing at arm's length.

An affected transaction includes transactions, operations, schemes, agreements or understandings between specified persons that are connected persons in relation to one another and, for years of assessment commencing on or after 1 January 2023, between specified persons that are connected persons or associated enterprises in relation to one another and any term or condition of that transaction, operation, scheme, or understanding is different from any

term or condition that would have existed, had those persons been independent persons dealing at arm's length.

The affected transaction must be entered into between or for the benefit of either or both:

- a resident and a non-resident;
- a non-resident and a non resident that has a permanent establishment in South Africa;
- a resident and non-resident that has a permanent establishment outside South Africa; and
- a non-resident and any other person that is a controlled foreign company in relation to any resident.

The definition of connected persons is contained in Section 1 of the South African ITA and encompasses the following.

- In respect of natural persons – relatives and trusts where the natural person or relative is a beneficiary.
- Trusts – beneficiaries of the trust and any connected person related to the beneficiary.
- Partnerships – members of the partnership or foreign partnership, and any connected person related to a member.
- In respect of companies – other companies considered part of the same group (if more than 50% of equity shares or voting rights are held), companies where at least 20% of equity shares or voting rights are held directly or indirectly, and other companies managed or controlled by connected persons. Close corporations also fall under this definition.
- Any person connected to another person according to the aforementioned provisions.

An associated enterprise means an associated enterprise as contemplated in Article 9 of the Model Tax Convention on Income and Capital of the OECD.

3. Methods and Method Selection and Application

3.1 Transfer Pricing Methods

Accepted transfer pricing methods in South Africa follow those set out by the OECD, with an emphasis on the use of the most appropriate method. The practice is that the OECD Transfer Pricing Guidelines are consulted for purposes of selecting the most appropriate transfer pricing method, amongst the:

- traditional transaction methods including:
  - (a) comparable uncontrolled price (CUP) method;
  - (b) resale price method;
  - (c) cost plus method; and
- transactional profit methods including:
  - (a) transactional net margin method; and
  - (b) transactional profit split method.

3.2 Unspecified Methods

Taxpayers must employ the most appropriate method among those prescribed by the OECD.

3.3 Hierarchy of Methods

In South Africa, the hierarchy of methods is not applied. Taxpayers are required to use the most appropriate method.

While Section 31 and PN7 don't establish a strict hierarchy for applying methods, traditional transaction methods are typically favoured, with the CUP method being preferred among them.

Among transactional profit methods, the TNMM tends to be favoured due to its perceived objectivity. However, SARS points out that comparing

operating expenses requires a similar structure of business to be truly reliable. This ensures a more accurate assessment of comparability.

3.4 Ranges and Statistical Measures

Determining the most appropriate transfer pricing method can result in a range of justifiable transfer prices. Within this range, selecting a specific price involves exercising judgement based on various factors.

For traditional transaction methods, a high level of comparability is essential. If the data is comparable and the transaction falls within the established range, it is generally considered to be at arm's length, meaning it reflects the price that unrelated parties would agree upon in a similar transaction under similar circumstances.

However, where the transaction falls outside the range, the adjustment should reflect the point in the range that best accounts for the facts and circumstances of the controlled transaction; in the absence of persuasive evidence for the selection of a particular point in the range, SARS may select the midpoint in the range.

In practice, SARS generally accepts an inter-quartile range, established after a proper search of comparables on a recognised database, as a reasonable basis from which further adjustments should be made for the particular circumstances of the taxpayer.

SARS warns that the ranges established by application of other methods will be evaluated thoroughly since the methods can result in extensive ranges, some of which may not be sufficiently accurate to permit the general statement that any point in the range may be regarded as arm's length.

3.5 Comparability Adjustments

The South African transfer pricing legislation does not contain a specific provision or inclusion for comparability adjustments. However, the OECD Transfer Pricing Guidelines are consulted to provide guidance on comparability adjustments.

Comparability adjustments could take place as a result of various factors which may have an impact on price.

4. Intangibles

4.1 Notable Rules

The South African domestic transfer pricing legislation does not contain a specific provision or inclusion on the pricing of transactions involving intangibles. However, South Africa follows the OECD Transfer Pricing Guidelines, which provide in-depth guidance on pricing of controlled transactions involving intangibles. This is referred to in PN7.

4.2 Hard-to-Value Intangibles

South Africa does not have any special rules regarding hard-to-value intangibles and follows the OECD Transfer Pricing Guidelines in this regard.

4.3 Cost Sharing/Cost Contribution Arrangements

South Africa permits cost sharing or cost contribution arrangements (CCAs) which involve multiple parties sharing the costs and risks associated with the development, production, or protection of assets as well as each participant's rights or interests in respect of such assets.

While South Africa acknowledges the concept of CCAs in principle, there is no specific legis-

lation, regulations or guidelines tailored exclusively to such arrangements. However, the arm's length standard and the OECD Transfer Pricing Guidelines are typically applied to CCAs in South Africa, ensuring that the contributions made by each party are valued appropriately and reflect the economic realities of the arrangement.

5. Affirmative Adjustments

5.1 Rules on Affirmative Transfer Pricing Adjustments

If the preparer of a tax return (ITR14) realises that an error has been made after submission of a return, the Request for Correction (RFC) process allows for the correction of a previously submitted return. This option is available on the relevant tax work page on the SARS e-Filing platform.

An RFC will not be allowed by SARS under the following circumstances.

- The prescribed period to amend an assessment has passed.
- There is a dispute in progress.
- An audit case has been finalised for the same year of assessment.
- A revised declaration or agreed estimate was performed by SARS for the company for the same year of assessment.
- The supporting document(s) has been submitted by the taxpayer after a compliance audit case was created for the same year of assessment.
- An active Limited/Full scope audit case exists for the same year of assessment.

6. Cross-Border Information Sharing

6.1 Sharing Taxpayer Information

South Africa has entered into various international treaties whereby exchange of information has been agreed. Such agreements have been concluded with Australia, Austria, Belarus, Belgium, Brazil, Bulgaria, Canada, Chile, China, Croatia, Cyprus, Czech Republic, Denmark, Finland, France, Germany, Greece, Hong Kong, Hungary, India, Indonesia, Iran, Ireland, Israel, Italy, Japan, Korea, Kuwait, Luxembourg, Malaysia, Malta, Mexico, Netherlands, New Zealand, Norway, Oman, Pakistan, Poland, Portugal, Qatar, Romania, Russian Federation, Saudi Arabia, Singapore, Slovak Republic, Spain, Sweden, Switzerland, Taiwan, Thailand, Turkey, Ukraine, United Arab Emirates, United Kingdom and the United States of America.

7. Advance Pricing Agreements (APAs)

7.1 Programmes Allowing for Rulings Regarding Transfer Pricing

The Tax Administration Laws Amendment Act, 18 of 2023, under Section 76A, introduced a framework for establishing an advance pricing agreement (APA) programme in South Africa. This section sets out the definition of an APA, its purpose, the relevant application fees, amendments, withdrawal, rejection, processing, compliance, extension and termination of APAs, along with procedures and guidelines.

7.2 Administration of Programmes

The programme is administered by a competent authority authorised by government to administer an agreement for the avoidance of double taxation.

7.3 Co-ordination Between the APA Process and Mutual Agreement Procedures

The proposed model for establishing APAs has not yet been implemented and accordingly, it cannot be determined at this stage whether there will be co-ordination between the APA process and Mutual Agreement Procedures.

7.4 Limits on Taxpayers/Transactions Eligible for an APA

Currently, notice of the limits regarding APAs through publication in the Government Gazette is awaited.

7.5 APA Application Deadlines

Currently, deadlines, including the form and manner of submission, in respect of APA applications through publication in the Government Gazette, is awaited.

7.6 APA User Fees

Currently, prescribed fees for APA applications through publication in the Government Gazette is awaited, which may include a pre-application consultation fee, an application fee, a cost recovery fee for processing an APA agreement application, and fees associated with the maintenance or extension of an existing APA.

7.7 Duration of APA Cover

In South Africa, APAs are valid for a maximum of five consecutive years of assessment. Upon specific request by a taxpayer, an extension of up to three additional years of assessment may be sought from SARS, commencing the day after the conclusion of the last year of assessment.

7.8 Retroactive Effect for APAs

The proposed model for establishing advance pricing agreements has not yet been implemented. Consequently, it remains uncertain whether APAs will have a retroactive impact until a court determines whether APA regulations or rules can apply retroactively.

8. Penalties and Documentation

8.1 Transfer Pricing Penalties and Defences

Penalties

The South African domestic transfer pricing legislation does not provide for any specific penalties or compliance incentives pertaining to the filing of transfer pricing documentation.

However, the general administrative penalties will apply for the late or non-filing of country-by-county reports (CbCR), master files and local files.

Administrative non-compliance penalties comprise fixed amount penalties as well as percentage-based penalties in accordance with Sections 210(1) and 211 of the TAA.

The penalty amount that will be charged depends on a taxpayer's taxable income and can range from ZAR250 up to ZAR16 000 a month for each month that the non-compliance continues.

Where the application of non-arm's length terms has resulted in any prejudice to SARS, the taxpayer may be liable for understatement penalties in terms of Section 222 of the TAA.

Understatement penalties are determined as a percentage of the difference between the understated amount of tax and the amount that should properly have been chargeable to tax. The percentage depends on the "behaviour" involved in the understatement and ranges between 10%, for a first case of "substantial understatement"

to 200% for a repeat case of "intentional tax evasion".

Transfer Pricing Documentation

South Africa has implemented the OECD's "three-tiered" approach to transfer pricing documentation, consisting of a CbCR, a master file and local file.

- Regulation 1598 issued by the Minister of Finance provides regulations for purposes of paragraph (b) of the definition of "International Tax Standard" in Section 1 of the TAA, promulgated under Section 257 of the TAA, specifying the changes to the CbCR standard for multinational enterprises. These Regulations specify the changes to the CbC Reporting Standard for MNEs required for South Africa's circumstances. The Regulations provide information with regards to which entities will have filing obligations, notification requirements, the specific information required to be included in the CbCR and timing of filing.
- In addition, Public Notice 1117 was issued in respect of returns to be submitted by persons in terms of Section 25 of the TAA.

The Notice provides that a Reporting Entity, as defined in the CbC Regulations, will be required to submit information relating to all three tiers of documentation (ie, CbCR, master file and local file). In addition, a person whose aggregate potentially affected transactions (essentially cross-border transactions with a connected person) for the year of assessment exceed or are reasonably expected to exceed R100 million for the year of assessment, will be required to submit the information relating to the master file and local file.

- The necessary returns must be submitted within 12 months of the end of the taxpayer's financial year.
- In addition to the submission of transfer pricing returns, SARS issued Public Notice 1334, in terms of Section 29 of the TAA, which provides for additional record keeping requirements specific to transfer pricing ("South Africa Record Keeping Requirements"). The South African Record Keeping Requirements provide for two levels of record keeping:
  - (a) records in respect of structure and operations – a person is required to keep records where the person has entered into a "potentially affected transaction", as defined, and the aggregate of the potentially affected transactions for the year of assessment exceeds or is reasonably expected to exceed R100 million; and
  - (b) records in respect of transactions – a person who has entered into a "potentially affected transaction" must keep records in respect of any such transaction which exceeds or is reasonably expected to exceed R5 million in value.

8.2 Taxpayer Obligations Under the OECD Transfer Pricing Guidelines

South African taxpayers are required to compile a master file consistent with Annexure I to Chapter V of the OECD Transfer Pricing Guidelines, a local file consistent with Annexure II to Chapter V of the OECD Transfer Pricing Guidelines and CbCR consistent with Annexure III to Chapter V of the OECD Transfer Pricing Guidelines.

9. Alignment With OECD Transfer Pricing Guidelines

9.1 Alignment and Differences
South Africa follows the OECD Transfer Pricing Guidelines.

9.2 Arm's Length Principle
South Africa follows the OECD Transfer Pricing Guidelines.

9.3 Impact of the Base Erosion and Profit Shifting (BEPS) Project
South Africa is a member of the G20, the OECD/G20's BEPS Project and the OECD's Inclusive Framework, in addition to its OECD Committee on Fiscal Affairs observer status since 2004.

South Africa has been amongst the first adopters of BEPS Actions in general.

SARS has consistently endorsed the OECD Transfer Pricing Guidelines in its policies, and legislative amendments to the South African ITA have been made to reflect certain guidance contained in the OECD Transfer Pricing Guidelines.

Notably, South Africa:

- was amongst the first batch of signatories to the Multilateral Instrument (MLI) in June 2017 (South Africa ratified the MLI in 2022);
- enacted (in 2016 and 2017) domestic regulations to enact transfer pricing documentation requirements aligned with Chapter V of the OECD's 2017 Transfer Pricing Guidelines (also referred to as BEPS Action 13), including the exchange of CbCR; and
- committed to implementing BEPS Action 14, Making Dispute Resolution Mechanisms More Effective.

9.4 Impact of BEPS 2.0
The Minister of Finance in his 2022/2023 Budget Speech presented to Parliament on 23 February 2022 announced that South Africa will introduce legislative amendments to implement the two-pillar solution once the framework is translated into local context.

South Africa will be implementing the Pillar Two Global Minimum Tax Rules, including an Income Inclusion Rule (IIR) and Domestic Minimum Top-Up Tax (DMTT). Subject to approval, the legislation for the new rules will be deemed to have come into operation on 1 January 2024 and will apply to fiscal years commencing on or after that date.

9.5 Entities Bearing the Risk of Another Entity's Operations
South Africa does not permit one entity in South Africa to bear the risk of another resident entity's operations.

10. Relevance of the United Nations Practical Manual on Transfer Pricing

10.1 Impact of UN Practical Manual on Transfer Pricing
In South Africa, while the UN Practical Manual on Transfer Pricing is taken into consideration, it does not have a direct impact on transfer pricing practice or enforcement.

11. Safe Harbours or Other Unique Rules

11.1 Transfer Pricing Safe Harbours
South Africa does not have specific transfer pricing safe harbours outlined in its legislation.

11.2 Rules on Savings Arising From Operating in the Jurisdiction

South Africa does not have any rules governing savings that arise from operating in South Africa.

11.3 Unique Transfer Pricing Rules or Practices

South Africa does not have any unique rules or practices applicable in the transfer pricing context.

12. Co-ordination With Customs Valuation

12.1 Co-ordination Requirements Between Transfer Pricing and Customs Valuation

There is co-ordination between transfer pricing and customs valuation from a South African perspective, notably as follows.

Value Declared to SARS at the Time of Importation

The Customs and Excise Act, 1964 (the "Customs Act") provides that the transaction value (price paid or payable for goods when such goods are sold for export to South Africa) between related parties will only be accepted for customs valuation purposes where the importer can demonstrate that:

- the relationship between the related parties did not influence the price paid or payable for the goods; or
- the transaction value closely approximates to one of the following test values:
  - (a) the transaction value of identical or similar goods sold at comparable trade and quantity levels to unrelated buyers in South Africa at or about the same time as the goods to be valued;
  - (b) the unit price at which the imported goods or identical or similar imported goods are sold (by the importers thereof to persons not related to them) in South Africa in the greatest aggregate quantity, at or about the time of importation of the goods to be valued; or
  - (c) a computed value, computed by means of specific information supplied by the producer of the goods.

Transfer pricing documents are an integral part of assessing whether the transaction values declared by the importer to SARS:

- are acceptable as values that closely approximate to one of the test values; or
- have been influenced by the relationship between the related parties.

Transfer Pricing Adjustments

The Customs Act provides that the importer must notify SARS Customs of any credit note, debit note or amended invoice, issued after importation of the goods, which adjusts the original invoice declared to SARS for purposes of importing the goods. The notification to SARS must detail the circumstances of the credit note, debit note or amended invoice and must be made within one month of the importer's receipt of the credit note, debit note or amended invoice.

Draft amendments of the rules to the Customs Act have recently been published which provide for the manner in which bills of entry may be adjusted where the customs value declared to SARS is affected by transfer pricing adjustments. The amended rules set out in detail the information and documentation that must accompany the notification letter to SARS which include, inter alia:

- the invoice, debit or credit note;
- transfer pricing policy;
- the adjustment factor used to determine the adjustment to the value as reflected in the transfer pricing policy; and
- the effect of the changes indicated on the customs duty and VAT in respect of the relevant bill of entry.

If the transfer pricing adjustment results in an increase to the declared customs value, the importer will be liable for the payment of any underpaid duties and value-added tax, as a result thereof.

If the transfer pricing adjustment results in a decrease to the declared customs value, the importer may submit vouchers of correction to SARS and a refund claim for any overpaid duties.

13. Controversy Process

13.1 Options and Requirements in Transfer Pricing Controversies

South Africa does not have a controversy process specifically for transfer pricing matters and the general tax controversy process is applied.

Once an audit has been completed, the taxpayer is entitled to object to an additional assessment raised by SARS and follow the normal process to resolve the dispute.

The legal foundation for these disputes, relating to all tax types administered by SARS except for the customs and excise Acts, is outlined in Chapter 9 of the TAA, along with the regulations established under Section 103 of the South African ITA.

Alternative dispute resolution procedures may also be followed at the election of the parties in order to resolve a TP dispute.

Under the “pay now argue later” rule, taxpayers are required to pay amounts owing to SARS, despite disputing the amount so owing. Such obligation is not suspended when an objection has been lodged.

Tax matters are addressed through the tax court, a specialised court dedicated to resolving tax disputes. The tax court possesses exclusive jurisdiction over tax matters and procedural issues related to tax matters.

Provision is made for appeals to higher courts under the required circumstances.

14. Judicial Precedent

14.1 Judicial Precedent on Transfer Pricing

The jurisprudence concerning transfer pricing is not extensively developed in South Africa and to date there has been only one transfer pricing case heard by the courts.

14.2 Significant Court Rulings

Aside from a case primarily addressing procedural aspects related to a transfer pricing dispute, there is only one case dedicated to transfer pricing.

In IT 14302 the case involved the determination of the value of a right in respect of intellectual property, and the calculation of royalties based on the value of such right, and the different methodologies used in these calculations, which yielded widely different outcomes.

During 2011, the taxpayer obtained advice on the royalty rate to be charged to its various operating companies, which resulted in a 1% royalty rate. SARS issued additional assessments to the South African resident company taxpayer during 2014 for the taxpayer's 2009 tax year under Section 31(2) of the ITA and contended that the transactions between the South African taxpayer and its operating companies did not meet the arm's length standard to the extent that a royalty of 1% is not an arm's length royalty and that a variable rate should have applied depending on the country and the year it was earned.

The court was tasked with determining the arm's length price of the royalty (taking into account its rationale for trade consequences and fairness) and the various methodologies that could be used to calculate the arm's length price.

The court found that where it is possible to locate a comparable cup, the OECD Transfer Pricing Guidelines provide that an internal CUP is the preferred method for determining the arm's length price and in the circumstances, there was a comparable internal CUP which reflected a royalty rate of 1%.

The taxpayer's appeal for years 2009 to 2012 was upheld and SARS' additional assessments set aside.

The case underscores the importance of adhering to the arm's length standard in determining royalty rates for intellectual property transactions. It highlights the necessity of considering various methodologies for calculating arm's length prices and the relevance of the OECD Transfer Pricing Guidelines in this context. It emphasises the preference for the CUP method when comparable information is available and the use of the most appropriate transfer pricing method.

15. Foreign Payment Restrictions

15.1 Restrictions on Outbound Payments Relating to Uncontrolled Transactions

In respect of externalising funds in relation to uncontrolled transactions, South Africa has country-specific exchange controls which could significantly complicate or delay cross-border cash flows.

Exchange control rules, generally administered by South Africa's central bank (Reserve Bank), are aimed at regulating inward and outward capital flows. Sometimes exchange control rules may prohibit certain categories of cross-border cash flows unless prior approval has been obtained.

Obtaining exchange control approvals can be a time-consuming and administratively burdensome process. In many instances, cross-border cash flows can practically be implemented, completely or partially without prior approval. However, prior approval may be required to declare dividends, settle foreign loans or interest payments, pay royalties and service fees, etc. Specific terms and conditions may apply to payments as advised by an Authorised Dealer or the Reserve Bank.

15.2 Restrictions on Outbound Payments Relating to Controlled Transactions

In South Africa, the Reserve Bank is responsible for reviewing and approving cross-border payments to connected parties in controlled transactions. Such approval is required in order to externalise funds.

15.3 Effects of Other Countries' Legal Restrictions

South Africa does not have any rules regarding the effects of other countries' legal restrictions contained in its domestic legislation.

16. Transparency and Confidentiality

16.1 Publication of Information on APAs or Transfer Pricing Audit Outcomes

The general rule is that every person employed by SARS in carrying out the provisions of the South African ITA must preserve the secrecy of matters that may come to that person's knowledge in the performance of that person's duties. Such persons are not entitled to communicate any such matter to any person who is not a SARS official.

There are specific exceptions to this rule but it is uncertain whether exceptions will be made for the publication of information on APAs.

Details concerning the outcomes of transfer pricing audits should remain confidential owing to the secrecy provisions or owing to settlement or other agreements with SARS.

16.2 Use of "Secret Comparables"

South Africa does not explicitly prohibit the use of "secret comparables" in transfer pricing documentation. However, the use of undisclosed or "secret comparables" could give rise to concerns regarding the transparency and accuracy of transfer pricing analyses which rely on such comparables.

In PN7, SARS recognises that it may have access to information which is not publicly available. It admits that the secrecy provisions under the tax legislation may prevent such information from being used as evidence in a court of law. Nevertheless, SARS could utilise such information for other purposes in performing its mandate.

SOUTH KOREA

Law and Practice

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Lee & Ko was founded in 1977 and is one of the oldest and largest Korean law firms. The specialised tax practice group includes expert tax lawyers and former government and tax officials, who assist clients to effectively handle civil and criminal tax investigations; former judges with vast experience in handling cases at all levels of litigation; and certified public accountants (including some members licensed as both lawyers and certified public accountants) with many years of dedicated tax experience. The group offers focused advice on tax planning, consultancy, audits, disputes, advanced ruling and legislative consulting, and transfer pricing. Current clients of the tax practice include nearly all of the largest Korean corporations and financial institutions, as well as many Fortune 500 companies. For many years the tax practice has been ranked at or near the top of the list of best Korean law firms by leading international and Korean legal directories.

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1. Rules Governing Transfer Pricing

1.1 Statutes and Regulations

The Korean transfer pricing (TP) regulatory regime is set out in the Law for the Co-ordination of International Tax Affairs (LCITA), and the enforcement and interpretative regulations, namely the Presidential Enforcement Decree of the LCITA and the Ordinance of the Ministry of Economy and Finance (MOEF) of the LCITA.

In addition to the TP legislation, the commissioner of the National Tax Service (NTS) may issue administrative orders and rulings to ensure consistent application of the laws. These do not constitute binding authority in Korea. Instead, the courts have final authority in interpreting the tax laws, including those governing the TP regulatory regime.

1.2 Current Regime and Recent Changes

Since its inception in 1990, the Korean TP regime under the LCITA has undergone continuous development, keeping pace with similar developments that have taken place in other OECD countries. Broadly, there were five major milestones, which are as follows.

The Origins of the Korean TP Regulatory Regime

The need for a TP regulatory regime first emerged against the backdrop of Korea's rapid economic growth in the 1980s, and the ensuing increase in the volume of cross-border transactions by multinational businesses. The first TP regulations were introduced in 1988.

Initially, these TP regulations were contained within a provision of the Presidential Enforcement Decree of the Corporate Income Tax Law (CITA), under an article relating to the denial of unfair transactions. This article regulated unfair transactions among related parties (at that time, applicable to both domestic and cross-border related-party transactions). Subsequently, the TP regulatory regime was made more robust when, in 1990, the Ministry of Finance and the NTS introduced standalone TP rules and regulations, to assist with interpretation of the above-mentioned CITA provision.

The Emergence of a Separate Statute Regulating TP and International Taxation

In the 1990s, there were significant changes to the US TP regime – ie, Section 482 and its subordinating regulations – as well as to the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the "OECD Guidelines"). To align Korea's tax law and practices with international norms in anticipation of joining the OECD, the LCITA, a separate statute governing TP and international taxation, was introduced in January 1996. The then-existing TP regulations under the CITA were relocated to the LCITA to reflect these international changes, with the LCITA and its regulations adopting the main contents of the OECD Guidelines.

The Korean TP Regime Overhauled

In the 2000s, the cross-border transactions of multinationals became increasingly complex, and it became apparent that Korea's TP regime lacked the sophistication and detail to keep pace with modern developments. As a result, disputes between taxpayers and tax authorities increased significantly during this period. To address this issue, the Korean government overhauled the TP regime in 2010. The new regime gave the NTS the right to adjust income and tax liability based on the arm's length principle, abolished the preferential application of the traditional transaction methods, and introduced more sophisticated TP methods that entailed features such as inte-

grated analysis and multi-year analysis of related transactions.

BEPS Actions 8–10 and 13 Codified Into the Korean TP Regime

With the emergence of the OECD's base erosion and profit shifting (BEPS) project in 2015, the government codified the contents of BEPS Actions 8–10 and 13 into the Korean TP regime. Consequently, new taxpayer reporting obligations were introduced into the LCITA, including preparing and submitting a "local file", "master file", and country-by-country (CbC) reporting. In addition, in line with the core concepts introduced in the pertinent BEPS Actions, the concept and scope of intangible assets were refined, and the arm's length principle was further refined.

OECD's Transfer Pricing Guidance on Financial Transactions and the COVID-19 Pandemic Codified Into the Korean TP Regime

The OECD's recent developments on transfer pricing were partly transposed into the LCITA and its subordinating regulations in 2022. Newly codified intercompany loan pricing methodologies by reference to the OECD's Transfer Pricing Guidance on Financial Transactions published in October 2020 have reinforced the LCITA's existing regime, which lacked sophistication, and have provided specific guidance to allow for greater tax certainty. In addition, a cash pool arrangement provision has been created under the subordinating regulations of the LCITA, where it prescribes the definition of a "cash pool arrangement" and how to derive arm's length remuneration for a cash pool leader and participants.

In line with the content of the OECD's Guidance on the Transfer Pricing Implications of the COVID-19 Pandemic published in December 2020, starting from 2022, taxpayers in Korea are allowed to include loss-making companies in their benchmarking analysis, if deemed appropriate, since such provision has been adopted into the subordinating regulations of the LCITA. From this historical background, the modern Korean TP regime has emerged as one that is highly synchronised with the OECD Guidelines.

2. Definition of Control/Related Parties

2.1 Application of Transfer Pricing Rules

Shareholding Test

The basic test of whether the parties to a transaction are related is based on percentage of ownership, as follows:

- a domestic resident owns, directly or indirectly, at least 50% of the voting shares of another foreign company;
- a foreign resident owns, directly or indirectly, at least 50% of the voting shares of a domestic company or a foreign company having a domestic place of business in Korea; or
- a third party, together with their relatives, holding, directly or indirectly, at least 50% of the voting shares of a domestic company or a foreign company having a domestic place of business in Korea, owns, directly or indirectly, at least 50% of another foreign company's voting shares.

De Facto Control Test

In addition, a related-party relationship also exists when one party to a transaction has de facto control over the other party, in respect of the transaction being tested. Such control is deemed to exist if one of the following criteria is satisfied:

- the parties have a common interest through an investment in capital, trade in goods or services, grant of a loan, or similar financial provision, and either party has the power to substantially determine the business policy of the other by any of the following means:
  - (a) at least 50% of the executive officers of the one party assumes the position of executive officers of the other party within three years;
  - (b) one party owns at least 50% of the voting shares of the other party through an association or trust;
  - (c) one party borrows at least 50% of the funds from the other party; or
  - (d) one party depends on the intellectual property right provided by the other party for at least 50% of its business activities;
- both parties have a common interest through an investment in capital, trade in goods or services, grant of a loan, or similar financial provision, and a third party has the power to substantially determine the business policies of both transacting parties by any of the following means:
  - (a) a third party owns, directly or indirectly, at least 50% of the voting shares of one party and has the power to substantially determine the business policies of the other party;
  - (b) a third party has the power to substantially determine the business policies of both parties; or
  - (c) one party is an affiliated company of a group within the context of competition law in Korea and another affiliated company of the same group owns, directly or indirectly, at least 50% of the voting shares of the other party.

When assessing whether one party has the power to substantially determine the business policy of the other, the amount of borrowings, the level of dependency of one party on the other, the control of the board and management, and other similar factors should be considered under a general facts and circumstances analysis.

3. Methods and Method Selection and Application

3.1 Transfer Pricing Methods

Article 8 of the LCITA lists six methods of calculating the arm's length price, as follows:

- comparable uncontrolled price method (CUP);
- resale price method (RPM);
- cost-plus method (CPM);
- transactional net margin method (TNMM);
- profit split method (PSM); and
- other reasonable methods.

3.2 Unspecified Methods

The last category in **3.1 Transfer Pricing Methods**, "other reasonable methods", should be applied only when none of the first five TP methods can reasonably be applied to derive an arm's length price. In this situation, other reasonable methods can be considered if their application can be deemed reasonable in the light of the customary practice and the substance of the transaction in question.

3.3 Hierarchy of Methods

CUP, RPM and CPM are categorised as "traditional transaction methods". By contrast, PSM and TNMM are categorised as "transactional profit methods". Previously, the traditional transaction methods were applied first, taking priority over the transactional profit methods.

However, the LCITA was revised at the end of 2010, abolishing this prioritisation, and since

that time taxpayers have been free to select the most reasonable method among the five TP methods available.

However, as described above, "other reasonable methods" can be applied only when none of the five specified TP methods can be reasonably applied. So, in that respect only, there is a limited hierarchy of methods.

3.4 Ranges and Statistical Measures

It is possible for the NTS or taxpayers to adjust the tax base based on the arm's length range, where the price applied to the cross-border related-party transaction is lower or higher than the arm's length price. More specifically, the NTS cites the concept of "interquartile range" as an example of a reasonable method of calculating the arm's length range.

3.5 Comparability Adjustments

Comparability Adjustments per the LCITA

When calculating the arm's length price, if there is some factor that makes it difficult to compare directly between the related-party transaction and comparable third-party transactions, an adjustment can be made to take this factor into account. Such factors include:

- types and characteristics of goods or services;
- functions of business activities;
- risks associated with transactions;
- assets used;
- contractual terms and conditions;
- economic conditions; and
- business strategies.

Risk Analysis Framework From the OECD Guidelines

In addition, it is noteworthy that the risk analysis framework first introduced in Chapter 1 of the OECD Guidelines released in July 2017 was codified into the LCITA in 2019. The purpose of this framework is to identify and assess economically significant risks assumed by taxpayers and their foreign related parties by virtue of accurately delineating controlled transactions. By incorporating this into Korean domestic law, taxpayers now have more practical and detailed guidance on the comparability adjustments.

4. Intangibles

4.1 Notable Rules

Definition of Intangibles in the Context of TP and Applicable TP Methods

The LCITA and its subordinating regulations provide a definition and examples of intangible assets, as well as stipulating factors to be considered when executing transactions involving intangibles with foreign related parties. CUP and PSM are given priority as the most appropriate TP methods for calculating the arm's length price for such transactions. If these priority methods are difficult to apply, other reasonable methods, such as the "discounted cash flow" method, can be used.

The Concept of Economic Ownership

When calculating the arm's length price for a transaction involving intangible assets between a resident taxpayer and foreign related parties, regardless of who legally owns the intangible assets, the allocation of excess profits created from the intangibles should be commensurate with the respective value contribution and the level of DEMPE (development, enhancement, maintenance, protection and exploitation) performed by each entity in the value chain. The focus is on the practical use and maintenance of the intangible asset; that is, economic ownership

rather than legal ownership. This is consistent with the OECD Guidelines.

4.2 Hard-to-Value Intangibles

Classification of Hard-to-Value Intangibles (HTVI)

Intangible assets that satisfy all the following requirements are classified as HTVI:

- when there is no comparable transaction between third parties at the time of the transaction involving intangible assets; and
- the intangible assets are under development, and they are expected to take a long time to be used commercially; or there is a high degree of uncertainty about the economic benefits expected from the intangible assets at the time of the transaction (this could be due to the level of innovation involved, or other similar unforeseen factors).

Ex Post Outcomes: Presumptive Evidence

In situations involving the transfer of HTVI or rights in HTVI, an outcome where the actual price exceeds 120% of the price agreed upon by related parties prior to the transaction can create a rebuttable presumption. Specifically, the NTS will be entitled to presume and able to claim that the price agreed in advance did not appropriately take into account reasonably foreseeable developments. Therefore, the presumption will be that the transfer price is unreliable.

Taxpayers can rebut this presumption by producing evidence showing that:

- they appropriately took into account the relevant factors when reaching their pricing arrangement; and
- the difference in the actual outcome was due to unforeseeable developments.

4.3 Cost Sharing/Cost Contribution Arrangements

A cost contribution arrangement (CCA) regime was initially codified into the LCITA in 2006, and since then, there have been several revisions to the provision.

The NTS's Authority to Re-determine the Arm's Length Deduction

The NTS has the authority to re-determine the tax base and tax liability of a resident company if:

- a resident business enters into a CCA with a foreign-related party, in order to jointly develop or acquire intangible assets; and
- the resident's actual share of costs is higher or lower than an arm's length share.

The NTS will then adjust the resident's share of the costs, based on the arm's length principle.

The NTS is especially likely to wield this authority if there is a 20% or more difference between the benefit that is expected (i) at the time of executing the CCA agreement, and (ii) after the joint development.

Methods of Measuring the Expected Benefit

The expected benefit can be calculated by considering one of the following as a proxy for the benefit received:

- costs saved; or
- an increase in any of the following items due to the use of intangible assets:
  - (a) sales;
  - (b) operating profit; or
  - (c) usage, production or sales volume.

NTS's Viewpoint on the CCA

Despite the enactment of the CCA regime in the LCITA, in practice, tax auditors have often challenged the validity of the CCA and typically deemed the payments made under the CCA as royalties to assess withholding taxes in Korea. As intangibles and CCA-related provisions have been supplemented during recent years, it is expected that the NTS will acknowledge the existence and the importance of intangibles and shift its view and perception to better recognise the CCA in practice as well.

5. Affirmative Adjustments

5.1 Rules on Affirmative Transfer Pricing Adjustments

The Taxpayer's Right to Make an Affirmative TP Adjustment

Taxpayers can make "self-initiated" TP adjustments, both downward and upward, provided there is a legitimate reason for doing so, such as, if there has been a deviation from an arm's length price. One noteworthy point is that this particular taxpayer's right was previously contained in the LCITA's subordinating regulations, but in 2019 was moved into the LCITA, demonstrating the importance of this taxpayer's right.

Circumstances That Warrant an Affirmative TP Adjustment

Taxpayers can make this type of adjustment by incorporating it as part of the tax return or filing a separate amended return, if the actual transaction price applied is lower or higher than the arm's length price in a cross-border related-party transaction. The deadline for the adjustment, which is consistent with the statute of limitations, is five years for a downward adjustment and seven years for an upward adjustment.

Another circumstance in which the adjustment can be made is when a mutual agreement procedure (MAP) or advance pricing agreement (APA) has been concluded. In this case, an adjustment can be made to harmonise the reported tax base and liability with the MAP or APA. Such an adjustment should be made by filing a return within three months of the notice of conclusion of the MAP or APA.

6. Cross-Border Information Sharing

6.1 Sharing Taxpayer Information

As of the end of December 2023, South Korea has signed 95 tax treaties (up from 94 last year due to a recently sealed tax treaty with Taiwan) and 12 "tax information exchange agreements". South Korea is also one of 147 signatories to the Convention on Mutual Administrative Assistance in Tax Matters.

The exchange of more TP-specific information with other taxing authorities is facilitated by the Multilateral Competent Authority Agreement, which allows signatories to exchange CbC reporting. South Korea is one of 100 signatories, and it has also separately signed a CbC reporting exchange agreement with the USA, based on the existing tax information exchange agreement with the USA.

7. Advance Pricing Agreements (APAs)

7.1 Programmes Allowing for Rulings Regarding Transfer Pricing

History of the Korean APA Programme

Korea launched its APA programme in 1995, and its first APA case was concluded with the USA

in May 1997. Since then, of 912 APA applications (both unilateral and bilateral), 666 cases had been concluded as at 31 December 2022. As is apparent from these statistics, the Korean APA programme has been very active since its inception, and it is expected that the demand for APAs will gradually increase, as many Korean companies set up their manufacturing and distribution entities in other parts of the world.

Types of APAs

Korean taxpayers can apply for a unilateral or bilateral APA, depending on the objective of the taxpayers and availability of MAP provision (ie, a bilateral APA) per pertinent tax treaty. However, it is noteworthy that even though the NTS still accepts unilateral APA applications due to the shorter processing time, etc, unilateral APAs are somewhat less favoured due to their limitation as a double tax prevention measure, unless taxpayers have a particular reason to pursue a unilateral APA.

7.2 Administration of Programmes

A starting point for processing APAs in Korea is to file an application for a pre-filing meeting with the NTS officers at the APA/MAP office, which sits within the International Taxation Bureau of the NTS Head Office. After successfully completing a pre-filing meeting and receiving a go-ahead sign from the APA/MAP office, taxpayers become eligible to file an official APA application to the APA/MAP office. Once an APA application is filed and the negotiation with the competent authority of the other contracting state is completed, the commissioner of the NTS has the final authority to approve APAs.

7.3 Co-ordination Between the APA Process and Mutual Agreement Procedures

As with many other countries, APA and MAP cases are assigned to sub-units within the APA/MAP team of the NTS, based on the counterparty's jurisdiction. Usually, one sub-unit is responsible for a few different jurisdictions in relation to APAs and MAPs.

Since APA and MAP cases are assigned within the APA/MAP office based on the country of the counterparty, APAs and MAPs can sometimes be reviewed together, and merged cases tend to result in a speedier process, due to the overlapping circumstances.

Even though in theory there is no law requiring NTS officials working on APAs and MAPs to co-operate, in practice, there is definitely co-ordination between these NTS teams.

7.4 Limits on Taxpayers/Transactions Eligible for an APA

Technically, there is no restriction on which taxpayers or transactions are eligible for an APA, as long as the taxpayer in question is a Korean legal entity or a branch/permanent establishment of a foreign corporation.

In practice, however, only taxpayers with a material amount of cross-border related-party transactions find APAs useful, in light of the potential tax exposure that could arise from TP-based assessment. There is no rule of thumb as to what constitutes a "material amount", as there can be substantial variation, depending on the industry and individual companies.

7.5 APA Application Deadlines

A taxpayer may file an application for an APA to the NTS at any point up to the day before the

commencement of the first year of the proposed covered period. For example, if a taxpayer applies for a five-year APA to run from 1 January 2025 to 31 December 2029, then the application must be filed by 31 December 2024. However, in order to file the application in time, the preparation for the APA should proceed at least six months before in light of the time required to complete a pre-filing meeting and secure a go-ahead sign from the NTS.

7.6 APA User Fees

There is no user fee that a taxpayer is required to pay to the NTS in connection with an APA application.

7.7 Duration of APA Cover

There is no statutory or other legal limit as to how many prospective years an APA can cover, but, in practice, taxpayers generally propose five-year coverage in their application.

7.8 Retroactive Effect for APAs

Roll-Back Provision

Taxpayers can request in their APA application that their APA takes retroactive effect.

In the case of APA applications filed before 1 January 2021, a roll-back provision could allow the APA to cover a period of up to five years immediately preceding the covered period, whereas for a unilateral APA, the limit for a roll-back is up to three years.

For APA applications filed after 1 January 2021, a roll-back provision for a bilateral APA could allow the APA to cover a period of up to seven years immediately preceding the covered period under the APA, whereas for a unilateral APA, the limit for a roll-back is up to five years.

APA and Suspension of Tax Audit

In general, a tax audit is not suspended merely by virtue of the taxpayer under audit filing an APA application. The NTS head office, however, may suspend its audit on transactions during the APA-covered period if the taxpayer appropriately filed an APA on the transactions at issue before receiving pre-notice of a tax audit.

8. Penalties and Documentation

8.1 Transfer Pricing Penalties and Defences

There are three main types of TP-related information that the NTS is entitled to request for submission.

TP-Related Forms

A taxpayer that is not subject to the regulations in the Combined Report of International Transactions (CRIT), which is described in the following section, but which still conducts international transactions with foreign related parties must submit the following information within six months from the end of each fiscal year:

- an international transaction statement for each foreign related party (submission is waived if the transaction amount does not reach a certain threshold);
- a summary income statement of each foreign related party that has cross-border transactions with a Korean taxpayer (submission is waived if the transaction amount does not reach a certain threshold); and
- a form stating the TP method selected and reasons for each related-party transaction – there are separate forms for tangible property transactions, intangible property transactions, service transactions and CCAs (but submis-

sion is waived if the transaction amount does not reach a certain threshold).

If any part of the international transaction statement is not submitted or is false, a fine of KRW5 million may be imposed on each foreign related party with which the Korean taxpayer had a transaction during the year.

The Combined Report of International Transactions

If a taxpayer is required to submit the CRIT (the threshold is explained in **8.2 Taxpayer Obligations Under the OECD Transfer Pricing Guidelines**) – consisting of a master file, local file and CbC report – the submission must be made within 12 months from the end of each fiscal year. If all or part of the report is not submitted or is false, a fine of KRW30 million is imposed for each such report. Additionally, for non-compliant taxpayers, the NTS may request the submission of missing reports with 30 days' notice, and failure to comply within such timeframe can trigger interest, which could add up to KRW200 million.

Given the foregoing burden of penalties for non-compliant taxpayers, starting from 2022, taxpayers will be able to benefit from reduced penalties if taxpayers voluntarily take a pre-emptive measure (ie, submission of missing reports or rectifying false information) and the rate of reduction varies from 30% to 90% depending on how soon such measure is taken.

Request for the Submission of a TP Report During a Tax Audit and Contemporaneous TP Documentation

The NTS may request certain information relating to the basis of the arm's length price calculation for TP purposes – ie, TP documentation – when a taxpayer is audited. If so, the taxpayer must submit it within 60 days of the request. If any part of the requested data is not submitted or is false, a fine of KRW30–70 million may be imposed, depending on the level of non-submission. As with the CRIT, the NTS can request the submission of missing reports with a 30-day notice period, where failure to comply within such timeframe can trigger interest, which could add up to KRW200 million.

If the NTS recognises that TP documentation is completed and maintained contemporaneously with a corporate tax return, and if the NTS also considers that the TP method has been carefully selected and applied in a reasonable manner, which could be sometimes quite subjective and contentious, a taxpayer can receive a 10% under-reporting penalty exemption, if at some point that taxpayer is audited and additional tax is assessed based on TP. When contemporaneous TP documentation is requested by the NTS, a taxpayer must submit it within 30 days.

In order to avoid penalties arising from the NTS's request for TP-related information, it is very important to comply with the submission deadline, and it is essential to include a reasonable explanation of the TP method applied by the taxpayer. This explanation should be supported by documentation and corroborating data. Moreover, the format of the TP documentation, and database used for benchmarking, should be in line with local practice and the NTS's expectations, to ensure that it is considered to be substantial and persuasive.

8.2 Taxpayer Obligations Under the OECD Transfer Pricing Guidelines

Threshold Requirements

Taxpayers with sales of KRW100 billion or more and KRW50 billion or more in cross-border transactions with their related parties in a given year are required to submit a master file and a

local file. As for the CbC report, foreign parent companies with sales of KRW1 trillion on a consolidated basis in the immediately preceding year should submit a CbC report, provided that:

- there is no CbC report submission requirement in their home country; and
- their home country has not executed a CbC report exchange treaty with Korea.

Submission Deadline

The CRIT – consisting of the local file, master file and CbC report – should be submitted within 12 months from the end of each fiscal year.

Contemporaneous TP Documentation

For those taxpayers not subject to the CRIT, there is still merit in having TP documentation ready, as the NTS may request it in the course of a tax audit, and if so, it should be submitted within 60 days of the request. Besides, by virtue of preparing contemporaneous TP documentation, taxpayers could benefit from the 10% under-reporting penalty exemption in the event that additional tax is assessed based on TP considerations.

9. Alignment With OECD Transfer Pricing Guidelines

9.1 Alignment and Differences

As an OECD member country, the Korean TP regime is highly synchronised and well aligned with the OECD Guidelines. There may be some minor local tweaks but, by and large, most of the regime is similar to that contained in the OECD Guidelines. This is because the Korean legislature and the MOEF closely monitor developments at the OECD level and adopt them into the Korean TP regime in a timely manner. For example, the updated core transfer pricing concepts introduced in BEPS Actions 8–10 and 13 and transfer pricing guidance on financial transactions as well as the Guidance on the Transfer Pricing Implications of the COVID-19 Pandemic were promptly incorporated into the Korean TP regime.

9.2 Arm's Length Principle

The LCITA defines the arm's length price as "the price that is to be applied or determined to be applied by a resident, a domestic corporation, or a permanent establishment in Korea in its ordinary cross-border transactions with third parties".

Since the price applied in a related-party transaction is judged to be high or low based on the arm's length price, the Korean TP regime has duly adopted the arm's length principle, and any deviation from this principle – eg, formulary apportionment – is not allowed under any circumstances.

As part of the arm's length principle, the NTS needs to fully understand the key details of the international transaction, including the commercial or financial relations between the resident and the foreign related party, as well as important terms and conditions. The NTS will then determine if the transaction makes sense from a commercial standpoint (ie, commercial rationality) when compared with similar transactions between unrelated parties. If it's determined that the transaction is not commercially rational and difficult to compute an arm's length price, the NTS may consider such transaction as if it had not occurred, or apply an arm's length method by re-characterising it as a new transaction in a rational manner.

9.3 Impact of the Base Erosion and Profit Shifting (BEPS) Project

The major impact of the OECD BEPS project on the Korean TP regime was that the obligation to submit the CRIT on cross-border related-party transaction information was stipulated, and the regulations on intangible assets were significantly supplemented. Moreover, due to the BEPS project, the risk analysis framework and a safe harbour provision for low value-adding intra-group services have been also adopted into the Korean TP regime.

The CRIT

If a Korean taxpayer's sales and cross-border related-party transactions exceed certain thresholds, the taxpayer is required to submit the CRIT, which consists of a local file, master file and CbC report. For detailed thresholds, please refer to **8.2 Taxpayer Obligations Under the OECD Transfer Pricing Guidelines**.

Intangible Assets

See **4.1 Notable Rules** and **4.2 Hard-to-Value Intangibles**.

Risk Analysis Framework

See **3.5 Comparability Adjustments**.

Low Value-Adding Intra-Group Services

As introduced in Chapter 7 of the OECD Guidelines, the safe harbour mark-up rate of 5% applicable to low value-adding intra-group services has been codified into Korean legislation, and taxpayers that meet a certain threshold requirement are allowed to apply it without having to conduct a separate benchmarking study. The threshold requirement is as follows:

If the cost plus the safe harbour rate of 5% exceeds the lesser of the following, then a taxpayer is not allowed to invoke and apply the safe harbour provision:

- 5% of the taxpayer's sales; or
- 15% of the taxpayer's operating expenses.

The definition of low value-adding services, and examples, are clearly set out in the legislation. See **11.1 Transfer Pricing Safe Harbours** for further information on low value-adding intra-group services.

9.4 Impact of BEPS 2.0

On 8 October 2021, the OECD/G20 Inclusive Framework on BEPS reached a final agreement on the two-pillar approach to address the tax challenges arising from the digitalisation of the economy. After the agreement, the MOEF announced its intention to codify the two-pillar approach, and execute and implement the multilateral agreement in 2023 as one of the signatories. In January 2022, the MOEF publicly put out a tender for research services on the codification plan for Pillars One and Two respectively.

However, as the development of Pillar One at the OECD level has been dragged on for quite some time and there are still many obstacles to overcome before reaching an implementation stage, it is highly likely that Korea's transposition of Pillar One into its own law will also be delayed.

On the other hand, there has been significant progress with Pillar Two at the level of both the OECD and Korea. Korea is known to be the first country to codify the main elements of Pillar Two into its own international tax regime – ie, the LCITA. It announced a proposed tax law change for 2023, incorporating Pillar Two provisions in July 2022, and later in December 2022, it was officially enacted and codified into a separate part of the LCITA, making Korea one of the early adopters

of Pillar Two. In July 2023, as part of the tax law changes for 2024, more extensive Pillar Two provisions incorporating OECD commentaries and administrative guidance on Pillar Two were proposed, and were officially enacted in December 2023. Particularly, as part of the tax law changes for 2024, the implementation of Undertaxed Payments Rule (UTPR) has been officially postponed from 2023 to 2024 in order to keep pace with other major countries. In January 2024, more specific and detailed regulation on Pillar Two was introduced by the MOEF as a part of the Presidential Enforcement Decrees of the LCITA and such promulgation solidified the legal framework for the implementation of Pillar Two. Pillar Two becomes effective for the fiscal years beginning on or after 1 January 2024, with the first information return due within 18 months from the end of the first effective fiscal year – ie, 30 June 2026.

9.5 Entities Bearing the Risk of Another Entity's Operations

In general, the Korean TP regime, just like the OECD Guidelines, does not contain clear regulations that restrict the form of business operations to particular types of entities (such as "entrepreneur" and "limited-risk entity"). Nevertheless, it is very common practice to characterise an entity according to some conventional and widely accepted TP categories, such as "entrepreneur", "entities performing and bearing routine functions and risks", and "limited-risk entities".

With regard to a limited-risk entity, the NTS may accept a guaranteed return by its parent company, but since the OECD Guidelines' Risk Analysis Framework was adopted into the Korean TP regime, the NTS's attention has been more focused on whether there is any discrepancy between the entity purported to be bearing economically significant risks (ie, the contractual arrangements) and the entity that is actually bearing those risks, as evidenced through its dealings and conduct (ie, substance).

10. Relevance of the United Nations Practical Manual on Transfer Pricing

10.1 Impact of UN Practical Manual on Transfer Pricing

As Korea's economy opened up rapidly in the 1990s, the need to participate in a wide range of international co-operation systems emerged. Accordingly, Korea joined the OECD in December 1996.

In July 1995, the OECD Guidelines were issued, and at the end of 1995, when Korea was pursuing OECD membership, it proactively reflected the OECD Guidelines through domestic legislation. Subsequent revisions to the OECD Guidelines – in 2010, 2017 and 2022 – have mostly been reflected in the Korean TP regime.

As an OECD member country, Korea has based its TP regime on the OECD Guidelines, and except with respect to the definition of related parties, Korea has generally not adopted the principles from the UN Practical Manual on Transfer Pricing.

11. Safe Harbours or Other Unique Rules

11.1 Transfer Pricing Safe Harbours

There are two main types of transactions where TP safe harbour rules may apply:

- low value-adding intra-group service transactions; and
- intercompany loan transactions.

Low Value-Adding Intra-Group Services

If an intercompany service transaction within a multinational group is of a supportive and "back office" nature, rather than relating to the core business activities of the taxpayer, then this is deemed to be a "low value-adding intra-group service". In this case, a 5% mark-up can be applied, without the need to conduct a separate benchmarking analysis.

In order for an intra-group service to be deemed as a low value-adding service, a unique and valuable intangible asset should not be used or created, and the service provider should not bear, manage or control any significant risk in the course of rendering the service.

The legislation provides the following as examples of services that do not constitute low value-adding intra-group services:

- research and development;
- exploration, extraction and processing of natural resources;
- manufacturing;
- sales and marketing; and
- finance, insurance and reinsurance.

Intercompany Loan Transactions

When a taxpayer conducts a financial transaction with a foreign related party, the arm's length interest rate can be calculated in two ways, as follows:

- by considering comparability factors such as the amount of the debt, maturity of the debt, existence of a guarantee, creditworthiness of the debtor and other factors; or
- by using the "safe harbour" interest rate prescribed in the LCITA.

In the latter case, the regulations stipulate that the interest rate for an overdraft, which is 4.6%, is deemed as a safe harbour rate when a Korean taxpayer lends funds to its foreign related parties. Conversely, if a Korean taxpayer borrows funds from its foreign related parties, Risk Free Rates (RFR) for respective currencies, which are enumerated in the subordinating regulation of the LCITA, such as SOFR for USD and KOFR for KRW, plus 150 basis points is deemed as a safe harbour rate. In the case where a certain currency is not enumerated in the regulation, SOFR will be used as the base rate pursuant to the regulation.

Starting in 2022, as referred to in **9.1 Alignment and Differences**, key points from the OECD Transfer Pricing Guidance on Financial Transactions have been codified into the subordinating regulations of the LCITA and the updated regulations supplement the aforementioned high-level regulations on intercompany loan pricing, with more detailed methodologies set out below:

- utilisation of financial derivative instruments such as credit default swaps by taking into account the comparability factors listed above; and
- utilisation of economic modelling by adding a number of premiums related to various aspects of a loan – such as, default risk, liquidity risk, expected inflation and maturity – to a risk-free interest rate.

11.2 Rules on Savings Arising From Operating in the Jurisdiction

Under the Korean TP regime, the concept of savings arising from operating in Korea is not specifically addressed. However, as Korea follows the OECD Guidelines, it would be difficult for the NTS or taxpayers to argue for the existence of such savings, and it is highly likely that such sav-

ings could be seen as part of a local market feature, which does not warrant any comparability adjustments, provided that reliable local market comparables can be identified.

Moreover, there has been no prominent case in which the location saving concept was disputed.

11.3 Unique Transfer Pricing Rules or Practices

There are no unique TP rules or practices in Korea.

12. Co-ordination With Customs Valuation

12.1 Co-ordination Requirements Between Transfer Pricing and Customs Valuation

In the Korean TP regime, there is some co-ordination between transfer pricing and customs valuation, as follows.

- When there is an upward adjustment on a dutiable value by the Korea Customs Service (KCS) for customs purposes, the taxpayer is entitled to file a downward amended return for TP purposes, within three months of receiving the customs duty assessment letter. However, there is an important precondition: such a claim for downward adjustment will only be accepted when the recalculation of customs value by the KCS is consistent with the relevant arm's length TP methods under the Korean TP regime.
- When a taxpayer applies for a unilateral APA to cover the method of calculating the arm's length price, it can simultaneously apply for an advance customs valuation arrangement, in order to obtain a pre-alignment between the arm's-length price and the dutiable value. Upon receipt of the application, the NTS and the KCS will co-operate on the method of calculating the arm's length price and dutiable value, and the range of the pre-adjusted price.

13. Controversy Process

13.1 Options and Requirements in Transfer Pricing Controversies

TP Review Committee

The NTS is legally required to establish a TP Review Committee (TPRC) within each regional tax office to review proposed TP adjustments prior to the completion of a tax audit. The TPRC is designed to ensure that taxpayers are treated fairly and consistently with regard to TP assessments. The TPRC is responsible for reviewing proposed adjustments that are:

- in excess of KRW5 billion (KRW10 billion in case of Seoul Regional Tax Office); or
- disputed by a taxpayer.

Review of Accuracy of Tax Imposition (RATI)

Once a tax audit has been completed, the tax auditor will provide a notice to the taxpayer of its findings and the proposed amount of additional tax that will be assessed. This notice is known as a Pre-Tax Assessment Notice (PTAN). Time limits are important, since the taxpayer has 30 days to appeal to an administrative body within the NTS to review the legal basis of the proposed tax assessment. This process is referred to as a request for a RATI.

Once filed, the tax auditor's right to issue a formal Tax Assessment Notice (TAN), which crystalises the taxpayer's obligation, is suspended until the RATI procedure is completed. The RATI is reviewed by a panel of reviewers comprised

both of NTS officials as well as outside experts such as professors, accountants, licensed tax representatives and attorneys who have good standing with the NTS. However, a senior official of the NTS has the final say in all decisions and sometimes conducts several hearings, particularly where the senior official disagrees with the decisions reached by the panel.

The RATI procedure is informal and taxpayers are often provided with an opportunity to appear before the panel or submit additional documents in support of their position that some or all of the proposed tax assessment is unjustified. The RATI process typically takes several months to complete.

If the taxpayer prevails, the RATI panel will issue a written decision that the proposed tax assessment should be cancelled and the tax audit will close.

Timing of the Disputed Tax Payment

If a taxpayer decides not to file a request for a RATI within 30 days of the issuance of a PTAN, or if the taxpayer receives an unfavourable decision in the RATI, the tax auditor will issue a formal TAN.

The issuance of a TAN formalises the taxpayer's obligation to pay the amount shown on the TAN (ie, the deficiency plus interest and penalty). Such an obligation must be settled (by payment or other arrangement, such as posting a bond or obtaining a guarantee) within 30 days of receipt.

If the taxpayer's obligation is not settled, additional interest can accrue, and depending on the facts and circumstances, the tax authority can seek to attach or freeze the taxpayer's assets and bank accounts.

Appeal to Administrative Bodies of the Government

Time limits are also important for the TAN, because the taxpayer has 90 days after receipt to appeal to one of three administrative bodies of the government, namely the Tax Tribunal, the Board of Audit and Inspection (BOAI) or the NTS's office of appeals. In the vast majority of cases, taxpayers appeal to the Tax Tribunal as it is considered more independent than the BOAI or the NTS. Another important reason to file an administrative appeal is that under the Korean tax dispute system, the taxpayer must file the appeal and wait at least 90 days before it can file a petition to the court.

The Tax Tribunal is established under the office of the prime minister and is administered by officials generally seconded from the MOEF and the NTS. Like the RATI panel, the adjudicators of the Tax Tribunal are comprised of NTS officials and outside experts, and a senior official at the NTS has the final say in all decisions. Tax Tribunal proceedings are less formal than court proceedings but more formal than RATI proceedings.

As in court proceedings, the taxpayer and the tax authority are expected to submit briefs with technical arguments and applicable evidence. The taxpayer will also be given a formal opportunity to speak and plead before the adjudicators, although recently some of these hearings have been held by videoconference.

A typical Tax Tribunal proceeding involving a foreign entity, or a Korean entity with foreign investment, or involving an international tax issue, may last six months, although a large or complex TP case can last a year or more. During the proceedings, it is also possible that the adjudicators may order a re-investigation, which is effectively a re-audit of the taxpayer. However, such

a re-investigation is essentially a desk tax audit, which involves the reviewing of files prepared by the tax auditor, rather than undertaking another field examination at the taxpayer's premises.

Judicial Litigation

Once a written decision has been issued and received by the taxpayer, the statute of limitations for filing a petition to the court is 90 days. In addition, as noted above, as long as the appeal has been filed with the Tax Tribunal for at least 90 days, the taxpayer has the option to file a petition to the district court without waiting for a decision from the adjudicators.

Both the plaintiff and the defendant have the right to appeal decisions of the district courts that are wholly or partially unfavourable, and, in practice, the losing party is virtually certain to appeal a district court's decision to the High Court that has competent jurisdiction. For example, a plaintiff appealing the decision of the Seoul Court for Administrative Matters can appeal to the Seoul High Court for Administrative Matters. The appeal period is two weeks from receipt of the written decision (unless extended due to a national holiday) and must be strictly adhered to.

Under the Korean judicial appeal system, all decisions of the High Court can be appealed to the Supreme Court within two weeks from receipt of a written decision by the appealing party. At all stages of tax litigation, the right of appeal is automatic, without having to seek permission, either from the original court or from the appeal court.

However, unlike the district court or the High Court, the Supreme Court does not have original jurisdiction and its role is limited to reviewing the technical accuracy of the legal analysis that formed the basis for the decisions rendered by the High Court. Moreover, after reviewing legal issues raised in the petition for appeal, the Supreme Court can decide to dismiss the petition without considering the merits of the appeal, on the basis that the same issue has already been decided several times by the Supreme Court or simply lacks technical merit.

Generally, this initial review process takes about four months, and if the appellant's petition has not been dismissed, it is an indication that the Supreme Court will undertake a substantive review of the case, and it may take up to two or even three years before a decision is rendered.

14. Judicial Precedent

14.1 Judicial Precedent on Transfer Pricing

Korea is not a common law country that follows the doctrine of precedent (or stare decisis). Instead, Korea has adopted the continental legal system. Hence, although, in practice, Supreme Court decisions are followed by lower courts, Supreme Court decisions do not create law in the form of legally binding precedents, as would be the case in a common law system.

Accordingly, although Supreme Court decisions are influential, the NTS is not obliged to follow them and sometimes differs from the Supreme Court in its interpretation of the law. However, the NTS will generally acquiesce after several consistent and uniform Supreme Court decisions have been issued.

Moreover, in practice, tax auditors are generally reluctant to progress cases to the court level unless there is some particular reason to do so, and prefer to negotiate and settle at a tax audit level. Hence, a majority of disputed cases involv-

ing TP issues are resolved at a tax audit level, and this results in relatively few TP court cases compared to common law countries.

14.2 Significant Court Rulings

Court Ruling Related to the Integrated Analysis of Individual Transactions

The case

Current Article 15 of the Presidential Enforcement Decree of the LCITA stipulates that when applying the arm's length pricing method, if each individual transaction is closely linked or consecutively conducted, it is not reasonable to calculate the price, profit, or net profit of each transaction separately, and the individual transactions may be assessed on an aggregate basis. Article 8 of the Ordinance of the LCITA lists the instances where individual transactions can be assessed on an aggregate basis as follows:

- the product line is closely linked, or they have the same product line;
- the transaction is to provide know-how and supply key components to a manufacturing company;
- the transaction is a circumvention using a related party;
- the sale of one product is directly related to the sale of another product, such as printers and toner, coffee makers and coffee capsules, and so on; and
- it is reasonable to assess the individual transactions on an aggregate basis in light of the substance and practice of the transaction.

Taxpayers and the NTS often dispute whether individual transactions should be aggregated in tax audits, and there have been cases involving this issue that were decided by the Seoul Administrative Court and the Seoul High Court in 2022 and 2023.

The taxpayer is a domestic corporation wholly owned by a Swiss-based luxury watch manufacturer (the "Parent Company") that exclusively imports and sells the Parent Company's luxury branch watches (the "Watches at Issue"). The taxpayer sells the Watches at Issue and provides warranty repair and overhaul services (the "Services at Issue") free of charge to its customers, regardless of which distributor or country they purchased the Watches at Issue from, as part of the Parent Company's policy to increase the value of its luxury watches worldwide. As the taxpayer did not receive any compensation from its Parent Company for the expenses incurred in providing the Services at Issue, the NTS calculated the arm's length price of the Services at Issue and the amount of transferred income for the 2013-2017 taxable years. This amount was included in the taxpayer's profits and treated as a deemed dividend since the adjusted income has not been repatriated to the taxpayer.

In June 2019, the taxpayer appealed to the Tax Tribunal after disagreeing with the NTS' assessment of arm's length pricing for the Services at Issue. Despite the Tax Tribunal ordering the NTS to re-investigate and determine the arm's length price, the NTS changed the arm's length method used for the Services at Issue from the Cost-Plus Method (CPM) to the Transactional Net Margin Method (TNMM) to re-assess the arm's length price. However, the re-assessed amount under the TNMM exceeded the original assessed amount and, thus, the NTS decided to stick to its original assessment based on the principle of prohibition of disadvantageous alteration. This is an unusual case because the result of reinvestigation by the NTS came out more negatively for the taxpayer than the original assessment. As the Tax Tribunal's re-investigation decision became meaningless in effect, the taxpayer filed a lawsuit with the Seoul Administrative Court.

The taxpayer argued that the assessments were unlawful since the Services at Issue and the transactions involving the taxpayer's import and sale of the Watches at Issue from the Parent Company were not only closely linked, but also continuous. Thus, the taxpayer argued it is unreasonable to segregate and independently calculate the arm's length price. Furthermore, the taxpayer highlighted that a third-party distributor of the Watches at Issue operated an authorised service centre and provided identical services without charging back the associated expenses to the Parent Company. However, NTS maintained that the transfer pricing adjustment was justified because transfer pricing is evaluated on an individual transaction basis. Given that the taxpayer rendered Services at Issue for watches it did not directly sell, the NTS argued that it was untenable to assume that the consideration received by the taxpayer for importing and selling the Watches at Issue encompassed compensation for the services provided. Thus, the NTS maintained that their adjustment should be justifiable.

The Seoul Administrative Court, a court of first instance, held that luxury watches constitute durable goods intended for long-term use, necessitating regular repair and maintenance, often involving intricate technical expertise. Furthermore, the court emphasised that the provision of dependable repair and ancillary services significantly enhances the value of such products. The court also asserted that the elevated selling price of luxury watches inherently encompasses the assurance and worth associated with reliable and convenient product management services. The court agreed with the taxpayer's arguments, finding that the import sales of the Watches at Issue and the Services at Issue were inherently linked to each other in substance and practice. Furthermore, the court determined that so long as the increase in sales of the Watches at Issue within the domestic market is translated to a tangible benefit upon the taxpayer, the taxpayer's exclusive right to distribute the Watches at Issue in Korea and its guaranteed profits therefrom should be construed as the taxpayer being properly compensated for the Services at Issue by the Parent Company (2020Guhap80806 dated 20 May 2022).

The NTS appealed to the Seoul High Court, which rejected the appeal citing entirely different reasons from the first instance ruling. The Seoul High Court reasoned that, according to the Presidential Enforcement Decree of LCITA, the arm's length price is typically calculated separately for each transaction. It was evident that the taxpayer's import sales transactions and the Services at Issue were not covered by specific items 1 through 4 of the Presidential Enforcement decree. Additionally, the court noted the lack of objective evidence to support that the taxpayer was assured exclusive import sales of the Watches at Issue as a precondition for providing the Services at Issue. The court also observed that the terms, contents, or sales volume of the contracts did not vary based on whether the Services at Issue were provided. Furthermore, the court found that the taxpayer's presented business reasons and the circumstances of the case were not sufficient to demonstrate that the importation and sale of the Watches at Issue and the Services at Issue were sufficiently linked or directly correlated. Despite the taxpayer's arguments, the court deemed it appropriate to evaluate these components separately for transfer pricing purposes. However, the Seoul High Court ultimately ruled in favour of the taxpayer, asserting that the NTS's selected comparables lacked adequate comparability to the Services at Issue. Since the NTS did not appeal this decision to the Supreme Court, the decision

was upheld at the second trial (2022Nu47935 dated 14 June 2023).

It would have been more implicative had the case reached the Supreme Court for a final decision. However, it is significant to highlight the central issue; that is, whether to aggregate individual transactions that seem to be linked in business practice. The differing conclusions between the first and second trials underscore the complexity and importance of this issue in transfer pricing analysis. Despite the specificity of the Presidential Enforcement Decree outlining items 1 through 4 and incorporating a catch-all provision under item 5, the Seoul High Court's interpretation differed from the initial ruling. The Seoul High Court's finding regarding the lack of objective evidence to establish a close linkage between two transactions for aggregation has an implication for taxpayers in the sense that taxpayers should present a legitimate argument supported by objective and concrete evidence in order to make a case for why an aggregated approach is more appropriate than a segregated analysis for their specific situations and circumstances.

15. Foreign Payment Restrictions

15.1 Restrictions on Outbound Payments Relating to Uncontrolled Transactions

Restrictions on outbound payments relating to uncontrolled transactions apply to payments made both to related parties and to third parties.

15.2 Restrictions on Outbound Payments Relating to Controlled Transactions

A Korean resident or corporation intending to make outbound payments to any recipient, in a controlled or uncontrolled transaction, in excess of USD50,000 per transaction must submit documents to a foreign exchange bank, proving the reason and amount of the payment.

However, the converse does not apply: foreign funds remitted to Korea by a non-resident or foreign corporation are not subject to this regulation.

15.3 Effects of Other Countries' Legal Restrictions

Upon the request of a taxpayer, the MOEF or the NTS can request that the competent authorities of another jurisdiction should initiate a MAP where:

- there is a tax treaty between Korea and the other jurisdiction;
- the other jurisdiction has made a TP adjustment in a related-party transaction;
- the related-party transaction is between a Korean resident and a resident of that other jurisdiction; and
- from the taxpayer's perspective, a corresponding adjustment is required to avoid double taxation.

16. Transparency and Confidentiality

16.1 Publication of Information on APAs or Transfer Pricing Audit Outcomes

Every year, the NTS publishes an APA Annual Report, which details the APA processing procedures and various statistics, and provides a description and history of the APA. The latest one available is the 2022 version published in December 2023.

16.2 Use of "Secret Comparables"

Taxation With Asymmetry of Information

There is an NTS internal administrative order which states that when a taxpayer requests information necessary for the exercise of its rights during a tax audit, the NTS should provide the information in a timely manner. This means that the taxpayer has the right to review and dispute any evidence gathered by the NTS in support of its tax assessment. For this reason, it is difficult for the NTS to assess taxes through information that is not made available to taxpayers.

Secret Comparables in Limited Circumstances

In a bid to reduce the number of taxpayers that are non-compliant with BEPS Action 13, the MOEF recently changed the existing regulations to allow the NTS to determine arm's length prices and make assessments based on non-public comparable data in cases where the local file, master file or CbC report is incomplete or absent.

In the past, taxpayers have challenged the NTS's use of secret comparable data because of the asymmetry of information and the unavailability of the data to the public.

However, as the LCITA now allows the tax authorities to use secret comparable data to assess non-compliant taxpayers, the NTS can legitimately and more aggressively assess taxpayers' TP when there is non-compliance.

SPAIN

Law and Practice

Contributed by:
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RocaJunyent was established in 1996 and is one of the most prominent Spanish law firms. It has offices in Madrid, Barcelona and Gerona, as well as associated offices in Palma de Mallorca, Lérida, Tarragona, Málaga, Seville, Bilbao, Badajoz, Burgos and Valladolid. The firm offers advice in all areas of law, especially those related to commercial, banking and financial, procedural and tax law. RocaJunyent is the only Spanish member of the international network TerraLex. Taxes are levied on all kinds of entities and situations, which is why RocaJunyent's tax department is prepared to respond to all kinds of problems – from large companies and their complex structures/operations to individual wealth/inheritance issues. The firm's services include business taxation, tax wealth management, M&A, transactions taxation, transfer pricing and tax litigation.

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1. Rules Governing Transfer Pricing

1.1 Statutes and Regulations

The main rules in Spain governing transfer pricing are:

- Act 27/2014 on Corporate Income Tax, hereinafter "CIT Act"; and
- Royal Decree 634/2015 on Corporation Tax Regulations.

1.2 Current Regime and Recent Changes

On 30 November 2006, Act 36/2006 of 29 November on Tax Fraud Prevention Measures was published in the Spanish Official Gazette, which provided for the obligation to value on arm's length basis transactions carried between related entities or persons. This Act is in line with the recommendations of the European Union Joint Transfer Pricing Forum and the principles laid down by the Organization for Economic Co-operation and Development (OECD) Transfer Pricing Guidelines.

Additionally, on 28 November 2014, Act 27/2014 of 27 November on Corporate Income Tax was published in the Spanish Official Gazette. The transfer pricing rules included in the CIT Act cover both companies and individuals. In this sense, transfer pricing rules apply to CIT, personal income tax and non-resident tax. In accordance with either the Spanish accounting principles and the CIT Act, controlled transactions carried out by related parties must be valued on an arm's length basis.

On 10 March 2021, the Official Gazette published the Royal Decree-Law 4/2021 of 9 March 2021, transposing Council Directive (EU) 2016/1164 of 12 July 2016, amended by Council Directive 2017/952 of 28 May 2017 (ATAD II Directive), as regards "hybrid mismatches", and amends the CIT Act and non-resident income tax Act.

This Royal Decree-Law 4/2021 introduces a new Article 15.bis in the CIT Act regarding "hybrid mismatches". This new article establishes the situations in which expenses derived from related transactions are not tax deductible because of a different tax characterisation of the expenses or transaction.

This new legislation came into force on 11 March 2021 and applies for periods that commenced on or after 1 January 2020 that have not ended on that date.

On 29 February 2024, Spanish Authorities published the general guidelines of the Tax and Customs Control Plan for the fiscal year as of 2024. In these guidelines, the Administration provides that it will be a special point of attention for the proper application of the OECD Transfer Pricing Guidelines by the multinational groups.

It can be said, when the current transfer pricing legislation was approved in 2006, the capabilities and knowledge of the Spanish tax authorities and tax professionals were not sufficiently developed to be able to apply the law properly. Now, things have changed, and transfer pricing is a significant matter for the attention of the companies and other economic players.

It should also be noted that the EU is planning to develop a Directive of transfer pricing to harmonise the legislation of the members of the Union about this issue. However, there is still not a fixed date for its entry into force.

2. Definition of Control/Related Parties

2.1 Application of Transfer Pricing Rules

Corporate Income Tax Act establishes that associated/related persons or enterprises shall mean:

- an enterprise and its shareholders or participants;
- an enterprise and its directors or administrators (although the remuneration received by directors or administrators solely for the exercise of their functions is excluded from consideration as a related transaction);
- an enterprise and the spouses or persons united by kinship relations, in direct or collateral line, by consanguinity or affinity up to the third degree of the shareholders or participants, directors or administrators;
- two enterprises that belong to a group;
- an enterprise and the directors or administrators of another enterprise, when both enterprises belong to a group;
- an enterprise and another enterprise in which the former has an indirect shareholding of at least 25% of the share capital or equity;
- two enterprises in which the same shareholders, participants or their spouses, or persons united by kinship relations, in direct or collateral line, by consanguinity or affinity up to the third degree, participate, directly or indirectly, in at least 25% of the share capital or own funds; and
- an enterprise resident in Spanish territory and its permanent establishments abroad.

The association is defined based on the relationship between the shareholders or participants and the enterprise, the participation must be equal to or greater than 25%. The reference to administrators will include both de jure and de facto administrators.

The Corporate Income Tax Act also details that a group exists when an enterprise holds or can hold control of another or others according to the criteria established in Article 42 of the Commercial Code (eg, 51% of voting rights), regardless of its place of residence and the obligation to file consolidated annual accounts.

However, there are some exceptions to the application of the transfer pricing rules, such as:

- the remuneration paid by an entity to its directors in the performance of their functions; and
- shareholder transactions such as dividends and capital contributions, as the CIT Act

stipulates a specific valuation rule for those transactions.

3. Methods and Method Selection and Application

3.1 Transfer Pricing Methods

The five transfer pricing methods accepted by the OECD have been adopted under Spanish legislation. As of fiscal year 2015, the CIT Act does not state a priority in the application of transfer pricing methods and they would be selected depending on the nature of the controlled transaction, the availability of reliable information and the degree of comparability between controlled and uncontrolled transactions.

The following are the definitions of the five prescribed methods as listed in Article 18 of the CIT Act.

Comparable Uncontrolled Price (CUP) Method

In this method, the price of the product or service in a transaction between related parties is compared with the price of an identical product or service or one with similar characteristics in a transaction between independent persons or enterprises in comparable circumstances. Where applicable, the necessary adjustments should be made to obtain an equivalent and to take into account the specific nature of the transaction.

This method is applied when there are many transactions of the same type with similar prices, and it shows the most similar price to market value.

Cost-Plus Method

In this method, the markup normal in identical or similar transactions with independent parties is added to the purchase price or cost of production of the product or service, or, failing this, the markup applied by independent parties to comparable transactions. Where applicable, the necessary adjustments should be made to obtain an equivalent and to take into account the specific nature of the transaction.

This method is commonly applied for the purchase and sale of semi-finished goods and provision of services.

Resale Price Method

In this method, the markup applied by the reseller itself in identical or similar transactions with independent parties is subtracted from the sale price of a product or service, or, failing this, the markup applied by independent persons or enterprises to comparable transactions. Where applicable, the necessary adjustments should be made to obtain an equivalent and to take into account the specific nature of the transaction.

This method is applied in commercialisation and distribution activities between related parties.

Profit Split Method

In this method, each associated party carrying out jointly one or more transactions is allotted part of the common profits resulting from the transaction or transactions, provided that this reflects what independent parties would have done in the same circumstances.

This method is used when the transactions are highly related, and it is not possible to analyse them separately. It is also applied when the operations add intangible value.

Transactional Net Margin Method

In this method, the net profits are allotted to the transactions carried out with an associated party, calculated based on the most appropriate base (costs, sales or assets) depending on the characteristics of the transactions, which the taxpayer or third parties would have obtained in identical or similar transactions carried out between independent parties. Where applicable, the necessary adjustments should be made to obtain an equivalent and to take into account the specific nature of the transaction.

This method is applied generally in transactions with data bases.

3.2 Unspecified Methods

CIT Act provides for the possibility that, if none of the methods previously discussed were applicable, any other generally accepted valuation methods and techniques that respect the arm's length principle shall be used, eg, the Discounted Cash Flow (DCF). However, it is not a common situation.

3.3 Hierarchy of Methods

The selection of the valuation method would depend on, among other factors, the character of the related-party transaction, the accessibility of available information, and the level of comparability between related and unrelated transactions.

3.4 Ranges and Statistical Measures

The Spanish Tax Authorities usually consider that, in practice, perfect comparables do not exist and hence they always try to apply the median resulting from their benchmark.

3.5 Comparability Adjustments

In this field the Spanish Tax Law is totally aligned with the OECD and, despite comparability adjustments are not frequent, they are perfectly accepted when they result in a comparability improvement.

Financial result adjustments and working capital adjustments are the most common adjustments.

4. Intangibles

4.1 Notable Rules

Spain has traditionally been an importer of intangibles rather than an exporter. Spanish taxpayers are usually audited on the royalties paid and the fees obtained by intellectual property. There is not a special rule for valuating transfer pricing on intangible transactions. However, all OECD criteria have been accepted and applied for valuating these types of intangible assets transactions.

4.2 Hard-to-Value Intangibles

Spanish legislation does not have any special rule regarding hard-to-value intangibles.

4.3 Cost Sharing/Cost Contribution Arrangements

Spain recognises the cost sharing agreement. In case these agreements are signed, the following information is required.

- Persons or entities signing the agreement shall have access to the property with similar economic consequences to the assets of the agreement that may be acquired.
- The contribution made by every participant must be valued in line with the utility obtained by the agreement.
- The agreement must foresee the compensation in the case of a change in the circumstances.

- Information about the participants – group structure, activities that are carried out and countries where other participants are established.
- Information about the activities and projects that are covered by the agreement.
- Duration of the agreement.
- Criteria used to quantify the profits distribution.
- Responsibilities of every participant.
- Consequences of being part of the agreement and for quitting it.

5. Affirmative Adjustments

5.1 Rules on Affirmative Transfer Pricing Adjustments

Once CIT tax return is submitted and an additional adjustment shall be included in the CIT tax return, it must be made by rectifying or complementing the former tax return.

According to Spanish Accounting Principles fair market value should be applied when preparing the company's financial statements; thus, any adjustments based on transfer pricing principles would also entail an adjustment to the financial statement.

Rectifying tax return could be submitted when a higher amount has been paid or a lower amount has been declared. The submission of any of these tax returns out of the deadline could imply a sanction and a surcharge.

6. Cross-Border Information Sharing

6.1 Sharing Taxpayer Information

All Double Taxation Treaty (hereinafter, DTT) signed by Spain have a clause of information exchange; the only country that did not include this clause in the DTT was Switzerland, but it was added in 2007.

The information shared with other jurisdictions according to DTT would be related to taxes agreed under the DTT.

Furthermore, the EU has developed the Directive 2011/16/EU for the administrative co-operation in tax field, providing for information exchange such as:

- financial account;
- tax rulings;
- country-by-country report; and
- prevention of money laundering.

This Directive envisages the possibility of some countries working together, controlling some companies with transactions in the jurisdictions involved. Within the European Union, a taxpayer can even be audited by some countries jointly.

In this sense, Spain has signed multilateral agreement with around 107 countries on automatic exchange of financial information. This agreement provides information about ownership, bank balance, dividends, interests and other capital income.

7. Advance Pricing Agreements (APAs)

7.1 Programmes Allowing for Rulings Regarding Transfer Pricing

APAs are accepted by the Spanish legislation.

7.2 Administration of Programmes

An APA must be granted by the International Tax Office within the Spanish Tax Agency. The APA could be unilateral, bilateral or multilateral. The APA can imply the agreement about the transfer pricing method for related parties' transactions, the profit level indicator and/or the level of profit.

The taxpayer must submit a formal request before Spanish Tax Agency, that is required to analyse it, negotiate with rest of the competent authorities – when other jurisdictions are involved – and accept or reject the request.

Tax Agency has a period of six months to express the opinion on the application of the APA. In case there is not an answer in the mentioned period, the proposal must be understood as rejected. However, and despite the mentioned six months period, the length of an APA approval usually lasts between one and two years.

7.3 Co-ordination Between the APA Process and Mutual Agreement Procedures

The APA and de Mutual Agreement Procedure (hereinafter, MAP) are two different procedures and there is not co-ordination between them.

It is worth mentioning that the tax office dealing with both, APA and MAP, is the same; thus, although there is not co-ordination, certain level of knowledge would exist.

The process for reaching an agreement MAP does not have a maximum length, but recent improvements have made the process faster.

7.4 Limits on Taxpayers/Transactions Eligible for an APA

All related entities are allowed to request for an APA and the application must include the following information: entities involved in the transactions, transactions description and main items to be considered when valuating the operations according to arm's length principle, including the method selected and the analysis for its selection. Sometimes, the Tax Agency requests for wider information in order to decide on the APA application.

In case an APA is granted, it is important to note that the company will be required to file every year, together with the tax return, a document explaining how the APA has been applied to the operations carried out in the period that have been affected by the APA and their valuation.

7.5 APA Application Deadlines

The APA request must be submitted before transactions are carried out; however, the APA could also include the valuation for previous operations (retroactive effects).

7.6 APA User Fees

There is no fee for requesting an APA in Spain.

7.7 Duration of APA Cover

The APA shall have effects on the transactions carried out after the approval, with a maximum length of four years. The APA can also have retroactive effects to years without statute of limitation protection.

The Taxpayer can ask for the renewal of the APA, within the six-months period before the

end of the applicable APA, being necessary to justify that the original circumstances have not changed, so that the agreement initially adopted is still applicable.

7.8 Retroactive Effect for APAs

In some cases, Tax Agency accepts the application of the APA for previous tax years when it is expressly requested. The retroactive effect is only accepted if regarding those years open to tax review (not statute-barred) provided that there is not any pending resolution for these operations. It will only be applicable to previous tax years, if this is expressly mentioned in the APA.

8. Penalties and Documentation

8.1 Transfer Pricing Penalties and Defences

There are two types of penalties that can be imposed regarding transfer pricing transactions:

- No value adjustments – when the value of the transaction is correct, but the entity does not have the documentation required in CIT Act, the sanction could be:
  - (a) EUR1,000 for each item of data; and
  - (b) EUR10,000 for set of omitted or false data related to the documentation required – this sanction cannot exceed the lower of the following:
    - (i) 10% of the aggregate amount of the transactions subject to CIT, PIT or Non-Resident Income Tax carried out in the tax period; or
    - (ii) 1% of net turnover.
- Value adjustments – in case of lack of complete documentation or in case the conditions applied to the controlled operation differed from those resulting from the documentation, a 15% penalty would be imposed.

The Tax Agency is used to deal with transfer pricing audit and this has resulted in a common procedure to check the transfer pricing policy.

8.2 Taxpayer Obligations Under the OECD Transfer Pricing Guidelines

The Spanish Corporate Income Tax Regulations establishes the content for transfer pricing documentation as follows.

Local File

The information that must be included on the local file documentation is the following.

- Taxpayer information – management structure, persons or companies receiving reports on the taxpayer's business activities, description of the taxpayer business activities and main competitors.
- Information regarding controlled transactions – description of the nature, amount of the transactions, information about companies with whom transactions are carried out, comparability analysis, explanation of the valuation method chosen, a copy of the agreement with any tax authority and any other information that could be relevant for valuing the operations.
- Taxpayer economic and financial information – the taxpayer annual financial statements, the reconciliation between the data used to apply the transfer pricing methods and the annual financial statements and the financial data for the comparable used and their source.

Companies or groups with a turnover below 45 million might prepare a reduced version of the

local file. If turnover is below 10 million, there is no obligation to prepare local file.

Master File

This information is required for companies with a net turnover equal to or greater than EUR45 million and the following details are required.

- Information related to the structure and organisation of the group – group description identifying every entity.
- Information related to the group's activities – main activities of the group, description of the functions performed, and of the method applied in related transactions.
- Information relating to the group's intangible assets – description of the group strategy, location of the main activities and intangible assets.
- Information relating to financial activity – description of the group means of financing with special mention to financing agreement with related entities.
- The group's financial and tax position – the group consolidated annual financial statements if it is mandatory and a list of any agreement with Tax Agency with effects for the group.

Country by Country Report

This report is required for companies with a net turnover of at least EUR750 million in the previous 12 months. Its content is in line with the standard template as included in the Action 13 Report of the OECD.

The transfer pricing documentation must be available to the tax authority as from the end of the voluntary payment period (for most of the companies on 25 July of each year).

Those companies that are taxed on consolidated basis for CIT purposes are exempt of having transfer pricing documentation as well as related companies with transactions that does not exceed EUR250,000.

The transfer pricing documentation must be prepared in accordance with the Spanish legislation, in compliance with OECD Guidelines and with the EU Joint Transfer Pricing Forum recommendation.

In short, related companies must make available to Spanish Tax Authorities the transfer pricing documentation.

- Local file – group companies with a net turnover of at least EUR45million.
- Master file – group companies with a net turnover of at least EUR45 million.
- Country-by-country report – group companies with a combined net group turnover equal to or greater than EUR750 million in the previous tax year.

9. Alignment With OECD Transfer Pricing Guidelines

9.1 Alignment and Differences

The main points of transfer pricing in Spain are fully aligned and based on the OECD Guidelines. However, the Spanish legislation differs from OECD Guidelines in terms of broader parameters for related parties. See **2.1 Application of Transfer Pricing Rules** for which parties are considered as related parties in Spain. These parameters would imply the need to prepare the transfer pricing documentation to operations that may not be considered as related parties' transactions in other countries.

9.2 Arm's Length Principle

Spanish CIT Act precisely exposes that all transactions carried out between related parties must be valued on arm's length basis. Furthermore, the proof that the transactions are carried about on arm's length basis must be provided by the taxpayer.

9.3 Impact of the Base Erosion and Profit Shifting (BEPS) Project

The Spanish legislation was not significantly affected by BEPS project because most BEPS proposals were somehow already included or deemed to be included in the Spanish Law.

9.4 Impact of BEPS 2.0

The OECD BEPS 2.0 project establishes, in its Pillar 2, a minimum taxation of 15% for companies with a net turnover of at least EUR750 million. The EU has also developed a Directive in relation with OECD BEPS 2.0 about the minimum taxation for large companies and this Directive is in process of being implemented into Spanish legislation.

Spanish Tax Authorities has recently published a draft of law modifying CIT Act and implementing Global Anti Base Erosion (GloBE), which is foreseen to be approved during 2024.

So, for the tax periods commencing on after 1 January 2024, group of companies with a total net turnover equal to or greater than EUR750 million will be taxed subject to Pillar 2 minimum tax of 15%.

As of 2021, Spain has applied digital tax (also known as the "Google Tax"); however, that tax is likely to disappear in the case of a common European approach being reached concerning Pillar 1.

9.5 Entities Bearing the Risk of Another Entity's Operations

In Spain there is no option for an entity to bear the risk of a transaction in the name of another company.

10. Relevance of the United Nations Practical Manual on Transfer Pricing

10.1 Impact of UN Practical Manual on Transfer Pricing

In Spain the UN Practical Manual on Transfer Pricing is not applied because the main reference for transfer pricing is the OECD guidelines. The UN Practical Manual on Transfer Pricing could only be considered as an interpretative criterion for some DTT.

11. Safe Harbours or Other Unique Rules

11.1 Transfer Pricing Safe Harbours

Spanish transfer pricing rules do not provide for safe harbours, though any safe harbours provided in the OECD guidelines will be directly applicable.

11.2 Rules on Savings Arising From Operating in the Jurisdiction

In Spain there is not any specific rule on savings arising from developing transactions.

11.3 Unique Transfer Pricing Rules or Practices

In Spain all transfer pricing rules are based on OECD transfer pricing guidelines and there is no special rule. As mentioned, the parameter of related parties is significantly broader in Spain compared to other jurisdictions.

12. Co-ordination With Customs Valuation

12.1 Co-ordination Requirements Between Transfer Pricing and Customs Valuation

Spain does not usually require co-ordination of valuation methods between transfer pricing and customs. In fact, there are several differences in the regulation of TP and customs; by way of example, definition of related parties is not absolutely the same in both fields.

That said, Spanish Customs Authorities are keen to increase customs value in accordance with transfer pricing rules (eg, those resulting from TP claims, APAs or lease of intangibles agreements).

13. Controversy Process

13.1 Options and Requirements in Transfer Pricing Controversies

During a tax audit, there are some meetings to discuss and to try to solve some controversial points. When the tax inspector has gathered all the information required, there is a period for the taxpayer to check the documents and submit any additional information or any argument to support its position. The process finishes with a proposal for an assessment by the tax inspector once the submission period has ended. There are three types of assessment documents:

- assessment resulting from an agreement/deal between the taxpayer and the tax authorities;
- assessment with the conformity of the taxpayer, showing the total acceptance to the tax auditor's proposal; and
- assessment in disagreement, in case the taxpayer rejects the tax auditor's facts and valuation grounds supporting the assessment.

Economic-Administrative Tax Courts ("Tax Courts") usually agree with tax inspectors' position and, in many occasions, it is necessary to appeal before courts of justice. The total litigation process could last over ten years.

When taxpayers disagree with tax inspectors, appeals must be submitted within one month since the notification date. There are Regional Tax Courts (TEARs) and Central Economic-Administrative Tax Court (TEAC).

If tax courts rejected the appeal, the taxpayer could file a contentious-administrative appeal before a court of justice within a period of two months since the tax court resolution date.

The Spanish courts with competence in tax matters are the National High Court and the Regional Courts of Justice, the first one with competence in appeal against the resolutions of the TEAC and the other with competence in appeal against the decisions of TEARs.

A negative resolution by the National High Court could be appealed before the Supreme Court in a period of 30 days since the negative resolution was notified.

When the case is relevant, the Supreme Court judgment creates case law, that will be considered as a doctrine for future similar cases.

14. Judicial Precedent

14.1 Judicial Precedent on Transfer Pricing

Traditionally, Spanish courts were not used to deal with transfer pricing cases. However, because of the large number of transfer pricing claims issued by the Spanish Tax Authorities, tax courts and judicial courts are becoming ever more sophisticated when analysing TP litigations.

The number of judicial precedents is quite limited, however, a few rather interesting judicial precedents have been issued in relation to matters like the use of secret comparable, conditions to use the median and statistical tools.

14.2 Significant Court Rulings

Some of the Most Relevant Judicial Court Judgments

The Regional Court of Justice of Murcia, in a sentence dated 30 January 2023, decided that the Spanish Transfer Pricing Regulations do not admit the application of the acquisition or production cost as a method to value operations between related parties.

National High Court sentence of 7 December 2022 provided that the Spanish Tax Authorities have to prove that assumed risks are the same in two operations if they want to argue that both are valid comparables in order to apply the CUP method.

On 28 November 2022 a sentence issued by National High Court concluded that the transactional net margin method cannot be used to assess the value of the transfer of mining exploitation rights to the extent that those rights only entail an administrative authorisation for carrying out an economic activity in the future, but not an actual activity.

The Regional Court of Justice of Valencia rule on 28 April 2022 stated that for valuing a related party operation, it can be taken that the valuation applied to another related party operation to the extent that the latter reflects market conditions.

The Nation High Court in its rule of 20 December 2021 exposed that the comparable uncontrolled price method used in prior tax years does not necessarily involve that it must also be applied in the following years. In this sense, as there are new circumstances and there are not any internal comparables, the comparable uncontrolled price method could not be applied and the transactional net margin method would be used instead.

The TEAC decision of 5 September and 3 October 2013 denied the application of a "secret comparable" to determine the market value of the operation. The TEAC declared that the application of secret comparable leaves the taxpayer without the possibility of legal defence against the value determination by the tax authorities.

On 15 October 2018, the Spanish Supreme Court issued a sentence explaining the different penalty regimes that can be applied to related-party transactions. This judgment stated that, in case the taxpayer is not obliged to have transfer pricing documentation, this sanction will not be applied. However, this does not avoid that general penalties can be applied to the taxpayer.

One of the most recent cases regarding transfer pricing is the National High Court judgment of 6 March 2019. This sentence stated that multi-year analysis could be accepted for conducting a comparability study, but comparison must

specifically relate to the taxpayer's results for each year under review. The National High Court accepted the entity allegations and concluded that, in order to use the median resulting from a benchmark, the Spanish Tax Authorities should demonstrate that there are some "comparability defects" in several comparables.

15. Foreign Payment Restrictions

15.1 Restrictions on Outbound Payments Relating to Uncontrolled Transactions

In Spain there are no restrictions for outbound payments to uncontrolled transactions.

It is important to mention that all transactions with related parties that are resident in countries considered to be tax havens will need to be supported through the required transfer pricing documentation, no matter the amount involved (ie, as from the first euro). Furthermore, the transfer pricing documentation on transaction with other entities resident in a tax haven require all the information about the parties (no possible simplification).

Furthermore, there is a form of the Bank of Spain (ETE) that must be submitted when there are payments; receipts to or received from non-residents. This form will be submitted monthly when the annual total amount of operations to be declared is equal or above EUR300 million, quarterly if the total annual amount is between EUR100 million and EUR300 million or yearly if the total annual amount over a year is less than EUR100 million.

However, if the total amount of the transactions is lower than EUR1 million per year, only the ETE form must be submitted when it is requested by the Bank of Spain.

15.2 Restrictions on Outbound Payments Relating to Controlled Transactions

In Spain there are no restrictions for outbound payments to controlled transactions, but all transactions with related companies or established in a tax haven jurisdiction must be justified with transfer pricing documentation.

15.3 Effects of Other Countries' Legal Restrictions

There is no relevant rule. Thus, Spanish Tax Authorities are free to apply domestic regulations – provided that they do not conflict with a Double Taxation Agreement or an EU rule.

16. Transparency and Confidentiality

16.1 Publication of Information on APAs or Transfer Pricing Audit Outcomes

For confidentiality reasons, neither audit results nor APAs are published in Spain.

16.2 Use of "Secret Comparables"

Spanish Tax Authorities have expressly rejected the application of secret comparables in order to value transfer pricing transactions (see **14.2 Significant Court Rulings**).

Trends and Developments

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RocaJunyent was established in 1996 and is one of the most prominent Spanish law firms. It has offices in Madrid, Barcelona and Gerona, as well as associated offices in Palma de Mallorca, Lérida, Tarragona, Málaga, Seville, Bilbao, Badajoz, Burgos and Valladolid. The firm offers advice in all areas of law, especially those related to commercial, banking and financial, procedural and tax law. RocaJunyent is the only Spanish member of the international network TerraLex. Taxes are levied on all kinds of entities and situations, which is why RocaJunyent's tax department is prepared to respond to all kinds of problems – from large companies and their complex structures/operations to individual wealth/inheritance issues. The firm's services include business taxation, tax wealth management, M&A, transactions taxation, transfer pricing and tax litigation.

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Tax Group Regime for Corporate Income Tax

Spain has a very interesting tax consolidation regime both for corporate income tax (CIT) and VAT. Most multinational groups operating in Spain apply the Tax Group Regime for CIT while the VAT Group Regime is usually applied by groups acting in certain specific sectors such as insurance, finance and health.

The Tax Group Regime allows investors to optimise their tax burden. Tax consolidation groups are formed by Spanish tax resident companies with a common ownership, and it entails the entire group being taxed as a single taxpayer.

To apply the Tax Group Regime, the following requirements should be met.

- The parent company must hold at least 75% of the shares or 70% in case of listed companies.
- This minimum percentage of shares must be maintained during the complete tax period.
- The parent company must be subject to CIT.
- The parent company must hold the majority of the voting rights.

The group CIT taxable income is determined by aggregating the stand-alone taxable income of each group entity; the resulting aggregation would then be reduced or increased profits and/or losses obtained in "internal" operations carried out between entities belonging to the group ("eliminated result"). These "eliminated results" will be reverted and they will become taxable as soon as the result is realised in an operation with a third party, outside of the group or either the transferring entity or the acquiring entity that has left the group.

The main advantages of the Tax Group Regime are the following.

- Taxation of profits (resulting from operations between group entities) would be deferred.
- Tax losses originating within the group, by any group company, could be fully offset with tax profits of any other company belonging to the group. Exceptionally, and only for the tax year 2023, a limit for this offsetting has been established and the current year's tax losses can only be offset by other group companies by up to 50% of that tax loss. The remaining 50% can be freely offset in the following ten years. Carried Forward Tax Losses originating before joining the Tax Group can only be offset by the company that generated them.

- Any tax incentives or tax credits generated within the Tax Group can be freely used by any company belonging to the group. Requirements, conditions and obligations resulting from the application of those tax incentives could be fulfilled by any entity belonging to the Tax Group. Tax incentives originating before joining the Tax Group can only be utilised by the single entity that originated them.
- Dividends, interests or any payments between entities of the same tax consolidation group could still benefit from the same participation exemption and are exempted from the obligation of withholding.
- Operations between related entities should be valued according to the arm's length principle and tax consolidation groups are not exempted from this obligation. However, entities belonging to a tax group are not obliged to prepare transfer pricing documentation in relation to intra-group operations; that which entails relevant savings on administrative and financial costs.

The application of the Tax Group Regime requires a decision from the Board of Directors taken before the beginning of the year in which it will be applied.

Capital losses from transfer of shares

Following the international trend, Spanish CIT rejects the tax deduction of the capital losses when the participation exemption would have been applicable had there been a capital gain. However, the tax treatment would be far different in case of a liquidation.

Sale of the shares that could benefit from the Participation Exemption

Capital gains resulting from selling shares of an entity when the selling company had at least 5% interest for at least 12 months would be 95% exempt.

In case of capital loss, the Spanish CIT provides that it would not be allowed, despite the acquirer and sale price; in other words, a capital loss from the sale to an independent party applying the arm's length principle will result in a non-deductible tax loss. This situation will not even change if both the selling and buyer entities are part of the same Tax Group.

A shareholder planning to transfer a portfolio might consider a liquidation instead of a sale.

Liquidating a company

According to the Spanish CIT, the process for liquidating a company will have tax consequences for both the shareholder and the liquidated company.

Liquidated company

The liquidated company will transfer all its assets and liabilities to their shareholders which would likely result in a tax loss. This tax loss cannot be utilised since the company will be extinguished.

Shareholder company

The difference between the value of the shares and the value of the assets received on account of the liquidation will generate a capital loss for shareholders that could be tax deductible.

In summary, in practice the only way to get a tax allowance from a portfolio capital loss is through the liquidation of the company which should be considered as an alternative to the transfer of shares.

Film tax incentives for both Spanish and foreign productions

Spain has some of the most attractive tax incentives for investments in film and series whose main features are the following.

- Spanish film productions – 30% tax credit in respect of the first million of the investment and 25% for the excess over this amount.
- Foreign films that incur Spanish production costs – 30% tax credit in respect of the first million of the investment and 25% on the excess over this amount.
- Visual effects productions with Spanish costs below EUR1 million – 30% tax credit.

Attention should be paid to the formal requirements of these tax incentives.

Limits to the application of Carried Forward Tax Losses

Like many other countries, Spain approved (after various crises since 2007) limitations on the offsetting of Carried Forward Tax Losses (CFTL).

The purpose of these limitations was to ensure a reasonable collection from the CIT, since accumulated CFTL since 2007 were so large that their full offsetting would lead to a minimum CIT collection. For this reason, in 2014 a limit was established for the CFTL offsetting and in 2016 two specific additional limitations for CFTL offsetting were created for large and very large cases. None of these limitations would apply if the offsetting does not exceed EUR1 million.

- In 2014, a first limitation was provided to all companies regardless of their size, which prevented the offsetting of an amount exceeding 70% of the taxable income for the period.
- In 2016, a second limit was approved, which was applicable only to large companies (those entities that in the previous financial year had a turnover of at least EUR20 million), which would determine that such companies would be subject to a stricter limit of 50% of the amount of the previous income.
- Also in 2016, a third limit was enacted for very large companies – those whose turnover in the previous financial year reached EUR60 million, whereby they could not offset more than 25% of the positive taxable income for the period with CFTL.

As mentioned, the last two limitations (applicable only to large and very large companies) were established by an exceptional legal instrument – the Royal Decree-Law – which is characterised as a law approved by the government, the executive power (breaking the separation of powers principle), and which the Spanish Constitution allows to be used only in situations of "extraordinary and urgent need".

The Spanish Constitutional Court – during January 2024 – has concluded that the legislative instrument used by the government (a Royal Decree-Law) was not an adequate means for amending of the CIT.

Due to the Constitutional Court's sentence ruling, the 25% and 50% limitations mentioned above would have disappeared and the only limitation that would exist would be the first – ie, 70% of the current year's taxable income, applicable to all companies, regardless of their size.

Unless the effects of the sentence declaration of unconstitutionality are limited by the legislator or the Constitutional Court itself, it will have a very significant effect on the CIT collection. In the authors' view, the main effects of such would be the following.

In relation to the fiscal year of 2023

The immediate consequence of this ruling of the Constitutional Court would be that in the CIT for the year 2023 (which is mostly declared and paid during July 2024) large and very large companies will be able to offset the taxable bases of previous years under the same conditions as the rest of the companies (ie, 70% or EUR1 million).

Unless the government introduces some regulatory modification, which is not foreseen at the time of writing this article, the collection of CIT will be greatly reduced and large and very large companies with CFTL will pay much lower amounts than those initially foreseen. However, it is expected that a regulation will be developed to reimpose limits on CFTL for the year 2024.

Large companies with CFTL currently subject to a tax audit

The effect of the Constitutional Court's sentence would be that the limitations established in 2016 would have ceased to exist. Hence, if a large company were being audited (especially if the tax audit could be near to the end) the possible contingencies claimed or to be claimed should be re-assessed to the extent that the amount claimed by the Tax Inspectorate would have changed if the CFTL limitations had not existed.

The result would be that the claim of the Tax Authorities would be lower than the amount initially assessed.

Ongoing litigation in relation to FY 2016 and beyond

Similar to the above, in the event that a large or very large company were in a litigation against the Spanish Tax Authorities as a consequence of a CIT claim, and as long as in the determination of the claimed amount the Spanish Tax Authorities had applied the CFTL limitations approved in 2016 (now sentenced as unconstitutional), the court would foreseeably order the Spanish Tax Authorities to re-assess the amount claimed, taking into consideration the existing CFTL that could not have been applied by virtue of the limitations approved in 2016 and that now have been declared unconstitutional by the Spanish Constitutional Court.

Accounting for Deferred Income Tax Assets (DTA) recognition

Another aspect in which the Constitutional Court's sentence may be of relevance is related to the capitalisation of tax credits resulting from pending CFTL.

Due to the limitations to offset CFTL, statutory auditors are often very reluctant to admit the accounting recording of a DTA representing the CFTL tax credit to be offset in the future.

After the declaration of unconstitutionality, and unless new limitations are approved, large and very large companies will be able to offset CFTL more quickly, which might result in the possibility of recording a higher DTA and, if applicable, in an improvement of the accounting result in fiscal year 2023 and subsequent years.

Looking forward

Given the great impact of the declaration of unconstitutionality, it is very possible that during 2024 there will be legislative amendments aimed at establishing new rules to limit the effects of the Constitutional Court's ruling.

SWITZERLAND

Law and Practice

Contributed by:
René Matteotti, Monika Bieri, Daniel Schönenberger, Caterina Colling-Russo and Christian Attenhofer
Tax Partner AG

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Tax Partner AG is focused on Swiss and international tax law and is recognised as a leading independent tax boutique. With currently 11 partners and counsel and a total of approximately 50 tax experts consisting of attorneys, legal experts and economists, the firm advises multinational and national corporate clients as well as individuals in all tax areas. A central focus lies on tax controversy and dispute resolution, including transfer pricing issues. Tax Partner AG also provides support regarding transfer pricing studies and the preparation of transfer pricing documentation. Other key areas include M&A, restructuring, real estate transactions, financial products, VAT and customs. Tax Partner AG is independent and collaborates with various leading tax law firms globally. In 2005 the firm was a co-founder of Taxand, the world's largest independent organisation of highly qualified tax experts.

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SWITZERLAND LAW AND PRACTICE

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1. Rules Governing Transfer Pricing

1.1 Statutes and Regulations

Preliminary Remarks

First of all, it should be noted, that Switzerland has no specific codified transfer pricing law. Consequently, there are no specific regulations regarding determination and documentation of transfer prices, neither at the federal level nor at the cantonal level. The arm's length principle is, nevertheless, recognised and substantiated by the practice of the Federal Tax Administration (FTA) and case law. In addition, Switzerland has accepted the initial version and all updates of the OECD Transfer Pricing Guidelines (TPG) without reservation, including the latest update in 2023. Thus, there is full consensus in Swiss tax law practice that the OECD TPG are an important – although not binding – interpretative tool for the application of the arm's length principle in Swiss tax law. The importance of the OECD TPG has been further underlined by the recently published paper of the Swiss tax authorities, namely the SSK (*Schweizerische Steuerkonferenz*) and the FTA regarding transfer pricing, as this paper strongly refers to and basically summaries the OECD TPG. Further the FTA recently published a Q&A on specific transfer pricing topics.

Mainly, transfer pricing issues arise in Switzerland in connection with federal and cantonal corporate income tax and federal withholding tax. However, transfer pricing issues might also arise in connection with VAT – eg, in the event of retrospective transfer pricing adjustments and VAT impact at the level of the foreign related party. While, in the area of corporate income tax, the federal government (limited to a supervisory role) and the cantons have parallel competence, the federal government has the exclusive competence to levy withholding tax, stamp duties and VAT. With regards to withholding tax, in 2019 the FTA established a competence centre for transfer pricing. It is therefore no surprise that, in practice, for withholding tax purposes, transfer prices are increasingly being critically scrutinised during tax audits. This concerns, in particular, the relocation of functions abroad and controlled transactions between Swiss companies and related companies domiciled in tax havens or low-tax countries. In General, Swiss withholding tax implications may be a substantial concern as a result of a transfer pricing adjustment done in tax audits.

OECD TPG

In exercising its supervisory role over the cantonal tax administrations, in 1997 and 2004 the FTA instructed the cantonal tax administrations with a circular letter to directly apply the OECD TPG. The Federal Supreme Court (FSC) tends to apply a static approach regarding the version of

the OECD TPG. Hence, the arm's length principle and the methods for determining the relevant transfer prices will be assessed according to the OECD TPG as they were published at the time the transaction in question was settled.

Statutes

Corporate income tax

From a corporate income tax perspective, the following two scenarios must be distinguished:

- controlled transactions between a company and its shareholders; and
- controlled transactions between a company and related parties, other than its shareholders.

The latter includes, in particular, transactions between group companies that are under the same management and control. In both situations, the arm's length principle has to be applied.

Under Swiss law, a tax authority may make an adjustment only if the following three conditions are met:

- the company has evidently received no adequate compensation for its services or deliveries;
- the compensation in question was in favour of the shareholder or a related party and would not have been provided to unrelated parties at the same conditions; and
- the evident discrepancy between the service or delivery and the compensation was recognisable for the company or the persons representing the company.

The first two conditions concern the question of whether the agreed transfer prices fall within the range of prices or margins that independent third parties would have agreed on for the respective intercompany transaction (services, goods, licensing, financing). The third condition, however, is a Swiss peculiarity: the tax authority may only make an adjustment if the violation of the arm's length principle is obvious and thus recognisable for the management or the board of directors. This has to be determined on the basis of the concrete facts and circumstances of the case at hand.

If profits are shifted from the subsidiary to the parent company due to an obvious violation of the arm's length principle, a deemed dividend is to be assumed and the tax authority is entitled to adjust the profit of the subsidiary. In addition, income is attributed to the shareholder to the extent of the deemed dividend. If, on the other hand, the violation of the arm's length principle leads to an increase of income at the level of the subsidiary, there is a so-called informal capital contribution. The tax treatment of such an informal capital contribution at the level of the shareholder and the beneficiary company depends on the facts and circumstances of the case.

If the contracting parties of a transaction violating the arm's length principle are sister companies, the so-called modified triangular theory applies. In a first step, the profit of the company that has distributed a deemed divided is adjusted. In a second step, the benefit is attributed to the shareholder, which in turn makes a hidden capital contribution to the beneficiary sister company.

Withholding tax

Hidden profit distributions described above, which result from a violation of the arm's length principle, regularly also trigger withholding tax consequences for the distributing company.

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Under Swiss law, withholding tax of 35% must be passed on to the recipient of the deemed dividend. The taxable company must therefore, in principle, reclaim the withholding tax from the beneficiary company. Unlike in the case of corporate income tax, it is not the triangular theory that applies, but the direct beneficiary theory. In the case of payments to sister companies, this means that the reimbursement must be requested by the benefiting sister company. If it is not possible to pass on the withholding tax, the deemed dividend is grossed up and the beneficiary is deemed to have effectively received only 65% of the deemed dividend. The corporation that provided the deemed dividend is therefore liable for the payment of the remaining 35%. This gross-up results in an effective withholding tax rate of 53.8% of the tax adjustment. Political discussions on also applying the triangular theory for withholding tax purposes are currently put on hold.

Foreign beneficiaries may request a full or partial refund of the withholding tax based on the applicable double taxation agreement (DTA). However, the application of the direct beneficiary theory regularly limits the treaty relief in cases where the direct beneficiary is not the direct shareholder. If specific conditions are met, the law entitles companies to fulfil the withholding tax liability by notification instead of paying the tax. In the case of deemed dividends, however, the application of the notification procedure is granted only very reluctantly. The notification procedure is not applicable in the case of deemed dividends to sister companies. If the notification procedure is not available, not only the full withholding tax but also an interest on late payment of 5% per annum will be due.

Stamp tax duty

Regarding stamp duties, the arm's length principle is only applied in certain cases. In principle, as in the case of withholding tax, the direct beneficiary theory also applies to the stamp duty, which means that only hidden capital contributions made directly by shareholders to the corporation are subject to the 1% stamp duty. In particular, this has the consequence that contributions to sister companies do not trigger stamp duty. Also, no stamp duty is triggered for so-called benefits periodically granted to the subsidiary, as is the case, for example, where the shareholder charges an interest rate that is too low according to the arm's length principle for the loan granted to the subsidiary.

Value added tax (VAT)

The Federal VAT Act, in contrast to the above-mentioned legislation, explicitly states that transactions between related parties have to be at arm's length. For VAT purposes, a related party is to be assumed if a shareholder holds at least 20% of the nominal share capital or an equivalent participation, or in the case of foundations and associations with which there is a particularly close economic, contractual or personal relationship.

Regarding the determination of the arm's length transfer prices for VAT purposes, it can generally be referred to the principles applicable for corporate income tax. However, according to administrative practice in specific cases, the arm's length price can be calculated on a lump-sum basis. If, for example, a holding company does not have its own personnel to effectively manage the holding company and that management is carried out by personnel of its subsidiaries, the arm's length remuneration can be set at 2% or 3% of the average total assets held by the holding company.

Furthermore, it should be noted that in relation to VAT, the FTA, according to case law and in contrast to corporate income tax, can challenge

the prices determined between related parties without first having to prove that the agreed remuneration violates the arm's length principle and that such a violation was obvious (see above comments on corporate income tax). If the FTA does not agree with the prices set by the taxpayer and the self-declaration respectively, the taxpayer has to prove that the prices nonetheless comply with the arm's length principle and are determined by using the appropriate transfer pricing method. Concerning the selection of the method, the FSC noted in a ruling concerning VAT that the selection of the method is regarded as a legal question that the FSC is free to review. The result of the selected method, however, is regarded as a question of fact that can only be reviewed by the FSC for obvious incorrectness or arbitrariness. It goes without saying that the challenging the selected method and the proving of obvious incorrectness or arbitrariness requires solid transfer pricing documentation, which is – however – not required by law.

Administrative Guidelines

As already set out, the FTA instructed the cantonal tax administrations by a circular letter of 1997, which was renewed in 2004, to directly apply the OECD TPG. The circular explicitly states that the profit margins for service companies must be determined in accordance with the arm's length principle – i.e, for each individual case on the basis of comparable uncontrolled transactions and with reference to the range of appropriate margins.

The most relevant administrative guidelines in Switzerland in the area of transfer pricing can be seen in the circulars published by the FTA providing safe harbour rules for thin capitalisation and for intra-group interest rates (see **11.1 Transfer Pricing Safe Harbours**) where the arm's length principle is not adhered to.

1.2 Current Regime and Recent Changes

Overview

As Switzerland adheres to the OECD TPG and has not established specific transfer pricing rules, the current regime and its development are, in general, reflected in the OECD TPG. However, the arm's length principle was already acknowledged before the first OECD TPG were published. Namely, in the matter of Bellatrix SA, the FSC confirmed in 1981 that for withholding tax purposes, the arm's length principle is applicable with regard to transactions concerning the company's shareholders.

Recent Changes

Prior to the progression of the BEPS project, core transfer pricing issues were seldom touched on by the tax administrations. However, transfer pricing issues increasingly form part of routine audits today. Hence, taxpayers are more often confronted with detailed questions regarding transfer pricing matters (eg, requests regarding detailed transfer pricing documentation and explanations concerning comparables). Switzerland itself also seems to be increasingly confronted with requests for administrative assistance in transfer pricing cases.

In international cases, the main focus is on the transfer of functions, the transfer or licensing of intellectual property rights, financial transactions, corporate management services and asset management services. Another main focus lies on transactions with foreign companies in low-tax jurisdictions Recently, the OECD TPG were also referred to in a purely national, inter-cantonal FSC case where one company was domiciled in a high-tax and one in a low-tax canton. In another purely domestic FSC case the OECD TPG were cited by the court in connection with the inter-cantonal value attribution of an intangible.

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2. Definition of Control/Related Parties

2.1 Application of Transfer Pricing Rules

Swiss tax law – except VAT-legislation (see more in **1.1 Statutes and Regulations**) – does not include an explicit definition of the terms "associated enterprises", "related parties" or "controlled transactions".

According to the FSC, for income tax purposes, related parties are to be considered as entities with close commercial or personal relationships, where any close relationship between the parties involved in the transaction is enough. According to the Swiss understanding of the term "related parties", direct or indirect control (participation in management or capital) in itself is not decisive. The crucial question is whether the tested transaction was conducted under the given conditions only as a consequence of the associated relationship. In practice, some cantonal tax administrations tend to apply the definition of "associated entities" set forth by the OECD. Furthermore, according to the FSC, "associated enterprises" or "related parties" can be assumed if the conditions agreed upon by the involved parties apparently do not meet the arm's length standard.

3. Methods and Method Selection and Application

3.1 Transfer Pricing Methods

Swiss domestic tax laws or practices do not provide specific transfer pricing methods. Nevertheless, as Switzerland adheres to the OECD TPG, all the usual transfer pricing methods are admissible ("most appropriate method" approach). However, according to the FTA circular of 2004, the cost plus method is, in general, not to be seen as an appropriate method for financial services or management functions.

3.2 Unspecified Methods

As Switzerland adheres to the OECD TPG, and these do not exclude the use of unspecified methods, such methods can indeed be applied.

However, if an unspecified method is intended to be applied, as the TPG specify, it should be explained why the methods described by the TPG themselves are not considered appropriate for the case at hand.

3.3 Hierarchy of Methods

As Switzerland in general follows the OECD TPG, the hierarchy of the transfer pricing methods as stipulated in the OECD TPG is also applicable in Switzerland. However, in individual decisions, the FSC has held that there is no fixed hierarchy of methods, meaning that the most appropriate method should be used according to the case at hand. In other rulings the FSC has held that the hierarchy of methods as stipulated in the OECD TPG should in fact be followed. In a recent decision by the Swiss Federal Administrative Court it was ruled that the FTA has to respect the hierarchy of methods according to the OECD's TPG.

In practice, the three traditional methods – ie, the comparable uncontrolled price (CUP) method, the resale price method and the cost plus method – are still preferred by the tax administrations. Furthermore, the CUP method enjoys preference over the other two traditional methods in the case of comparability. However, the transactional net margin method (TNMM) is the most commonly used method in Switzerland for determining transfer prices for services (corporate services, contract manufacturing services, contract R&D services), and routine distribution, whereas the CUP method is the most commonly

used method for intangible property licensing and financing.

The hierarchy of transfer pricing methods as stipulated in the older versions of the OECD TPG can still be of relevance. This is due to a static approach to the application of the TPG that means that the version of the TPG in effect at the time the transaction was settled is applied (see **1.1 Statutes and Regulations**).

It is sometimes difficult, however, to assess whether an update of the OECD TPG can be considered merely a more detailed explanation of the existing principles or an actual change in the guiding principles. If the former is the case, a dynamic approach to the application of the TPG is permissible as well.

3.4 Ranges and Statistical Measures

The use of statistical tools that consider central tendency, such as the interquartile range or other percentiles, is not required. However, in practice, such tools are usually used to narrow the range, in particular because the comparables in a benchmark study are usually not perfect.

For the determination of adequate transfer prices, the tax authorities generally consider the interquartile range as the arm's length remuneration.

3.5 Comparability Adjustments

Swiss domestic tax laws do not provide specific guidance on comparability adjustments. However, the OECD TPG on how and when to apply comparability adjustments are applicable.

4. Intangibles

4.1 Notable Rules

Swiss domestic tax laws do not provide specific guidance on the pricing of controlled transactions involving intangibles. Rather, the OECD TPG are to be consulted regarding transfer pricing of intangibles.

4.2 Hard-to-Value Intangibles

Officially, Switzerland did not adopt the hard-to-value intangibles (HTVI) approach as defined in Chapter VI of the OECD TPG as this approach seems to collide with long-standing case law and the tax laws themselves. In particular, the question is whether ex post data can influence open or final tax assessments.

However, in general, due to the adherence to the OECD TPG, the OECD's approach regarding HTVI should be applicable in Switzerland.

Open Tax Assessments

If a tax assessment is not yet final, a transfer pricing adjustment requires, inter alia, an obvious mismatch between the value of the transferred intangible and the compensation received, and that this mismatch was recognisable for the persons in charge (see **1.1 Statutes and Regulations**). This mismatch is evaluated ex ante, namely at the time the transaction was settled.

The hard-to-value intangibles (HTVI) approach, however, assesses the conditions of the transaction ex post and does not provide an answer to whether a potential mismatch was ex ante already obvious and, thus, recognisable. Hence, the HTVI approach – as mentioned above – does not seem to fit into pre-existing domestic law and the respective case law. So far, however, there is no precedent on this issue.

Final Tax Assessments
If a tax assessment is already final and legally binding, an adjustment is generally only possible if the tax administration becomes aware of new facts or evidence. As long as the taxpayer provided the tax administration with appropriate and correct transfer pricing documentation during the assessment relating to the ex ante valuation of the intangible in question, the administration is not entitled to come back to its own evaluation should ex post show that the value of the intangible is, in fact, higher. In this case, the ex post data would not qualify as new facts or evidence, and thus prohibit the final tax assessment from being reopened and changed.

4.3 Cost Sharing/Cost Contribution Arrangements
Switzerland recognises cost contribution arrangements and applies the OECD TPG correspondingly. However, Switzerland does not have special rules that apply to such arrangements.

5. Affirmative Adjustments

5.1 Rules on Affirmative Transfer Pricing Adjustments
Switzerland does not have specific rules regarding affirmative transfer pricing adjustments. Generally, pursuant to Swiss tax law, the financial statements prepared in accordance with commercial law are, in principle, binding for tax purposes. The tax administrations can only deviate from the financial statements in order to determine the taxable base if the statements violate accounting principles as set forth in the federal Code of Obligations, or if specific rules of the tax law require an adjustment.

However, as long as the tax return has not yet been filed by the taxpayer, the balance sheet can, in accordance with the Code of Obligations, be adjusted without further restrictions. Once the tax return has been filed, a balance sheet adjustment is only permissible if it violates commercial law. Hence, if a transfer pricing issue arises once the tax return has been filed, an adjustment, in principle, will only be allowed if the original transfer prices also violate commercial law.

However, as long as the adjustment increases the taxable profit, the tax administrations are likely to accept such adjustments, even if the original transfer prices were in line with the accounting principles as set forth in the Code of Obligations. This is due to the fact that if a transaction is not conducted according to the arm's length principle, the tax administration can by law make the respective adjustments.

Neither transfer pricing-specific returns nor related-party disclosures are required to be filed with the corporate income tax return.

6. Cross-Border Information Sharing

6.1 Sharing Taxpayer Information
Exchange of Information on Request
In 2009, Switzerland committed to the internationally agreed standard regarding the exchange of information on request. By doing so, Switzerland renewed most of its more than 100 DTAs.

Moreover, in 2016, Switzerland ratified the Multilateral Convention on Mutual Administrative Assistance in Tax Matters, extending the network of jurisdictions for exchange of information even further. Switzerland has implemented the legal basis for exchange of information on request with around 140 jurisdictions. In addi-

tion, Switzerland has signed ten tax information exchange agreements.

Under current law, administrative assistance may only be provided if the requesting state demonstrates in its request that the information requested is foreseeably relevant and confirms that it will treat the requested information confidentially. Administrative assistance may be refused if the information is to be used for taxation contrary to the DTA or if the requested information could not be obtained by the Swiss tax authorities under domestic tax procedural law.

Practice shows that foreign tax authorities are increasingly submitting requests for administrative assistance to Switzerland when auditing transfer prices, thereby requesting very comprehensive information and data. In this context, the Federal Tax Court (FTC) has – correctly in itself – decided that requested information for the verification of transfer prices must be exchanged. In doing so, the FTC referred in particular to the explanations of the OECD TPG in Chapter V regarding documentation (in the 2010 version). At the same time, the FTC stated that the OECD TPG are not binding for the court and merely represent an interpretative instrument. This means in the context of international exchange of information in tax matters that the provision of administrative assistance is not limited to the information required to apply a specific transfer pricing method. It is sufficient that there is merely a reasonable connection between the information requested and the facts described in the request for administrative assistance. As a result, the administrative assistance provided by Switzerland in transfer pricing cases can be very comprehensive and information is also transmitted that would not be required for the application of the methods defined in the OECD TPG.

Spontaneous Exchange of Information on Specific Tax Rulings

Switzerland has implemented the spontaneous exchange of information on tax rulings into domestic law as of 1 January 2017. In particular, it has also committed to the spontaneous exchange of unilateral rulings on transfer pricing and permanent establishments with the state of the direct parent, the state of the group top company and, if available, the state of the counterparty of the transaction.

Automatic Exchange of Information on Country-by-Country Reports (CbCR)

As of 1 January 2017, Switzerland also signed the Multilateral Competent Authority Agreement on the Exchange of Country-by-Country Reports (MCAA CbCR). However, the MCAA CbCR will not be applicable between Switzerland and another state until the other state has also included Switzerland on its list.

7. Advance Pricing Agreements (APAs)

7.1 Programmes Allowing for Rulings Regarding Transfer Pricing

Unilateral Rulings

Switzerland has a long-standing practice regarding the issuance of unilateral rulings. This practice also includes the issuance of unilateral transfer pricing rulings.

With respect to corporate income tax, cantons have the authority not only to assess cantonal and municipal taxes but also federal corporate income taxes. This means that the cantons can issue advance (tax) rulings not only regarding cantonal and municipal taxes but also regarding federal income taxes. However, the FTA still exercises an important supervisory function over

the cantons and can also intervene in individual cases. In practice, the FTA is becoming increasingly involved in discussions, especially in large transfer pricing cases.

It should be noted that it is important to provide the competent tax administration with comprehensive documentation to keep the tax administration updated regarding the underlying facts of the unilateral transfer pricing ruling at all times, as the tax administration could challenge the validity of the ruling if the relevant facts have not been fully disclosed or new developments not communicated. Once a ruling has been granted, the facts on which it is based must be continuously monitored and changes must be identified, analysed and, if necessary, reported to the tax authorities.

Advance Pricing Agreements

In Switzerland, advance pricing agreements (APAs) are available. APAs have become a favoured option for Swiss-based international groups with complex or high-volume transactions. In practice, the procedure starts with a presentation of the facts and a formal request to the State Secretariat for International Finance (*Staatssekretariat für internationale Finanzfragen*, or SIF), the competent authority in Switzerland.

In 2020, 85 APA proceedings were opened, and 55 of the 304 pending APA proceedings have been closed. The SIF has published guidance on APAs.

7.2 Administration of Programmes

With regard to bilateral and multilateral APA procedures, the competent authority in Switzerland is the SIF.

Concerning unilateral transfer pricing rulings for corporate income tax purposes, the cantonal tax administrations and the FTA will be the competent authorities.

7.3 Co-ordination Between the APA Process and Mutual Agreement Procedures

Since the SIF is also the competent authority for mutual agreement procedures (MAPs), co-ordination between APA procedures and MAPs is ensured.

7.4 Limits on Taxpayers/Transactions Eligible for an APA

In principle, the APA programme is open for all taxpayers that engage in cross-border intra-group transactions.

7.5 APA Application Deadlines

The application for an APA procedure can be filed at any given time.

7.6 APA User Fees

Under current practice, APA procedures are free of charge. However, the implementation costs in connection with a mutual agreement can in individual cases be charged to the taxpayer (Article 23, Federal Law on the Implementation of International Agreements in the Tax Field).

7.7 Duration of APA Cover

In practice, an APA will cover three to five years. However, Switzerland does not have specific time limitations that an APA may or may not cover. Rather, the time period to be covered by an APA has to be decided depending on the characteristics of the case at hand and is subject to negotiations. Hence, the duration is typically a trade-off between administrative-economical reasoning and the uncertainty concerning future developments of the transactions that are the subject of the APA.

7.8 Retroactive Effect for APAs

Basically, unilateral rulings cannot have retroactive effect, as ruling requests can only be accepted if they concern future affairs.

However, as bilateral and multilateral APAs are based on the MAP provision of the respective tax treaty, the aforementioned restriction does not apply. Hence, APAs can, depending on the involved countries, have retroactive effect. However, the retroactive reach is limited to ten years by Swiss domestic law. In practice, Switzerland seeks to limit the retroactive effect of APAs to five years. The limiting factor in practice is often the legislation in the country of the counterparty, as only certain foreign tax authorities allow a rollback period.

8. Penalties and Documentation

8.1 Transfer Pricing Penalties and Defences

Transfer Pricing Penalties

Switzerland does not impose penalties that apply specifically in the transfer pricing context, except for violations of the CbCR requirements.

As a general rule, tax adjustments to values that are determined on a discretionary basis – as is the case with transfer pricing – have no criminal consequences. This principle only applies, though, to the extent that the provisions of commercial law have not been violated and the relevant transactions have been presented correctly in accordance with commercial law. However, violations of the arm's length principle can, under certain circumstances, still be qualified as unlawful tax evasion (or tax fraud) and as such be subject to penalties. This is the case if basic principles of transfer pricing have been grossly neglected and, thus, the violation of the arm's length principle is not only recognisable by the company or the persons in charge, respectively, but downright obvious. In such cases, it can be assumed that the transfer prices were deliberately set in violation of the arm's length principle. Furthermore, ignoring an earlier correction by the tax authorities could also give rise to a violation of the arm's length principle that could lead to prosecution. This would be the case, for example, if the tax authority had rightly objected to an assessment in previous tax periods and the taxpayer deliberately stuck to the original estimate or approach, respectively, without disclosing it to the tax authority.

In the case of tax evasion (or tax fraud), penalties may be imposed for all taxes involved. For instance, a transfer price-induced adjustment by the tax administration concerning corporate income tax may trigger respective consequences regarding withholding tax or VAT. In the case of corporate income tax, the penalties are determined based on the unlawfully evaded tax amount, whereas – if the respective year has already been finally assessed – the potential penalty ranges from one third of the evaded tax to three times that amount. In general, the fine is equal to the amount of the evaded tax. Mitigating circumstances, such as full co-operation, are taken into account when determining the fine for tax evasion – as shown by the only tax evasion case in the context of transfer pricing decided by the FSC to date. In this case, the evasion fine was set at 75% of the evaded tax due to full co-operation.

If the tax has not yet been definitively assessed, there may a case of attempted tax evasion, which reduces the penalty by one third. It is important to note that for the purposes of corporate income tax the fine is imposed on the company. Regarding withholding tax and VAT,

however, the fine is directly imposed on the person(s) responsible for the violation. At least in these cases, the fine is not determined based on the amount of tax evaded, but according to a fixed fine range.

Documentation Obligations

Swiss tax laws – apart from the Federal Act on the international automatic exchange of country-by-country reports of multinational groups – do not define specific documentation requirements with respect to transfer pricing. However, taxpayers must provide all documents necessary in order to enable the tax administration to conduct a proper assessment of the taxable base. This legal obligation is based on the principle that the taxpayer and the tax administration jointly determine the relevant facts to ensure a complete and correct assessment as far as corporate income tax is concerned. In particular, taxpayers are obliged to provide the tax authorities with any information on transactions between associated companies upon request. As a consequence, despite the lack of specific documentation rules, taxpayers are strongly advised to have full and state-of-the-art transfer pricing documentation at hand that can, if requested by the tax administration, be disclosed. This also includes intercompany agreements with respect to the controlled transactions. Such documentation will also be helpful in the defence of potential tax evasion charges. Such documentation should also include sound and updated benchmarking studies. In addition, it should be noted, that with regard to MAPs and APAs, the master and local file as well as any other relevant information for the resolution usually have to be presented by the taxpayer.

If no appropriate transfer pricing documentation can be presented and the taxable base subsequently cannot be properly determined, the tax administration might need to estimate the transfer prices. Even though that estimate has to be dutiful and based on experience, such estimates are rarely in favour of the taxpayer. Although such an estimate is not to be considered as a penalty, it still has to be taken into consideration as a potential negative impact. The reason for that is that the courts will reject such an estimate only if the taxpayer can demonstrate that the transfer prices set by the tax administration are obviously flawed or arbitrary.

Penalty Relief

Federal and cantonal Swiss tax laws provide for a one-time voluntary disclosure, which leads to a complete penalty relief if specific statutory conditions are met. Outside the voluntary disclosure procedures, penalties charged are lower in the case of ordinary negligence and higher in the case of gross negligence. Collaboration with the tax administration in the course of a tax criminal investigation will usually result in a lower penalty. Regarding the question of culpability, the importance of state-of-the-art transfer pricing documentation should be emphasised. If a company does have such documentation, it will be difficult for the tax administrations to substantiate culpability. However, as indicated above, many disputes can be prevented or settled by negotiations with the tax authorities during a tax assessment or tax audit process (by filing formal complaints).

Back Taxes

It is worthwhile noting that criminally relevant violations of the arm's length principle may also trigger back taxes. This is the case if the tax administration becomes aware of new facts or pieces of evidence that have not been disclosed to the tax administration with the tax return or during the ordinary tax assessment procedure. In order to levy back taxes the tax administration

can reopen tax assessments as far back as for the last ten fiscal years.

8.2 Taxpayer Obligations Under the OECD Transfer Pricing Guidelines

Concerning transfer pricing documentation, Switzerland legally only requires preparing a CbCR. There is no legal obligation to prepare a master or local file.

However, in view of a potential challenge of the transfer prices by the tax authorities, it is nonetheless advisable to have master and local files (or similar documentation) at hand. In practice, tax authorities increasingly expect local files (at last broadly in line with the OECD TPG) for Swiss companies to be prepared by taxpayers in the event of a tax audit.

9. Alignment With OECD Transfer Pricing Guidelines

9.1 Alignment and Differences

Though the OECD TPG are not implemented into domestic law, the administrative practice has declared the OECD TPG as applicable. The importance of the OECD TPG for administrative practice is underpinned by the paper on transfer pricing recently published by the FTA, which makes strong reference to the OECD TPG.

Nonetheless, a caveat is made regarding the application of thin capitalisation rules and the determination of intra-group interest rates for loan receivables and loan payables both in Swiss francs and in foreign currencies. In this regard, the FTA annually publishes safe haven interest rates that deviate from the arm's length principle as defined and agreed upon in the OECD TPG (see **11.1 Transfer Pricing Safe Harbours**).

There is a long tradition in Swiss tax law of applying the formulary apportionment method for the profit allocation between the Swiss head office of an enterprise and its foreign permanent establishments. However, Switzerland now follows the OECD-authorised approach for the attribution of profits of permanent establishments (AOA). The FSC has, in its ruling in the matter of Swiss International Airlines, even shown sympathy for the application of the AOA also in domestic matters, but ultimately left the question open. In this respect, it should be noted that Switzerland has numerous DTAs in force that are still based on the OECD Model Convention, where the application of the formulary apportionment method for the allocation of profits to permanent establishments was considered permissible. However, Switzerland tends to follow the AOA even if a tax treaty has not yet been updated regarding the new Article 7.

9.2 Arm's Length Principle

Besides the above-mentioned exceptions, deviations from the arm's length principle can be seen in the implementation of the patent box and the notional interest deduction, which were introduced in connection with the corporate tax reform that came into force on 1 January 2020.

In line with BEPS Action 5, cantons are allowed to exempt income from patents and similar rights from taxation up to 90%. To determine the qualifying income, a top-down approach is used. Thereby, income from routine activities and trade marks is to be excluded, thus being subject to ordinary taxation. According to the FTA, it is not necessary to determine the income for routine activities and brand use by means of transfer pricing studies. Instead, for reasons of practicability, the law provides for fixed margins. For the income of routine functions, a mark-up of cost plus 6% is defined, and concerning the

income of trade marks, as a rule of thumb, 1% of the turnover of the patent box is regarded as appropriate. However, the right to prove higher or lower income from trade marks based on the arm's length principle is reserved.

The law also provides for simplifications in connection with the notional interest deduction (only available in the canton of Zurich). The special feature of the Swiss notional interest deduction is that it is only possible on the so-called security equity. For this purpose, core and security equity must be determined in a first step. The law does not require the preparation of a transfer pricing study for this purpose.

For reasons of practicability, the regulation rather provides for equity backing rates for the individual assets, following the circular on thin capitalisation and its inversed maximum safe haven debt capacity rates (for example, for intercompany loans, a minimum equity rate of 15% is required). If these rates are exceeded, there is security capital on which an imputed equity interest deduction can be claimed. In general, this interest is also not determined on the basis of the arm's length principle. Rather, the law provides for the interest rate for ten-year federal bonds. However, to the extent the security capital is attributable to receivables from related parties, an interest rate corresponding to the arm's length principle may be applied.

9.3 Impact of the Base Erosion and Profit Shifting (BEPS) Project

In general, the BEPS project had a major impact on the Swiss tax law landscape. Based on BEPS Action 5, Switzerland agreed to spontaneously exchange certain tax rulings, and based on BEPS Action 13, to the exchange of country-by-country reports (see **6.1 Sharing Taxpayer Information**).

Moreover, Switzerland abolished the administrative practices on Swiss finance branches and principal companies (see **1.2 Current Regime and Recent Changes**). The BEPS project raised the awareness of transfer pricing considerably, prompting the tax administrations – at cantonal and federal level – to address this issue more frequently and persistently (see **1.2 Current Regime and Recent Changes**).

9.4 Impact of BEPS 2.0

Switzerland is in favour of long-term, broad-based multilateral solutions instead of a multitude of (confusing) national measures. Thus, in principle, Switzerland supports the parameters of the discussed rules regarding the international profit reallocation of large multinational entities (MNEs) according to Pillar One as well as the minimum taxation global anti-base erosion (GloBE) rules according to Pillar Two, in order to restore legal certainty for countries and corporations.

Pillar One

Regarding Pillar One, Switzerland advocates that the interests of small, economically strong countries be taken into account in the implementation. Although in principle Pillar One works in both directions, Switzerland exports much more than it imports, as it creates attractive location conditions for a wide range of industries while is itself a small but nevertheless important consumer market.

Pillar Two

On 18 June 2023, the Swiss electorate voted on the implementation of the OECD/G20 minimum taxation (and the creation of the constitutional basis for the introduction of Pillar One), with the proposal being approved by 78.5%. The referendum was necessary as the introduction of the OECD/G20 minimum taxation required an

amendment to the Federal Constitution. This was because the OECD/G20 minimum taxation would have contradicted the constitutional principle of equal treatment of taxpayers. With the approval of the constitutional amendment, which came into force on 1 January 2024, the Federal Council enacted the ordinance on minimum taxation at federal level on the same day. At the same time, some cantons also decided to increase tax rates for companies.

It should be noted, however, that the minimum taxation in Switzerland is currently limited to the national supplementary tax (Qualified Domestic Minimum Top-up Tax, QDMTT). The Federal Council has refrained from applying the international supplementary tax rules (Income Inclusion Rule, IIR and Undertaxed Profit Rule, UTPR), which are provided for in the ordinance, for the time being. The partial introduction of the minimum taxation results in a tax increase for Swiss corporate groups and in particular US corporate groups with directly held Swiss constituent entities, provided the GloBE effective tax rate ETR in Switzerland is below 15% (and no corresponding substance-based income exclusion applies). However, there will generally be no additional tax burden for corporate groups from countries that introduce an IIR from 1 January 2024.

The reasoning of the Federal Council for this partial introduction of the minimum taxation is the aim of preventing the erosion of the Swiss tax base in favour of other countries. In contrast, an IIR would currently lead to the capture of under-taxed tax substrate from abroad, with negative effects on Switzerland's attractiveness as a business location. As things stand at present, it is expected that Switzerland will apply all measures, including the UTPR, from 2025 if at least the EU member states have introduced the UPTR by this point, which is to be expected based on the current legal situation.

It is obvious, that Pillar Two (as well as Pillar One) poses major challenges for Switzerland. Low taxes, clearly a locational advantage for Switzerland, will lose importance. However, the liberal economic system – in particular, the liberal labour law – good infrastructure, the first-class education system and the comparatively moderate corporate tax burden are reasons why Switzerland is, and will continue to be, a popular location for group headquarters and entrepreneurial activities that yield high residual profits, despite quite high labour costs by international standards.

Even though the effective Swiss tax burden may increase for multinational companies that fall under the Pillar Two regime, their higher tax costs may be offset by other benefits: the cantons are analysing how to use the expected additional tax revenues from the additional qualified domestic top-up tax, and it can be expected that they will take measures to maintain and even improve their attractiveness. In this context, the instrument of the Qualified Refundable Tax Credit (QRTC) will play an important role.

Given this situation, there will also be a significant tax rate differential between Switzerland and many other jurisdictions after Pillar Two, so foreign tax authorities are expected to continue to be increasingly interested in intra-group transactions with Swiss companies.

9.5 Entities Bearing the Risk of Another Entity's Operations

From a contract and commercial law perspective, a group can freely allocate risks and functions to be assumed between its entities. With a view to the acceptance of such an allocation, the

FSC held, in favour of the taxpayers, that the tax administration must recognise the contractual distribution of functions and risks undertaken by group entities, if these were not merely sham structures.

However, as the tax administrations are also following a substance-over-form approach in the area of transfer pricing, the splitting up of the assumption of risks and functions is increasingly questioned by the tax authorities. In particular, the tax administrations will evaluate whether the personnel of a risk-bearing entity were effectively able to manage and control the assumed risks.

10. Relevance of the United Nations Practical Manual on Transfer Pricing

10.1 Impact of UN Practical Manual on Transfer Pricing

The UN Practical Manual on Transfer Pricing is of only minor importance in Swiss transfer pricing practice.

11. Safe Harbours or Other Unique Rules

11.1 Transfer Pricing Safe Harbours

There are safe harbour rules that apply to thin capitalisation and to interest rates that are regularly used by corporate taxpayers (see **9.1 Alignment and Differences**).

Thin Capitalisation

The FTA published thin capitalisation rules in its Circular Letter No 6 (6 June 1997). In this circular, the maximum debt is determined according to maximum debt capacity ratios that apply for each asset category. No interest expense can be made on debt that surpasses this maximum debt amount (to be considered as constructive dividend distribution). Special safe haven rules might apply on the level of the Swiss cantons (eg, a maximum debt ratio of 6/7 in the canton of Zug).

Interest Rates

Furthermore, the FTA annually publishes circular letters providing inbound and outbound safe harbour interest rates on long-term intercompany loan receivables and payables.

The FTA, in principle, allows taxpayers to deviate from the conditions set out in the above-mentioned circular letters if the taxpayer can prove that the applied interest rate is at arm's length by performing and providing a detailed transfer pricing analysis.

11.2 Rules on Savings Arising From Operating in the Jurisdiction

Switzerland does not have any specific rules relating to location savings and relies on the OECD TPG on this issue. However, Switzerland does not provide notable location savings in the sense of the OECD TPG as production and labour costs are comparatively high.

11.3 Unique Transfer Pricing Rules or Practices

Switzerland does not have unique transfer pricing rules and, in principle, adheres to the OECD TPG.

12. Co-ordination With Customs Valuation

12.1 Co-ordination Requirements Between Transfer Pricing and Customs Valuation

Switzerland levies VAT on imported goods (import tax) of 8.1%, where the tax is assessed on the respective consideration. The import tax is levied by the Federal Customs Administration, which acts, like the FTA, as an independent administrative body of the federal government.

Despite the fact that the FTA and the Federal Customs Administration act independently, the administrations are entitled and encouraged to exchange relevant information between themselves and with other interested administrative bodies. The information exchange has massively increased within the past couple of years, which is mostly due to improved electronic systems, allowing a comprehensive and steady data flow. Hence, transfer pricing adjustments should always be considered for import tax purposes, as well.

Regarding customs duty, no adjustment is generally required as the customs duty itself is based on weight and not on monetary value. It is to be noted that Switzerland has abolished levying customs duty on industry products as of 1 January 2024.

13. Controversy Process

13.1 Options and Requirements in Transfer Pricing Controversies

General

Transfer pricing issues can generally be raised by the tax administration in the course of ordinary tax assessments or in the course of audits. For the transfer pricing controversy process, whether a cantonal tax administration or the FTA raised the issue of transfer pricing has to be differentiated. While the cantonal tax administrations raise this issue in the context of corporate income tax, the FTA may also challenge transfer pricing with regard to withholding tax, stamp duty or VAT.

As will be shown, taxpayers may challenge the results of a tax assessment or of an audit in an administrative objection proceeding before bringing the case to court. As regards the selection of the courts, the taxpayer does not have options since the competent courts are determined by law.

Corporate Income Tax

Transfer pricing adjustments affecting corporate income tax have to be discussed with the cantonal tax administrations, as they are the competent authorities to assess and levy corporate income tax at cantonal and federal level. If a tax administration has already issued an assessment or a decision, a formal objection can be lodged with the tax administration itself within 30 days. The tax administration will then have to evaluate the material objections and render a new decision.

The tax administration's second decision can be appealed before court, again within a 30-day deadline. Generally, each canton provides two judicial instances; though, typically, smaller cantons only establish one judicial instance.

Once the highest cantonal court has rendered its decision, an appeal with the FSC can be lodged, also within 30 days. In contrast to the cantonal instances, the FSC will only deal with questions concerning the correct application of the law, which includes the application of the OECD

TPG as soft law. Issues concerning the facts will only be dealt with if the facts were arbitrarily established. In the context of transfer pricing, it is worth noting that the choice of the transfer pricing method and its correct application is a question of law, whereas the result is considered a factual question. Hence, regarding the determination of the arm's length remuneration, the FSC can only intervene if the remuneration appears arbitrary.

The disputed tax needs to be paid irrespective of the fact of appealing a decision or moving the case forward into court. If the appeal/objection is successful, the tax already paid will be paid back, with interest. However, the FSC clarified that the tax administration is not entitled to enforce the disputed tax amount as long as the controversy has not been decided with legal effect. Nevertheless, the tax authority may request a freezing order at any time, even before the tax amount has been legally determined, if the taxpayer is not domiciled in Switzerland or payment of the tax owed by them appears to be at risk. The freezing order is immediately enforceable and has the same effects in the debt collection proceedings as an enforceable court judgment.

Withholding Tax, Stamp Duty and VAT

In contrast to the cantonal tax administrations, the FTA can raise transfer pricing issues in connection with withholding tax, stamp duty and VAT. As at the cantonal level, the taxpayer can object to a negative decision of the FTA before appealing to the court.

As such a decision affects taxes being levied by a federal administrative authority, the appeal has to be lodged with the Swiss Federal Administrative Court (FAC)– within 30 days. This court's decision can then – again within 30 days – be appealed with the FSC.

14. Judicial Precedent

14.1 Judicial Precedent on Transfer Pricing

Due to Switzerland's practice of issuing transfer pricing rulings and its APA programme, disputes on core transfer pricing issues that have to be settled by courts are relatively rare. Nevertheless, the FSC as well as the FAC have recently issued important decisions that raise key issues in the field of transfer pricing. Furthermore, it can be observed that cantonal courts are also scrutinising transfer pricing in more detail and increasingly refer to the OECD TPG.

14.2 Significant Court Rulings

FAC Decision A-4976/2022 of 4 September 2023

Although this case was not decided by the FSC, the ruling of the FAC nevertheless contains interesting and important considerations with respect to the selection and application of transfer pricing methods; especially concerning financial service transactions. The case at hand concerned Company A ("A AG") – an asset manager operating in Switzerland. A AG had outsourced part of its activities to two companies domiciled abroad, Company B ("B Ltd.", domiciled in Hong Kong) and Company C ("C AG", most likely domiciled in Germany). These companies were each owned by different shareholders, with individual I holding a direct or indirect stake in all companies to varying degrees. In addition, his two sons held substantial shares in A AG and one of these sons also held a substantial share in C AG.

With regard to the services provided by B Ltd. and C AG, the FTA was of the opinion that the services had been provided at an excessive price and made adjustments for the 2015 and 2016 tax periods. With regard to the services

provided by C AG, which essentially related to the creation of model portfolios, the FTA justified its assumption of an obvious mismatch on the fact that two employees of A AG also worked for C AG, whereby they had an hourly rate of CHF60 at A AG and C AG charged CHF300 per hour for the creation of the model portfolios. The FTA concluded that the hourly rate charged by C AG was obviously too high and not in line with the arm's length principle. It reached the same conclusion with regard to B Ltd., which provided services to A AG for "non-discretionary investment advisory" and "Asia market news". To the extent that the dealing at arm's length principle was violated, the FTA assumed a deemed dividend and levied WHT of 35%.

With regard to the assumption of a deemed dividend by the FTA, the FAC first pointed out that the tax administration has to prove the existence of an obvious mismatch between the service rendered and its consideration. Once this proof has been provided, the person concerned has the opportunity to provide evidence to the contrary. With regard to the assumption of an obvious mismatch, the FAC further stated that such a mismatch could only be assumed if the actually agreed prices lay outside the benchmark range for arm's length conditions. For the determination of the benchmark, the FAC acknowledged that the hierarchy of methods according to the OECD TPG has to be respected. Thus, firstly, an effective comparison has to be sought. Only if there is no effective comparison should the applicability of the various transactional standard methods be assessed, whereas the CUP has priority. With regard to the application of the cost plus method (CPM), the FAC stated that the relevant cost base included all direct and indirect costs.

Against this background, the FAC held that the FTA's approach had violated the methodological hierarchy according to the OECD by relying exclusively on the CPM. In addition, the FTA only considered the labour costs and did not take into account any other direct or indirect costs to determine the relevant cost base. In the opinion of the FAC, the FTA wrongly relied on the CPM and also applied it incorrectly. As a result, it referred the case back to the FTA for reassessment.

This ruling is part of a series of more recent rulings that heavily refer to the OECD TPG and make extensive statements on transfer pricing methodology. For example, in a case that has not yet been legally decided, the competent court of first instance dealt in detail with the question of the lege artis performance of a benchmark analysis. This development is to be welcomed, as the systematic application of the OECD TPG creates legal certainty and prevents seemingly arbitrary assessments by the administration.

FSC Decision 9C_686/2022 of 14 March 2023

In this decision the FSC dealt with the question of whether a real estate management fee of 20% on the gross rental income charged by a fund to one of its special purpose vehicles was, in fact, at arm's length. In the case at hand, a foreign pension fund invested – inter alia – indirectly into Swiss real estate via Company A ("A GmbH"), which was held by foreign companies without notable substance. The fund management was provided by a foreign asset manager H. For its services asset manager H charged a fee of 1.25% based on the assets under management to the fund which in turn charged 20% on the gross rental income generated by the real estate held by A GmbH to A GmbH itself (the allocation

of the fee was based on the real estate assets managed by the fund).

The FTA contested that the fee should be calculated on an arm's length basis and was of the opinion, that – according to practice applicable for pure real estate companies – only 5% calculated on the gross rental income generated by the real estate held by A GmbH (equal to CHF200,000) would qualify as a commercially justified administration fee. In addition, the FTA argued that the fee paid by the fund to asset manager H also covered services in favour of other real estate held by the fund outside of Switzerland. Accordingly, the FTA held that A GmbH could only be charged for services that could directly be attributed to the activities of A GmbH. Thus, the amount exceeding the 5% threshold was qualified by the FTA as deemed dividend and as such subject to 35% WHT. According to the FAC, the significant discrepancy indicated that A GmbH provided a benefit without a corresponding equivalent consideration. It was questionable, for instance, whether a single piece of real estate, of whose rental income 80% was attributable to a single tenant, required specific management services at all. Furthermore, the lack of a contract between asset manager H and A GmbH showed that the service had its legal basis in the shareholding relationship and had an unusual character. The mere listing of the services allegedly provided or invoiced was not sufficient evidence.

Against the FTA's position, A GmbH argued that it was to be regarded as an economic unit with the fund and, thus, not as a pure real estate company. As a consequence, the 5% limit could not be applied since this limitation only applies for pure real estate companies. Furthermore, A GmbH argued that there was neither a mismatch between the management fee and the services consumed by A GmbH nor would an eventual mismatch have been recognisable for the management of A GmbH. This was due to the fact that asset manager H was an independent third party and the remuneration of asset manager H was, by definition, at arm's length. The lack of a contract between asset manager H and A GmbH was justified by considerations of practicability.

The FSC essentially supported the arguments of the FTA and the FAC. However, the FSC amended the findings of fact in line with the statement that A GmbH had conceded in the proceedings before the FTA that the services provided by asset manager H in the area of investment advice were marginal. The services were essentially limited to the real estate management of the property held by A GmbH – ie, so-called facility services. For such services, compensation of only 2–6% of the annual gross rental income can be considered as customary and, thus, at arm's length. Against this background, the 5% fee according to FTA practice is not objectionable.

This ruling, although it may well be correct in its result, gives rise to the following issues: As shown, the FTA's practice provides for a 5% fee for administrative costs. However, this percentage should be limited to the purely technical administration costs and not also include asset management. In addition, the 5% fee should be interpreted as a safe haven rule, which means that proof of remuneration in line with third-party comparisons should always be reserved, provided, however, that the services in question can be documented. However, practice shows that the tax authorities tend to use the 5% rule as an at arm's length benchmark, which is certainly not in line with the OECD TPG.

FSC Decision 2C_907/2022 of 16 December 2022

In this case, a Swiss entity with domicile in Geneva ("A SA") held a subsidiary in Gibraltar, which, in turn, held directly and indirectly 79.53% of Company D with domicile in the British Virgin Islands (BVI). A SA was active in the business of asset and fund management and was, as far as was evident, operationally run by individual B, the sole shareholder of A SA. For the sake of completeness, it is worth mentioning that the name of the shareholder and A SA can be tracked down using the information in the anonymised decision and that the person concerned was also mentioned in the Panama Papers.

Company D, for which B served as a director, owned shares in various companies, whereas the assets were managed by B who received a salary from A SA of around CHF700,000 per year. A SA, however, did not charge Company D for the services of B. Further, Company D had no employees or any other physical substance. In light of these facts, the tax administration of the Canton of Geneva was of the opinion that A SA should have been compensated by Company D at arm's length and added 79.53% of Company D's earnings to the earnings of Company A. This offset was challenged by A SA, which ultimately brought the case to the FSC.

The FSC ruled, inter alia, that the approach taken by the tax administration of Geneva was not in line with the arm's length principle. According to the FSC, the tax administration should have analysed the value of the services rendered by B to Company D and set the respective service fee accordingly. However, the FSC nevertheless confirmed the offset of 79.53% arguing that the established structure was abusive and served only the purpose of avoiding taxes. According to the FSC it would have been much more logical if the funds were managed directly by A SA. Following this line of argument, the earnings of Company D were added to the earnings of A SA to the extent of 79.53%.

This case shows that the law provides tax administrations with different means to prevent undue profit shifting to offshore jurisdictions. The FSC, however, upholds that corrections based on transfer pricing principles have to be justified according to best practice. Simple lump-sum offsets are therefore inadmissible from the perspective of transfer pricing. In specific cases, however, this does not protect the taxpayer from corresponding offsets.

15. Foreign Payment Restrictions

15.1 Restrictions on Outbound Payments Relating to Uncontrolled Transactions

Switzerland does not have any specific rules or even restrictions regarding uncontrolled outbound transactions.

15.2 Restrictions on Outbound Payments Relating to Controlled Transactions

Switzerland does not have any specific rules or even restrictions regarding controlled outbound transactions.

However, as for all transactions, the payments have to be commercially justified in order to be effectively deductible for corporate income tax purposes. Furthermore, according to the FSC, a "particularly qualified" duty to co-operate with the tax authorities in the case of cross-border legal relationships has to be taken into account. This increased duty especially applies to out-

bound payments to a non-DTA foreign country or to a DTA foreign country to the extent that the DTA does not yet meet the current OECD standard on information exchange. The reasoning is that the circumstances of the foreign recipient are beyond the control of the domestic tax authorities.

15.3 Effects of Other Countries' Legal Restrictions

Switzerland does not have specific rules regarding the effects of other countries' legal restrictions. In the event that a foreign entity is affected by an adjustment of a payment to a Swiss entity due to such restrictions, a double taxation is most likely to be incurred.

However, Swiss tax authorities may prevent a double taxation with unilateral measures if they agree to the reason and extent of the correction. Otherwise, a MAP would need to be initiated if a double taxation agreement is applicable.

16. Transparency and Confidentiality

16.1 Publication of Information on APAs or Transfer Pricing Audit Outcomes

In Switzerland, taxpayer information is kept strictly confidential. Thus, results from APAs and transfer pricing audits are not published.

However, it is to be noted that court rulings (excluding the reasoning) are made publicly available at the court for 30 days, whereby the names are generally not redacted. The FAC, as an exception, also redacts the names during the temporary public disclosure. After the public disclosure, rulings are published online with the names redacted. Despite the redactions, it cannot be excluded that from the other pieces of information of the decision, the party concerned can be identified. Outside of the administrative procedure, tax secrecy is therefore not guaranteed.

16.2 Use of "Secret Comparables"

In principle, Switzerland adheres to the OECD TPG and follows the principle according to which the tax administration is prohibited from basing transfer pricing adjustments on secret comparables.

Trends and Developments

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Tax Partner AG is focused on Swiss and international tax law and is recognised as a leading independent tax boutique. With currently 11 partners and counsel and a total of approximately 50 tax experts consisting of attorneys, legal experts and economists, the firm advises multinational and national corporate clients as well as individuals in all tax areas. A central focus lies on tax controversy and dispute resolution, including transfer pricing issues. Tax Partner AG also provides support regarding transfer pricing studies and the preparation of transfer pricing documentation. Other key areas include M&A, restructuring, real estate transactions, financial products, VAT and customs. Tax Partner AG is independent and collaborates with various leading tax law firms globally. In 2005 the firm was a co-founder of Taxand, the world's largest independent organisation of highly qualified tax experts.

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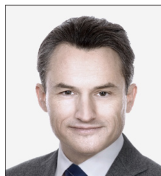

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More Guidance and Increased Focus on Transfer Pricing

Traditionally, transfer pricing has played a modest role in Switzerland; influenced by the country's historically low corporate income tax rates and the favourable tax regimes available. However, a noticeable shift has taken place in recent times. In the opening two months of 2024, two additional guidance documents have been issued.

The first was guidance issued by the Swiss Tax Conference together with the Swiss Federal Tax Administration (SFTA), and the second, on 23 February 2024, saw the SFTA introducing a new publication of its transfer pricing practice, presented in the form of a Q&A.

This article highlights the key aspects of each of these guidance papers and discuss the expected impact they might have, as well as other recent regulatory developments in and key decisions in the Swiss transfer pricing space.

Guidance Issued by the Swiss Tax Conference and the Swiss Federal Tax Authority

On 23 January 2024, the Swiss Tax Conference, an organisation of the cantonal tax administrations, together with the SFTA, published a comprehensive paper on transfer pricing for the dossier "Tax Information" on the Swiss tax system. This publication, which mainly refers to the OECD TP Guidelines for Multinational Enterprises and Tax Administrations (the "OECD TP Guidelines"), makes it clear that transfer pricing is becoming increasingly important in Switzerland.

Despite the fact that this publication is not legally binding in Switzerland, the guidelines contained therein are important in interpreting the arm's length principle and stress the interpretation of the OECD TP Guidelines as soft law in Switzerland. In essence, the paper discusses the comparability analysis, the method selection, intangibles, services and financial transactions, without covering cost contribution arrangement and transfer pricing aspects of business restructurings.

The publication, with respect to administrative approaches to avoiding and resolving transfer pricing disputes, recommends filing simultaneous transfer pricing ruling requests with both cantonal and federal tax authorities due to the potential impacts on income tax and withholding tax. The paper briefly touches upon the process of primary, corresponding and secondary adjustments.

While confirming the three-tiered documentation approach, the paper clarifies that in Switzerland,

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the only mandatory transfer pricing documentation is the country-by-country report (if the relevant group turnover threshold of CHF900 million is surpassed).

Swiss law does not specify other particular requirements; however, taxpayers must provide relevant information upon request under the existing collaboration obligation. This implies a recommendation for Swiss companies involved in cross-border intercompany transactions to proactively prepare comprehensive supporting transfer pricing documentation, to document the process of ensuring the arm's length nature of these transactions.

Q&A Section Published by the SFTA

On 23 February 2024, the SFTA also published a Q&A list (in German and French) on a new separate website, shedding light on its transfer pricing practice. In this Q&A, the SFTA clarifies 41 questions in relation to transfer prices, always with reference to the OECD TP Guidelines. It is the first time that the SFTA has published its practice on selected transfer pricing issues.

Normally, administrative tax practice is published in the form of circulars in which it is also indicated to which taxes the particular circular applies. It is not made clear in the Q&A whether the practice disused in it only applies to federal direct tax and Swiss withholding tax or also to stamp duties and/or VAT.

Further, the Q&A only applies to international transactions. Considering the increased number of inter-cantonal transfer pricing cases (please note that the effective tax rates in Switzerland range from around 11% to 21%), it would have been welcomed if these answers had been declared applicable also to intra-national constellations.

Cost-plus method

For example, the Q&A answers the question on the composition of the cost base for the cost-plus method calculation. The answer, referring to the OECD TP Guidelines, points out the distinction that needs to be made between operating costs (ie, expenses that a company regularly incurs to keep business processes and systems running and to provide services that generate value), and non-operating costs, such as taxes and financing costs.

Though the SFTA is referring to the cost-plus method for the purpose of a benchmark study, it actually means the application of the transactional net margin method (TNMM), using the profit level indicator mark-up on total operating costs.

Financing costs (at least for typical service companies and non-capital-intensive (routine) production companies) are also not usually incurred during actual operating activities and do not generate added value. Thus, as non-operating costs do not contribute to a company's "value added", they are generally not included in the cost base.

This is a welcome clarification by the SFTA as there were disputes with the cantonal tax authorities that wanted to have these costs included (in all circumstances). However, it still needs to be seen whether the cantonal tax authorities will apply these guidelines.

In addition, the questionnaire comments on the treatment of pass-through costs, as well as the mark-up for low value-adding services, both in line with the OECD TP Guidelines.

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Withholding tax in the case of primary, corresponding and secondary adjustments

Further, the questionnaire also provides answers as to when Swiss withholding tax is triggered in the case of primary adjustments, profit repatriations and secondary adjustments.

The SFTA stresses that primary and corresponding adjustments typically relate to income tax. If such primary adjustment results in a profit repatriation, these are not considered to be deemed dividends and are not subject to withholding tax if they are carried out in accordance with the result of a mutual agreement procedure or a unilateral agreement. In the absence of a mutual agreement procedure or a Swiss internal agreement, withholding tax is levied on payments made for the purpose of repatriation.

If, for example, a primary adjustment made by a cantonal tax administration is confirmed in whole or in part in the mutual agreement procedure, the question of the secondary adjustment arises – ie, the levying of withholding tax by the SFTA on the amount of the primary adjustment confirmed in the mutual agreement procedure. In this respect, the SFTA differentiates between no withholding tax if there is a respective agreement in the mutual agreement or withholding tax (especially in cases of evident profit shifts). If addressed in the agreement, the repatriation of profits must take place within 60 days of the mutual agreement's conclusion.

Financing transactions

Surprisingly, out of the 41 questions, 20 relate to financing transactions. This shows the importance of financing transactions in general and the clear need for the tax authorities to provide clarification to taxpayers. Considering that the chapter on financing transactions is only part of the OECD TP Guidelines as of the 2022 update, it is unclear whether these answers are also valid for the years before. Below, several interesting questions that are raised and answered in this area are explored.

The SFTA publishes, on an annual basis, safe harbour interest rates applicable to shareholder and intercompany loans, denominated in Swiss francs and foreign currencies. If these rates are adhered to, no proof is required that the arm's length principle is met.

Nonetheless, according to case law, these safe harbour rates do not apply for short-term loans. However, these safe harbour rates are not binding for foreign tax authorities. Thus, a taxpayer may set interest rates that deviate from the safe harbour. As a consequence, the arm's length character of the transaction has to be demonstrated in a separate study. As part of the questionnaire, the SFTA clarifies the requirements for doing so.

With respect to the application of a credit rating, the SFTA outlines the importance of distinguishing between the credit rating of the borrower and the credit rating of the particular transaction and recommends using the credit rating of the particular transaction. If a credit rating from an independent rating agency is available for a borrower, this must be used. If such a rating is not available, an estimation/calculation of the rating must be made.

There are various approaches to this – eg, applying the methods defined and used by rating agencies or the use of financial software to calculate the rating using statistical models. It is recommended that one of the methods used by rating agencies is applied. However, the use of financial software is not ruled out, provided that the reliability of the results can be demonstrated.

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An internal credit rating performed by a bank may be accepted by the SFTA if it is proven that the same method is applied for interest rate setting (since banks apply different methods and standards owing to regulatory and industry-specific differences compared to rating agencies).

The SFTA also answers the question of when the rating of a group can be used for a borrower. The SFTA specifies in this respect that a company must be rated as if it were not part of a group (ie, on a standalone basis). However, any implicit support must be taken into account. In exceptional cases, the group credit rating can be used for the rating of a borrower. However, it must be demonstrated that this is the most reliable indicator taking into account all facts and circumstances. In particular, the creditworthiness indicators of the company must not differ from those of the group (eg, in the case of structures in which the group is held by a number of intermediate holding companies).

The SFTA confirms that it is not easy to find comparative values in Swiss francs and that comparative values in other currencies can also therefore be used. The SFTA recommends the use of comparative values in Euros in view of the proximity and economic interdependence between Switzerland and the EU. In this case, a reliable adjustment of the results is necessary to improve comparability. In practice, it is appropriate in most cases to make an adjustment corresponding to the difference between a swap interest rate in Swiss francs and a swap interest rate in euros for the same term.

Regarding reference rates, the SFTA mentions the importance of using a reference rate that is equivalent to those used in practice by banking institutions as a substitute for LIBOR. These rates are determined according to new market standards set by stock exchange institutions or central banks that administer them. For the Swiss franc, this is SARON (Swiss Average Rate Overnight). LIBOR can have different maturities (eg, one day, one week, three months), while the alternative interest rate chosen is a daily rate. For this reason, a method to derive a longer-term interest rate from this daily rate should be taken into account. The appropriate method for intercompany loans in Swiss francs is the "last recent" option and the use of the SARON Compound Rate

Tax authorities are dedicating increased human resources to transfer pricing

There is already an increased focus of transfer pricing in Swiss tax audits. This tendency is also supported by the increased human resources dedicated to transfer pricing topics with the SFTA, which also supports the cantonal tax authorities in treating transfer pricing cases. Together with the published practices it is assumed that the Swiss tax authorities will handle transfer pricing matters more professionally in line with the OECD TP Guidelines.

Recent landmark decision

Swiss courts are judging more and more transfer pricing cases. This is clear evidence that the tax administrations are increasingly scrutinising transfer pricing.

It can be further seen that the cantonal courts now examine the cases at hand in much more technical detail. The Cantonal Tax Appeals Court in Zurich, for example, recently analysed which interest rate is at arm's length for intercompany loans that qualify as Additional Tier 1 Capital for Basel III purposes. In that decision, the court also discussed in detail the nature of the Swiss safe harbour interest rates and stated that they are not applicable to such loans but that an

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individual approach is required, referring to the principles stipulated in the OECD TP Guidelines.

In its decision, the court analysed the benchmarking study that had been performed in depth and rejected the comparables that were chosen. The court even added additional (local) comparables that were in the public domain and used regression analysis to derive the arm's length interest rate. In the end, the court supported the appeal filed by the tax payer.

Conclusions

The issuance of these new Swiss transfer pricing guidelines is expected to lead to an increased focus on transfer pricing in Switzerland. Also, the new transfer pricing publications issued by the SFTA provide for more transparency on Swiss transfer pricing practice, even if these publications do not yet cover all aspects of transfer pricing (eg, business restructuring).

Swiss tax authorities have increased human resources dedicated to transfer pricing topics with the SFTA, which also support the cantonal tax authorities in treating transfer pricing cases and tax audits.

Pragmatic approaches, such as simply cost-based methods, will often no longer be possible, and the principles of the OECD TP Guidelines are expected to be established in Switzerland. Even though there is no transfer pricing documentation obligation in Switzerland, an increased need for professional benchmarking and documentation is anticipated. This proactive approach is essential to effectively defend, and align with, the OECD TP Guidelines, demonstrating the arm's length nature of intercompany transactions. In tax audits, the federal and cantonal tax authorities increasingly expect transfer pricing documentation in line with the OECD TP Guidelines from the taxpayer.

UGANDA

Law and Practice

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Birungyi, Barata & Associates was founded in 2003 and has since established itself as the leading tax law firm in Uganda, aiming to provide professional and efficient tax and legal services that optimise client value. The firm has been at the helm of tax litigation, firmly impacting and changing the legal landscape of tax with game changing tax decisions. The firm offers bespoke advisory services on domestic and international tax, tax litigation, planning, audit, and consultancy. The firm has grown to be recognised by local and international peers, as well as international legal ranking firms for its excellence in tax and legal services. The firm's expertise extends to individuals, multinational corporations, international organisations, and government agencies across a spectrum of tax-related matters.

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1. Rules Governing Transfer Pricing

1.1 Statutes and Regulations

The rules governing transfer pricing in Uganda are contained in the Income Tax Cap 340 which is the main statute, and the Income Tax (Transfer Pricing) Regulations.

- The Income Tax Act Cap 340 – Section 90 of the Income Tax Act (ITA) allows the Commissioner to adjust transactions between associates as necessary to reflect chargeable income at arm's length. In addition, Section 91 grants the Commissioner the authority to recharacterise transactions linked to tax avoidance or lacking substance, and to disregard those without substantial economic effect.
- The Income Tax (Transfer Pricing) Regulations – these came into force on 1 July 2011 and apply to controlled transactions between a resident and another resident party or non-resident entity. The Regulations are implemented in line with Article 9 of the OECD Model Tax Convention and the OECD Transfer Pricing Guidelines.

1.2 Current Regime and Recent Changes

History

The history of Uganda's transfer pricing regime traces back to the enactment of the Income Tax Act in 1997, which laid the groundwork for addressing tax avoidance practices under Section 90 and Section 91 of the Act which require taxpayers in related party transactions to deal at arm's length.

Current Regime

Uganda's Transfer Pricing Regulations came into force on 1 July 2011, and they apply to transactions between associated entities, for both domestic and cross-border transactions.

Changes and policy considerations

- On 5 May 2012, the Uganda Revenue Authority (URA) issued a Practice Note (General Notice 386 of 2012) providing guidance on the documents to be maintained by taxpayers for transfer pricing purposes. The practice note aimed at assisting taxpayers in complying with Transfer Pricing Documentation requirements and guiding the URA during the audit process.
- Section 90 of the ITA was amended by the Income Tax (Amendment Act) 2017 to broaden the rules' scope, extending their application to transactions between associates. Prior to the 2017 amendment, the provision only covered "taxpayers" which meant that persons who were not registered taxpayers, such as non-residents, would not be included.
- On 23 June 2023, Uganda signed into law The Convention on Mutual Administrative Assistance in Tax Matters Act 2023, and it took effect on 1 July 2023. The Act gives force of law in Uganda to the provisions of the Convention on Mutual Administrative Assistance in Tax Matters, the Multilateral Competent Authority Agreement on Automatic Exchange of Financial Account Information, and Standard for Automatic Exchange of Financial Account Information in Tax Matters, alongside related regulations.
- The Uganda Revenue Authority has an International Tax Unit which was set up to handle international tax issues and transfer pricing audits.

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2. Definition of Control/Related Parties

2.1 Application of Transfer Pricing Rules

Definition of Associates

According to Section 3 of the Income Tax Act, a person is treated as an associate of the other if the person acts in accordance with the directions, requests, suggestions, or wishes of another person. This definition does not apply to an employee–employer relationship.

In the case of a company, an associate refers to a person who either alone or together with an associate or associates controls 50% or more of the voting power in the company either directly or through one or more interposed companies, partnerships or trusts.

Definition of Controlled Transactions

The transfer pricing Regulations define controlled transactions to mean transactions between associates.

Technical Control Test

The test is not flexible as the rules require technical control of 50% or more of the voting power in the company.

3. Methods and Method Selection and Application

3.1 Transfer Pricing Methods

The Transfer Pricing Regulations ("TP Regulations") specify the following transfer pricing methods:

- Comparable Uncontrolled Price Method;
- Resale Price Method;
- Cost Plus Method;
- Transaction Net Margin Method; and
- Transactional Profit Split Method.

3.2 Unspecified Methods

Regulation 7(5) of the Income Tax (Transfer Pricing) Regulations 2011 gives taxpayers the option to apply a transfer pricing method other than those explicitly outlined in Regulation 3 if they can demonstrate to the Commissioner that:

- none of the specified methods are suitable for assessing whether a controlled transaction aligns with the arm's length principle; and
- such other method yields a result consistent with that between independent parties engaging in comparable uncontrolled transactions in comparable circumstances.

3.3 Hierarchy of Methods

The law does not provide for a hierarchy for the transfer pricing methods. Uganda has a flexible approach in selecting the most appropriate transfer pricing method as long as the result of the transaction is at arm's length. The most appropriate method is evaluated based on:

- the strengths and weaknesses of the method in the circumstances of a case;
- appropriateness of the method having regard to the nature of the transaction and functions undertaken by each party;
- availability of reliable information needed to apply the transfer pricing methods; and
- degree of comparability between controlled and uncontrolled transactions, and the reliability of any necessary adjustments.

3.4 Ranges and Statistical Measures

There are no specific provisions in the law relating to the use of ranges or statistical measures. However, Regulation 8 of the TP Regulations requires taxpayers to provide sufficient information and analysis to verify that the controlled

transactions are consistent with the arm's length principle.

The onus is on the taxpayer to demonstrate that their intercompany transactions are priced in accordance with what would have been agreed upon between unrelated parties in an open market setting.

3.5 Comparability Adjustments

Regulation 4 outlines factors that ought to be considered in determining comparability of transactions. These factors are:

- the characteristics of the property transferred;
- functions undertaken by the person entering into the transaction taking account of assets and risks assumed;
- contractual terms of the transactions;
- economic circumstances in which the transactions take place; and
- business strategies pursued by the associate to the controlled transaction.

According to Regulation 10, in cases where a competent authority of another country, with which Uganda has a Double Taxation Agreement (DTA), makes an adjustment resulting in taxation in that other state or the profits becoming taxable in Uganda, the Commissioner shall, upon request by the taxpayer, assess whether the adjustment aligns with the arm's length principle. If it is determined to be consistent, the Commissioner shall correspondingly adjust the amount of tax levied in Uganda on the income or profits, thereby preventing double taxation.

4. Intangibles

4.1 Notable Rules

The Transfer Pricing Rules ("TP Rules") and Income Tax Act do not provide for a definition for intangible property. However, under the ITA, an intangible asset is treated as immovable property.

Section 90(2) of the ITA allows the Commissioner to adjust the income arising from any transfer or licence of intangible property between associates so that it is commensurate with the income attributable to the property.

The documents to be maintained with respect to intangible property include the form of the transaction, the type of intangible, the rights to use the intangible that are assigned, and the anticipated benefits from its use.

The scope of the TP Rules in respect to intangibles includes their supply and acquisition. Since the TP Regulations follow the OECD Transfer Pricing Guidelines ("OECD TP Guidelines"), the rules and methods outlined therein are applicable.

4.2 Hard-to-Value Intangibles

The transfer pricing legislation in Uganda does not have any special rules regarding hard-to-value intangibles.

4.3 Cost Sharing/Cost Contribution Arrangements

The Practice Note issued by the URA in 2012 recognises Cost Contribution Arrangements. In order to prove that cost sharing is at arm's length, a party is required to provide supporting documents which include:

- copies of agreements and relevant changes to the agreements;
- a list of all parties involved;
- how much associated parties who are non-participants use the shared resources;
- how long the sharing agreement lasts, what activities are covered;
- who benefits from the agreement;
- any differences between expected and actual benefits;
- each party's responsibilities;
- how much each participant contributes; and
- what happens if someone joins or leaves the agreement.

The URA has the power to adjust the income or deductions of a taxpayer if it believes that the conditions of a cost-sharing arrangement do not comply with the arm's length standard.

5. Affirmative Adjustments

5.1 Rules on Affirmative Transfer Pricing Adjustments

The TP Rules do not provide for specific rules regarding affirmative transfer pricing adjustments. However, according to Section 24 of the ITA, the taxpayer may request the Commissioner to amend a return upon discovering an error within three years from the date of filing the return. In his case, the taxpayer may make the necessary adjustments in computing the assessable income. The Commissioner is obliged to notify the taxpayer of the decision within 30 days.

6. Cross-Border Information Sharing

6.1 Sharing Taxpayer Information

Uganda has a network of Double Taxation Agreements (DTAs) with various countries, namely: Denmark, India, Italy, Mauritius, Netherlands, Norway, South Africa, the United Kingdom and Zambia. These treaties were signed to avoid double taxation and promote economic co-operation.

The DTAs include provisions for the exchange of information to prevent tax evasion and ensure compliance with tax laws, for example, Article 26 of the DTA between Uganda and the UK provides for a mechanism for tax authorities in the UK and Uganda to exchange confidential information regarding taxpayers for the purposes of applying the treaty or domestic law.

On 4 November 2015, Uganda signed the OECD Multilateral Convention on Mutual Administrative Assistance in Tax Matters (MAAC) becoming the 8th African country and the 90th jurisdiction of the convention.

Uganda is also a signatory to the East African Community Agreement for the Avoidance of Double Taxation and Prevention of Fiscal Evasion with Respect to Taxes on Income. Article 27 of the Agreement provides for the exchange of information between the member states to prevent fraud and tax evasion. However, this agreement is not in force due to the delay in ratifying it by one of the member states, Tanzania.

7. Advance Pricing Agreements (APAs)

7.1 Programmes Allowing for Rulings Regarding Transfer Pricing

According to Regulation 9(1) of the TP Regulations, a person may request the Commissioner to enter into an advance pricing agreement to establish an appropriate set of criteria for determining whether they have complied with the arm's length principle for certain future controlled transactions undertaken over a fixed period of time.

7.2 Administration of Programmes

APAs are administered by the Commissioner of the Uganda Revenue Authority.

7.3 Co-ordination Between the APA Process and Mutual Agreement Procedures

In case of a dispute arising from an APA, the MAP may be invoked to resolve the dispute. Co-ordination between APA and MAP in this case facilitates a seamless resolution of any disputes or issues arising from the APA.

7.4 Limits on Taxpayers/Transactions Eligible for an APA

The law does not provide for limitations regarding which taxpayers or transactions are eligible for an APA.

7.5 APA Application Deadlines

The law does not specify a deadline by which a taxpayer must file an APA application.

7.6 APA User Fees

The law does not provide for any user fee for a taxpayer seeking an APA.

7.7 Duration of APA Cover

The law does not specify the number of years an APA can cover. However, Regulation 9(7) provides that the APA shall specify the years of income for which the agreement applies.

7.8 Retroactive Effect for APAs

An APA applies to the controlled transactions specified in the agreement that are entered into on or after the date of the agreement.

8. Penalties and Documentation

8.1 Transfer Pricing Penalties and Defences

Penalties

A taxpayer is liable on conviction to imprisonment for a term not exceeding six months or a fine not exceeding UGX500,000 (approximately USD127) or both for contravening the TP Regulations.

Section 49A(1) of the Tax procedures Code Act also imposes a penalty of UGX50 million (approximately USD12,700) for failure to provide records in respect of transfer pricing within 30 days following the request.

A taxpayer has a right under Section 24 of the Tax Procedures Code Act to lodge an objection with the Commissioner within 45 days from the date of receipt of the assessment.

Defending penalties

A taxpayer dissatisfied with an objection decision has a right to appeal the decision up to the Supreme Court.

Transfer Pricing Documentation

Regulation 8(1) of the Income Tax (Transfer Pricing) Regulations requires taxpayers to prepare and keep transfer pricing documentation.

Taxpayers are required to record in writing sufficient information and analysis to verify that the controlled transactions are consistent with the arm's length principle.

The documentation must be in place prior to the due date for filing the income tax return for the relevant year of income. The documents include:

- the ownership and organisational structure of the entity;
- operational structure;
- description of the controlled transactions;
- description of the comparables;
- economic conditions;
- description of the method selected and reasons why it was selected;
- functional analysis;
- cost contribution arrangements;
- management strategy/policy;
- where applicable, financial information relevant in comparing profit and loss between associated entities; and
- all outcomes from a comparability analysis, and explanation of capital relationship.

8.2 Taxpayer Obligations Under the OECD Transfer Pricing Guidelines

The law does not specifically mandate taxpayers to prepare all the files and reports as outlined in the OECD TP Guidelines. However, the documentation required from the tax payer as outlined in the TP Rules mirror the information required in a local file which contains detailed information relating to specific intercompany transactions.

9. Alignment With OECD Transfer Pricing Guidelines

9.1 Alignment and Differences

How are the OECD and Ugandan Income Tax Aligned?

Uganda's TP Regulations are aligned with the OECD TP Guidelines. Regulation 6 provides that the Regulations must be construed in accordance with the arm's length principle under Article 9 of the OECD Model Tax Convention on Income and Capital and the OECD TP Guidelines for Multi-national Enterprises and Tax Administrators. The Regulations also adopted the same transfer pricing methods as stated in the OECD TP Guidelines.

Uganda has also followed the OECD approach in the DTAs signed with other states, for example, in allocating taxing rights, taxing residents on their worldwide income, definition of a permanent establishment and beneficial owner, among others.

However, where there is a conflict between the Act and the OECD documents, the Income Tax Act prevails.

Differences

- OECD taxes royalties only in resident states, whereas Uganda taxes based on source of income in Uganda by way of withholding tax.
- Under the OECD, there is no withholding tax on payments made by resident companies, whereas in Uganda withholding tax is applicable to resident taxpayers providing goods and services.
- OECD allows for losses to be deducted but they cannot be added back, whereas in Uganda taxpayers can carry back losses.

- Uganda uses a criterion of 90 days/6 months for permanent establishment, while the OECD's period is 12 months.

9.2 Arm's Length Principle

Uganda's TP Rules apply the arm's length principle as embedded in Sections 90 and 91 of the ITA. The Rules do not provide for any other approach.

9.3 Impact of the Base Erosion and Profit Shifting (BEPS) Project

The BEPS project has influenced the country's transfer pricing landscape by prompting amendments to its domestic tax laws, aligning them with the transfer pricing principles to prevent base erosion, ensure arm's length transactions between related parties and limit on interest deductions. The amendments include the following.

- Amending the definition of beneficial ownership in 2022 (Section 2 (ea) of the ITA to include legal person and trusts).
- Restricting interest between related parties to 30% EBITDA (Section 25 (3)).
- Taxing non-resident contractors/professionals and ensuring taxation of Ugandan source service contracts (Section 88 (5) of the ITA).
- Expanding of definition and taxation of mining and petroleum operations (Part IXA of the ITA)
- Introducing Digital Tax in 2023 at a rate of 5% to bring the digital economy into the tax base alongside VAT on electronic services.
- Expanding the definition of source of income under Section 79 of the ITA to include income derived from the direct or indirect change of ownership by 50% or more of a person other than an individual, a government, a political subdivision of a government and a listed institution located in Uganda.

Controversies often arise in respect to income sourcing and beneficial ownership definitions. For example, the dispute in the case of Rwenzori Bottling Co. Ltd V URA TAT No 21 of 2021 arose from the application of the amended interest deduction rules. The dispute in the case of Aponye Uganda Limited V URA TAT 80 of 2021 related to the definition of beneficial ownership.

9.4 Impact of BEPS 2.0

Uganda has not clearly stated its position on the OECD two-pillar solution but has participated in proposing a fair tax deal through the African Tax Administration Forum.

Pillar 1, aiming to allocate taxing rights to market jurisdictions, is viewed as fair to curb profit shifting and base erosion by MNEs.

Uganda, like other developing countries, opposes the rules under Pillar 2, citing that the 15% rate is low compared to the corporate tax rate of 30%, which could still allow for tax avoidance. Uganda also offers tax incentives to attract foreign direct investment, such as exemptions, and implementing the minimum tax could impact such investments.

9.5 Entities Bearing the Risk of Another Entity's Operations

The law does not permit an entity to bear the risk of another entity's operations by guaranteeing the other entity a return.

10. Relevance of the United Nations Practical Manual on Transfer Pricing

10.1 Impact of UN Practical Manual on Transfer Pricing

While Uganda's TP Guidelines explicitly state adherence to the OECD TP Guidelines, Uganda has also incorporated and adheres to certain provisions of the UN Model Tax Convention (UN MTC) regarding the allocation of taxing rights. However, there have been no amendments to the rules or administrative guidance by the URA to incorporate the UN Practice Manual on Transfer Pricing.

Source of Income

Uganda taxes all income derived from sources within its territory which mirrors the principles outlined in the UN MTC. This includes income from agreements, shipping, air transport, dividends, interest, and digital services.

Permanent Establishment

Uganda follows the UN MTC's criteria for determining a permanent establishment, particularly in the context of construction projects. This includes:

- a place where a person is engaged in a construction, assembly or installation project for 90 days or more;
- a place where a person is installing substantial equipment or machinery; and
- provision of services through employees or other personnel within a period of 90 days in any 12-month period.

Double Taxation Agreements (DTAs)

In some of its DTAs, Uganda adheres to the guidelines outlined in the UN MTC. For example, the DTAs with India and South Africa allocate taxing rights to the source state concerning the definition of permanent establishment, business profits, independent personal services and dependent personal services. In addition, the DTA with India allocates fees arising from the provision of technical services to the source state.

11. Safe Harbours or Other Unique Rules

11.1 Transfer Pricing Safe Harbours

The TP Rules in Uganda do not offer any exceptions to the penalty regime for transactions considered immaterial. According to the Practice Note issued by the URA, the documentation obligation is applicable to controlled transactions involving associated entities that in aggregate amount to UGX500 million (approximately USD127,200). Consequently, the requirement for TP documentation does not extend to controlled transactions valued below USD127,200.

11.2 Rules on Savings Arising From Operating in the Jurisdiction

Uganda does not have specific rules on location savings but since the country follows the OECD TP Guidelines, they would apply.

11.3 Unique Transfer Pricing Rules or Practices

Uganda does not have unique rules for disallowing marketing expenses by a local entity that is a licensee claiming local distribution intangibles or practices specific to the transfer pricing context. The general practice is that all allowable deductions relating to associated enterprises undergo extra scrutiny by the URA.

12. Co-ordination With Customs Valuation

12.1 Co-ordination Requirements Between Transfer Pricing and Customs Valuation

The TP Rules do not provide for co-ordination between transfer pricing and customs valuation. However, the practice is that the rules apply in the same manner as they do to other related-party transactions.

Customs valuation in Uganda is based on the value of the goods and follows sequential methods, namely:

- Transaction value;
- Transaction value of identical goods;
- Transactional value of similar goods;
- Deductive method;
- Computed method; and
- Fall-back method.

(These follow the GATT rules.)

The arm's length principle is applicable in Customs transactions. Therefore, in the case where the URA queries the transaction value of imported goods, adjustments may be made to the price based on the best method such as transaction value of similar or identical goods.

13. Controversy Process

13.1 Options and Requirements in Transfer Pricing Controversies

Administrative Appeal

According to Section 24(11) of the Tax Procedures Code Act 2014 and Rule 2 of the Tax Procedures Code (Alternative Dispute Resolution Procedure) Regulations, 2023, a taxpayer can challenge the results of a transfer pricing audit through alternative dispute resolution. The methods used under this process are conciliation and negotiation. A taxpayer is required to indicate the preferred method, and, where applicable, indicate a proposal for settlement of the dispute.

Payment of Disputed Amount

A taxpayer who lodges an objection is mandated under Section 15 of the Tax Appeals Tribunal to pay 30% of the tax assessed or that part of the tax assessed not in dispute, whichever is greater. The Tax Appeals Tribunal in the case of Century Bottling Company V Uganda Revenue Authority Misc Application No 32 of 2020, and in several other cases that followed, has allowed taxpayers to pay the 30% in instalments.

Jurisdiction of Courts

In July 2017, the Supreme Court ruled in the case of Uganda Revenue Authority v Rabbo Enterprises (U) Ltd and Mt. Elgon Hard wares Ltd (Civil Appeal No. 12 of 2004) that the Tax Appeals Tribunal holds original jurisdiction over all tax dispute. Consequently, all tax appeals from the Commissioner's decision must first be filed and heard by the Tax Appeals Tribunal. Previously, the Income Tax Act allowed taxpayers to appeal either to the High Court or the Tax Appeals Tribunal, but this provision was appealed in 2014. Therefore, there is no longer a choice of court to pursue appeals.

Judicial Appeal

A taxpayer aggrieved by the decision of the Tax Appeals Tribunal may within 30 days after receipt of the decision lodge an appeal in the High Court only on questions of law. Where a taxpayer is dissatisfied with the decision of the High Court, he/she may, within 30 days upon receipt of the decision of the High Court, lodge an appeal in the Court of Appeal only on questions of law.

A taxpayer dissatisfied with the decision of the Court of Appeal may, with leave of court, lodge an appeal in the Supreme Court. Such an appeal to the Supreme Court may be lodged with a certificate of the Court of Appeal concerning that the matter raises questions of law of great public importance, or if the Supreme Court in its overall duty to see that justice is done, considers that the appeal should be heard.

14. Judicial Precedent

14.1 Judicial Precedent on Transfer Pricing

Whereas Uganda has a known established transfer pricing legal and administrative frameworks, the judicial precedent in respect to transfer pricing is not yet well developed. There are very few decided cases by the Tax Appeals Tribunal and some of the matters have been settled by ADR between the URA and the taxpayer.

14.2 Significant Court Rulings

Bondo Tea Estates Ltd. v URA, TAT No 65 of 2018

The applicant supplied tea to an associated company, Kijura Tea Company Limited. URA adjusted the price on grounds that there were under declarations made and the two had related party transactions. The applicant challenged the adjustment stating that the price set with Kijura Tea Company limited was at arm's length and that URA ought to have put into consideration factors like additional expenses, prices charged, location of fields and tea factories to establish differences and information on unrelated companies.

One of the issues for determination by the Tribunal was whether the average price adjustment by the URA was in conformity with the law. The Tribunal held that there was no under declaration since the URA did not put into consideration factors to determine the arm's length and thus the adjustments made were not in conformity with the law.

East African Breweries Ltd v URA, TAT No 14 of 2017

East African Breweries Limited International (EABLI) is a wholly owned subsidiary of East African Breweries Limited and incorporated in Kenya. The URA audited Uganda Breweries, also a subsidiary of EABLI, and found information relating to transactions with EABLI and issued an assessment on the basis that EABLI sourced income in Uganda while marketing products on behalf of group companies in Uganda.

The applicant challenged the assessment on the basis that it did not source any income from Uganda as it was not resident and did not conduct any marketing activities in Uganda. The applicant purchased goods from Uganda Breweries Limited at a cost-plus markup of 7.5% and sold the goods to external customers at a cost-plus markup of between 70 and 90%.

The Tribunal found that the markup of the sale of the goods by Uganda Breweries Limited to the applicant was far lower than that between the applicant and the final consumers in other countries, and that the transfer pricing arrangement between the companies was not at arm's length.

White Sapphire & Crane Bank v URA HCCS No 465/2015

The 1st plaintiff was a company incorporated under the laws of Mauritius and a shareholder in Crane Bank Uganda. The 1st plaintiff was wholly owned by a Kenyan resident. The 2nd plaintiff paid dividends to the 1st plaintiff and withheld tax at 10% pursuant to Article 10 of the Uganda–

Mauritius DTA. The defendant raised an additional assessment on the basis that tax ought to have been withheld at a rate of 15%.

The issues for determination by the Tax Appeals Tribunal were whether the plaintiffs were entitled to a deduction under the provision of Article 10 of the DTA and whether the plaintiff was entitled to a reduction by virtue of Section 88(5) of the ITA and on account of residence of the first plaintiff.

The court held that the 1st plaintiff was a resident in Mauritius and entitled to benefit from Article 10(2) of the DTA. The court also found that the plaintiff cannot file such an action in the High Court and directed that the case should be resolved by Mutual Agreement Procedure with competent authorities of Mauritius.

Target Well Control Uganda Ltd v URA HCCS No 751/2015

Target Well Control Uganda, a company incorporated under the laws of Uganda, was leased directional drilling equipment by Target Well Control (UK). The URA raised an additional assessment on the ground that the defendant contended that the lease payments ought to have been subjected to withholding tax which would be remitted to the defendant. The plaintiff challenged the assessment on the ground that the income arose from payments the plaintiff made to Target Well Control (UK) for intercompany equipment leasing and did not attract withholding tax deductions under the Double Tax Agreements between Uganda and the United Kingdom.

The issue for determination before court was whether the plaintiff would be liable to pay withholding tax on the intercompany lease payments. The court found that the lease payments made to Target Well Control (UK) were not subject to withholding tax under the Income Tax Act as its collection was barred by the double tax covenant between Uganda and the UK.

Target Well Control (UK) would only be required to pay tax under the Convention if it could be demonstrated that it conducted business directly or through a permanent establishment in Uganda.

Rwenzori Bottling Company Ltd v Uganda Revenue Authority TAT 21 of 2021

Rwenzori Bottling Company incurred interest expenses from banks and other institutions and claimed interest deduction based on EBITDA. The URA disallowed the deduction and issued an additional assessment said to arise from overstated interest expenses.

The dispute revolved around the interpretation of Section 25(3) of the ITA, which sets a limit on interest deductions, and its application. The varying interpretations of the provision resulted in different computations. The difference was due to the depreciation and amortisation which the URA did not include when determining EBITDA. The Tribunal found that interest, depreciation and amortisation should be added back to chargeable income to determine the 30% limit on interest, and that including tax and interest while excluding depreciation and amortisation would be to deliberately distort the formula.

15. Foreign Payment Restrictions

15.1 Restrictions on Outbound Payments Relating to Uncontrolled Transactions

The TP Rules in Uganda do not restrict outbound payments relating to uncontrolled transactions.

However, the Income Tax Act under Section 83 subjects such payments to withholding tax. These include interest, royalties, dividends, management charge, natural resource payments and agency fee in cases of Islamic financial institutions. Withholding tax under this provision does not apply to an amount attributable to the activities of a branch of the non-resident in Uganda.

Outbound payments in Uganda are subject to the Anti-Money Laundering Regulations 2015 which were enacted to prevent the illicit flow of funds and ensure the transparency and legitimacy of financial transactions.

The AML framework typically includes measures such as customer due diligence, transaction monitoring, and reporting of suspicious activities.

In the context of outbound payments, including royalties, factors that may be considered to prevent money laundering include:

- source of funds;
- recipient verification;
- transaction monitoring; and
- documentation requirements.

15.2 Restrictions on Outbound Payments Relating to Controlled Transactions

The TP Rules include restrictions on outbound payments relating to uncontrolled transactions which are applied similarly to outbound payments relating to controlled transactions. The key consideration is that the pricing from which the payments are made is at arm's length.

15.3 Effects of Other Countries' Legal Restrictions

The TP Regulations, do not explicitly address the effects of other countries' legal restrictions on transfer pricing. However, international tax matters, including issues related to double taxation and the interaction of legal restrictions between countries, are often addressed through Double Taxation Agreements (DTAs) or other recognised international treaties that have been ratified by Uganda.

To understand how Uganda handles the effects of other countries' legal restrictions on transfer pricing, one would need to refer to the specific provisions of the relevant DTAs that Uganda has in place with other jurisdictions. These agreements establish principles for avoiding double taxation and provide mechanisms for resolving disputes, including situations where the tax treatment in one country is affected by legal restrictions imposed by another.

16. Transparency and Confidentiality

16.1 Publication of Information on APAs or Transfer Pricing Audit Outcomes

Uganda does not have a public database or platform where information on Advance Pricing Agreements or transfer pricing audit outcomes is routinely published.

16.2 Use of "Secret Comparables"

There is no provision under Uganda's tax regime that expressly prohibits the use of secret comparables.

UK

Trends and Developments

Contributed by:
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Transfer Pricing in the UK as of 7 March 2024

UK statistics

The UK tax yield from transfer pricing (including from related actions and enquiries) rose marginally to GBP1,635 million in 2022–2023 (up from GBP1,482 million in 2021–2022 but still down from the high watermark of GBP2,162 million in 2020–2021). The 2022–2023 revenue stems from a lower number of settled enquiries (153, down from 175 in 2021–2022), indicating increasing HMRC focus on higher value actions.

Interestingly, only 15 Advance Pricing Agreements (APAs) were agreed with HMRC during the 2022–2023 tax year (down from 20 in 2021–2022, and the recent high point of 30 in 2018–2019). With APAs taking an average of over 45 months to agree (albeit down from over 58 months in 2022–2023) it is unsurprising that there has been some reluctance from taxpayers to pursue the process. The delays stem from HMRC's approach in entering into bilateral or multilateral agreements with interested jurisdictions. In particular, a taxpayer's business operations could undergo material changes in the period taken to reach agreement. In contrast, the average time to resolve mutual agreement procedure (MAP) cases is 28.4 months (up from 21.1 months in 2021–2022), which may have further encouraged taxpayers to seek forgiveness rather than consent.

However, recent figures indicate a change in this approach, with the number of APA applications increasing significantly in recent years (to 45 in 2022–2023, up from 40 in 2021–2022). With Pillar II proposals taking effect in many jurisdictions this year, this increase is understandable: Transfer pricing allocations will have a key impact in determining the effective tax rate in relevant jurisdictions, meaning that any subsequent challenge to transfer pricing will have a knock-on impact on Pillar II calculations. This heightens the risk of double taxation, as well as the related administrative burden (in having to resubmit returns, for example), increasing the benefits of achieving certainty via APAs.

In contrast to APAs, the number of Advance Thin Capitalisation Agreements (ATCAs) in force has fallen hugely, from 334 in 2017–2018 to only 30 in 2022–2023. This is primarily due to the introduction, in 2017, of the corporate interest restriction, an additional regime which broadly limits deductions for UK finance expenses to 30% of an adjusted EBITDA. In practice (although transfer pricing rules take priority under applicable law), the relatively formulaic operation of the corporate interest restriction means that it serves as the first line of defence against tax deductions, thereby reducing pressure on transfer pricing analysis in a finance context. Staffing levels within the relevant HMRC team have not fallen

in this period, so, at first glance, it is perhaps surprising that this drop-off in ATCAs has not resulted in an appreciable reduction in the average time to agree APAs. However, this relative increase in HMRC manpower has been offset by APA processes becoming ever more complex as a result of increases in (i) the data available to HMRC (eg, as a result of country-by-country reporting (CbCR) rules), and (ii) the jurisdictional spread of taxpayer operations (as to which, see further below).

Unfortunately, the trend towards increasing complexity in the application of transfer pricing rules looks likely to continue.

Complexity arising from increased mobility

One of the key impacts of the recent pandemic, which is likely to impact transfer pricing for many years to come, has been the increased mobility of the workforce. Indeed, it is becoming increasingly necessary for multinational groups (MNGs) to offer flexibility/hybrid working of this kind to attract, and retain, key talent. This has led to an increased likelihood of (i) MNG functions being spread across an increased number of jurisdictions (including jurisdictions in which relevant MNGs have not had a historic presence and which may not have material experience in, or resources to devote to, negotiating and agreeing APA and MAP processes), and (ii) individuals holding key decision-making or risk functions carrying out such functions across a number of jurisdictions. Countries such as Croatia, Portugal, Brazil and Estonia (which have not historically served as locations where material MNG functions are carried out) have opened up specific visas for individuals working remotely, increasing the likelihood of these countries being drawn into disputes of this kind.

This flexibility in working arrangements is expected to materially complicate the transfer pricing exercise in the coming years, and to increase the information required to be maintained by MNGs to support positions taken.

- Historical means of allocating profits between low-risk functions, such as number of employees or floorspace, would need to be tracked on an ongoing basis, and/or may no longer serve as appropriate measures, respectively.
- For high risk/value functions, the roles and responsibilities of individuals would need to be reviewed with enhanced granularity (to consider whether the work carried out in a particular jurisdiction gives rise to a permanent establishment there and, if so, the appropriate level of profit attribution).
- While transfer pricing rules have always required transactions to be priced based on the reality on the ground, unless adequate limitations are put in place to restrict employees' ability to carry out certain functions in particular jurisdictions, it will be increasingly difficult to predict and apply outcomes ahead of time, at the cost of MNGs' certainty and ability to plan.
- Taxpayers that are party to APAs will need to be mindful that any flexibility proposed to be offered to employees does not breach the terms of any existing APAs.
- Timeframes in which APAs can be agreed and MAPs and other disputes resolved are likely to be extended, as it will be necessary for tax authorities to consider information at a previously unnecessary granular level of detail.

Such complexity seems likely to increase the risk of double taxation. In particular, jurisdictions to which profits were traditionally allocated may be reluctant to accept (and hence more likely

to challenge) reductions in such allocations. In addition, given that OECD Pillar I proposals (if implemented) are expected to reduce the taxing rights of jurisdictions that have typically served as MNG headquarters (such as the UK, the US and the Netherlands), there is a risk that tax authorities in such jurisdictions may increasingly look to transfer pricing to stem expected revenue losses, becoming more aggressive in their approach thereto.

Somewhat helpfully, the Organization for Economic Co-operation and Development (the OECD) has identified tax complexities arising from the increase in remote-working as one of two key tax areas (together with climate change) on which it plans to focus in the near future. Such work will continue on from the helpful guidance published by the OECD in 2020 and 2021 in response to the pandemic (which covered employment tax, and residency and permanent establishment risk, as well as separate transfer pricing guidance). However, in recent years, the vast majority of OECD resources have been devoted to progressing Pillar I and Pillar II workstreams, and it is disappointing that no definitive timeline for, or scope of, the remote-working project has yet been published. It is hoped that:

- this workstream can be accelerated;
- the scope of the project addresses the full range of resulting tax complications, across personal, corporate (including transfer pricing) and indirect tax; and
- the need for timely progress is not at the expense of thoughtful consideration, and appropriate stakeholder input, as to how the burden of increased tax complications and compliance for taxpayers can best be mitigated.

Increase in data-keeping obligations and data available to tax authorities

HMRC has, in recent years, indicated a need to plug a perceived “information gap” in the context of transfer pricing. More detailed record-keeping requirements, and an increase in the data available to tax authorities, have followed, and are likely to be features of transfer pricing going forward. Indeed, if anything, the greater risk is that the information available to HMRC and other tax authorities may outweigh their resources to properly consider it.

Looking at the UK in particular, in 2023, transfer pricing record-keeping requirements were expanded.

- Broadly, UK taxpayers subject to CbCR (ie, those that are members of MNGs with global revenue of at least EUR750 million) are now required to maintain a local file and master file containing the information described in Annexes I and II to Chapter V of the 2022 OECD Transfer Pricing Guidelines (eg, a description of local management functions, a functional analysis of material related-party transactions, a description of the transfer pricing policy applied thereto and information supporting the taxpayer’s view that the policy is arm’s length). The files can be requested by HMRC at any time, must be provided within 30 days of request and taxpayers that fail to comply will be subject to a rebuttable presumption that errors are careless (such that tax geared penalties would apply). The changes are consistent with the information that HMRC would have expected taxpayers to maintain as part of their obligations to keep records supporting their corporation tax returns, so are not expected to materially increase transfer pricing obligations for in-scope taxpayers. However, interestingly,

HMRC guidance advises large businesses that are not in scope to voluntarily prepare such data, suggesting a level of "mission creep" that may be of concern to relevant taxpayers.

- HMRC was also empowered to introduce legislation requiring in-scope taxpayers to prepare a short "Summary Audit Trail" (SAT). The SAT would set out the steps taken by the taxpayer in preparing the local file, to enable HMRC to undertake "high level quality assurance" on the data provided. Such legislation was delayed, pending a consultation that was due to take place in 2023 (but has not yet opened). Taxpayers have voiced concerns that:
  - (a) the SAT may replicate information contained in the files themselves (thereby increasing compliance without any benefit to HMRC);
  - (b) the requirement goes beyond international consensus; and
  - (c) the requirement would, if genuinely necessary, be best implemented as part of a multilateral process to ensure standardisation.

In light of this, it is hoped that HMRC may decide not to pursue the proposal further.

In addition to an increase in legislative requirements, tax authorities, including HMRC, are likely to have access to an increase in publicly available information regarding taxpayers, due to a trend toward increasing tax transparency.

- EU public country-by-country requirements will take effect this year. Where MNGs subject to the rules have UK operations, the information published thereunder would in any event be available to HMRC under CbCR exchange of information rules. These EU disclosures will nevertheless constitute an additional source of information to HMRC, as they will provide comparative detail on non-UK operations. This additional information is likely to lead to enhanced scrutiny of benchmarking by UK taxpayers, and a better understanding by HMRC of how the UK fits into wider MNG operations. (The same is true of EU proposals to require large taxpayers to publicly publish their effective tax rate, if implemented.)
- MNGs are becoming increasingly focused on economic, social and governance (ESG) standards. Two of the most widely-used ESG standards, produced by the Global Reporting Initiative and the World Economic Forum, respectively, both include standards on tax transparency (proposing, for example, that signatories publish figures for their total tax paid, with varying degrees of specificity). While there has not yet been wide-spread take-up of voluntary tax disclosure standards, it is likely that there will be some movement in that direction in the coming years, and that MNG may come under increasing pressure to publicise information regarding their tax affairs.

This increase in publicly available information means that MNGs' transfer pricing may be subject to scrutiny not only from tax authorities, but also from the wider public and the press (who may not have appropriate experience or context to interpret it). As such, transfer pricing is likely to represent an increasing reputational risk, and may be subject to increased attention from non-tax executives within MNGs. This creates enhanced risks of challenge, as it seems likely that, where MNGs' tax positions are subject to public or press scrutiny, tax authorities will feel emboldened in pursuing enquiries and assessments.

Proposals for limited simplification

The increased complexity of MNG operations (as a result of globalisation, changes in supply chains, and the above-mentioned mobilisation) in recent years has increased the burden of transfer pricing compliance. Taxpayers have, as a result, called for simplification.

Such calls have been acknowledged in the UK by HMRC, and at an international level by the OECD, with varying degrees of success. Proposed changes contemplated by HMRC seem to be a welcome step toward a more pragmatic approach. However, the resulting benefits are likely to be outweighed by failures to reach international consensus on OECD-led proposals.

UK-specific proposals

In summer 2023, HMRC launched a consultation on potential changes to transfer pricing rules, with a general objective of simplifying the application of the rules (where possible). Having considered responses thereto, the government proposes to make some targeted changes which should be helpful to taxpayers, including the following.

1. UK–UK transactions

UK transfer pricing rules generally apply to UK–UK transactions. This has long been considered by taxpayers to introduce a disproportionate compliance burden (given the low risk of tax-loss to HMRC where UK taxpayers are on both sides of the related- party transaction). Most respondents to the consultation felt that the application of the rules in this context should be limited to scenarios where there is a UK tax advantage (eg, where one party is subject to a higher UK corporation tax rate under specific regimes, such as those applying to oil and gas companies). In response, the government has confirmed it will relax the obligation to apply transfer pricing between UK entities where the UK tax base is not disadvantaged. Respondents were split as to whether this would be best implemented via an express requirement for a UK tax advantage, or more prescriptive drafting (for example, expressly referencing a rate differential) for greater clarity. The government has not yet chosen a preferred approach, although has noted that it will consider whether an exhaustive and specific list of exceptions can be achieved without prejudicing its aim of simplification.

2. Participation condition

The consultation discussed the merits of changing the existing participation condition, which applies, broadly, where entities are under common control (by reference to shareholding, voting power or other powers conferred by governing documents). This was due to government concern that the existing definition of control does not adequately capture circumstances where excessive influence (eg, by major creditors) could impact provisions. Views were sought on a potential move to a more principle-based approach such as:

- the US approach in applying transfer pricing rules where taxpayers are “acting in concert”;
- the Norwegian approach, which requires a “community of interest” (a fact-dependent test that considers whether either party is dependent on, or under the influence of, the other); or
- the Swiss approach, which simply asks whether the tested transaction occurred only because of the relationship between the parties.

Most respondents considered that these alternatives would introduce subjectivity and decrease

certainty, and favoured a prescriptive approach. While little detail has been provided, the government seems to have taken this feedback on board, noting that (i) it will address known problem-cases in a targeted and prescriptive manner (seeking to avoid material increases in the compliance burden), and (ii) where current rules produce uncertainty, amendments will be made.

3. Guarantees

Broadly, current UK law provides that in determining whether a financial transaction between related parties is arm's length, account should be taken of all factors other than the effect of parent guarantees. There is currently doubt as to whether the exclusion extends to implicit support (by virtue of simply being part of an MNG). Following consultation, to better align with the most recent OECD guidance published in 2022, the government intends to amend the legislation to allow regard to be had to (i) implicit support (in line with guidance that the government intends to publish), and (ii) guarantees (within the scope of UK transfer pricing rules that reduce borrowing costs) when determining whether the terms of the debt (but not the amount) are arm's length.

4. Interactions with market value rules

Currently, under UK rules for the taxation of (i) intangibles, there is a market value override which sits alongside the arm's length rule (with taxpayers taxed in accordance with the former if it is higher), and (ii) loan relationships and derivative contracts, related-party transactions are required to be taxed in line with an "independent terms assumption" (which broadly refers to the terms that would have been entered into between knowledgeable and willing parties dealing at arm's length). These various valuation premises were identified as increasing taxpayer compliance, and as potentially creating a different outcome to the outcome under applicable treaties. Following consultation, the government proposes to simplify related-party transactions by (i) only requiring the arm's length provision to be considered for intangibles (thereby allowing related-party intangible transactions to benefit from APAs), and (ii) in the case of loan relationship and derivative transactions, "simplifying and clarifying" the rules (with further detailed information regarding the proposed changes not yet available).

5. Definition of permanent establishment

While not expressly a part of the transfer pricing rules, the consultation also addressed whether to expand the definition of "permanent establishment" to align with the current OECD guidance. Specifically, respondents were asked for feedback on government proposals to:

- expand the definition to cover "dependent agents that habitually play the principal role leading to the conclusion of contracts that are routinely concluded without modification by the enterprise"; and
- narrow the independent agent exclusion to remove any person "act[ing] exclusively or almost exclusively on behalf of one or more enterprises to which [they are]... closely related" (changes, in each case, that were first introduced into OECD commentary in 2017 and against which the UK has reserved its position).

Respondents raised concerns that the proposed changes would lower the threshold for permanent establishments and increase uncertainty in tax treatment and the risk of double taxation. The proposals were considered to be particularly

detrimental for the asset management industry in:

- potentially reducing the scope of activities (eg, discretionary asset management) that could be carried out in the UK without the possibility of a taxable presence; and
- limiting recourse to the independent agent exemption (given that most managers hold interests in funds they manage, and hence are likely to be "closely related").

Respondents noted that, if implemented, there would, in particular, be an immediate detrimental effect on offshore fund structures which rely solely on domestic provisions to prevent the creation of a taxable presence for investors (especially where the structure did not qualify for the UK's "investment management exemption" to prevent such taxable presence, and relied solely on the above definitions). More generally, respondents highlighted that the UK fund industry had been structured around the existing definitions, and that if the proposed changes were implemented, the resulting uncertainty in tax treatment would likely result in fund managers relocating to Luxembourg or Ireland and/or reduced investment into the UK. In light of these concerns, the government noted that it would consider further whether to implement the proposals, but gave assurances that it would, in any event:

- not amend the UK's double tax treaties to mirror any such changes; and
- seek to prevent unintended consequences for offshore investors in UK-managed funds.

OECD

The OECD has attempted to address taxpayers' desire for simplification with a proposal for a streamlined, formulaic approach to transfer pricing for baseline marketing and distribution functions.

Broadly, the formula (so called "Amount B") would be applied on the basis of a "pricing matrix" which uses a specific return on sales as the net profit indicator. The matrix would provide for different pricing depending on (i) the applicable industry, and (ii) whether the taxpayer's expenses and net operating assets, relative, in each case, to revenue, are high, medium or low. Where taxpayers' priced in-scope related-party transactions are in line with the Amount B produced by the matrix, the provision would be deemed to be arm's length.

While it is helpful that the OECD has sought to address taxpayers' requests for simplicity, there are concerns that this dual-track approach may inadvertently increase the compliance burden, with taxpayers having to familiarise themselves with, apply, and police implementation of, a new second standard (in addition to the existing standards applied to other related-party transactions). In particular, such activities typically attract relatively simple and well-understood transfer pricing methodologies, and so the need for alternative standards is not necessarily clear.

Indeed, OECD proposals are likely to increase, rather than reduce, complexity (and the risk of double taxation) in light of recent announcements that:

- the implementation of Amount B rules will be optional for jurisdictions;
- where one relevant jurisdiction has decided not to implement the rules, it would not be bound by the application of the rules in other relevant jurisdictions (eg, for MAP purposes) and Amount B should not be used as the basis for MAP disputes; and

- jurisdictions opting into the proposals can decide whether to allow (on a permissive basis) or require (on a mandatory basis) taxpayers to apply the streamlined "Amount B" approach.

To prevent taxpayers bearing the burden and cost of fragmented approaches to adoption, it is hoped that either (i) international consensus can be reached, so that the rules will be adopted uniformly, or (ii) proposals are abandoned until such time as full consensus can be reached.

Conclusion

Unfortunately, transfer pricing trends generally appear to be moving against taxpayers' interests.

Broadly:

- changes in working practices, and proposed OECD-led tax changes (ironically designed to increase simplicity), seem likely to increase complexity, the risk of double taxation and the timeframe for resolving disputes; and
- increases in data-keeping obligations, and in the information available to tax authorities, are likely to increase taxpayers' compliance burdens and the likelihood of challenge.

While some recent UK developments buck the trend (such as proposed changes to simplify UK transfer pricing rules and recognition of the need for further deliberation before pursuing any changes to the domestic "permanent establishment" definition), they are unlikely to materially move the needle against an otherwise unfavourable outlook. Against this background, it would be prudent for MNGs to:

- build out their internal transfer pricing compliance resources/staffing;
- develop efficient and standardised methods of contemporaneous data collection and analysis (potentially with assistance from artificial intelligence); and
- explore the possibility of APAs to enhance certainty and minimise the risk of challenge.

USA

Law and Practice

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1. Rules Governing Transfer Pricing

1.1 Statutes and Regulations

In the United States, the rules of transfer pricing are established in terms of statute in Section 482 of the Internal Revenue Code (the "Code") and in terms of regulation in the Treasury regulations beginning with Section 1.482-0 and ending with Section 1.482-9.

The statute itself is brief, merely one paragraph with no subsections. Its role is to establish the government's authority to reallocate income "in order to prevent evasion of taxes or clearly to reflect the income" in controlled transactions.

The US Department of the Treasury (the "Treasury") regulations, on the other hand, are extraordinarily detailed and extensive, establishing the various pricing methods and rules to be applied in multiple circumstances, such as the provision of loans or advances, the transfer of tangible goods or intangible property, or the rendering of services among related parties.

The US Internal Revenue Service (IRS) also regularly issues guidance through revenue rulings, revenue procedures, other agency directives and any number of "informal" guidance that all attempt to address questions of interpretation or enforcement of the transfer pricing provisions.

Finally, there is a long line of federal court decisions interpreting Code Section 482 and applicable regulations and guidance that must be consulted when considering transfer pricing issues.

1.2 Current Regime and Recent Changes

The government's authority to regulate the allocation of income between controlled parties stretches back a long way. The current Code Section 482 has its origins in Section 45 of the Revenue Act of 1928, a provision that was largely unchanged until revisions in 1986, when Code Section 482 was amended to incorporate the "commensurate with income standard" with respect to the transfer (or licensing) of intangible property. More recently, in 2017, Code Section 482 was amended by the Tax Cuts and Jobs Act to capture concepts that had previously been embodied solely in the Treasury regulations, namely with respect to the "aggregation" of transactions among controlled parties in certain circumstances and the consideration of "realistically available alternatives" when pricing intangible property transfers.

The Arm's Length Standard

The "lingua franca" of transfer pricing jurisprudence, the "arm's length standard", is not set forth in Code Section 482, and has never been. However, it has been embodied in US transfer pricing law since the 1930s as part of the Treasury regulations. These regulations have been revised multiple times over the years. The most sweeping revisions followed the "1988 White Paper" commissioned by the US Congress to study and evaluate US transfer pricing following the inclusion of the "commensurate with income standard" in 1986. That led, in 1994, to extensive revisions to the transfer pricing regulations.

Among the most significant changes that arose out of those 1994 changes was to make clear that in performing transfer pricing analyses, there is no "hierarchy of methods" to determine the arm's length price, which had been a major area of dispute for many years. In other words, in considering all of the various methods available to determine the "best method", no method is preferred over any other.

Cost Sharing Agreements

Because some of the most contentious transfer pricing issues in the last 25 years relate to "cost sharing agreements" with respect to the transfer and development of intangible property, there have been many significant revisions to the regulations dealing with such agreements. Indeed, in the 1968 version of the regulations, cost sharing consisted of one paragraph. It has been revised multiple times since 1995, and today, Treasury Regulation Section 1.482-7 (Methods to determine taxable income in connection with a cost sharing arrangement) is one of the most detailed and complex provisions of the transfer pricing regulations.

2. Definition of Control/Related Parties

2.1 Application of Transfer Pricing Rules

The US transfer pricing rules apply to so-called controlled transactions. The rules do not require technical control (ie, they do not require that one party to the transaction should own any specified percentage of another party to the transaction). Instead, the test for determining whether a controlled transaction exists (and therefore whether the IRS may apply the transfer pricing rules to reallocate income) is a flexible test that allows the IRS to apply the transfer pricing rules in cases of common ownership (direct or indirect) but also where there is no technical ownership if the parties to the transaction are "acting in concert" with a common goal or purpose.

3. Methods and Method Selection and Application

3.1 Transfer Pricing Methods

US transfer pricing regulations list a number of specific transfer pricing methods that taxpayers can use depending on whether the controlled transactions cover tangible property, intangible property (including cost sharing) or services.

With respect to the transfer of tangible property, the methods are:

- the comparable uncontrolled price ("CUP") method;
- the resale price method;
- the cost-plus method; and
- unspecified methods.

With respect to the transfer of intangible property, the methods are:

- the comparable uncontrolled transaction ("CUT") method; and
- unspecified methods.

Transactions involving both the transfer of tangible or intangible property are also subject to evaluation under:

- the comparable profits method; and
- the profit split method, which includes the:
  (a) comparable profit split method; and
  (b) residual profit split method.

With respect to cost sharing arrangements specifically, the methods for valuing any platform contribution of intangibles to such an arrangement are:

- the CUT method;
- the income method;

- the acquisition price method;
- the market capitalisation method;
- the residual profit split method; and
- unspecified methods.

With respect to controlled services transactions, the methods are:

- the services cost method;
- the comparable uncontrolled services price ("CUSP") method;
- the gross services margin method;
- the cost of services-plus method;
- the comparable profits method;
- the profit split method; and
- unspecified methods.

Controlled transactions with respect to loans or advances, cost sharing agreements, and certain services also have detailed regulatory requirements that must be satisfied to determine whether those transactions are in accordance with arm's length principles.

3.2 Unspecified Methods

Under US law, taxpayers can price any controlled transactions using an "unspecified" method if it is the "best method" for determining arm's length results.

3.3 Hierarchy of Methods

Since 1994, there has been no "hierarchy" of methods set forth in the transfer pricing regulations. Although US courts have sometimes shown a preference for transaction-based methods, such as the CUT or CUP methods, in appropriate circumstances, a recent appellate court opinion questioned the Tax Court's application of a transactional method and remanded the case for further consideration – see Medtronic v Commissioner, 900 F.3d 610 (8th Circuit 2018). The Tax Court then applied an unspecified method to try to bridge the gap between the parties. The case is again on appeal.

3.4 Ranges and Statistical Measures

The US has no direct "statistical measure" requirement, although statistics can be used as tools within the various specified methods or in applying unspecified ones.

The "arm's length range" acknowledges that often the arm's length price of a good or service, or profits of an enterprise, will be within an arm's length range of results and will not be a single point. If taxpayers can demonstrate that their results are within that range, then the government will not adjust the prices or profits determined. If, however, the government determines that the taxpayer's price or resulting profits are outside the arm's length range as determined by the taxpayer or the government by the same or a different method, then the government will adjust the taxpayer's results accordingly. When a taxpayer's or the IRS's analysis produces a range of results rather than a single point, the Treasury regulations generally support use of the interquartile range of those results to enhance the reliability of the results and evaluate arm's length pricing, rather than the full range of results, unless all the data points in the range are of sufficiently high reliability as to warrant use of the full range.

3.5 Comparability Adjustments

The US requires comparability adjustments. In determining whether uncontrolled transactions are "comparable" in the first instance for purposes of determining whether the taxpayer's controlled transactions have been conducted in accordance with the arm's length standard, there are a number of factors that need to be considered. And, to the extent that there are differences between the controlled transaction

and the uncontrolled transaction, adjustments for these comparability factors should be considered as well. The factors for determining (and adjusting for) comparability include:

- functions performed;
- contractual terms;
- risks assumed;
- economic and financial conditions;
- the nature of property or services transferred; and
- special circumstances, such as:
  - (a) market share strategy; and
  - (b) different geographical markets (eg, location savings).

4. Intangibles

4.1 Notable Rules

The Commensurate With Income (CWI) Standard

Transfer pricing under US law is governed primarily by Code Section 482 and its implementing Treasury regulations, together with the "Associated Enterprises" Article (usually Article 9) of US tax treaties (if a transfer pricing issue involves an associated enterprise in a treaty jurisdiction). The second sentence of Code Section 482, the statute that gives the IRS the authority to make transfer pricing adjustments, provides: "In the case of any transfer (or license) of intangible property (within the meaning of [Code] section 367(d)(4)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible."

This is called the CWI standard. When the CWI standard was added to the Code in 1986, "intangible property" was defined in Code Section 936(h)(3)(B), but in 2017 "intangible property" was redefined more expansively in Code Section 367(d) to include "goodwill, going concern value, or workforce in place (including its composition and terms and conditions (contractual or otherwise) of its employment)". The prior definition in Code Section 936(h)(3)(B) had a residual category, "any similar item, which has substantial value independent of the services of any individual". The newer definition in Code Section 367(d) is modified to read "other item the value or potential value of which is not attributable to tangible property or the services of any individual".

Transfers of Intangibles

Treasury Regulation Section 1.482-4 governs the transfer pricing of intangibles. It points to three specified methods for determining the arm's length consideration for the transfer of an intangible – the CUT method (in Section 1.482-4(c)), the comparable profits method (in Section 1.482-5) and the profit split method (in Section 1.482-6) – and a residual "unspecified method" (in Section 1.482-4(d)), which must satisfy certain criteria.

Section 1.482-4 also provides other special rules for transfers of intangibles. These include rules implementing the CWI standard (Section 1.482-4(f)(2) – "Periodic adjustments"), rules for determining the owner of intangible property (Section 1.482-4(f)(3)), and rules for determining contributions to the value of intangible property owned by another (Section 1.482-4(f)(4)).

Section 1.482-4 provides the specific methods to be used to determine arm's length results in a transfer of intangible property, including in an arrangement for sharing the costs and risks of developing intangibles other than a cost sharing arrangement covered by Section 1.482-7. The latter section provides very detailed rules applicable specifically to cost sharing arrangements.

4.2 Hard-to-Value Intangibles

The OECD

Treasury regulations addressing controlled transactions involving intangible property predate and differ slightly from OECD guidance on hard-to-value intangibles (HTVI), which are a subset of intangibles.

Base erosion and profit shifting (BEPS) Actions 8–10 reports treat the HTVI approach as part of the arm's length principle. HTVI are intangibles for which, (i) at the time of their transfer, no sufficiently reliable comparables exist; and (ii) at the time the transaction was entered into (a) the projections of future cash flows/income expected to be derived from the transferred intangibles, or (b) the assumptions used in valuing the intangibles, were highly uncertain. If HTVI requirements are met, in evaluating the ex ante pricing arrangements, a tax administration is entitled to use ex post evidence about financial outcomes to inform the determination of arm's length pricing arrangements.

The HTVI approach will not apply if any one of four exemptions applies.

US Federal Law

By contrast, US federal law takes a slightly different approach, applicable not to a special class of intangibles, but rather to all intangibles. In 1986, Code Section 482 was augmented with the CWI standard. In 1988, Treasury and the IRS agreed to interpret and apply the CWI standard consistently with the arm's length standard (Notice 88-123, 1988-2 C.B. 458, 475). The Tax Court explained that Congress never intended the CWI standard to override the arm's length standard (Xilinx, Inc v Commissioner, 125 TC 37, 56–58, aff'd 598 F.3d 1191 (9th Circuit 2010)).

The periodic adjustment rule

Subparagraph 1.482-4(f)(2)(i) (the "periodic adjustment rule") implements the CWI standard, providing that if an intangible is transferred under an arrangement that covers more than one year, the consideration charged in each year may be adjusted to ensure that it is commensurate with the income attributable to the intangible (ie, actual profits rather than prospective profits). Furthermore, in determining whether to make such adjustments in a taxable year under examination, the IRS may consider all relevant facts and circumstances throughout the period the intangible is used.

Exceptions from application of the periodic adjustment rule

Subparagraph 1.482-4(f)(2)(ii) lists five exceptions from application of the periodic adjustment rule. The four exemptions from application of the HTVI rule mirror these exceptions to some extent, but there are differences. For example, Section 1.482-4(f)(2)(ii)(D) provides relief from potential periodic adjustments if "extraordinary events that were beyond the control of the controlled taxpayer and that could not reasonably have been anticipated" cause actual profits to be substantially different from projected profits. The example provided of an "extraordinary event" is an earthquake. The OECD guidance provides a more favourable exemption – if the taxpayer provides details of the ex ante projections that demonstrate they were reliably prepared and had accounted for reasonably foreseeable events and other risks, then adjustments using ex post profits will not be made.

4.3 Cost Sharing/Cost Contribution Arrangements

The US recognises research and development cost sharing arrangements. Major versions of Treasury regulations addressing cost sharing

arrangements were issued in 1968 (one paragraph), 1995 (15 pages), 2009 (61 pages) and 2011 (77 pages), with amendments and proposed regulations along the way. The 1995 cost sharing regulations were the subject of three significant tax court cases:

- Veritas Software Corporation v Commissioner, 133 TC 297 (2009) (buy-in issue), nonacq. 2010-49 IRB;
- Altera Corporation & Subsidiaries v Commissioner, 145 TC 91 (2015), revised, 926 F.3d 1061 (9th Circuit 2019), en banc rehearing petition denied, 941 F.3d 1200 (9th Circuit 2019) (validity upheld of requirement to share stock-based compensation costs of intangibles); and
- Amazon.com, Incorporated v Commissioner, 148 TC 108 (2017), affiliated, 934 F.3d 976 (9th Circuit 2019) (buy-in issue, and pool of intangible development costs).

Currently, there is one docketed tax court case addressing the 2009 temporary regulations' determination of the "PCT Payment" (the successor of the "buy-in" payment provision under the 1995 regulations).

5. Affirmative Adjustments

5.1 Rules on Affirmative Transfer Pricing Adjustments

Treasury regulations under Code Section 482 do not allow a taxpayer to make an affirmative transfer pricing adjustment after filing a tax return. Section 1.482-1(a)(3) – entitled "Taxpayer's use of section 482" – provides: "If necessary to reflect an arm's length result, a controlled taxpayer may report on a timely filed US income tax return (including extensions) the results of its controlled transactions based upon prices different from those actually charged. Except as provided in this paragraph, section 482 grants no other right to a controlled taxpayer to apply the provisions of section 482 at will or to compel the district director to apply such provisions. Therefore, no untimely or amended returns will be permitted to decrease taxable income based on allocations or other adjustments with respect to controlled transactions."

Notwithstanding Section 1.482-1(a)(3), there are at least two established paths to post-filing reductions to US income from a transfer-pricing adjustment – one regulatory and one judicial.

The Regulatory Path

The regulatory path addresses set-offs under Treasury Regulation Section 1.482-1(g)(4). Suppose, for example, that in a tax year, B pays A an above-arm's length price in a controlled transaction. If, with respect to another controlled transaction between A and B, in the same tax year, the IRS makes a Code Section 482 adjustment increasing A's income, then A can use as a set-off against (ie, reduction of) the IRS adjustment of the overpayment (ie, excess above arm's length amount) A received from B in the different controlled transaction.

The Judicial Path

The judicial path ties to a line of cases supporting the proposition that if the IRS makes an adjustment with respect to a taxpayer's controlled transaction, then the courts have authority to determine the arm's length transfer pricing for the transaction, even if that results in a refund for the taxpayer (eg, Pikeville Coal Company v US, 37 Fed. Cl. 304 (1997), motion for reconsideration denied, 37 Fed. Cl. 304 (1997); and Ciba-Geigy Corporation v Commissioner, 85 TC 172 (1985)).

Additional Points
In addition to the above regulatory and judicial paths, two other points bear mention. First, under the United States' bilateral income tax treaty network, it is possible for a taxpayer utilising the mutual agreement process to secure a reduction in its reported US income attributable to a transfer pricing position. Second, the CWI standard was originally added in 1986 (and tweaked slightly in 2017), after the progenitor of Section 1.482-1(a)(3) arose, which stated that only the IRS may apply the provisions of Code Section 482. The language of the CWI standard ("shall be commensurate with the income attributable to the intangible") nominally applies both to the IRS and to taxpayers. Accordingly, it may be possible for a taxpayer to assert that the CWI standard gives it the right – for example, in the case of a transfer of intangible property – to override Section 1.482-1(a)(3) and adjust its originally reported taxable income downward (eg, on an amended tax return) to accurately reflect the income attributable to the intangible. This assertion would assuredly be challenged by the IRS; however, this issue has never been addressed by a court.

6. Cross-Border Information Sharing

6.1 Sharing Taxpayer Information
The United States is a party to a vast tax treaty network that allows for extensive exchange of information (EOI) among countries. EOI agreements generally authorise the IRS to assist and share tax information with non-US countries to enable those countries to administer their own tax systems and, of course, vice versa. These EOI agreements are memorialised in various forms, including bilateral tax treaties, tax information exchange agreements and multilateral treaties, such as the OECD/Council of Europe Convention on Mutual Administrative Assistance in Tax Matters and the Hague Convention on the Taking of Evidence Abroad in Civil or Commercial Matters.

Limits, Exceptions and Exemptions
There are few limits on the types of taxes (income, estate, etc) that may be the subject of EOI requests, although each agreement has particular limits on, or exceptions to, the type of information that may be exchanged or how that information may be used among the "competent authorities" of each state. The US tax treaties in general, however, follow the US Model Treaty, which provides in Article 26(1) that: "The competent authorities of the Contracting States shall exchange such information as may be relevant for carrying out the provisions of this Convention or of the domestic laws of the Contracting States concerning taxes of every kind imposed by a Contracting State to the extent that the taxation thereunder is not contrary to the Convention, including information relating to the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, such taxes. The exchange of information is not restricted by paragraph 1 of Article 1 (General Scope) or Article 2 (Taxes Covered)."

Under most EOI agreements with the US, there are few types of information that may not be exchanged. Under many EOI agreements, however, the US is not obliged to exchange information that it deems contrary to public policy or that would disclose trade or business secrets, under the "Business Secrets Exemption". Also, the US, like many European countries specifically, has various "data privacy" laws that may restrict or prevent it from exchanging certain types of information across borders.

7. Advance Pricing Agreements (APAs)

7.1 Programmes Allowing for Rulings Regarding Transfer Pricing

The United States has a robust, well-developed advance pricing agreement (APA) programme. The programme dates back to the early 1990s. It used to be located in the IRS's Office of Chief Counsel but is now located in the IRS's Large Business and International Division (LB&I). In 2012, the APA programme merged with the portion of the US Competent Authority office charged with resolving transfer pricing disputes under the United States' bilateral income tax treaty network to create the Advance Pricing and Mutual Agreement (APMA) programme.

In late 2020, the APMA programme expanded to also include the Treaty Assistance and Interpretation Team (TAIT). TAIT seeks to resolve competent authority issues arising under all other articles of US tax treaties. Since its inception, the United States' APA programme has executed over 2,200 APAs.

7.2 Administration of Programmes

APMA administers the APA programme. According to APMA's most recently published APA annual report in March 2023, covering January through to December 2022, at the end of 2022 "the APMA Program comprised 59 team leaders, 26 economists, nine managers and three assistant directors" in addition to the programme's director. Individual teams include both team leaders and economists. APMA's primary office is in Washington, DC, but it also has offices in California, Illinois and New York.

7.3 Co-ordination Between the APA Process and Mutual Agreement Procedures

Both the APA process and mutual agreement procedures (MAPs) fall under APMA's jurisdiction, so the same APMA teams and personnel are responsible for transfer pricing matters regardless of whether those matters arise in an APA context or a MAP proceeding.

7.4 Limits on Taxpayers/Transactions Eligible for an APA

Generally, APAs are available to any US person (which includes domestic corporations and partnerships) and any non-US person that is expected to file one or more US tax returns during the years that address the issues to be covered by the proposed APA. As stated in Revenue Procedure 2015-41, which governs APAs in the United States, APAs generally "may resolve transfer pricing issues and issues for which transfer pricing principles may be relevant..." As the Revenue Procedure also states, "APMA may also need to consider additional, interrelated issues, additional taxable years... or additional treaty countries... in order to reach a resolution that is in the interest of principled, effective, and efficient tax administration."

There are limits on APA access for issues that are, or have been, designated to be subject to litigation. Effective 25 April 2023, LB&I issued internal guidance providing a list of criteria APMA personnel should consider in determining whether to accept an APA request or propose alternative APA workstreams, such as the International Compliance Assurance Programme or joint audits with foreign tax authorities. Many commentators view this guidance as reflecting a more selective approach to APA request approvals.

7.5 APA Application Deadlines

APAs can include both prospective (future) years and, where applicable, "roll-back" (prior) years. Roll-back years are addressed in **7.8 Retroactive Effect for APAs.** Designation of the first prospective year of an APA application ties to the timing of the filings of the taxpayer's tax return for the year and the taxpayer's APA request. Generally, the first prospective year is the year in which the taxpayer files a complete or sufficiently complete APA request by the "applicable return date", which is the later of the dates on which the taxpayer actually files its US tax return for the year or the statutory deadline for filing the return without extensions. All proposed APA years ending before the first prospective year will be considered roll-back years. For bilateral or multilateral APAs, APMA requires that the taxpayer files its completed APA request within 60 days of when it filed its request with the foreign competent authority (bilateral) or authorities (multilateral).

7.6 APA User Fees

There are user fees associated with seeking an APA. For APA requests filed after 1 February 2024, the fees are USD121,600 for new APAs, USD65,900 for renewal APAs, USD57,500 for small case APAs (applicable if the controlled group has sales revenue of less than USD500 million in each of its most recent three back years, and meets other criteria) and USD24,600 for amendments. User fees can be mitigated if multiple APA applications are filed by the same controlled taxpayer group within 60 days.

7.7 Duration of APA Cover

There is no prescribed limit on the number of years that can be covered by an APA. An APA application should propose to cover at least five prospective years, and APMA seeks to have at least three prospective years remaining at the time the APA is executed. Roll-back years, if any, will add to the aggregate APA term. According to APMA's most recently published APA annual report, the average term length of APAs executed in 2022 was six years, but the full range of terms spanned from one to 11 years.

7.8 Retroactive Effect for APAs

An APA can cover not only future years, but also prior (or "roll-back") years. Roll-back years are the years of an APA term that precede the first prospective year (see **7.5 APA Application Deadlines**). A taxpayer seeking roll-back coverage should include the roll-back request in its APA application, and APMA can suggest, or even require, the addition of roll-back coverage when the taxpayer does not request it where the facts and circumstances are sufficiently similar across the proposed prospective and roll-back periods.

8. Penalties and Documentation

8.1 Transfer Pricing Penalties and Defences

Specific US Transfer Pricing Penalties

Transfer pricing penalties under the Code and Treasury regulations

Code Section 6662 – entitled "Imposition of Accuracy-Related Penalty on Underpayments" – imposes two specific types of transfer pricing penalties, in addition to other penalties. The penalty regime is somewhat complex and uses a variety of overlapping terms. Code Section 6662(a) provides that if any portion of an underpayment of tax required to be shown on a tax return is attributable to one or more of the causes described in Code Section 6662(b), an amount equal to 20% of the portion of the underpayment attributable to such cause(s) will be added to the tax. The "accuracy-related penalties" arising

from the causes listed in Code Section 6662(b) are further named in regulations. Penalties cannot be "stacked" – only one penalty can apply to a given underpayment of tax.

The two transfer pricing penalties are part of the trio of penalties in the "substantial valuation misstatement" penalty under Chapter 1 of the Code (Normal taxes and surtaxes), introduced in Code Section 6662(b)(3) and described in Code Section 6662(e) and in Treasury Regulation Sections 1.6662-5 & 6. The 20% penalty is imposed under Code Section 6662(a) if tax underpayments exceed certain thresholds (described below). Subsection 6662(h) doubles the penalty (to 40%, called a "gross valuation misstatement penalty") if the tax underpayments exceed doubled upper, or halved lower, thresholds (described below).

The transactional penalty

The first transfer pricing penalty (the "transactional penalty" described in Code Section 6662(e)(1)(B)(i)) applies if the tax-return-reported price for any property or services, on a transaction-by-transaction basis, is 200% or more, or 50% or less, than the correct Code Section 482 price. For the corresponding gross valuation misstatement penalty, replace 200% with 400% and 50% with 25%.

The net Section 482 transfer pricing adjustment penalty

The second transfer pricing penalty (called either the "net Section 482 transfer pricing adjustment penalty" or the "net adjustment penalty" described in Code Section 6662(e)(1)(B)(ii)) turns on the amount of the "net Section 482 transfer price adjustment" – in essence, the aggregate of all Code Section 482 adjustments for a given taxable year – defined in Code Section 6662(e)(3)(A) as "the net increase in taxable income for the taxable year (determined without regard to any amount carried to such taxable year from another taxable year) resulting from adjustments under Section 482 in the price for any property or services (or for the use of property)". The net Section 482 transfer pricing adjustment penalty applies if the net Section 482 transfer pricing adjustment exceeds the lesser of USD5 million or 10% of the taxpayer's gross receipts. For the corresponding gross valuation misstatement penalty, replace USD5 million with USD20 million and 10% with 20%.

Defending against transfer pricing penalties

Code Section 6664(c)(1) provides in general that no penalty shall be imposed under Code Section 6662 with respect to any portion of an underpayment of tax if it is shown that there was a reasonable cause for such portion and that the taxpayer acted in good faith with respect to such portion (the "Reasonable Cause & Good Faith Exception"). A substantial body of case law addresses the Reasonable Cause & Good Faith Exception, but almost none of it arose in the context of transfer pricing penalties.

Code Section 6662(e)(3)(B) excludes from the penalty threshold determinations, for the net Section 482 transfer pricing adjustment penalty, any portion of the increase in taxable income attributable to any redetermination of price if the taxpayer meets three requirements, which depend on whether or not the taxpayer used a specified transfer pricing method. If the taxpayer used a specified transfer pricing method, then Code Section 6662(e)(3)(B)(i) requires that:

- the taxpayer's use of the method was reasonable;
- the taxpayer has documentation on its application of the method; and
- the taxpayer gives the documentation to the IRS within 30 days of a request.

Treasury Regulation Section 1.6662-6(d) greatly expands on the documentation needed to demonstrate compliance with Code Section 6662(e)(3)(B). Subparagraph 6662(e)(3)(D) overrides application of the Reasonable Cause & Good Faith Exception to impose a net Section 482 transfer pricing adjustment penalty unless the taxpayer meets the requirements of Code Section 6662(e)(3)(B).

The Reasonable Cause & Good Faith Exception applies to prevent imposition of the transactional penalty. Treasury Regulation Section 1.6662-6(b)(3) provides, however, that if a taxpayer meets the Section 1.6662-6(d) requirements with respect to a Code Section 482 allocation, the taxpayer is deemed to have established reasonable cause and good faith with respect to the item for penalty protection purposes. Thus a taxpayer meeting the requirements of Section 1.6662-6(d) is protected against either transfer pricing penalty.

8.2 Taxpayer Obligations Under the OECD Transfer Pricing Guidelines

Treasury Regulation Section 1.6038-4 – titled "Information returns required of certain United States persons with respect to such person's US multinational enterprise group" – provides that certain US persons that are the ultimate parent entities of US multinational enterprise (US MNE) groups with annual revenue for the preceding reporting period of USD850 million or more, are required to file Form 8975.

Form 8975 and Schedule A are used by filers to report certain information annually with respect to the filer's US MNE group on a country-by-country basis. The filer must list the US MNE group's constituent entities, indicating each entity's tax jurisdiction (if any), country of organisation and main business activity, and provide financial and employee information for each tax jurisdiction in which the US MNE does business. The financial information includes revenues, profits, income taxes paid and accrued, stated capital, accumulated earnings and tangible assets other than cash.

9. Alignment With OECD Transfer Pricing Guidelines

9.1 Alignment and Differences

There is broad alignment of US transfer pricing rules under Code Section 482 with the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the "TP Guidelines"). In 2007 in formal guidance, the IRS signalled its belief that Code Section 482 and its associated Treasury regulations were "wholly consistent with... the OECD Transfer Pricing Guidelines", and the 2022 United States Transfer Pricing Country Profile provided to the OECD, states that "US transfer pricing regulations are consistent with the [Transfer Pricing Guidelines]".

Both the Code Section 482 Treasury regulations and the TP Guidelines have subdivisions broadly dealing with the arm's length standard/principle, transfer pricing methods, comparability, intangibles transfers, services and cost sharing arrangements/cost contribution arrangements. The TP Guidelines go further in certain respects, however, such as by including subdivisions addressing administrative approaches to avoiding and resolving transfer pricing disputes (Chapter IV); documentation, including the three-tiered approach (master file, local file and country-by-country reporting) (Chapter V); and transfer pricing aspects of business restructurings (Chapter IX).

9.2 Arm's Length Principle
It is challenging to answer the question of whether there are any circumstances under which US transfer pricing rules depart from the arm's length principle. US transfer pricing rules use the concept of the "arm's length standard" rather than the "arm's length principle". The standard is not found in Code Section 482, but cases addressing the statute and its predecessor have held the standard to be fundamental in the application of the statute. Section 1.482-1 of the Treasury regulations provides that, in determining the true taxable income of a controlled taxpayer, "the standard to be applied in every case is that of a taxpayer dealing at arm's length with a controlled taxpayer". The regulation continues that "[e]valuation of whether a controlled transaction produces an arm's length result is made pursuant to a method selected under the best method rule described in Section 1.482-1(c)".

US transfer pricing rules provide a range of specified methods for determining arm's length consideration in controlled transactions. While there is no formal hierarchy, the CUT method is paramount in the intangibles context in the sense that pricing determined using such method is immune from adjustment under the CWI standard under certain circumstances. The transfer pricing rules do not nominally depart from the arm's length principle, but one way they do depart from it is in the context of cost sharing arrangements, governed by Section 1.482-7. There, whether or not such an arrangement is considered arm's length is determined solely by whether the arrangement meets the requirements of the regulation (ie, Section 1.482-7 redefines the arm's length standard). Another way the transfer pricing regulations depart from the arm's length standard is that they allow certain services to be priced at cost (with no profit element) if the taxpayer complies with the applicable rules.

9.3 Impact of the Base Erosion and Profit Shifting (BEPS) Project
See **9.4 Impact of BEPS 2.0**.

9.4 Impact of BEPS 2.0
The IRS believes the transfer pricing rules under Code Section 482 and its implementing Treasury regulations are consistent with the TP Guidelines but there is a belief among tax practitioners that differences exist. Any such differences are likely to manifest themselves in APA or MAP proceedings under US tax treaties with countries whose transfer pricing rules follow the TP Guidelines.

9.5 Entities Bearing the Risk of Another Entity's Operations
One party to a controlled transaction can bear the risk of the other party to the controlled transaction's operations by guaranteeing the other party a return, but the risk-bearing party must be appropriately compensated for the risk it bears. US regulations provide that contractual risk allocations will be respected if the terms are consistent with the economic substance of the underlying transactions. Comparison of risk bearing is also important in determining the degree of comparability between controlled and uncontrolled transactions.

10. Relevance of the United Nations Practical Manual on Transfer Pricing

10.1 Impact of UN Practical Manual on Transfer Pricing
The UN Practical Manual on Transfer Pricing (the "UN Manual") does not have a significant impact on transfer pricing practice or enforcement in the

United States. While the UN Manual may be a reference point for US transfer pricing matters in which the counterparty country relies on the UN Manual more substantially, Code Section 482, its implementing Treasury regulations, US case law and, where relevant, the TP Guidelines are the primary authorities for US transfer pricing practice and enforcement.

11. Safe Harbours or Other Unique Rules

11.1 Transfer Pricing Safe Harbours

The United States transfer pricing rules do not have safe harbours for transactions deemed immaterial or for taxpayers of a certain size. But the rules do contain isolated safe harbours that apply to certain types of transactions. Chief among them is the services cost method (SCM), a specified transfer pricing method that permits (but does not require) a taxpayer to charge out certain "covered services" at cost (ie, with no mark-up/profit element).

Covered services eligible for the SCM include specified covered services (ie, those on a list published by the IRS, which includes services such as IT, HR and finance) and low-margin services (those for which the median comparable mark-up on total costs is 7% or less). A service is not eligible for the SCM if it is on a list of excluded activities contained in a regulation (eg, manufacturing, research and development, and distribution). In addition, to qualify for the SCM, a taxpayer must reasonably conclude in its business judgement that the activity does not contribute significantly to key competitive advantages or fundamental risks of success or failure. The IRS generally defers to taxpayers with respect to the so-called "business-judgement" prong of the SCM.

Another isolated safe harbour relates to loans. The applicable rules provide for safe harbour interest rates for bona fide debts denominated in US dollars where certain other requirements are met.

11.2 Rules on Savings Arising From Operating in the Jurisdiction

The US transfer pricing rules address location savings under the regulations that deal with comparability. The location savings rule is not specific to savings that arise from operating in the United States – it applies generally to determine how to allocate location savings between a US company and an affiliate operating in a lower-cost locale. The rule looks to hypothetical bargaining power and provides that the affiliate in the lower-cost locale should keep a portion of the location savings if it is in a position to bargain for a share of the location savings (ie, if there is a dearth of suitable alternatives in the low-cost locale or similar low-cost locales).

11.3 Unique Transfer Pricing Rules or Practices

The US does not have special rules that disallow marketing expenses by local licensees claiming local distribution intangibles. Rules that were once unique to the US, such as the CWI rule that allows the IRS to make after-the-fact adjustments based on actual results in the case of an intangibles transfer lasting more than one year, are becoming more common as other tax authorities focus on hard-to-value intangibles.

12. Co-ordination With Customs Valuation

12.1 Co-ordination Requirements Between Transfer Pricing and Customs Valuation

The US requires a certain level of co-ordination between transfer pricing and customs valuation. Code Section 1059A and the Treasury regulations thereunder look to ensure that, when any tangible property is imported into the United States in a related-party transaction, the importer cannot claim a higher tax basis on its imported merchandise for income tax purposes than the value it claimed for the purpose of its customs obligations. In other words, the related-party importer generally cannot claim that the value of the property for transfer pricing purposes under Code Section 482 is higher than the value of the property for the purpose of paying customs duties in the United States.

The Code and Treasury regulations recognise, however, that there may be differences in value that are appropriate once specific methods and factors are taken into account. Among those factors are freight charges; insurance charges; the construction, erection, assembly, or technical assistance provided with respect to the property after its importation into the United States; and any other amounts that are not taken into account in determining the customs value, are not properly included in the customs value, and are appropriately included in the cost basis or inventory cost for income tax purposes. This last factor typically allows a taxpayer to demonstrate how its transfer price of the imported good accords with the arm's length standard required under Code Section 482, and why any difference between that arm's length value and the customs value is in accord with its obligations under Code Section 1059A.

This is an area that continues to confound taxpayers and the tax and customs authorities, which are not as co-ordinated as they would like. Taxpayers should carefully consider these tax and customs obligations.

13. Controversy Process

13.1 Options and Requirements in Transfer Pricing Controversies

The US transfer pricing controversy process comprises audit, administrative appeals and judicial phases.

- Audit – US transfer pricing audits can be long and intensive, involving hundreds of information requests and dozens of interviews. In the event a taxpayer does not agree with an audit adjustment proposed by the IRS, the taxpayer generally has the right to pursue an administrative appeal. The examination team will issue a letter that gives the taxpayer 30 days to contest the adjustment by filing a protest to be considered by the IRS Independent Office of Appeals. Alternatively, a taxpayer can head straight to litigation.
- Administrative appeal – the IRS Independent Office of Appeals handles administrative appeals of audit adjustments in transfer pricing and other cases. Appeals officers will consider the examination file, the taxpayer's protest, and the IRS examination team's rebuttal. The Office of Appeals will then conduct one or more conferences with the aim of settling the dispute. Appeals officers are instructed to account for the probable results in litigation and settle cases based on the "hazards of litigation". A taxpayer unable to resolve its dispute with the IRS Independent Office of Appeals can proceed to court.

- Judicial process (trial and appeal) – a taxpayer can generally litigate a transfer pricing case in the US Tax Court, a federal district court, or the Court of Federal Claims. The US Tax Court is the only prepayment forum (ie, the only court in which the taxpayer can litigate without first paying the disputed tax and suing for a refund). The federal district courts and the Court of Federal Claims hear refund suits. In the narrow context of taxpayers in bankruptcy, transfer pricing disputes can be addressed prior to payment.

Taxpayers and the government can appeal trial court decisions to the federal appellate courts. US Tax Court and federal district court decisions are appealable to the 12 regional circuit courts of appeals. Court of Federal Claims decisions are appealable to the US Court of Appeals for the Federal Circuit. Appellate court decisions can be petitioned to the US Supreme Court, which has discretion as to whether to grant a review (and which does so in relatively few cases).

14. Judicial Precedent

14.1 Judicial Precedent on Transfer Pricing

Judicial precedent on transfer pricing in the US is fairly well developed. But transfer pricing cases are facts-and-circumstances dependent, which makes it difficult to rely too heavily on precedent from one case to the next.

14.2 Significant Court Rulings

There have been a number of important transfer pricing court cases in the United States. Select opinions in those cases are summarised below.

- 3M Co & Subs v Commissioner (2023 (US Tax Court) – still active): The Tax Court ruled 9–8 in an opinion reviewed by the full Tax Court that the Treasury regulation addressing foreign payment restrictions is valid and that the taxpayer failed to satisfy the requirements of that regulation. As a consequence, the Tax Court imposed a royalty adjustment based on the parties' stipulated arm's length royalty rate. 3M appealed the Tax Court's decision. The case is currently before an appeals court.
- Eaton Corp & Subs v Commissioner (2013, 2017, 2019 (US Tax Court); 2022 (6th Circuit)): In connection with the IRS's cancellation of two APAs, the US Court of Appeals for the Sixth Circuit, affirming in part and reversing in part the prior Tax Court decisions, held (i) consistent with contract-law principles, the IRS has the burden of proof to show it is permitted to cancel the agreement under the terms of the APA; (ii) the IRS may only cancel an APA on the limited set of grounds listed in the relevant revenue procedure, which the IRS failed to prove; (iii) the taxpayer's post-return self-corrections to comply with the APA are Code Section 482 adjustments; and (iv) the taxpayer may obtain double-tax relief through the relevant revenue procedure since the self-corrections were Code Section 482 adjustments.
- The Coca-Cola Co v Commissioner (2020 and 2023 (US Tax Court) – still active): The Tax Court ruled that the IRS was not arbitrary and capricious in applying the comparable profits method with the return on assets profit level indicator to allocate income from six foreign affiliates to the US parent. In so doing, the Tax Court did not allow the taxpayer to argue based on the substance of the controlled transactions. The Tax Court allowed the taxpayer to offset against its royalty obligations amounts paid historically as dividends in satisfaction of a pricing method previously agreed between the taxpayer and the IRS.

The Tax Court subsequently applied its 3M ruling and found against the taxpayer on the issue of whether the IRS could make transfer pricing adjustments that resulted in royalty payments in excess of those permitted by Brazilian law. The taxpayer has indicated an intent to appeal the Tax Court's decision in the case.

- Medtronic, Inc v Commissioner (2016 (US Tax Court); 2018 (8th Circuit); 2022 (US Tax Court) – still active): The Tax Court revised its earlier opinion after the 8th Circuit remanded for lack of sufficient development and analysis in applying the Tax Court's own transfer pricing method based on the taxpayer's CUT methodology. In its second opinion, the Tax Court rejected both the taxpayer's original CUT and the IRS's comparable profits method (CPM), and determined that the best method required the use of an unspecified method. The IRS appealed the Tax Court's decision, and the taxpayer then cross-appealed. The case is currently before an appeals court.
- Amazon.com, Inc v Commissioner (2017 (US Tax Court); 2019 (9th Circuit)): The Tax Court ruled that the IRS's application of the income method to price a cost sharing buy-in was arbitrary, capricious or unreasonable. The Tax Court agreed with the taxpayer that the IRS had wrongly included non-compensable goodwill and going-concern value in its adjustment. The US Court of Appeals for the Ninth Circuit agreed with the taxpayer and affirmed the Tax Court decision, rejecting the IRS's argument that goodwill and going-concern value were compensable under the then-existing regulations (which have since been amended).
- Altera Corp v Commissioner (2015 (US Tax Court); 2018 (9th Circuit)): The Tax Court sided with the taxpayer and invalidated a regulation that required parties to a cost sharing agreement to share the costs of stock-based compensation. A divided US Court of Appeals for the Ninth Circuit reversed and upheld the regulation.
- Bausch and Lomb, Inc v Commissioner, (1989 (US Tax Court); 1991 (2nd Circuit)): The Tax Court sided with the taxpayer and rejected the IRS's attempt to collapse a licence of technology and subsequent sale of contact lenses and treat a licensee as a contract manufacturer. The US Court of Appeals for the Second Circuit affirmed.
- Hospital Corporation of America v Commissioner (1983 (US Tax Court)): The Tax Court held that a business opportunity is not property and respected a transaction in which a foreign affiliate entered into a contract that the US parent could have entered into itself. The Tax Court proceeded to make substantial income allocations based on the US parent's contributions to the foreign business.
- B Forman Co v Commissioner (1970 (US Tax Court); 1972 (2nd Circuit)): The Tax Court sided with the taxpayer and required technical control for the transfer pricing rules to apply. The US Court of Appeals for the Second Circuit reversed and endorsed a flexible "acting in concert" test. That IRS-favourable standard was then incorporated in the transfer pricing regulations.

15. Foreign Payment Restrictions

15.1 Restrictions on Outbound Payments Relating to Uncontrolled Transactions

With the potential exception of targeted economic sanctions programmes (ie, embargoes), the US does not restrict outbound payments relating to uncontrolled transactions.

15.2 Restrictions on Outbound Payments Relating to Controlled Transactions

The US does not restrict outbound payments relating to controlled transactions. But the US instituted a base erosion and anti-abuse tax in 2017 that targets outbound payments in controlled transactions that strip earnings out of the US through deductible payments. Some have suggested that the tax should be repealed because it is easily avoidable and has not raised substantial revenue.

15.3 Effects of Other Countries' Legal Restrictions

The US regulation regarding the effects of other countries' legal restrictions is being challenged in court. The regulation provides that the IRS will respect a foreign legal restriction only if certain requirements are met. Chief among those requirements is that the foreign legal restriction must be publicly promulgated and generally applicable to uncontrolled taxpayers in similar circumstances. The regulation also requires that:

- the taxpayer must exhaust all remedies provided by foreign law for obtaining a waiver;
- the foreign legal restriction must expressly prevent payment of part or all of the arm's length amount in any form (eg, by payment of a dividend); and
- the related parties must not have circumscribed or violated the foreign legal restriction in any way (eg, by arranging for an intermediary to pay on behalf of the controlled payer).

The regulation provides another difficult-to-satisfy avenue for compelling the IRS to respect a foreign legal restriction – if a taxpayer can demonstrate that the foreign legal restriction affected an uncontrolled taxpayer under comparable circumstances for a comparable period of time. As noted in **14.2 Significant Court Rulings**, the Tax Court upheld the regulation in 3M Co & Subs v Commissioner. Its ruling in that case is now on appeal. The same issue is also presented in The Coca-Cola Co v Commissioner, in which the Tax Court also ruled against the taxpayer on the issue. The taxpayer in that case has also indicated an intent to appeal.

16. Transparency and Confidentiality

16.1 Publication of Information on APAs or Transfer Pricing Audit Outcomes

Pursuant to the Ticket to Work and Work Incentives Improvement Act of 1999, Congress required the IRS to publish an annual report on its APA programme. The first report covered the period from the APA programme's inception in 1991 through to 1999, and the IRS has published annual reports every year since. The annual reports provide substantial data and other information on APAs during the covered years, including:

- the number of APA applications filed in total and, for bilateral APAs, by foreign country;
- the number of APAs executed in total and, for bilateral APAs, by foreign country;
- the number of APA applications pending in total and, for bilateral APAs, by foreign country;
- the number of APAs revoked or cancelled and APA applications withdrawn;
- the number and percentage of APAs executed by industry and certain sub-industries;
- the nature of the relationships between the controlled parties in executed APAs;
- the types of covered transactions in executed APAs;
- the types of tested parties in executed APAs;

- the transfer pricing methods used in executed APAs;
- the sources of comparables, comparable selection criteria and the nature of adjustments to comparables or tested party data in executed APAs;
- the use of ranges, goals and adjustment mechanisms in executed APAs;
- the use of critical assumptions in executed APAs;
- the term lengths of executed APAs;
- the amount of time taken to complete new and renewed APAs; and
- post-execution efforts to ensure compliance with an APA and ensure the adequacy of required annual documentation under an APA.

There are no similar publicly available reports on IRS transfer pricing audit or administrative appeal outcomes.

16.2 Use of "Secret Comparables"

There is no evidence that the United States relies on secret comparables for transfer pricing enforcement. If the IRS asserts a transfer pricing adjustment at the end of an audit, then the IRS will provide the taxpayer with a written report in which it discloses any comparables on which it is relying to justify its adjustment. Similarly, in litigation, the IRS will provide one or more expert witness reports detailing the IRS's transfer pricing analyses and the bases for them.

In the APA context, the annual report required by Congress (see **16.1 Publication of Information on APAs or Transfer Pricing Audit Outcomes**) specifies the sources of comparable data on which APMA relies, with the list generally composed of publicly available databases.

Trends and Developments

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Gibson Dunn & Crutcher is a full-service international law firm that advises on some of the most significant transactions and complex litigation around the world. Consistently achieving top rankings in industry surveys and major publications, Gibson Dunn & Crutcher is distinctively positioned in today's global marketplace, with more than 1,800 lawyers and 20 offices, including Abu Dhabi, Beijing, Brussels, Century City, Dallas, Denver, Dubai, Frankfurt, Hong Kong, Houston, London, Los Angeles, Munich, New York, Orange County, Palo Alto, Paris, San Francisco, Singapore and Washington, DC. Gibson, Dunn & Crutcher's global tax controversy and litigation group represents multinational corporations, privately held companies, investment funds, partnerships, sovereign wealth funds and individuals in resolving a broad range of complex domestic and cross-border tax disputes. It works with clients at all stages of tax controversy, ranging from audit and administrative resolution through to trial court proceedings and judicial appeals. The tax controversy and litigation lawyers work closely with the firm's market-leading corporate, commercial litigation, intellectual property, appellate and other practices in a variety of contexts.

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Introduction

Transfer pricing in the United States is governed primarily by the extensive set of Treasury regulations promulgated under Internal Revenue Code Section 482. Following substantial revisions to those regulations in the 1990s and earlier in the 2000s, they have remained largely unchanged for nearly a decade. Certain ancillary Treasury regulations have changed to reflect implementation of the Tax Cuts and Jobs Act of 2017, but the regulations under Section 482 have remained constant. What has evolved over the past decade, however, are the US Internal Revenue Service's (IRS's) efforts at heightened transfer pricing enforcement under those regulations, and, collaterally, heightened transfer pricing enforcement by taxing authorities at the state level. This chapter summarises some of the more notable elements of those enhanced enforcement initiatives.

The Transfer Pricing Audit Process

An important development in United States transfer pricing over the past few years has been the IRS's increased focus on the use of standard practices and processes in all transfer pricing audits. Those efforts prompted the IRS Large Business & International Division (LB&I) to issue a Transfer Pricing Audit Roadmap (the "Roadmap") in 2014. LB&I replaced the Roadmap in 2018 with a document titled the "Transfer Pricing Examination Process" (TPEP), which was most recently revised in September 2020. LB&I has stated its intent to update the TPEP publication regularly based on feedback from examiners, taxpayers and practitioners. The TPEP publication is more detailed and comprehensive than the prior Roadmap. In 2023, the IRS updated the Internal Revenue Manual, a document that guides IRS personnel when administering the income tax laws, to incorporate the TPEP.

One of the main highlights of the TPEP publication is that it divides transfer pricing audits into three phases:

- the planning phase;
- the execution phase; and
- the resolution phase.

The planning phase

The planning phase involves internal IRS coordination and review of taxpayer documents (including annual reports, tax returns, and the country-by-country report) and the preparation of ratio analyses to determine "whether cross-border income shifting is occurring". The IRS then develops a preliminary working hypothesis and risk analysis before scheduling an opening conference with the taxpayer. The fact that the IRS is engaged in analysing taxpayers' transfer pricing and deciding whether income shifting has occurred without meaningful taxpayer input has worried taxpayers and practitioners.

The execution phase

The execution phase resembles a transfer pricing audit before the TPEP. The IRS issues information requests and develops the facts. The IRS is supposed to meet periodically with the taxpayer to confirm relevant facts. And the IRS should update its risk assessment continuously to determine which issues will continue to be examined. The IRS is also supposed to issue a so-called acknowledgement of facts (AOF) information request at the end of the execution phase. The purpose of the AOF information request is to have the taxpayer confirm (or supplement) the facts that the IRS believes it has developed during the audit and on which the IRS will base transfer pricing adjustments. The idea behind this is to lock down the facts before the IRS proposes transfer pricing adjustments so that the administrative appeals process is

based on an agreed set of relevant facts. The IRS may issue additional information requests after receiving a taxpayer's AOF response.

The resolution phase

The resolution phase involves an attempt to reach agreement with the taxpayer before the IRS issues a document that affords the taxpayer the right to pursue an administrative appeal or the opportunity to pursue mutual agreement procedures (MAPs) under applicable US tax treaties. The IRS is also supposed to consider early resolution tools, including referring the case for mediation under a special programme called Fast Track Settlement.

Audit timelines

The TPEP publication does not mandate any specific audit timeline. It contains two exhibits with examples of transfer pricing examinations (which include time for administrative appeals and MAP processes) – one spanning 24 months and the other spanning 36 months. The TPEP publication specifies that the sample timelines should only be used as guides and that every examination plan's timeline should be adapted to the particular case.

The TPEP publication is an important development in the US transfer pricing landscape that reflects the IRS's continued focus on standardising transfer pricing audits. Taxpayers and practitioners should familiarise themselves with the document and consider accepting the IRS's invitation to provide feedback in order to improve the transfer pricing audit process.

Increased Involvement of the US Competent Authority in Transfer Pricing Audits

In 2019, LB&I issued memorandum LB&I-04-0219-001, which mandates that LB&I examination teams consult with members of the IRS Advance Pricing and Mutual Agreement Program (APMA) on procedural and substantive matters regarding potential transfer pricing adjustments involving countries with which the United States has a tax treaty. Although the memorandum has an expiration date of 18 February 2021, it continues to reflect LB&I's apparent practice.

US tax treaties designate the Secretary of the Treasury or his delegate as the US "competent authority". That authority, in turn, has been delegated to the directors of Transfer Pricing Operations (TPO, subsequently renamed Treaty & Transfer Pricing Operations or TTPO) and APMA. TTPO is an organisation within LB&I, and APMA is an organisation within TTPO. The US competent authority has authority to apply the provisions of US tax treaties.

Transfer pricing issues arise under Article 9 ("associated enterprises") of US tax treaties, and these issues compose a substantial portion of both the US competent authority's caseload and LB&I's taxpayer examination inventory.

The MAP articles of US tax treaties give a taxpayer the right to ask for assistance from the US competent authority if the taxpayer believes that the actions of the US or a treaty country have resulted, or will result, in the taxpayer being subject to taxation not in accordance with the applicable US tax treaty. This situation can arise, for example, if LB&I examiners propose a transfer pricing adjustment that increases the income of a US parent corporation with respect to a transaction with a foreign subsidiary corporation that is a tax resident of a country with which the US has a tax treaty. Unless the foreign subsidiary gets a correlative tax deduction, double taxation arises.

The US parent corporation (or, under some tax treaties, the foreign subsidiary) can make a competent authority request. If the US competent authority accepts the request, it will try to resolve the issue through consultations with the applicable foreign competent authority, but in some cases it may resolve the issues unilaterally. In the above example, the US parent corporation can make a competent authority request when it gets a written notice of proposed adjustment from LB&I examiners. This is important because the US competent authority assumes exclusive jurisdiction within the IRS if the US competent authority accepts a request; that is, LB&I examiners and/or IRS Appeals lose jurisdiction.

The US competent authority is likely to take a holistic view of the proposed transfer pricing adjustment; in particular, to what extent the proposed adjustment would be perceived as being at arm's length under the transfer pricing rules of the foreign country. The US competent authority can modify, or even eliminate, the LB&I examiners' proposed adjustment if it believes that treatment is warranted to relieve double taxation.

The mandate in the 2019 LB&I memorandum signals, on the one hand, that sharing of information and experience by APMA with LB&I examiners is intended to give examiners "useful information for consideration in their selection and development of transfer pricing issues". But the memorandum also clarifies that examiners are ultimately responsible for selecting and developing issues and should retain "an appropriate degree of independence... from the competent authority process".

For examinations opened after 30 September 2017, approval from the Transfer Pricing Review Panel (TPRP) is required where the LB&I examiners believe the taxpayer's chosen method (as reflected in the taxpayer's Section 6662 transfer-pricing documentation) does not reflect arm's length results. The LB&I examiners seek approval to change the taxpayer's transfer pricing method by filing a specified form together with documentation (that includes work papers and a draft report or any other format that is clear and concise) with the issue team manager and territory manager for approval. If approved, the material is submitted to the Director of Field Operations of the Transfer Pricing Practice (TPP DFO) for approval before it is uploaded to a SharePoint site for review by the TPRP.

The TPRP generally consists of the TPP DFO or APMA director (depending on whether the case is an examination case or an APA programme case), a senior adviser to the TTPO director, and the TPPO manager. The TPRP meets on an ad hoc basis and anticipates meeting at least bimonthly. The TPRP review process is supposed to be completed within 60 days of a submission to the TPRP. The process is a purely internal one. Taxpayers have no ability to participate and are advised to address any concerns through the normal examination process.

An interesting dynamic could develop in the IRS process for making transfer pricing adjustments in situations involving treaty-partner countries. According to the 2019 memorandum, APMA involvement is only intended to influence LB&I examiner behaviour, and not the other way around. It remains to be seen whether the sharing of information and experience by APMA with LB&I examiners means the examiners are less likely to make transfer pricing adjustments that would be modified or entirely rejected by the US competent authority.

Change in the Way the IRS Audits Large US Corporate Taxpayers: Revenue Procedure 94-69 Replaced by Revenue Procedure 2022-39

Revenue Procedure 94-69 allowed certain taxpayers to disclose additional income for a year under audit to prevent the imposition of penalties under Section 6662 of the Internal Revenue Code. For examinations beginning after 16 November 2022, a new disclosure procedure, Revenue Procedure 2022-39, applies.

The imposition of penalties under Section 6662 turns on whether there has been a sufficiently large underpayment of tax. An underpayment of tax generally means the excess of income tax successfully imposed by the IRS over "the amount shown as the tax by the taxpayer on his return". This latter amount includes not only the amount shown on the taxpayer's original return but also any amount shown as additional tax on a qualified amended return (QAR). Disclosing additional tax on a QAR can eliminate the risk that a Section 6662 penalty will be imposed. A QAR includes an amended return filed after the due date of the return for the taxable year, but it must be filed before the taxpayer is first contacted by the IRS concerning an examination of the original return for that year.

This timing requirement was troublesome for large taxpayers that were subject to audit under the Coordinated Industry Case (CIC) programme. CIC programme taxpayers included all domestic corporations over a certain size. CIC programme taxpayers were under continuous audit and therefore arguably could not meet the timing requirement for filing a QAR.

But the relevant regulations allow the IRS by revenue procedure to prescribe the way the QAR rules "apply to particular classes of taxpayers". To alleviate the inequity faced by CIC taxpayers, the IRS issued Revenue Procedure 94-69, which allowed such taxpayers to file a written statement with their examination team within a certain period near the start of an exam. The written statement was treated as a QAR. CIC taxpayers could thus reduce their risk of having penalties imposed by disclosing amounts of tax due in this manner.

In 2019, the IRS announced a replacement of the CIC programme with the Large Corporate Compliance (LCC) programme. The LCC programme replaces automatic examination of every return within the CIC programme with a method for selecting returns by using data analytics "to identify the returns that pose the highest compliance risk". LB&I withdrew Revenue Procedure 94-69 after the LCC programme replaced the CIC programme because, unlike the CIC programme, the LCC programme is not necessarily a continuous examination programme. LB&I became concerned that Revenue Procedure 94-69 created an advantage for LCC taxpayers over other taxpayers that are required to use the "normal" QAR process.

Many former CIC taxpayers asserted that, under the LCC programme, they would likely continue to find themselves under near-continuous audit because large corporate taxpayers tend to have more complex issues and transactions that the IRS could identify as carrying higher compliance risks. In response, the IRS refined its position by issuing Revenue Procedure 2022-39.

Under Revenue Procedure 2022-39, if the IRS has audited (or is auditing) the taxpayer (corporation or partnership) for at least four of the five preceding taxable years under the LCC or CIC programme (or the Large Partnership Compliance Program or a successor programme), then

the taxpayer can submit a Form 15307, Post-filing Disclosure for Specified Large Business Taxpayers, to the IRS examiner within 30 days of a request, which the IRS will treat like a QAR.

APMA's Growing Role

As noted above, the referenced 2019 LB&I memorandum portends an increased role for APMA in LB&I transfer pricing audits involving affiliates and transactions in treaty-partner countries. APMA's increasing role in the audit context is consistent with its increasing presence in transfer pricing enforcement through the channels for which it has more direct responsibility: advance pricing agreements (APAs) and MAPs.

Since its creation in 2012 with the merger of the previously separate APA programme and the portion of the US competent authority office charged with resolving transfer pricing disputes under the United States' bilateral income tax treaty network, APMA has become an increasingly significant presence in the US transfer pricing enforcement landscape. Data bears this out. APMA has concluded more APAs every year on average since 2012. Likewise, APMA's MAP inventory has grown substantially since APMA's first year. Approximately two thirds of the cases in APMA's MAP inventory are transfer pricing cases.

APMA's workloads in the APA and MAP realms are expected to continue to grow. Increasingly aggressive transfer pricing enforcement efforts by jurisdictions around the world, combined with the potential impacts of the OECD's ongoing two-pillar attempt to address global tax challenges, suggest an ever-increasing role for APAs for taxpayers desiring advance certainty, and likewise, an increasing role for the MAP process for taxpayers seeking to avoid double-tax consequences from audit adjustments.

Faced with a growing case inventory, LB&I issued a memorandum in 2023 containing instructions that could deter some taxpayers from filing APA requests. That memorandum provides that LB&I examiners will be involved in the initial assessment of APA requests, which was not the case in the past. The memorandum also indicates that the OECD's International Compliance Assurance Programme (ICAP) might be a better vehicle than an APA for addressing a taxpayer's transfer pricing issues. Although the memorandum indicates that it is not intended to decrease the number of APA requests, taxpayers are concerned that LB&I examiners' involvement in the APA review process could lead to more joint audits or to examiners advocating that taxpayers go the ICAP route rather than seeking APAs.

Transfer Pricing Across the United States: the Focus of the States on Transfer Pricing Enforcement

Individual state revenue agencies often look to interstate transactions among commonly controlled parties to determine how much income is properly "apportioned" to their state for the purposes of imposing state income and other taxes. Using various tools such as "nexus apportionment" and "forced combination" (to name a couple), states seek to ensure that they are taxing the activities conducted in their states and the income earned therefrom. Over the past several years, however, states have also been looking to transfer pricing and techniques based on those found in federal law to examine intercompany transactions between related companies across state borders in an attempt to combat perceived tax avoidance.

The aim of transfer pricing at the state level is similar to what it is internationally: to ensure that transactions between related parties for tangible and intangible goods and services are in accord-

ance with comparable transactions between unrelated parties. In the US, this is particularly relevant in so-called separate return states, where the activities of entities doing business in those states are taxed separately. Likewise, this is also important when considering intercompany transactions with foreign affiliates, as foreign affiliates are often excluded from state returns altogether.

In 2016, the Multistate Tax Commission (MTC), an intergovernmental state tax authority that was created to promote uniform and consistent tax policy and administration among the states, began giving significant attention to the issue of transfer pricing enforcement, creating the State Intercompany Transactions Advisory Service to provide transfer pricing training to state auditors. While the MTC effort did not gain significant support, it did reflect an effort by the states to increase their transfer pricing knowledge and audit capabilities using analogous state laws and authorities.

For example, various state revenue agencies have started dedicating significant resources to transfer pricing training and education to enhance enforcement efforts. A recent study indicated that nearly half of the states' revenue agencies have hired third-party transfer pricing experts, signed "exchange of information" agreements, and invested in "Section 482 training". Moreover, some states have been retaining outside counsel and transfer pricing experts to pursue their enforcement initiatives, including former US Treasury and IRS counsel personnel.

The past year witnessed significant events in the state transfer pricing realm. Highlights include a South Carolina judge's ruling against Tractor Supply Company in a transfer pricing case. The judge agreed with the state taxing authority that the markup on inventory that a Texas affiliate applied on sales to the corporate parent and an affiliate in Michigan shifted income from South Carolina retail sales to Texas and that combined unitary reporting, which eliminated the effect of the inventory markup and resulted in a larger taxable base to which South Carolina could apply its income tax rate, was warranted. Another highlight was Louisiana's large transfer-pricing suit against ConocoPhillips Co in which Louisiana alleged that the taxpayer shifted income out of Louisiana through the pricing of related party oil and gas transactions and intercompany services.

Taxpayers doing business in the US should continue to expect state revenue agencies to scrutinise their controlled transactions. With continuing budget challenges, states have begun utilising whatever tools they have available to maximise revenue and increase their collection coffers. To prepare, companies doing business in the US should ensure that they prepare and update their interstate transfer pricing studies and should be ready to face potential state transfer pricing challenges.

Increasing LB&I Audit Activity

LB&I has continued to expand audit efforts involving transfer pricing issues. This includes a recent initiative targeting US distribution subsidiaries of large foreign corporations that report recurring losses or low margins on US federal income tax returns. The IRS will receive substantial additional funding in the coming years, and there is reason to believe that a meaningful portion of those funds could be used to ramp up transfer pricing enforcement.

Increased Scrutiny of Economic Substance

In recent public statements, IRS officials have signalled an intent to invoke economic sub-

stance principles more frequently in the transfer-pricing context. The IRS has already done so in docketed litigation, including in Perrigo Co v United States, No 1:17-cv-00737 (W.D. Mich. 2021). In this case, the IRS argued that Perrigo's transfer to a foreign affiliate of rights to manufacture and distribute a pharmaceutical product in the United States lacked economic substance; the IRS asserts transfer pricing adjustments in the alternative. The case awaits a ruling.

Increased Potential for Penalty Assertions

LB&I has indicated that it intends to scrutinise taxpayers' annual transfer-pricing documentation more closely to determine whether penalties are warranted. The IRS has already begun asserting penalties in docketed transfer-pricing cases, even where taxpayers prepared annual documentation for the years involved. It appears that there will be increased penalty assertions in the coming years and US taxpayers would be well advised to pay closer attention to their transfer pricing documentation to minimise penalty risk.

Judicial Opinions

3M Co & Subs v Commissioner (2023) (US Tax Court – still active) – the Tax Court ruled 9–8 in an opinion reviewed by the full court that the Treasury regulation addressing when the IRS will respect foreign payment restrictions is valid and that the taxpayer failed to satisfy the requirements of that regulation. In so doing, the court rejected challenges on multiple administrative law grounds. The court distinguished precedent pre-dating the regulation at issue, including a Supreme Court decision. The dissenting judges raised a number of challenges to the court's opinion and would have invalidated the regulation. The case is currently on appeal.

Medtronic, Inc v Commissioner (2016 (US Tax Court); 2018 (8th Circuit); 2022 (US Tax Court) – still active) – following the 8th Circuit's reversal and remand of the Tax Court's prior decision, the Tax Court conducted a limited retrial after which it rejected both the taxpayer's application of the comparable uncontrolled transaction (CUT) method and the IRS's application of the comparable profits method (CPM). The court determined that the best method was an unspecified method that borrowed aspects of both parties' proposed pricing methods. The IRS appealed the Tax Court's decision. Medtronic then filed a cross appeal. The case is currently on appeal.

The Coca-Cola Co v Commissioner (2020 (US Tax Court) – still active) – the Tax Court rejected the taxpayer's application of the CUT method and ruled that the IRS was not arbitrary and capricious in applying the CPM with a return on assets profit level indicator to allocate income from six foreign licensees to the US licensor. Historically, the IRS has been unsuccessful in seeking to apply the CPM to price licensing transactions. The court also ruled for the IRS on Brazil-specific issues in 2023. The court applied the 3M ruling, as it was required to. The case presents a number of important issues, including the same regulatory validity issue in dispute in 3M, and remains subject to appeal.

Eaton Corp & Subs v Commissioner (2013, 2017, 2019 (US Tax Court); 2022 (6th Circuit)) – this case stemmed from the IRS's cancellation of two APAs based on the taxpayer's alleged material failures to comply with the terms of the APAs. The courts ultimately held that the IRS had improperly revoked the APAs without reaching the substantive transfer pricing questions presented. The taxpayer recently filed lawsuits that address substantive transfer pricing issues in later years.

ZAMBIA

Law and Practice

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Mulenga Mundashi Legal Practitioners is a full-service law firm with strong capabilities and a proven track record in tax advisory and tax litigation. It operates from an office in Lusaka and has a team of five partners, ten associates, six legal assistants and seven trainee advocates. The firm is ranked as a leading firm by Chambers and Partners.

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1. Rules Governing Transfer Pricing

1.1 Statutes and Regulations

The rules governing transfer pricing include legislation and various regulations. These are the Income Tax Act, Chapter 323 of the Laws of Zambia (the "Income Tax Act") as read with the Income Tax (Transfer Pricing) Regulations, Statutory Instrument No 20 of 2000 (the "Transfer Pricing Regulations") (collectively, the "Transfer Pricing Rules"), as amended by the following regulations:

- the Income Tax (Transfer Pricing) (Amendment) Regulations, Statutory Instrument No 24 of 2018;
- the Income Tax (Transfer Pricing) (Amendment) Regulations, Statutory Instrument No 117 of 2020;
- the Income Tax (Transfer Pricing) (Amendment) Regulations, Statutory Instrument No 107 of 2021;
- the Income Tax (Transfer Pricing) (Amendment) Regulations, Statutory Instrument No 89 of 2022; and
- the Income Tax (Transfer Pricing) (Amendment) Regulations, Statutory Instrument No 62 of 2023.

1.2 Current Regime and Recent Changes

Although Zambia's Transfer Pricing Rules were first introduced in 1999 under Section 97A of the Income Tax Act, and in 2000 under the Transfer Pricing Regulations, the Zambian government only began to focus on major transfer pricing reforms in 2012, when four officers from the Zambia Revenue Authority's (ZRA) Large Taxpayers Office undertook transfer pricing audits within mining and non-mining audit units. These reforms commenced when the ZRA became aware of the need for robust documentation rules to clarify taxpayer expectations and avoid unnecessary delays in the audit process.

In March 2016, the ZRA created a Transfer Pricing Unit comprising four officers with the aim of providing a direct focus on transfer pricing audit cases, which generally take a longer period of time to conclude compared with normal audits. Additionally, the ZRA had noted that without specific guidelines taxpayer compliance was dif-

ficult to enforce regarding the need to prepare a transfer pricing policy document for the relevant group. This is in view of the fact that the ZRA, in ensuring compliance, relied on the general provisions in the Income Tax Act to compel taxpayers to submit transfer pricing documentation and information.

In 2017, the Zambian government joined the Inclusive Framework on Base Erosion and Profit Shifting (BEPS) and agreed to adopt the BEPS project agreement, the country-by-country reporting measures to prevent tax treaty shopping, and the minimum standards that were set out by the OECD and G20 nations in 2015. In doing so, the government aimed to increase tax revenue payments and reduce the tax burden on easy-to-pay taxes by creating an atmosphere of fairness among companies that are liable for tax, which, it was hoped, would lead to voluntary compliance.

In view of the foregoing, the government strengthened the Transfer Pricing Rules by amending the Transfer Pricing Regulations. Major changes were introduced in 2018 when these amendments introduced, inter alia, provisions relating to the arm's length principle and preparation of transfer pricing documentation. In 2021, the requirement for country-by-country reporting was introduced, and further amendments were made to the Transfer Pricing Regulations in 2022 and 2023.

In 2024, the provisions of the income tax were amended to enhance clarity and coherence in determining the timeline for submitting claims related to transfer pricing when legal proceedings are involved. Section 97A(11) of the Income Tax Act outlines prerequisites for claiming credit under a Double Taxation Agreement for foreign tax, emphasising the exclusion of any foreign tax amount not meeting arm's length conditions. It underscores that the determination of income eligible for credit should align with arm's length conditions. Section 97(11A) imposes a time limit, stipulating that claims must be submitted within twelve months from the assessment date. The crux of the recent amendment, encapsulated in Section 97A(11B), addresses a procedural nuance, in that for cases under litigation, the date of determination or the final ruling shall be considered as the date of assessment. It states that in cases where a decision under Section 97A is under appeal or pending before a court, the date of assessment mentioned in Section 97(11A) will be deemed the date when the decision on appeal is rendered or the final court ruling is provided.

The Transfer Pricing Rules recognise the application of the OECD Transfer Pricing Guidelines and the United Nations Practical Manual on Transfer Pricing for Developed Countries. However, the Transfer Pricing Rules will prevail in the case of any inconsistencies.

2. Definition of Control/Related Parties

2.1 Application of Transfer Pricing Rules

The Transfer Pricing Rules apply to controlled transactions, which are defined as transactions between associated persons. Associated persons include the following:

- parties connected directly or indirectly through shareholding, equity or partnerships;
- any joint venture owned or operated jointly with an unrelated person;
- connected persons;
- parties connected through direct or indirect management control and capital; or

- any existing arrangements, whether in writing or not, that benefit two or more entities whose conditions are deemed not to be at arm's length.

It is important to note that a party is associated with another if:

- the person participates directly or indirectly in the management, control or capital of the other; or
- the persons participate directly or indirectly in the management, control or capital of both of them.

3. Methods and Method Selection and Application

3.1 Transfer Pricing Methods

The Transfer Pricing Rules provide for the following five transfer pricing methods that taxpayers may use:

- comparable uncontrolled pricing method;
- resale pricing method;
- cost plus method;
- transactional net margin method; and
- transactional profit split method.

3.2 Unspecified Methods

A different method may be applied by a taxpayer or the Commissioner General of the ZRA, provided the Commissioner General is satisfied that:

- none of the approved methods can be reasonably applied to determine arm's length conditions for the controlled transaction; and
- such other method yields a result consistent with that which would be achieved by independent persons engaging in comparable uncontrolled transactions under comparable circumstances.

Where the taxpayer wishes to apply a different method, the taxpayer must state why the five transfer pricing methods listed in **3.1 Transfer Pricing Methods** were regarded as less appropriate or non-workable in the circumstances of the case, and the reasons why the selected method was regarded as the most appropriate for satisfying the arm's length principle.

The application to use a different transfer pricing method should be made in writing to the Commissioner General.

3.3 Hierarchy of Methods

The tax authorities have the discretion to select the most appropriate transfer pricing method from the methods listed in **3.1 Transfer Pricing Methods** based on the facts and circumstances of the case and reliability of data for the comparability analysis. The tax authorities will consider the following:

- the respective strengths and weaknesses of the methods in the circumstances of the case;
- the appropriateness of the approved transfer pricing method, having regard to the nature of the controlled transaction, determined through an analysis of the functions undertaken by each person in that controlled transaction and taking into account assets used and risks assumed;
- the availability of reliable information needed to apply the selected transfer pricing method or other transfer pricing methods; and
- the degree of comparability between controlled and uncontrolled transactions, including the reliability of comparability

adjustments, if any, that may be required to eliminate differences between them.

The rules provide that where the comparable uncontrolled price method and the other listed transfer pricing methods can be applied with equal reliability, the tax authorities would choose the comparable uncontrolled price method. Further, where the comparable uncontrolled price method, the resale price method, the cost plus method, the transactional net margin method and the transactional profit split method can be applied with equal reliability, the tax authorities would choose either the comparable uncontrolled price method, the resale price method or the cost plus method.

3.4 Ranges and Statistical Measures

The Transfer Pricing Rules provide for the arm's length range, which is defined as a range of relevant financial indicator figures including prices, margins or profit shares produced by the application of the most appropriate transfer pricing method to a number of uncontrolled transactions, each of which is relatively equally comparable to the controlled transaction based on comparability analysis (though in some cases not all examined comparable transactions will have a relatively equal degree of comparability).

Further, the regulations provide for the interquartile range, which is used to enhance the reliability of the analysis where the range includes a sizeable number of observations, and the taxpayer has made reasonable efforts to exclude points of lesser degree of comparability.

3.5 Comparability Adjustments

There is no express requirement for comparability adjustments. However, when picking the most appropriate transfer pricing method, the tax authorities consider the degree of comparability between controlled and uncontrolled transactions, including the reliability of comparability adjustments.

It is worth noting that the tax authorities may adjust the taxpayers' results where the results fall outside the arm's length range.

4. Intangibles

4.1 Notable Rules

Zambia's Transfer Pricing Rules define "intangible property" as including any property which is not a physical or financial asset, and is capable of being owned or controlled for use in commercial activities. This includes the following:

- patent;
- invention;
- secret formula or process;
- design;
- model;
- plan;
- trade mark;
- know-how; or
- marketing intangible.

For transactions that involve intangible property such as licences and sales, the determination of the arm's length conditions for controlled transactions between associated parties takes into account both the perspective of the transferor of the property and the perspective of the transferee. Such transactions also take into account the pricing at which a comparable independent enterprise would be willing to transfer the property and the value and usefulness of the intangible property to the transferee in its business.

In transactions involving the licensing, sale or transfer of intangible property, a person is

required to consider special factors relevant to the comparability of the controlled and uncontrolled transactions, including the following:

- the expected benefits from the intangible property;
- any geographic limitations on the exercise of rights to the intangible property;
- the commercial alternatives otherwise available to the acquirer or licensee derived from the intangible property;
- the exclusive or non-exclusive character of the rights transferred; and
- whether the transferee has the right to participate in further developments of the intangible property by the transferor.

4.2 Hard-to-Value Intangibles

Zambia does not have any special rules regarding hard-to-value intangibles.

4.3 Cost Sharing/Cost Contribution Arrangements

The Transfer Pricing Rules recognise cost contribution arrangements and define them as arrangements among persons to:

- share the costs and risks of developing, producing or obtaining assets, services or rights; and
- determine the nature and extent of the interests of each participant in the results of the activity of developing, producing or obtaining the assets, services or rights.

There are no special rules that apply to these types of arrangements.

5. Affirmative Adjustments

5.1 Rules on Affirmative Transfer Pricing Adjustments

A taxpayer may make an adjustment where the conditions of an actual transaction differ from the arm's length principle requirements. The taxpayer may make the relevant adjustment in the calculation of assessable income included in the annual tax return. Generally, year-end adjustments are permitted before filing of the income tax return for the relevant financial year.

6. Cross-Border Information Sharing

6.1 Sharing Taxpayer Information

Zambia has signed 23 tax treaties which provide for exchange of information agreements.

Further, it has signed the ATAF Agreement on Mutual Assistance in Tax Matters which established exchange of information and assistance in tax collection among the contracting countries in Africa.

While Zambia has international agreements which provide for exchange of information, this is not sufficient for country-by-country (CbC) reporting purposes. Zambia has not yet implemented the Qualifying Competent Authority Agreements (QCAA) which govern the automatic exchange of CbC reports filed on an annual basis between party jurisdictions and between authorised representatives of those jurisdictions that are parties to an international agreement.

7. Advance Pricing Agreements (APAs)

7.1 Programmes Allowing for Rulings Regarding Transfer Pricing

Zambia does not have advance pricing agreements (APAs), and these are not expected in the near future given that transfer pricing audits are still in their early stages.

7.2 Administration of Programmes

This is not applicable in Zambia. See **7.1 Programmes Allowing for Rulings Regarding Transfer Pricing**.

7.3 Co-ordination Between the APA Process and Mutual Agreement Procedures

This is not applicable in Zambia. See **7.1 Programmes Allowing for Rulings Regarding Transfer Pricing**.

7.4 Limits on Taxpayers/Transactions Eligible for an APA

See **7.1 Programmes Allowing for Rulings Regarding Transfer Pricing**.

7.5 APA Application Deadlines

See **7.1 Programmes Allowing for Rulings Regarding Transfer Pricing**.

7.6 APA User Fees

This is not applicable in Zambia. See **7.1 Programmes Allowing for Rulings Regarding Transfer Pricing**.

7.7 Duration of APA Cover

See **7.1 Programmes Allowing for Rulings Regarding Transfer Pricing**, as this is not applicable in Zambia.

7.8 Retroactive Effect for APAs

This is not applicable in Zambia. See **7.1 Programmes Allowing for Rulings Regarding Transfer Pricing**.

8. Penalties and Documentation

8.1 Transfer Pricing Penalties and Defences

The Transfer Pricing Rules provide that failure to maintain the required transfer pricing documentation or make transfer pricing information available to the ZRA when required to do so may render the entity liable to pay a fine not exceeding ZMW30,000 or to imprisonment for a term not exceeding 12 months, or to both.

Although the fine is capped at ZMW30,000, interest is always charged on debts owed to the ZRA and there is no cap on the interest that accrues on such debts. Interest is charged at the Bank of Zambia discount rate plus 2% per annum. The Income Tax Act also states that the Transfer Pricing Regulations may create offences which will render an entity liable to pay a fine not exceeding ZMW24 million; however, presently the Transfer Pricing Regulations do not contain penalties and provide that the penalties under the Income Tax Act are applicable.

The Transfer Pricing Rules further provide that a taxpayer is required to provide transfer pricing documentation to the ZRA within 30 days from the date of receiving the request for documentation. In addition, where the ZRA serves a taxpayer with a notice of assessment, the taxpayer may within 30 days of the date of said service object to the assessment by way of written statement addressed to the Commissioner General of the ZRA, setting out the grounds of objection. If the taxpayer is dissatisfied with the outcome of the

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Commissioner General's decision concerning the objection to the assessment, the taxpayer may, within 30 days of the date of being served written notice of this decision, appeal against the assessment to the Tax Appeals Tribunal (the "Tribunal").

Taxpayers must retain documents and records relating to transfer pricing for ten years from the date of the last entry in those documents and records. The documentation must contain information that verifies that the conditions in a taxpayer's controlled transactions for the relevant tax year are consistent with the arm's length principle. The documentation must reflect the following:

- the controlled transactions, including the nature, terms and price of each controlled transaction, details of property transferred or services provided, and the quantum and value of each respective transaction;
- the identity of associated persons involved and the relationship between the associated persons;
- a detailed comparability analysis of the person and associated person with respect to each documented category of controlled transaction, including the functions performed, risks, borne tangible and intangible assets used and any changes made compared to prior years;
- details of other controlled transactions that directly or indirectly affect the pricing of the subject controlled transaction;
- records of the economic forecasts, budgets or other financial estimates prepared by the person for that person's business or separately for each division or product that may have a bearing on a controlled transaction;
- uncontrolled transactions and information on financial indicators for unrelated parties relied on in the transfer pricing analysis, including a description of the comparable search methodology, and a record of the nature, terms and conditions relating to any uncontrolled transaction with unrelated parties relied upon in the transfer pricing analysis;
- the details of any comparability adjustments performed, indicating whether they have been performed on the tested party or on the comparable uncontrolled transaction, or both;
- the transfer pricing methods considered in determining the arm's length price in relation to each transaction or class of transaction, the method selected as the most appropriate method, why that method was selected, and how that method was applied in each controlled transaction;
- which associated person is selected as the tested party, and an explanation for the choice of the tested party;
- a summary of financial information used, and the assumptions made in applying the transfer pricing methodology;
- the reasons for performing a multi-year analysis, where applicable;
- the assumptions, policies and price negotiations, if any, which have critically affected the determination of the arm's length price;
- details of the adjustments, if any, made to the transfer price to align it with the arm's length price, and consequent adjustments made to the total income for tax purposes;
- the reasons for concluding that the controlled transactions were conducted on an arm's length basis, based on the application of the selected transfer pricing method;
- information and allocation schedules showing how the financial data used in applying the transfer pricing method may be tied to the annual financial statements of the taxpayer;

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- summarised schedules of relevant financial data for comparables used in the analysis; and
- any other information, including information relating to the associated person that may be relevant for determination of the arm's length price.

Transfer pricing documents and records must be prepared on an annual basis.

8.2 Taxpayer Obligations Under the OECD Transfer Pricing Guidelines

Zambia has adopted a three-tiered structure or approach that taxpayers must adopt. The master file and local file reports are mandatory, while a country-by-country report must only be prepared and filed with the ZRA subject to meeting certain conditions.

9. Alignment With OECD Transfer Pricing Guidelines

9.1 Alignment and Differences

Zambia's Transfer Pricing Rules closely align with the OECD Transfer Pricing Guidelines, as they are to be construed in a manner consistent with the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations as supplemented and updated from time to time.

Where there is any inconsistency between the Transfer Pricing Rules and the OECD Guidelines, the Transfer Pricing Rules prevail to the extent of the inconsistency.

9.2 Arm's Length Principle

Zambia's Transfer Pricing Rules do not depart from the arm's length principle.

9.3 Impact of the Base Erosion and Profit Shifting (BEPS) Project

The OECD's BEPS project influenced amendments to Zambia's Transfer Pricing Rules. Zambia joined the Inclusive Framework on BEPS and in 2020 an amendment was introduced to bring about country-by-country obligations to the domestic landscape, thereby fulfilling the country-by-country reporting minimum standard and implementing it into domestic law.

It also worth noting that the BEPS-recommended transfer pricing methods have been implemented. These are as listed in **3.1 Transfer Pricing Methods**.

9.4 Impact of BEPS 2.0

Zambia has not explicitly provided a conclusive perspective on the OECD's BEPS 2.0 initiatives. However, the country continues to introduce changes to the domestic Transfer Pricing Rules to ensure they are aligned with the OECD Guidelines. Zambia's joining the Inclusive Framework on BEPS in 2017 illustrates the country's commitment to and participation in reducing multinational tax avoidance and improving cross-border tax dispute resolution.

The OECD's BEPS 2.0 initiatives involving Pillar One and Pillar Two are likely to be implemented, even though there is no definite set period for such implementation. The initiatives will likely address challenges in taxation of the digital economy in Zambia, which could lead to an increase in Zambia's revenue growth from taxation of multinational entity digital companies, and also to tax certainty.

An example of Zambia's commitment to the OECD's BEPS 2.0 initiatives is that while previously Zambia's tax legislation did not have specific rules dealing with the digital economy and

digital services, as of 1 January 2023 the government has extended the turnover tax regime to service providers in the gig economy, which is a segment of the digital economy that involves individuals carrying out business through an online platform and under flexible or temporary conditions, and that includes an independent contractor or freelancer conducting business through an online platform. This exemplifies Zambia's commitment to unifying approaches on taxation of the digital economy.

For Zambia, the likely impact of the OECD's BEPS 2.0 initiatives involving Pillar One and Pillar Two in the coming years is the growth of Zambia's revenue gains.

9.5 Entities Bearing the Risk of Another Entity's Operations

The Transfer Pricing Rules do not provide for an entity to bear the risk of another entity's operations.

10. Relevance of the United Nations Practical Manual on Transfer Pricing

10.1 Impact of UN Practical Manual on Transfer Pricing

The Transfer Pricing Regulations provide that they are to be construed in a manner consistent with the UN Practical Manual on Transfer Pricing for Developing Countries as supplemented and updated from time to time. This illustrates Zambia's consistency with the application of transfer pricing rules in accordance with the UN Practical Manual on Transfer Pricing. The Manual essentially influences the practice of transfer pricing in domestic legislation.

11. Safe Harbours or Other Unique Rules

11.1 Transfer Pricing Safe Harbours

Safe harbours are provided on the amount charged for the provision of a low value-added service between connected persons. They only apply to the mark-up applied to the cost of the services. Taxpayers will still need to establish that all other conditions of the transaction are at arm's length, including that:

- the services were actually provided;
- the services provide economic benefit to the recipient that is not incidental, duplicative or only relating to the activities of the shareholder;
- the cost of the services has been calculated using an appropriate cost base;
- the services have been allocated using appropriate allocation keys;
- the service providers have applied the cost plus method to determine the costs; and
- the mark-up on these costs is no more than 5%.

11.2 Rules on Savings Arising From Operating in the Jurisdiction

Zambia does not have specific rules governing savings that arise from operating in Zambia.

11.3 Unique Transfer Pricing Rules or Practices

There are currently no notable unique rules or practices in Zambia, as the country's Transfer Pricing Rules are highly influenced by the OECD Transfer Pricing Guidelines and are construed in a manner consistent with the Guidelines, except where there is inconsistency.

12. Co-ordination With Customs Valuation

12.1 Co-ordination Requirements Between Transfer Pricing and Customs Valuation

The Transfer Pricing Rules do not require co-ordination between transfer pricing and customs valuation; however, the ZRA has an integrated tax administration system called ASYCUDA (Automated System for Customs Data) which captures customs information and uses this as intelligence data in audits.

13. Controversy Process

13.1 Options and Requirements in Transfer Pricing Controversies

Zambia's domestic transfer pricing controversy process is as follows.

Where the ZRA issues a notice of assessment following a transfer pricing audit and a taxpayer is unhappy with this, the taxpayer can challenge the assessment within 30 days of receiving notice of it. This can be done by objecting to the results of the transfer pricing audit in the notice of assessment by way of writing to the Commissioner General of the ZRA, setting out the taxpayer's grounds of objection.

If the Commissioner General makes a determination following the taxpayer's objection, and the taxpayer is still dissatisfied with this, they have the right to appeal to the Tribunal within 30 days of receiving the Commissioner General's decision. The decision of the Tribunal will be enforced as if it were the decision of the High Court of Zambia. Where a decision made under Section 97A of the Income Tax Act is under appeal or pending before a court, the date of assessment will be deemed to be the date when a final decision relating to the appeal is made. The 30-day period to challenge such an assessment will only begin to run once the decision is made.

It is important to note that all tax laws in Zambia, including the Transfer Pricing Rules, are based on the "pay now, argue later" rule of taxation. As such, no legislation contains any express provision that empowers the Tribunal to grant a stay of execution to prevent the ZRA from collecting dispute tax in cases where there is an appeal lodged with the Tribunal.

If either the ZRA or a taxpayer is aggrieved by the decision of the Tribunal, they have the right to appeal against the Tribunal's decision to the Supreme Court of Zambia. The Supreme Court may determine the matter or refer it back to the Tribunal for re-hearing, confirmation, reduction, increment or annulment of the assessment or decision made by the Tribunal, and may make such further or other order on appeal, as to costs or otherwise, as the Supreme Court considers necessary.

Because the Supreme Court is Zambia's final court of appeal, its decision on a particular transfer pricing dispute is final as it does not have the jurisdiction to review its judgments, or to set aside and re-open an appeal.

14. Judicial Precedent

14.1 Judicial Precedent on Transfer Pricing

Although Zambia has a well-established legal framework for pursuing transfer pricing, and the ZRA formed a dedicated Transfer Pricing Unit in March 2016, the judicial precedent on transfer

pricing is not yet well developed as not many disputes on transfer pricing have been taken to the courts.

14.2 Significant Court Rulings

Mopani Copper Mines Plc v The Zambia Revenue Authority – SCZ/8/269/2016

This case is considered the landmark case on transfer pricing in Zambia. It arose from an appeal from the Tribunal in which the Tribunal held against Mopani on a complaint raised by the ZRA disputing certain tax assessments made by the ZRA. In brief, the ZRA undertook an audit on the mining industry's cost levels, and the exercise involved a tax audit on costs, revenues and transfer pricing practices. The audit was largely centred on possible transfer pricing practices between Mopani and its shareholder, Glencore International AG (GIAG), a related party that bought copper at a significantly lower price than the price at which it was sold to third parties.

The tax audit raised some concerns regarding certain related party transactions. The issue was whether the transactions between Mopani and GIAG were at arm's length, given GIAG's shareholding in Mopani. The ZRA had issued a tax assessment following conclusions that the internal pricing was not decided in line with the arm's length principle, and that one of the major reasons for the mispricing was to reduce tax liability.

Mopani argued that Section 95 of the Income Tax Act was wrongly invoked by the ZRA in the case of transfer pricing as that section can only be invoked where there is reason to believe that the main purpose of the transaction was to avoid or reduce liability with respect to tax, in which case the Commissioner General of the ZRA would direct that a particular adjustment be made. Section 95(1) of the Income Tax Act provides that:

"Where the Commissioner General has reasonable grounds to believe that the main purpose or one of the main purposes for which any transaction was effected (whether before or after the commencement of this Act) was the avoidance or reduction of liability to tax for any charge year, or that the main benefit which might have been expected to accrue from the transaction within the three years immediately following the completion thereof, was the avoidance or reduction of liability to tax, he may, if he determines it to be just and reasonable, direct that such adjustments shall be made as respects liability to tax as he considers appropriate to counteract the avoidance or reduction of liability to tax which would otherwise be effected by the transaction."

The ZRA explained the nature of the symbiotic business relationship between Mopani and GIAG and how that special relationship reflected in the sales of the copper produced by Mopani. The ZRA further stated that the audit by the ZRA revealed issues that could cause any prudent tax authority to have misgivings about the arm's length claim of the transactions between Mopani and GIAG. This, in the Supreme Court's view, rightly raised reasonable suspicion sufficient to lead the ZRA to invoke Section 95 of the Act.

The Supreme Court of Zambia held in favour of the ZRA and ordered that Mopani pay a total of ZMW240 million in taxes assessed for the 2006 to 2010 tax years. This particular case shows the applicability of the Commissioner General's discretion under Section 95 of the Income Tax Act concerning transfer pricing.

Nestlé Zambia Trading Limited v The Zambia Revenue Authority – 2018/TAT/03/DT

In this case, Nestlé Zambia Trading Limited ("Nestlé Zambia") appealed against the decision of the ZRA on an assessment resulting from a transfer pricing audit covering the period of 2010 to 2014. Nestlé Zambia argued that the ZRA wrongfully assessed when it was found liable for additional tax, as Nestlé Zambia's non-compliance with the arm's length principle had not been tested.

Nestlé Zambia also argued that the ZRA had erred in law and fact by issuing its assessment on the premise that Nestlé Zambia could not run at a loss since incorporation, when all the evidence provided to the ZRA showed the various factors which led to Nestlé Zambia's loss-making, and that the ZRA failed to objectively test the related party transactions, to which it raised transfer pricing concerns but made assumptions and estimates that were excessive and unreasonable.

Nestlé Zambia further argued that the ZRA erred in law and fact when it categorised Nestlé Zambia as a low-risk distributor when it was shown beyond doubt that Nestlé was an independent full-fledged distributor company undertaking all the sale and distribution functions as well as the typical risk incurred in performing these functions.

In turn, the ZRA argued that it carried out adequate tests on all related party transactions and the analysis of contracts and transactions revealed that Nestlé Zambia's transactions were mainly with various related parties. The ZRA further argued that Nestlé Zambia was paying royalties to Nestlé South Africa for the exclusive use of Nestlé trade marks and patents as a distribution company in violation of the arm's length principle, and that the assessments were made under the Income Tax Act and were therefore not estimates or assumptions.

The Tribunal held in favour of Nestlé Zambia except for the argument on the categorisation of Nestlé Zambia as a low-risk distributor, and stated that it was erroneous for the ZRA to have aggregated the unrelated, discontinuous and not closely linked transactions as a means to test for arm's length. The Tribunal held that the assessment by the ZRA was wrongly arrived at because said assessment was based on inaccurate transfer pricing results emanating from the use of an inappropriate transfer pricing method and disproportionate comparables.

The case referred to the OECD Transfer Pricing Guidelines, showing their applicability in Zambia, and provided guidance with regard to similar cases involving transfer pricing audits and assessments.

15. Foreign Payment Restrictions

15.1 Restrictions on Outbound Payments Relating to Uncontrolled Transactions

Zambia's Transfer Pricing Rules do not restrict outbound payments relating to uncontrolled transactions.

15.2 Restrictions on Outbound Payments Relating to Controlled Transactions

Zambia's Transfer Pricing Rules do not restrict outbound payments relating to controlled transactions.

15.3 Effects of Other Countries' Legal Restrictions

The Transfer Pricing Rules do not provide for rules regarding the effects of other countries' legal restrictions.

16. Transparency and Confidentiality

16.1 Publication of Information on APAs or Transfer Pricing Audit Outcomes

The ZRA does not publish information on APAs or transfer pricing audit outcomes.

16.2 Use of "Secret Comparables"

The Transfer Pricing Rules do not prohibit the use of secret comparables. In fact, the ZRA has procured a database for the use of comparables.

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