



Strategic Insights into Transfer Pricing: Unveiling Common Audit Red Flags (Part II)

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Reading time: 15-20 minutes

This blog is the second of our two-part series calling attention to common red flags that stand out for tax authorities during audits. In these blogs we share our experience with tax audits, specifically pointing out some pitfalls to watch out for while framing Transfer Pricing (“TP”) policies and compiling TP documentation. 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, do also read our other blog on this topic, in which we listed our first four tips for effectively managing and mitigating these “red flags”.

5) GENERIC AND TEMPLATE STYLE TP DOCUMENTATION

With regard to TP files, generic or standardized templates are strongly discouraged. Tick-the-box and fill-in-the-blank overviews fail to capture the unique aspects of a business. Oversimplifying and using generic content or a one-size-fits-all approach can expose the company to increased scrutiny. And on close inspection, generic documents (often and easily) reveal inconsistencies or inadequacies in a company's TP practices. This could put the company in a precarious legal position by (possibly) shifting the burden of proof onto the company to demonstrate that its TP arrangements are in accordance with the applicable laws and regulations.

It is also advisable to steer clear of incorporating “page-fillers” in TP documents, such as, for instance, extensive sections straight out of the TP Guidelines. This only serves to annoy the reader, be it the tax inspector or anyone else. It does not in any way contribute to the goal of clarifying the TP policies and practices to the reader. Copy-pasting TP Guidelines or other such material does not give the tax authorities the impression that the company is compliant with the TP documentation requirements or that the company's TP model is aligned with the arm's length principle.

Tax authorities tend to pick up on TP documentation that appears to be prepared as a compliance formality, prompting a closer look. They look unfavourably on master and local files that have a generic and template-style approach. Instead they prefer tailored documents that provide a sufficient degree of detail, allowing them to assess the TP model without having to ask for extra information and supporting documents. Companies should, therefore, ensure that their TP documentation is as detailed and specific as possible, accurately reflecting the operations. This involves moving beyond a tick-the-box mentality to provide a comprehensive and nuanced analysis of the functions, assets and risks employed/undertaken by the entities involved in the intercompany transactions.

6) BARE MINIMUM PREPAREDNESS

Some managers believe that commissioning a master and/or local file and some generic benchmark studies will suffice the requirements of a TP audit. This belief underestimates the level of scrutiny that the tax authorities go to in such audits. While the timely submission of these documents forms the essential groundwork for the audit process, these merely serve as the starting point for tax authorities' inquiries. The initial document set, which typically includes the master and/or local file, a reconciliation of the TP policy with the financials going back several

years, financial statements, internal agreements and details of any business restructuring, represents the basic information required in the early stages of a TP audit. However, the audit's scope quickly expands beyond these basics. Tax authorities engage in a detailed examination of the transactions and their pricing, moving past the surface level.

Often the second or third round of questions includes a quest for supporting documentation that goes beyond these standard documents. In these questionnaires, tax authorities may request minutes from meetings, email correspondences, internal presentations, information in other countries, and other evidentiary documents that provide a deeper context and substantiation for the practices and assertions made in the TP documentation and internal agreements. The request for such detailed and corroborative evidence underlines the tax authorities' commitment to understanding the full narrative of TP policies, in order to ascertain whether they reflect genuine business activities and the arm's length principle. It is thus crucial for companies to recognize the importance of a comprehensive and robust approach to TP documentation and record-keeping.

7) OTHER CONSIDERATIONS

In addition to the key red flags already discussed, we have observed several other items that may draw scrutiny in the context of TP compliance. Listed here below are some additional pitfalls that companies should be wary of.

- **Poorly drafted, incomplete or overly complex internal agreements:** This can signal a lack of attention to TP compliance. We often see (draft) versions of internal agreements without signatures and authorizations being submitted to the tax authorities. This paints a bad picture of the management of company affairs; it is seen lack of planning and low priority to TP. Draft documents, missing information, incomplete sections, documents that have year-end signing dates with retroactive applications going back 1-2 years, and the like are indications that the internal agreements (that are reflective of the company's TP policy) have been drafted in a hurry or as an afterthought. Properly executed agreements, with clear terms and authorizations, are crucial for demonstrating a well-managed and compliant TP policy.
- **Lack of back-office/service charges:** Multinational groups often have some degree of centralization for back-off/support services, such as administration, accounting, logistics, IT and human resources. In TP audits, examining the charges for these internal services is a common starting point for tax authorities. It allows auditors to check out the capabilities of a company to deal with TP regulations in an isolated manner, independent of broader TP complexities. The absence of service charges in a multinational group's internal transactions can signal a potential oversight or intentional non-compliance with TP obligations, prompting a more thorough investigation of intercompany transactions. Multinational groups with centralized or cross-border support services (like admin, IT, logistics, HR, etc.) should have a system for keeping track and charging fees for these services. The fees should be benchmarked/arm's length.
- **Inconsistency in selecting TP methods:** Using different TP methods for similar transactions across various jurisdictions will raise questions about the consistency and rationale behind a group's TP policies. For instance, consider a scenario where a company employs a license model based on a CUP analysis for its contract manufacturing operations in India. Meanwhile, for a similar contract manufacturing agreement in Mexico, the company opts for a TNMM approach. Such a divergence in TP policies for comparable contract manufacturing operations raises eyebrows. It could be seen as an indication that the TP policy isn't being followed consistently or that there is a fragmented approach to TP both of which are problematic from a tax audit perspective. A unified approach is essential to avoid audit risks by ensuring that similar transactions

across different jurisdictions are treated in a consistent manner, reflecting a coherent and justifiable TP policy.

- **Fixed Margins, Safe Harbours and Preferential Tax Regimes:** Relying on fixed margins or safe harbour rules, while simplifying compliance in one jurisdiction, may attract scrutiny in others, especially if such practices result in tax outcomes that deviate from those expected under the arm's length principle. Applying preferential tax regimes in one jurisdiction can be a red flag for tax authorities in other jurisdictions, as it may indicate an attempt to shift profits to the jurisdiction offering favourable tax treatment, potentially undermining fair tax distribution across jurisdictions where the group operates.

SUMMARY & CONCLUDING REMARKS

This two-part blog-series addresses the need for well-thought-through TP policies as well as consistent and meticulous TP documentation. We have also stressed on the importance of having a proactive approach towards TP documentation, avoiding generic templates and aligning tax practices with the arm's length principle and global standards in order to ensure compliance and mitigate audit risks.

To reiterate, first and foremost, the overall group structure needs to align with the group's business reality. With some restructuring, a group can eliminate entities in low-tax jurisdictions that serve no real purpose anymore, and only raise red flags for tax authorities. All intercompany transactions, including management fees and charges for support services, should be reflected in carefully drafted and properly signed internal agreements. These internal agreements should include all relevant clauses, especially those relating to the pricing of the internal transactions. Care should also be taken to ensure that the internal agreements aren't overly complicated because this might indicate to tax authorities that there is something amiss in the pricing of internal transactions that the company and its advisors want to draw their attention away from.

For a multinational group, it is imperative to have a robust TP policy in place that is consistently followed throughout the organization. Inconsistencies in the TP policy will show up in the TP documentation. If the overall TP strategy and policy are well thought through and sufficiently communicated throughout the organization, preparing TP documentation and being prepared for tax audits will not be a problem. Trying to manage TP only when faced with an audit can be daunting and costly (in terms of management time and advisory fees). Companies should have a proactive approach toward TP documentation (i.e., master and local files) and steer clear of generic templates and tick-the-box/fill-in-the-blank layouts.

A proactive approach towards TP also prepares the company for questions from the tax authorities regarding non-standard items such as the use of safe harbours and fixed margins in certain jurisdictions, recent business restructurings, etc. If a group has undertaken a business restructuring and/or an IP transfer, this should be properly documented, down to minutes of meetings, etc., because these documents will serve as a defense line when questioned by the tax authorities. In tax audits, tax authorities do not stop at master and local files. They get into the nitty-gritty of the transactions and the pricing thereof, and ask for supporting documentation, such as minutes of meetings, emails, etc., to back up what is claimed in the TP documents and internal agreements. If the company readily offers up the requisite documentation/proof, it gives the impression that the company is prepared, but also that it is transparent and forthcoming with the tax authorities. Hence, being prepared gives the taxpayer a chance to control the narrative in a tax audit.

In our opinion, tax audits should be viewed as an opportunity to be transparent and forthcoming with tax authorities. If a company is well prepared with its TP documentation, tax audits can be embraced. A proactive approach towards TP means having a well-thought-through TP strategy that is applied consistently throughout the organization, everything important being well documented and TP is embedded in the ordinary course of business. This will enable companies to be extremely cooperative with the tax authorities throughout the tax audit process.

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