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ROUNDTABLE

Transfer pricing

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TRANSFER PRICING

As their enforcement activity has grown in the past few years, global tax authorities are increasingly likely to challenge intercompany transactions. Intense media scrutiny and a public backlash against perceived tax practices have put multinational firms under greater pressure than ever before. The OECD project on base erosion and profit shifting (BEPS) is likely to substantially influence transfer pricing rules, and tax administrations are collecting and sharing data with growing voracity. It should come as little surprise, then, that transfer pricing disputes are on the rise.

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Nate Carden focuses on planning and controversies arising in connection with transfer pricing and related international tax issues. He specifically concentrates on the tax aspects of ongoing business operations. Mr Carden works with clients across many industries, with a particular focus on life science, health care and technology. He has been recognised as a leading lawyer in International Tax Review.

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FW: What changes or developments have you seen in the transfer pricing environment over the last 12-18 months? How has this impacted upon companies and their operations?

Carrillo: The transfer pricing market is becoming increasingly complex as tax authorities around the world place greater focus on transfer pricing and the role it can play in base erosion profit shifting (BEPS). A major part of this focus is the issue of intangibles, as these are key to the allocation of profits in cross-border transactions. This increased focus on transfer pricing increases the risk of double taxation for multinational corporations and reduces their flexibility to react to market conditions. Heavy penalties are often associated with transferring operations from a high-labour-cost country to a lower-labour-cost country. As a result, multinationals are becoming much more careful about where they set up operations, and the way in which they do business around the world.

Kanter: Earlier in 2013 the OECD started various initiatives aiming to limit multinationals from – artificially – shifting profits across jurisdictions by adjusting their tax and transfer pricing models. These initiatives specially address transfer pricing documentation and highlight the need for further transparency on the overall value chain and related intercompany transactions – for example, the OECD Action Plan on Base Erosion and Profit Shifting (BEPS) and the OECD White Paper on Transfer Pricing Documentation. The exchange of tax information is also being addressed through multilateral agreements. Public interest and pressure on transfer pricing related matters have also increased. These recent global transfer pricing developments mean that multinational groups are even more compelled to ensure they have a consistent – and moderate – transfer pricing policy supported by comprehensive transfer pricing documentation.

Bernhardt: Obviously, on an international level the various documents issued by the OECD on transfer pricing in 2013 have already considerably changed the landscape, and will continue to do so. The wide spectrum of the papers – ranging from plain vanilla topics to the policy driven action plan on BEPS – has brought transfer pricing to the attention of the general public. While most of the OECD papers are still in draft form and even formulated action points are awaiting international and national implementation, the pressure on companies to focus more on transfer pricing is already there. In addition to these international developments, many countries have further elaborated on their national rules, including Germany which has recently implemented the so called Authorised OECD Approach (AOA) under which general transfer pricing rules now also apply to permanent establishments. While the latter change might seem somewhat technical, its practical implications are not only very relevant for specific industries – such as financial institutions as well as oil and gas exploitation and the heavy industrial construction sector – but concern every company with permanent establishments abroad.

Carden: By far the biggest recent change in the transfer pricing environment is the increased public attention and scrutiny that transfer pricing is receiving in the media and by high level government officials – not just tax administrators. After media reports and legislative hearings in the US and UK negatively portrayed some multinationals engaged in cross-border related-party transactions, the past year brought about extensive discussion regarding potential changes to the rules of international taxation. International tax was even a high profile topic at the G-20 summit, with leaders expressing support for reforms across a number of areas, including transfer pricing. In response, the OECD has set an aggressive 12 to 24 month timeframe to achieve results based on its 15-point Action Plan on BEPS. Meanwhile, in the US there are international tax reform proposals that have been circulated by influential members of Congress. Despite this attention, however, it is far from clear that these will lead to any final results and, if so, when. Nevertheless, multinationals are expending significant amounts of time and resources to study the proposals, engage with policymakers, and work with advisers to model the possible consequences of adoption of these proposals for both revenue and employment.

Secular: Transfer pricing has become a more important area for the UK tax authorities over the last few years and will become more so in the foreseeable future as the amount of additional tax collected through a transfer pricing investigation has been demonstrated to be far greater than that collected through any other investigation. The changes in the penalty regime whereby a penalty is now levied on the adjustment rather than the tax arising will only increase the risk of challenge and the level of monitoring has increased. As the tax take continues to be low, filling the coffers will only happen through penalties and it is anticipated that the level of enquiry will rise and enforcement increase. We are seeing more enquiries over the last 18 months and anticipate more as time progresses. To date, though, companies continue to play a waiting game, preferring to wait until an enquiry is raised rather than dealing with the matter in advance, primarily due to resource constraints. As the OECD issues more guidance on particular issues concerning transfer pricing, taxpayers can expect further developments on local legislation as the tax authorities react to the OECD pronouncements. The white paper on intangibles, for instance, is the latest paper to be issued by the OECD.

Moreira: It is not possible to address transfer pricing matters over the last 12 to 18 months without emphasising the focus that the OECD has dedicated to this issue. Last year we saw the OECD issue a report for G-20 leaders regarding concerns over BEPS, and developing and implementing an action plan to counter BEPS covering several matters such as the review of transfer pricing guidelines on intangible assets, the release of a 'white paper' on transfer pricing documentation requirements, the review of Section E in chapter 4 of the transfer pricing guidelines on the use of safe harbour provisions and the new guidelines addressed to the tax administration's design risk assessment approaches before moving to transfer pricing audits. It is intended that this action plan will apply to several domestic and multilateral legal amendments within OECD Member Countries by December 2015, so it is expected that both the tax administrations and taxpayers will have to look to transfer pricing matters in a whole new way following such changes. Considering the historical relationship between Portugal and Angola, it is also important to highlight the entry into force of the Angolan Large Taxpayers Act which establishes a transfer pricing regime that broadly follows OECD guidelines – for example, the respect for the arm's length principle, the use of traditional TP methods and the demand for the preparation of a transfer pricing file. Due to the importance that Angolan operations have in the turnover of several Portugal-based multinationals, the introduction of a transfer pricing regime will force these entities to be more careful when establishing commercial relations with local related entities and to duly document the compliance of the arm's length principle.

FW: To what extent have tax authorities placed greater importance on the issue of transfer pricing? What indications are there that governments have stepped up enforcement in recent ▸▸

years, and in what ways are they doing so?

Kanter: In general, there is an increased focus on transfer pricing during tax audits. Tax authorities have also intensified their programs relating to enhanced tax relationships. This relates partly to the post-recession economic environment, partly to the increasing number of cross-border intercompany transactions and the work of the OECD, and partly to additional public and political pressure on transfer pricing – for example, Starbucks, Apple, and so on. Also, tax authorities have become more knowledgeable on transfer pricing matters and have increased their cross-border cooperation and coordination. Most jurisdictions have introduced rules relating to preparing transfer pricing documentation. Stronger enforcement on transfer pricing can clearly be seen in a number of territories through the increase of transfer pricing audits and the investment of additional transfer pricing resources. In addition, several countries publish their own interpretation of the OECD transfer pricing guidelines such as the Netherlands and Australia.

Bernhardt: The German tax authorities have, in recent years, continuously and substantially increased their transfer pricing expertise both in terms of numbers of transfer pricing auditors and the specific training for these auditors. One can observe that specialised transfer pricing auditors are now regularly called in to participate in international audits, and that transfer pricing matters increasingly represent the main areas of disputes between companies and tax auditors. In Germany, the focused transfer pricing auditors often come from the central federal tax agency – *Bundeszentralamt für Steuern* – where they are also grouped in accordance with industry specialisation. The auditors thus have nationwide experience to draw conclusions from, including competitor firms of the company currently audited.

Carden: There has been an uptick in transfer pricing enforcement activity over the past few years, and companies should expect that to continue for the foreseeable future. Many governments view increased enforcement as one new way of raising revenues in a weak global economy, which is not surprising given that a successful transfer pricing adjustment could net hundreds of millions of dollars. Moreover, tax authorities are likely to feel empowered to more aggressively pursue multinationals, especially given wide dissatisfaction – from national legislatures, the public, and even other countries' tax authorities – with perceived transfer pricing abuses by companies. Intensified enforcement efforts have taken the forms of enlarged or restructured transfer pricing operations, closer cooperation with international organisations like the OECD, and changes in approach to transfer pricing even without changes to the rules. For instance, some transfer pricing officials have suggested that they intend to evaluate companies' transfer pricing based on economic and finance theory rather than governing regulations and observable third party behaviour.

Secular: Transfer pricing has certainly come to the forefront of attention by tax authorities now, primarily because of the low tax take. This has led to more enquires of a general nature to start with as tax authorities look to understand the business more and seek areas in which they can raise detailed enquiries. Taxpayers need to be careful how they deal with enquiry letters, particularly those that are general in nature and could perhaps form a 'fishing enquiry'. Responses need to be specific and focused on the main points. HMRC has also recently announced changes to restrict the use of compensating adjustments where partnerships obtain services from their service companies as part of their overall action on tax avoidance.

Moreira: In the last publicly known report on activities developed towards the combat of fraud and tax evasion, published by Portugal's Tax Affairs Office, it was revealed that one of the focuses on which tax audits are centring, and will continue to centre, their attention will be the enhancement of measures to combat international tax evasion through the control of transfer pricing policies; the payments made to other group companies based in countries with a more favourable tax regime; and transactions made with tax havens and with interposed companies. Another measure identified in the report refers to the intention of tax authorities to identify the perimeter of economic groups and promote activities of control covering all operations involving group companies. In order to deal with this enhanced focus on transfer pricing matters, the tax authorities have already hired a large number of specialists to be included in the teams responsible for transfer pricing audits and Advance Pricing Agreement (APA) negotiations. Following a trend adopted by the majority of OECD member countries, Portugal has created a Large Taxpayers Unit responsible for dealing exclusively with monitoring, assisting and auditing major taxpaying companies and groups. Considering that large taxpayers are usually part of a group of companies with local and international exposure, it is normal that transfer pricing issues will be one of the points of discussion with the tax inspectors appointed to monitor each of those large taxpayers.

Carrillo: Governments around the world are placing great importance on the topic of transfer pricing and have issued clear mandates to their taxing authorities to address the issue more aggressively. This is evidenced by the number of countries that have recently enacted transfer pricing legislation; by the increased audit activity in the area of transfer pricing by tax authorities worldwide; by the investment tax authorities have made in expanding their resources, such as staff and investigative tools, in the area of transfer pricing; and by the initiatives undertaken in the area of transfer pricing by organisations like the OECD, the UN and the World Bank.

FW: Are tax authorities more inclined to work together on cross-jurisdictional joint audits? How does this approach aid participating countries and what challenges does it raise for multinationals?

Carden: I see cross-jurisdictional joint audits as an aspirational goal for tax authorities, not a widespread current practice. Joint audits could benefit tax authorities in a number of ways, including increased access to information, shared strategies for approaching certain tax positions, and early and cooperative resolution of double taxation issues. The OECD's 2013 white paper on transfer pricing documentation, which proposes standardising transfer pricing documentation requirements to streamline cross-jurisdictional information sharing, reflects this trend. However, there are downsides, particularly where one jurisdiction views an issue or transaction as a high priority item, while the other prefers to dedicate resources to other areas. Similarly, cross-jurisdictional audits could also benefit multinationals, including through early resolution of cross-border issues, rather than lengthy competent authority proceedings. However, cross-border audits also pose challenges to multinationals, including responding to broader information requests, and navigating relationships with multiple audit teams and unfamiliarity with foreign audit procedures. Especially when confronted with such a coordinated, cross-border approach, multinationals must ensure they present a consistent transfer pricing theory across jurisdictions.

Secular: The UK and US tax authorities have had a system of working together on cross-border joint audits for over two years now and ▸▸

as it seems successful it will not be too long before other jurisdictions follow suit. The reason for having this arrangement is twofold. First it enables real time matters to be discussed and agreed between the tax authorities. Second, and more importantly, it shows areas where there may be differences in treatment enabling the tax authorities to raise enquiries and obtain information that much quicker. There are also in place Exchange of Information Agreements within Europe under which tax authorities can exchange information much more quickly and become more focused on areas of concern within their jurisdictions. In addition, as more high profile multinationals have their tax affairs mentioned in newspaper headlines, there will be increasing calls for action from the general taxpaying public. All of this means that multinationals can expect more enquiries in the foreseeable future from more than one tax authority. It is essential that multinationals are prepared for the challenges ahead.

Moreira: Despite the increased focus of the Portuguese tax authorities on dealing with transfer pricing issues in order to counter BEPS and the expansion of the treaties signed by Portugal with several jurisdictions concerning administrative cooperation in tax matters, the truth is that there are no relevant developments concerning the ability of the Portuguese tax administration working with other tax administrations on cross-jurisdictional transfer pricing matters. This may be easily revealed by the scarcity of APAs that have been concluded between taxpayers and the Portuguese tax authorities – according to the public data, only one APA has been concluded while a further three are being evaluated. Fewer mutual agreement procedures have been initiated and concluded by the Portuguese tax authorities.

Carrillo: Tax authorities are working together more closely. The number of information-sharing treaties being entered into by OECD-member countries is growing. However, I'm not aware of cross-jurisdictional joint audits taking place as a coordinated effort. At the end of the day, transfer pricing is a zero-sum game. One tax authority's increase in tax revenue from a given intra-group transaction would mean the other tax authority's tax revenue would be reduced – if both tax authorities are jointly working together. Failure to do so would result in double taxation for the multinational corporation being audited. Still, information sharing initiatives are on the rise and this, again, reduces the flexibility that multinational organisations have to react to unique market conditions, and forces multinationals to be consistent in their global transfer pricing policies.

Kanter: Tax authorities have geared their focus toward analysing the overall business and transfer pricing model and have increasingly stepped away from a one-sided to a two-sided transfer pricing analysis. This is also supported by, *inter alia*, recent OECD publications. Consequently, as part of this broader transfer pricing examination, tax authorities collaborate more intensively with each other. Increased collaboration can also be seen in the area of bilateral APAs, Competent Authority agreements and the exchange of tax information through multilateral agreements, especially within the EU. For multinational taxpayers, joint tax audits pose both opportunities and challenges. As tax authorities coordinate their tax audits, a common understanding of the arm's length nature of the overall transfer pricing model can be reached faster and simpler. This takes away some possible concerns by tax authorities that the transfer pricing structure has been set-up for tax purposes only. On the other hand, joint tax audits force multinational taxpayers to dedicate massive resources and to coordinate the tax audit in multiple jurisdictions at the same time. Not all organisations have adjusted their tax audit manuals and procedures to deal with joint tax audits.

As more high profile multinationals have their tax affairs mentioned in newspaper headlines, there will be increasing calls for action from the general taxpaying public.

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FW: Have you seen an increase in transfer pricing disputes between companies and tax authorities in your region? Are today's governments and tax authorities now more likely to enter into litigation against multinational firms?

Secular: There is an increase in transfer pricing disputes but, to date, there has not yet been a significant increase in litigation. This will come, though, as the general anti-avoidance legislation is used to challenge arrangements between connected companies and changes to the transfer pricing rules take effect. The recent changes affecting partnerships and service companies is one area where challenges are likely to arise but it is questionable whether litigation will increase for some years given the costs involved and the lack of resource within tax authorities – complex and high valued transactions are likely to be the focus. That said, as joint cross-border audits gather momentum, the risk of litigation in a few years time will increase.

Moreira: Transfer pricing disputes between the Portuguese tax authorities and multinational firms tend to increase, mainly due to the 'close relationship' that is established between them and tax inspectors from the Large Taxpayers Unit – as the latter will be especially interested in understanding the terms and conditions established on cross-border transactions. Besides this, due to the Portuguese government's need to ensure the country's fiscal sustainability without being able to implement a further increase of the tax rates, one of the solutions that is being considered to increase the state's tax revenue is to enlarge the taxable basis, which can be accomplished through a thorough analysis of taxpayer's related party transactions in order to conclude that transfer pricing adjustments should be made.

Carrillo: While there has been an increase in transfer pricing audits and enquiries, these do not necessarily end in litigation. Litigation is costly and both tax authorities and multinationals try to resolve transfer pricing issues via dispute resolution channels – MAPs or Competent Authority negotiations.

Kanter: In general, there are an increased number of transfer pricing disputes around the globe. Litigations, however, are scarce in most jurisdictions, although these are likely to increase. Possible litigations are also closely linked to other available instruments to solve transfer pricing disputes, such as the possibility to enter into mutual agreement procedures or arbitration under international trea- ▸▸

ties. In addition, a number of European tax authorities have introduced enhanced tax relationship programs – for example, the UK, the Netherlands, among others – with the aim of proactively dealing with potential transfer pricing disputes rather than reactively through tax audits. As a result of a relatively low number of transfer pricing jurisprudence in most jurisdictions, the experience of tax courts is limited. As a result, it may be preferred to settle rather than to litigate. Also, given recent public emphasis on transfer pricing, litigation may want to be avoided from a corporate social responsibility perspective. Finally, to avoid lengthy discussions or, worse, litigate against tax authorities, uni-, bi-, or multi-lateral advanced pricing agreements can help to solve past transfer pricing issues. It depends on the overall strategy of the multinational firms in general or the assessment on a case by case basis as to which approach is preferred.

Carden: As enforcement has increased, the number of transfer pricing disputes – including in litigation forums – seems to have increased as well. In the US there are at least five significant transfer pricing cases pending in the Tax Court. Notably, some of these cases seem to have reached the litigation forum, at least in part based on IRS positions that are more aggressive than has been common historically. For example, one taxpayer has alleged that the IRS backed out of a memorandum of understanding between the taxpayer and the IRS regarding tax treatment for the years at issue. Another case arose after the IRS imposed adjustments after cancelling an APA it had with the taxpayer. Because of the desire to establish precedents supporting certain transfer pricing and valuation theories, the US tax authorities appear likely to view pursuit of a promising case as well worth the cost and effort. Conversely, taxpayers are often not in a position to accept the results of the government's settlement proposals, both because the amounts at issue are large and because companies have made significant operational and capital expenditure decisions based in part on the expected tax treatment of their investments, meaning that conceding certain principles would have substantial negative consequences in the future.

FW: What insights can we draw from high profile transfer pricing disputes seen in the past 12-18 months? Have they affected the way other companies deal with transfer pricing?

Bernhardt: One of the recurring themes in recent high profile transfer pricing disputes is certainly 'substance', which will without doubt be a key concept going forward. While the term hardly represents a clearly defined technical concept, it expresses the general need that transfer prices are to be set in line with economic realities. One should neither misunderstand nor underestimate the far reaching nature of this concept. Often, it is limited to the question of whether, for example, a company owning all of a multinational group's patents has sufficient substance to justify that it earns high licence income. Another well-known example comprises thinly staffed entrepreneur companies that claim a substantial part of the group's profit. However, the concept of substance is increasingly applied to standard intercompany transactions too, such as internal financing arrangements. Take the situation of an in-house bank in a tax preferential environment, which many groups have. The question here is: how much substance is needed within the bank to justify interest spreads or guarantee fees and similar financial income to be allocated to the bank? As substance is not a black and white concept, and therefore hard to counterattack, it is often used by tax authorities to challenge transfer pricing structures.

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Carden: During the past few years, the US IRS has created an independent transfer pricing organisation to examine transfer pricing issues and various officials have repeatedly discussed the importance of focusing litigation efforts on cases that the government believes it will win, particularly after several high profile losses. In particular, it appears that the US tax authorities view litigation as an important vehicle for addressing the tax consequences of transferring intangibles and are specifically seeking to establish a precedent under which a US taxpayer that licences, transfers or cost shares an intangible with a foreign affiliate is entitled to compensation that leaves the foreign affiliate with nothing more than a routine return for its activities, effectively transferring the benefits of the foreign affiliate's risky investments back to the US. This theme appears in a number of contexts – restructuring of operations in Puerto Rico, licences to foreign subsidiaries and upfront payments required when taxpayers apply the cost sharing regulations. Whether the US tax authorities have, in fact, picked good litigating vehicles to establish such precedents remains to be seen.

Secular: A general lack of high profile transfer pricing disputes recently has not led companies to deal proactively with their transfer pricing position and, on the whole, they are tending to play a waiting game and react only when an enquiry occurs. It is common knowledge that the UK tax authorities have a lack of resources, meaning that they concentrate on prospects where the fee generation is significant. However, certain taxpayers fail to appreciate the level of upheaval that can arise when HMRC raise the issue and the amount of management time that can be wasted in dealing with the issues. Medium sized companies in particular do not always appreciate that they should be prepared for the HMRC challenge as their exemption from transfer pricing can be removed at any time.

Moreira: In the past 12 to 18 months, transfer pricing court disputes between the Portuguese tax administration and taxpayers have been mainly focused on analysis, under the arm's length principle, of the terms and conditions agreed on financing transactions between related parties. This can be regarded as a sign that Portuguese based companies facing difficulties in obtaining credit from financing institutions have turned to their group counterparts to address their treasury problems. Despite the fact that in those court disputes it has been concluded that the tax adjustments made by tax authorities were illegal and consequently they were annulled, companies consider it increasingly important to establish arm's length conditions in financing transactions established among related parties and have the proper documented evidence.

Carrillo: The focus on intangibles continues to be at the forefront. The need to have substance around one's multinational operating structure is paramount, and clearly documented and maintained transfer pricing policies are instrumental in defending and explaining your tax position.

Kanter: Some very large multinationals have been 'named and shamed' in the public press in relation to alleged aggressive transfer pricing structures. As a result, shareholder value has been damaged through consumer boycotts, general consumer mistrust, and so on. Also, in the global political arena, discussions around aggressive tax planning have intensified. Rather than defending the reasonableness of your transfer pricing structure to tax authorities, there is now more emphasis on being able to sustain the structure from a political and public interest perspective. Transfer pricing is no longer an isolated item in tax departments but has clear links to Corporate Relations and the overall company strategy.

FW: In your opinion, how difficult is it for multinational companies to maximise tax efficiency while maintaining compliance with transfer pricing regulations? What obstacles need to be overcome in order to strike a balance?

Moreira: In the medium term it will be much harder to maintain the current balance. The advent of the OECD's Action Plan on BEPS has raised the awareness of the domestic tax authorities to intra-group trade issues. As a result, compliance with transfer pricing regulations should generally become more burdensome to the taxpayer while trying to maintain tax efficiency throughout the global business. Of course, this does not mean international tax planning options are no longer applicable, but they will certainly be more closely scrutinised from a transfer pricing perspective. To overcome the foreseeable restrictions in this respect, taxpayers should pay more attention to the economic rationale behind the pricing of intra-group transactions and comply with all the documentation requirements.

Carrillo: Maximising tax efficiency is not in conflict with tax compliance. Tax departments charged with maximising tax efficiency must do so within the parameters of the law and existing transfer pricing regulations. In my opinion, maximising tax efficiency without complying with transfer pricing regulations is inefficient as it yields to more controversy, which is costly.

Kanter: It is not transfer pricing regulations – based on the arm's length principle – that limit the goal to maximising tax efficiency *per se*. The limit is rather set by the augmented political and public pressure. Also, business reality may not allow significant changes to multinationals' value chains to achieve further tax efficiency. If, for instance, a principal structure – IP, services, manufacturing or distribution related – has been set-up in a low tax jurisdiction, in-depth transfer pricing documentation is even more critical to demonstrate a clear link to business reality. Functional substance supporting the principal structure is in any case a must for any long-term sustainable transfer pricing model.

Carden: Undoubtedly, transfer pricing regulations affect the extent to which intercompany transactions can achieve tax-efficient results. However, this trade-off varies substantially across companies and even within the same company. Materiality of transfer pricing issues, projected audit risk and availability of resources can all factor into how much a taxpayer focuses on and invests in exacting compliance with transfer pricing regulations. The reality is that documented compliance does not equate to a controversy-free audit. Because analyses under transfer pricing regulations are so fact intensive, multinational taxpayers can expect a back-and-forth with tax authorities on transfer pricing issues, such as appropriate transfer pricing methods and the arm's-length range of results. Therefore, a company's transfer pricing model must balance efficiency with risk. What is even more important is that a company's transfer pricing model remains consistent with its global functional platform and overall corporate strategy. Corporate investments in organic growth present both planning opportunities and controversy risks, since the functions performed by various affiliates often change. Appropriate structuring of intercompany pricing can allow companies to retain much of the value they create with these initiatives; missteps conversely can create significant audit exposures.

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> TIAGO MARREIROS MOREIRA

Secular: Although jurisdictions are updating their transfer pricing legislation and increasing requirements, the basic rules have been in existence for some time and multinationals should be aware of these and be able to manage their affairs. That said, as more and more companies expand their operations into emerging markets where the transfer pricing legislation is non-existent or fairly basic, it can be problematic to understand and deal with the issues. This is especially the case where those jurisdictions do not follow the OECD Guidelines or have not adopted them entirely into tax law. The differences in interpretation of transactions and so on can lead to double taxation issues that may not necessarily be resolved under the terms of a double taxation treaty – if in fact one exists. This is where multinationals will face obstacles and difficulties in resolving them and should seek the assistance of their own tax authorities to reach an acceptable conclusion in a short time frame. It is in this area that a working relationship with their tax authorities may produce actual benefits.

FW: What steps should companies take if they become the subject of a tax audit or investigation? What relevant documentation should be available in preparation for this event?

Carrillo: Multinational enterprises that take a proactive approach to managing transfer pricing will generally already have in place most of the relevant documentation needed to address a tax enquiry. Multinationals that take a more reactive approach should, at a bare minimum, always have intra-group agreements and minutes from board of director and management meetings available outlining the overall transfer pricing policy. Broadly speaking, the information needed is a description of the business as a whole, an overview of the specific business unit under scrutiny, a description of the intra-group transac-

tions, a functional analysis, an economic analysis and any supporting documents – like intra-group agreements.

Kanter: First, the basis for managing a successful tax audit is to have pre-agreed tax audit company policies and procedures. Functional responsibility to administer the tax audit should be appointed in advance. Second, transfer pricing documentation should be readily available and up-to date. This documentation should in general be centrally prepared leveraging on global best practices but including a local 'twist' to reflect local specific facts and circumstances. Third, clear communication guidelines should be determined and documents shared with tax authorities should be agreed up-front. The procedure and timing of the tax audit should be arranged as soon as possible with tax authorities.

Bernhardt: The new and evolving theme here seems to be the urgent need to obtain control over the entire transfer pricing cycle. The main elements of a complete transfer pricing cycle include the corporate strategy and its reflection in the transfer pricing strategy; transfer pricing planning and policy setting, formulating guidelines and contracts, and so on; intercompany price setting and invoicing; transfer pricing monitoring and price adjustments; documentation; and defence in tax audits and litigation. Historically, multinational groups focused almost exclusively on transfer pricing planning and documentation. Increasingly, it turns out that the true issues arise from a lack of implementation and monitoring. Therefore, it is time to acknowledge that a group needs an additional transfer pricing implementation function which, in practice, will often separate from both the tax department and the controlling department. The new function will have a distinct professional profile and focus – different to what we have typically seen in the past. The function will be more controlling than tax driven, and with a core responsibility for transfer pricing implementation.

Carden: Transfer pricing audits can consume significant resources for the companies involved. Consequently, companies should prepare well before an audit is initiated. First, companies should give thorough consideration to and document the rationale underlying intercompany transactions before completion, execute intercompany agreements that accurately reflect the companies' course of dealing, and prepare transfer pricing studies demonstrating the arm's-length nature of prices used. Documentation rules vary by jurisdiction, however, so preparing organised, comprehensive documentation in advance of a transfer pricing audit can not only help the audit run more smoothly, but also reduce the burden on corporate resources during the audit. Second, a company should put in place appropriate document retention procedures both to ensure the availability of required information and to ensure compliance with pertinent controversy and litigation rules. At the same time, a company should clearly identify any documentation subject to privilege so that it may be withheld should the company decide to assert available privileges. Finally, companies must engage with tax authorities to define the scope of the audit and expectations regarding the types of information to be provided.

A group needs an additional transfer pricing implementation function which, in practice, will often separate from both the tax department and the controlling department.

LORENZ BERNHARDT

Secular: The first thing any company should do if it becomes the subject of a transfer pricing audit or investigation is to seek professional help. It needs to take control of the investigation and prevent the tax authorities using the opportunity of an enquiry to widen the investigation into other areas. Managing the expectations of the tax authorities is paramount and it is essential that the investigation is controlled. In addition, taxpayers should ensure that they have adequate documentation supporting their position. Failure to have any documentation will generally lead to an immediate penalty. Penalties can also arise if the documentation is inadequate. Companies should be prepared in advance for a possible challenge and, if appropriate, have a health check of their position, particularly if they are medium sized. Currently, medium sized companies in the UK are exempt from the transfer pricing rules but the UK tax authorities can remove their exemption at any time by issuing a direction and such companies then fall entirely within the confines of the legislation. It is always recommended that medium sized companies at least document the policies they follow when transacting with related parties.

Moreira: The first step that companies should take is to contact their tax or legal adviser to assist and advise them as well as their internal transfer pricing team, if they have one. The documentation requirements are essential to enable the domestic tax authorities to assess the compliance of taxpayers with transfer pricing regulations. According to the relevant Portuguese legislation, companies are broadly required to present the annual report and accounts, a list of intra-group transactions, documentation supporting each transaction, an economic analysis of the company and a functional analysis of the intra-group transactions.

FW: In your opinion, has regulatory change made understanding potential tax liabilities a greater challenge for multinational firms, or does it reduce uncertainty concerning risks and opportunities within a company's tax structure?

Kanter: Assessing potential tax liabilities in detail has increased the overall compliance burden relating to transfer pricing. This costs time and resources. It is difficult to balance this additional burden with the value it adds for multinationals, also factoring in that the assessment contains a number of assumptions leading to somewhat ambiguous results. However, while it is always important to maintain transparency towards tax authorities, the publication of uncertain tax positions are sometimes misused by tax authorities leading to additional questions and potential tax audits.

Carden: Despite the absence of significant US regulatory change in 2013, continued recent transfer pricing initiatives spearheaded by international organisations suggest that global regulatory changes are coming. In 2013, the OECD presented its BEPS action plan and released guidance on a number of topics, including a revised discussion draft on transfer pricing aspects of intangibles and a white paper on transfer pricing documentation. The UN also launched the final ver-

sion of its manual on transfer pricing for developing countries. As tax jurisdictions adopt regulations reflecting these definitions, multinationals will encounter new transfer pricing regimes and their attendant challenges. Key high-tax countries, including the US and UK, have already and likely will continue to introduce and debate tax legislation aimed at keeping a larger portion of multinationals' income as part of the country's tax base. In the US, proposed changes make it increasingly difficult to predict the impact of transfer pricing on a company's overall global effective tax rate on operating income.

Secular: To a great extent, regulatory change should enable a multinational organisation to understand the risks and challenges it faces but as the world shrinks, and companies expand their operations into emerging markets where regulations are non-existent or basic, the challenges and risks are heightened. This is particularly the case where the emerging markets have either not adopted the OECD guidelines or have done so only piecemeal; the risk of different interpretations by local and home tax authorities increases and the level of risk becomes uncertain. It can take a while for new legislation to be tested and, often, tax authorities have to make regular changes to achieve the right result for both parties, which increases the period of uncertainty and raises the risk of challenge.

Moreira: Considering the dynamics of transfer pricing regulation, which in this case enables the Portuguese tax authorities to make positive adjustments to the taxable income of a resident company or permanent establishment at the level of the respective CIT, its absence or vagueness tends to play in favour of multinational companies. For instance, in Angola there was no transfer pricing regulation until October 2013 and, as such, Angolan resident subsidiaries or permanent establishments of multinational companies were not subject to positive adjustments to their taxable income with respect to violation of intra-group transfer pricing. Currently, due to the enactment of a transfer pricing regime, intra-group transactions may be subject to scrutiny by the Angolan tax authorities.

Carrillo: The more guidance and clarity tax authorities provide, the greater the degree of certainty multinationals have, and the better equipped they are to set forth tax structures that are compliant. Where potential tax liabilities become difficult to ascertain is where tax authorities are vague about what they require or about how they treat specific intra-group transactions.

FW: Do you expect any further regulatory changes to affect transfer pricing over the next few years? Are multinationals keeping a close eye on any potential shifts in tax policy and planning for this possibility?

Bernhardt: The BEPS action plan remains, in essence, a political statement. As long as tax laws are contained in national legislation, BEPS might change the overall tax climate but not the technical rules that need to be applied by companies. Obviously, therefore, local implementation in the various countries would be necessary, but will only eventuate if politicians in the various countries are serious about the BEPS action plan. Thus, it remains to be seen whether one has to expect further regulatory changes. However, at least equally important will be a not-unlikely worsening of the climate between taxpayers and tax administrations, to the extent the BEPS discussions should strengthen the belief of some tax authorities that they are always 'the good ones' whereas every transfer pricing structuring of international groups is 'wrong'.

Where potential tax liabilities become difficult to ascertain is where tax authorities are vague about what they require or about how they treat specific intra-group transactions.

LUIS CARRILLO

Carden: Companies should be prepared for regulatory changes in the coming years, though being prepared for specific changes may be difficult because countries face competing objectives – raising revenue and maintaining or enhancing competitiveness. Given the current environment, it seems possible that some transfer pricing-specific changes could, in isolation, be made over the next few years. However, if changes to transfer pricing rules wait for a broader tax reform package, it could be years before any statutory changes emerge given the practical difficulties associated with consensus building, both in national legislatures and in international organisations like the OECD. Although declarations of support for international tax reform like the G-20's are significant as a harbinger of what may come, high-level international consensus is very different from arriving at agreement on specific points of law. Despite difficulties with predicting what and when the results of this latest press for reform may be, multinationals realise that it is important not to be caught unprepared and they are watching closely for potential regulatory changes.

Secular: Further regulatory changes are expected to impact on transfer pricing in the next few years as the tax authorities expand their attacks on tax avoidance and the general public increasingly calls for action against the 'unfairness in the system' as more companies are highlighted in the press for not paying tax even though there may be perfectly legitimate reasons for not doing so. Multinationals would be wise to ensure they track all developments and trends, no matter how remote they may seem, so they are prepared for all eventualities – regular health checks of their position would not go amiss.

Moreira: Once again it is important to mention the OECD's Action Plan on BEPS which foresees a number of measures to be taken in the area of transfer pricing, in order to put more emphasis on value creation in highly integrated groups, tackling the use of intangibles, risks, capital and other high-risk transactions to shift profits. Concurrently, I think developed countries will assist amendments to transfer pricing regulations in such a way that the requirements to qualify as related entities for these purposes become stricter. For instance, in Portugal as per the recently enacted amendments to the CIT Code two, parties qualify as related companies whenever one entity participates, directly or indirectly, in at least 20 percent – formerly 10 percent – of the share capital or voting rights of another entity or both entities are at least 20 percent – formerly 10 percent – owned, directly or indirectly, by the same legal entity. On the other hand, in developing Portuguese speaking countries – such as Angola – we should expect the enactment of transfer pricing regulations.

Carrillo: I absolutely expect further regulatory changes around the world. The area of intra-group finance is likely to be the next big area of focus once the dust settles in terms of intangibles. Most practitioners in the field of transfer pricing are likely to keep a close eye on any shifts in tax policy – whether at multinationals, at advisory firms or at tax authorities themselves. The degree to which multinationals pay attention to this issue is related to the level of transfer pricing risk each enterprise perceives, given its unique circumstances.

Kanter: Many jurisdictions together with the OECD, EU and UN have intensified their work on transfer pricing related matters. There is also increased political pressure and determination to resolve unwanted international tax issues and to untangle differences in tax laws and in the interpretation thereof between jurisdictions. Multinationals are in general moving – or have already moved – to a more modest approach relating to transfer pricing. Emphasis is geared towards creating a long-term, defendable and sound transfer pricing system. This means putting a stronger focus on functional substance and business reality – rather than maximising tax efficiency only.

FW: What final advice can you give to companies on reviewing and amending their transfer pricing policies and structures in today's tax environment?

Carden: In light of the increasing intensity of transfer pricing audits, multinationals should approach their transfer pricing policies with the expectation that they will be scrutinised by tax authorities. If a company is amending its policy, it should balance the anticipated benefits of adopting a new policy with the possibility that it could help tax authorities identify areas of exposure for years not yet audited, or could become obsolete in relatively short order if a reform initiative were to be adopted. Most importantly, though, companies must align their transfer pricing policies with their anticipated operating footprint. Transfer pricing regulation and enforcement is becoming increasingly focused on the location of people and functions, not just economic risk. Decisions regarding operating footprint of course touch all parts of a business and are very difficult to change. As a result, successful multinationals are ones that integrate development of transfer pricing policies with anticipated operational changes and actively seek input from all potential stakeholders rather than developing transfer pricing policies in the vacuum of the tax department.

Secular: All taxpayers are advised to regularly check their transfer pricing position to ensure that they are not caught out by developments and changes in legislation wherever they operate. Although the UK currently has exemptions for small and medium sized companies, there are certain restrictions that apply which nullify the exemptions. In addition, HMRC can remove the exemption for medium sized companies at any time. Emerging markets are issuing new legislation on transfer pricing and even Western European tax authorities are changing their existing legislation, particularly in the areas of documentation and penalties. The OECD continues to announce changes to its guidelines – the latest drafts being on intangibles – and further changes to legislation could follow as tax authorities react to the OECD pronouncements. Regular reviews of a taxpayer's position through internal and external health checks are recommended.

Given the global complexities of a multinational business model, it is imperative to use a central documentation approach in order to safeguard consistency, harmonisation and to maintain best practices.

MARC KANTER

Moreira: Multinational companies with more aggressive transfer pricing policies should consider adapting their structure to ensure they comply with the arm's length principle and the documentation requirements. In Portugal, tax authorities are expected to be much more demanding about the economic justification of intra-group prices and should test the functional analysis coherence: functions, risks and assets must be duly apportioned between the intra-group companies.

Carrillo: Being proactive about monitoring, documenting and maintaining transfer pricing policies and structures is becoming increasingly important. It is becoming much more expensive to be reactive and to 'roll the dice' with regards to preparing documentation if and when there is an audit. Having access to information and analytical tools helps companies better manage transfer pricing risk. Multinationals with internal people and information resources increase the level of internal expertise in this area of tax, can achieve a greater degree of certainty and reduce surprises, and generally have a greater degree of control over transfer pricing risk.

Kanter: The starting point to support any transfer pricing system is to make sure that your transfer pricing documentation is in good order. Given the global complexities of a multinational business model, it is imperative to use a central documentation approach in order to safeguard consistency, harmonisation and to maintain best practices. Also, as business models are changing, the transfer pricing model should be adjusted accordingly to reflect business reality. A transparent and proactive approach towards tax authorities is key, rather than taking a 'wait and see' approach until a tax audit starts. APAs – uni-, bi-, or multi-lateral – may be considered.

Bernhardt: My final advice is based on two notions: 'substance' and 'transfer pricing implementation'. With respect to substance – companies are well advised to align their transfer pricing with economic realities, and to check on this alignment continuously. Hardly anything is more difficult to counter than findings by the tax authorities that transfer pricing does not match actual behaviour and structures within a group. Second, transfer pricing implementation reaches much further than 'old-style' documentation. It is so important to have good price setting mechanisms in force, including the appropriate IT systems, to monitor price setting regularly and thoroughly, and take immediate action if needed. This new functionality requires an additional set of capabilities which is typically not found within tax, transfer pricing and controlling departments. Not to blame existing departments, but there is often an urgent need for specific transfer pricing implementation, monitoring and controlling; without this, little can be gained even with the most perfect transfer pricing guideline, as recent practical experiences show that the main issues increasingly come from a lack of proper transfer pricing implementation. ■