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This blog is the first of our two-part series calling attention to some easily avoidable perils we encounter in Transfer Pricing (“TP”) documentation. These items are also the “red flags” that stand out for tax authorities during TP audits. Though there is no such thing as a “bullet-proof TP strategy”, avoiding these red flags can alleviate some pressure from the audit procedure. In general, being prepared with the requisite documentation and engaging proactively with the tax authorities makes the process less stressful. In our view, tax audits should be viewed as an opportunity to be transparent and forthcoming with the tax authorities. To help companies prepare for tax audits and questions from the tax authorities, we are sharing our experience with tax audits, specifically pointing out some pitfalls to watch out for while developing TP policies and compiling TP documentation.

1. Big swings in profits

Large fluctuations in a company’s profits one year to the next naturally draw the attention of the tax authorities. In every such case, there is bound to be a discussion. Hence, it is critical to understand the reasons behind profit fluctuations to assess the appropriateness of the TP model and its alignment with the company’s actual operations and market conditions. In the absence of a clear and reasonable explanation, tax authorities may propose an adjustment to the taxable profits, assuming that the variance is caused by a deliberate attempt to shift profits.

Surely, big swings in profits could well be caused by an external commercial factor, such as a decrease in demand for the company’s products or a supply chain issue. However, if the variance in profits reported is not clearly explained in the TP documentation and linked to a verifiable external commercial factor, tax authorities will definitely take a closer look into the internal transactions to verify the cause of the variance. This is particularly true if profits appear to be shifted from a jurisdiction with a higher tax rate to a jurisdiction with a low tax rate.

This could imply that there has been a cross-border re-location of functions, assets and/or risks (“FAR”). In such case, the tax authorities will want to inspect the related inter-company transactions and check whether the FAR have been transferred at arm’s length. They will want to confirm whether the party that has given up some profit-generating FAR has been proportionally compensated.

If however the variance in profits is not linked to the transfer of FAR, it could mean that the company has made some changes to its TP model and policies. In such case, the tax authorities will want to determine whether the TP policies and model applied in previous years were misaligned with the actual operations of the company or if the newly adopted model and policies are misaligned. Accordingly, they could propose an adjustment, either to the profits of the current year or of the previous years, if the change in the TP model and policies cannot be adequately explained.

2. Business reorganizations and IP transfers

Business reorganizations and transfers of intellectual property (“IP”), whether such transfers are part of reorganizations or as standalone transactions, are key areas that warrant close attention from tax authorities. Such transactions are notable for their complexity and the significant values often involved, especially in the case of IP, which is hard to value. Lately, we have witnessed an increase in litigation relating to business reorganizations wherein the nature and value of FAR transferred was not immediately clear from the outset. The courts’ decisions in these cases relied heavily on the profit allocation and TP models (pre and post restructuring), inferred from internal emails, presentations, etc.

Though we do not know exactly why these particular cases/reorganizations were picked for scrutiny and why the tax authorities decided to look beyond the financials and internal agreements submitted, into the internal emails, etc., we can guess that the documentation provided did not sufficiently support the internal pricing for the transactions related to the

reorganizations. Further, we have our reservations about the methodology (of the courts) of valuing a transfer of functions/assets/risks by merely comparing a company's pre and post restructuring profits as this essentially involves comparing two sets of controlled data. The focus of such discussions should be on [1] the identification of the transferred FAR and, [2] subsequently, the valuation of FAR transferred.

Having said that, we recommend that companies have the appropriate TP documentation in place (specially in case of reorganizations and IP transfers) so as to minimize the chances of scrutiny beyond the documentation provided. Companies carrying out reorganizations and IP transfers need to identify the scope and value of the functions, risks and/or assets transferred. It is recommended to follow the guidance of Chapters VI and IX of the OECD's Transfer Pricing Guidelines for Multinationals and Tax Administrations 2022 ("TP Guidelines").

Chapter VI, which focusses on intangibles, introduces the concept of "DEMPE functions" (Development, Enhancement, Maintenance, Protection, and Exploitation). This concept helps in determining the economic ownership of IP among related parties. Chapter IX provides detailed guidance on the arm's length pricing of the transactions relating to reorganizations as well as for pricing the controlled transactions post-reorganizations. The guidelines in these chapters serve as a valuable resource for ensuring that internal transactions related to business reorganizations and IP transfers are priced in accordance with economic value and reflect commercial reality, aligning with the arm's length principle.

3. Revenue-workforce gap

An obvious "red flag" in a TP audit is when the overall group structure does not align with the commercial reality as this might be a sign of (deliberate or unintentional) profit shifting. A tell-tale sign of this could be, for instance, large amounts of revenue in a country where the organization employs very few or no individuals to whose activities these revenues can be attributed or linked.

When assessing the alignment of an organization's structure with its commercial realities, we often start with a simple FTE-reconciliation. This involves comparing the number of employees, their roles and the related operational expenditure per company/country to the revenues attributed to the operations in these companies/countries. An aspect of this analysis includes examining the net/gross margins per employee and comparing the gross margin to operational expenses (OPEX). Should these ratios exceed certain benchmarks, it raises a flag, particularly when such discrepancies occur in jurisdictions with low or no tax.

Tax authorities would want to understand whether a relatively small employee base in a specific country adds significantly higher value to the overall business, as measured in income, compared to other countries where the organization operates. In this context, companies are prompted to pre-empt questions from the tax authorities and be prepared with a description of the unique skills or local factors that could justify disproportionate income. For instance, high income could be explained by a unique skill set of the employees in that country, a high degree of risk managed by them or other specific market conditions. Such factors need to be identified and documented thoroughly.

The taxpayer should be able to justify the numerical discrepancy by an underlying business reason. If the income in a low-tax jurisdiction disproportionately dwarfs that in other countries within a group of companies without a clear explanation rooted in commercial reality, tax authorities are bound to scrutinize the variance and the underlying TP model. Even a relatively small gap between income and workforce (in terms of absolute numbers) may jeopardize the integrity of the entire TP model. Understanding and being well versed with the dynamics of the business (in terms of the relation between the revenue and the workforce) is crucial for compliance with international TP principles.

4. Delayed responses and missed deadlines

In any audit, it is critical that companies are able to quickly reply to questions raised by tax authorities. Delays in providing TP (or other) documentation requested by tax authorities give the impression that a company is underprepared, if not non-compliant/non-transparent. Hence, responding to any questionnaire before the deadline is critical. Besides, preparing internal documentation only when requested by the tax authorities can be time and resource-consuming as these would then have to be prepared outside the ordinary course of business, absorbing time and incurring additional advisory fees.

Companies are advised to prepare an initial set of documentation that is "ready-to go" in case of questions from tax authorities regarding their TP policies. This documentation should encompass a reconciliation of the TP policy with financial statements over several years, a broad description of the TP policy, and the internal agreements that support the TP policy. Often, local and/or master files would be part of this set.

Such preparedness not only aids in demonstrating compliance but also positions the company favourably during audits. It may also place a company in a better position from a legal standpoint, especially regarding the burden of proof in disputes. Usually, the burden of proof in tax-related matters rests with the tax authorities. However, companies that fail to adequately document their operations and TP policies risk significant adjustments, penalties and a potential shift in this burden. Companies can mitigate these risks by maintaining transparent, up-to-date documentation and engaging cooperatively with tax authorities, safeguarding their interests and ensuring compliance with international TP regulations.

Concluding remarks

Tax authorities typically conduct TP audits with a retrospective lens, often reviewing transactions from the last two or three years. Given that audits frequently begin a year or two after the end of the calendar year, the impact of a TP audit can extend up to four or five past years. This means that the tax authorities can propose an adjustment to the profits reported in these years, exposing the company to multiple years of double taxation, significantly impacting a company's financial statements and cash flow. On the other hand, tax authorities around the globe have become more experienced with resolving cases of double taxation. Many countries (including the E.U. member states) now have formal mechanisms to address double taxation.

However, this proficiency may lead tax authorities to employ a more confrontational approach in TP audits. Tax inspectors, aware of the legal assurance that double taxation will be resolved and keen to avoid undermining the efforts of colleagues involved in resolving cases of double taxation, might feel compelled to propose bolder TP adjustments. As tax authorities come to view the potential for double taxation resolution as leverage in negotiations with other jurisdictions, the initial tax assessments could increasingly be seen as a starting point for discussions. For companies, this could mean larger than anticipated TP adjustments.

This scenario places companies in a challenging position as they must navigate the complexities of resolving double taxation while also managing the broader implications of significant retroactive TP adjustments. In this regard, it is important to have a proactive approach towards TP and a well-thought-through TP policy that is applied consistently throughout the organization with all the relevant information thoroughly documented. Adopting such approach enables companies to easily cooperate with the tax authorities throughout the tax audit process, sharing information well before deadlines, avoiding detailed questionnaires and scrutiny, minimizing double taxation, saving time and resources on preparing last-minute TP-files and benchmark studies, etc.

Our aim with this blog-series is to shed light on the tax audit process, highlighting TP issues that the tax authorities frequently pick up on. We want to share with our network the recurring challenges we have observed and encourage a proactive approach towards TP. Our insights are meant to serve as a starting point for companies to assess and refine their approach to TP in order to be better prepared for audits and scrutiny. If you find the insights in this blog helpful, look out for our second blog of this series, in which we continue to unfold our findings and delve deeper into strategies for effectively managing and mitigating TP "red flags".

DISCLAIMER

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