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What triggers a tax authority challenge?

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Knowing what triggers a transfer-pricing challenge once an audit is initiated is a key element in assessing and managing transfer-pricing risk. In our experience, taxpayers are not always aware of many significant transfer-pricing examination triggers, or believe that a transfer-pricing examination may be irrelevant because their company is in a loss position. This article discusses key factors that may trigger local transfer-pricing examinations in various jurisdictions around the world, to help taxpayers enhance their awareness and management of transfer-pricing exposures. *[Data included in Table 1 drawn from a worldwide survey of KPMG's global transfer pricing services practice]*

As an increasing share of world trade consists of cross-border transactions within groups of affiliated companies, the issue of the "correct" tax liability in each jurisdiction has become more dependent on companies' ability to structure, implement and defend their transfer-pricing policies effectively. The taxable income of individual affiliates is the result of many factors, including its affiliated group's international tax posture and the associated transfer-pricing payments and receipts that support that posture. As a result, knowledgeable tax authorities around the globe have continued to sharpen their focus on transfer pricing during recent years, and many tax authorities now view this area as a top enforcement priority. For example, as discussed below, the US Internal Revenue Service (IRS) has a formal policy of requesting transfer-pricing documentation in many corporate tax audits, and India implemented a formal policy of conducting transfer-pricing examinations of all Indian corporate taxpayers with aggregate international related party transactions exceeding Rs50 million ($1.1 million) (Indian Tax Authority Instruction No 3 of 2003, dated May 20 2003). Though tax authorities have adopted many forms of enforcement, the most common situation involves local documentation requirements and penalties for failure to comply with such requirements, with the threat of a transfer-pricing challenge always on the horizon.

For those jurisdictions with documentation requirements, the most essential trigger for a transfer-pricing examination is simply the failure to meet these requirements. The IRS implemented a directive in 2003 requiring the first Information Document Request (IDR) issued in a Large and Mid-size Business (LMSB) audit to include a request for the taxpayer's transfer-pricing documentation for the years under examination. This directive also reinforced the IRS' "30-day rule," which requires taxpayers to produce contemporaneous transfer-pricing documentation within 30 days of receiving such a request, and increased the level of IRS approvals that field examiners must obtain to waive transfer-pricing penalties in cases in which a taxpayer failed to provide documentation within 30 days or provided inadequate documentation.

Many countries have adopted similar rules requiring taxpayers to produce transfer-pricing documentation rapidly upon request. For example, taxpayers in France have

Canada

Recent experience indicates that the Canadian Revenue Agency (CRA) has become quite aggressive in its enforcement of Canada's transfer-pricing legislation. Indeed, the CRA is increasing the strength and breadth of its transfer-pricing challenges – the presence of large intercompany transaction volumes or transactions with affiliates in tax havens almost certainly will trigger a transfer-pricing examination. The CRA's approach to such examinations is highly interactive and typically goes well beyond requests for transfer-pricing documentation. Examinations frequently include a desk audit of the tax returns for the years under examination, meetings, site visits and multiple follow-up questions.

60 days to produce documentation, while taxpayers in Spain have only 20 days. Although having transfer-pricing documentation does not always prevent additional tax authority scrutiny, a taxpayer's inability to produce documentation may raise tax authority suspicions, even in countries that do not have formal penalty rules. This is especially true in cases in which the taxpayer shows unusual profits, significant volatility in year-to-year profits or net operating losses (NOLs). For example, KPMG's Canadian member firm reports above that the tax authorities there take a particularly aggressive, thorough transfer-pricing enforcement approach.

Table 1 lists nine common triggers of transfer-pricing examinations and provides relative rankings of each trigger's importance according to members of KPMG's global network transfer pricing team in 10 key jurisdictions. In certain jurisdictions, multiple triggers reflect the same ranking for various reasons, such as a "tie" in importance. For example, KPMG's French member firm reports that the French Tax Authority (FTA) tends to view company reorganizations with shifts in functions and risks and large shifts in operating profits (or shifting from profitability to generating losses) as equally important triggers for transfer-pricing examinations. Another reason that multiple triggers reflect the same ranking in a jurisdiction may result from the local tax authority's view that multiple triggers are connected. For example, KPMG's German member firm reports that Germany's tax authority tends to view losses as the most important single transfer-pricing examination trigger for foreign-owned subsidiaries, but not necessarily for German companies with foreign operations.

This article applies the term "trigger" somewhat loosely. The factors listed in table 1 may in fact trigger a transfer-pricing examination or alternatively may trigger further investigation upon discovery during an existing tax audit. Examples of the latter might include the performance or receipt of management services, or intangibles licensing (inbound or outbound). In certain countries, such as Germany, where taxpayers with annual revenues over a certain amount face tax audits every three to four years, all of the listed triggers typically are areas for further investigation upon the commencement of the tax audit.

The expected triggers

Several triggers listed in Table 1 are as expected. For example, it is not surprising that the likelihood of a transfer-pricing challenge increases as a taxpayer's volume of intercompany transactions increases. Similarly, virtually all tax authorities worldwide are interested in intercompany transactions involving intangible property, especially transactions involving large royalty payments. Additional scrutiny is likely when royalty payments occur in a high-profit environment or when a loss-making affiliate is paying royalties. In the former case, tax authorities may think it is more likely in such cases that the rate is too low when the taxpayer has a very profitable intangible; in the latter case, the tax authority in the royalty-paying jurisdiction is likely to question whether the local affiliate is in fact benefiting from the licensed intangible.

Transactions resulting from tax planning (or those that appear to a tax authority to result from tax planning) also are expected triggers for transfer-pricing challenges. Such trans-

Table 1: Transfer pricing triggers (1 = Highest; 9 = Lowest)

	Americas			Europe				Asia		
Transfer pricing audit triggers	Canada	Mexico	US	Belgium	France	Germany	UK	China	India	Japan
Company characterization or re-characterization	3	1	4	4	1	3	3	5	6	2
Large shift in level of operating profits/losses	6	3	3	2	1	6	2	2	5	1
Large transactions with affiliates	7	8	6			5	8	4	1	1
Operating losses (single or multi-year losses)	9	2	1	1	4	1	4	1	1	6
Presence of cost sharing arrangements	8	5	7			8	5	8	4	4
Presence of intercompany intangibles transactions	2	6	8			7	6	7	2	5
Presence of intercompany services transactions	4	4	9			2	7	6	3	
Subsidiary of foreign parent	5	9	2	3	3	1	9	9		
Transactions with companies located in tax havens	1	7	5		2	4	1	3	7	3

US

The existence of a cost-sharing arrangement is a frequent trigger for a transfer-pricing challenge by the IRS. In many examinations involving cost-sharing agreements, the IRS has tended to assume at the outset that the taxpayer has set its "buy-in" payments, which are the amounts that participants must pay for their share of existing intangibles to enter into the cost-sharing arrangement for future intangibles development, at levels that result in the outbound transfer of intangibles from the US to tax havens at amounts that are "less than full consideration." The IRS has responded by issuing a cost-sharing examination checklist to guide examiners through a list of documents for review and to help examiners determine if documentation is sufficient to avoid penalties.

France

Similar to other European tax authorities, the FTA has recently moved transfer pricing to the top of its list of priority issues, which is especially problematic for major companies that can expect a transfer-pricing examination every four years. The FTA does not adopt a consistent approach from one transfer-pricing examination to another, but is more likely to adopt a pragmatic approach that varies in accordance with the facts and circumstances of each case. Two key focus areas of the FTA are the recharacterization of full-fledged distributors to stripped entities such as limited risk distributors or commissionaires with, for example, Swiss principal companies, and similar recharacterizations of manufacturers. The FTA refers to these situations as "tax delocalization schemes" and views them as eroding French tax revenues. The FTA will challenge a company's adoption of such structures in cases in which it deems the compensation is not appropriate for the French entity's functions and risks. It should be noted, however, that in several examinations, the FTA has found companies' structures to be valid and properly compensated.

actions involving low-tax jurisdictions may take various forms. The first example of such planning involves intercompany transactions with countries having favourable tax rates, such as Ireland and Switzerland. Most tax authorities are aware of these two countries' receptivity to the establishment of "principal" corporate structures or central research facilities due to their favoruable tax rates and pro-business environments. The second involves intercompany transactions with other countries such as Bermuda, the British Virgin Islands and the Cayman Islands, all of which have even more favourable tax climates, along with relatively well-defined legal systems. Tax authorities generally consider the latter list of countries to be tax havens and many presume that an affiliate domiciled in any of these countries would not have earned the income that they report if transacting at arm's length, because companies formed in such jurisdictions may lack substance. This is the case especially when an intercompany payment simply moves, for example, from the UK to Bermuda, but the other characteristics of the business relationship, including the amount of the payment, are unchanged. In such cases, although the transfer price is unchanged, examiners typically establish a strong presumption at the outset that the sole purpose of the payment is to shift income to the tax haven.

Tax-planning transactions that are transfer-pricing examination triggers may also involve the use of a low-tax jurisdiction in a specific arrangement supported by the regulations, such as a cost-sharing arrangement. The US provides a good example of these trends, as described by KPMG's US member firm's transfer-pricing specialists above.

Recharacterization of existing entities is another expected transfer-pricing examination trigger. Such recharacterizations frequently result from tax planning that reduces the functional and risk profiles of manufacturing, distribution or services operations located in high-tax jurisdictions by shifting certain functions and risks into low-tax jurisdictions. Examples of such recharacterizations include transforming a full-fledged manufacturer into a contract manufacturer or a buy-sell distributor into a limited-risk distributor or a commissionaire.

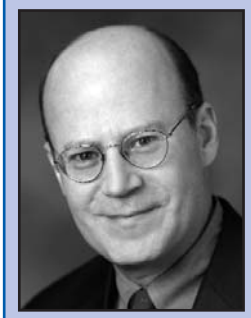
Recharacterization is also a significant trigger because many tax authorities view it as an approach that taxpayers use to justify showing significantly reduced income in high-tax jurisdictions compared to historical years' income in these jurisdictions. This is especially true in the case of tax examiners in OECD countries, who generally apply extra scrutiny to the underlying facts and circumstances of such recharacterizations and may seek to disprove the taxpayer's assertion that a recharacterization has occurred. Such examinations generally involve close scrutiny of the affiliate in the low-tax jurisdiction to question whether it has the economic substance that the taxpayer has claimed. European countries also have attempted to address the restructuring issue by raising permanent establishment (PE) concerns.

All of the above reasons make it imperative for companies engaging in tax planning and restructuring to prepare documentation that explains the new structure, contrasts it with the previous structure, and provides analytical support for the envisioned profit (and loss) shifts. In addition to documentation, legal agreements and written intercompany agreements that clearly specify the assumption of functions and risks form a strong foundation to support such a structure. This situation is connected with the tax-haven trigger discussed above and is exemplified in the above report from KPMG's French member firm.

The unexpected

A tax authority's scrutiny of large intercompany transactions, transactions involving intangibles and transactions with affiliates in low-tax jurisdictions resulting from tax planning is not surprising. Paradoxically, many tax authorities are even more interested in intercompany transactions involving loss-making affiliates in high-tax jurisdictions than in transactions in low-tax

Biography



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jurisdictions resulting from tax planning to shift assets, risks and functions. A common misperception among taxpayers is that losses during open tax years or historical NOLs available from previous years can remove the need to prepare transfer-pricing documentation. The reasoning that taxpayers typically apply to support this misperception is that NOLs would apply against a proposed transfer-pricing adjustment, and therefore such adjustments may not trigger the payment of any additional tax in the current year. While this is okay, our experience indicates that the very existence of losses is one of the leading transfer-pricing examination triggers worldwide. Far from removing the need for transfer-pricing documentation, losses are another crucial reason to prepare documentation.

This trigger is at the core of most tax authorities' transfer-pricing enforcement approach. Even in countries with transfer-pricing rules that emphasize transactional methods, in our experience, examiners primarily focus on profitability (or the lack of profitability) first. Most examiners worldwide assume that all companies are in business to earn profits (especially in the local jurisdiction) and tend to attribute low profits or losses to transfer-pricing distortions, in the absence of evidence to the contrary. The tendency to draw this conclusion is even stronger when the examiner has reason to believe that affiliates in other jurisdictions or comparable companies in the examined company's industry show stronger financial results than those of the examined company.

Germany

Transfer pricing is a focus area in almost all German tax audits of foreign-owned subsidiaries. Domestic multinationals are also starting to face additional scrutiny from the German tax authority, as an exemption system provides increased incentives to shift profits abroad. In addition to their general focus on loss-making foreign-owned subsidiaries, German tax inspectors are increasingly subjecting subsidiaries of Asia-Pacific-based companies to intense scrutiny and focus on loss-making distributors and undocumented management services providers in these examinations. One unique aspect of the German transfer-pricing examination process is its relatively greater emphasis on legal structure as opposed to the arm's-length principle.

Germany provides a good example of the scrutiny faced by loss-making subsidiaries, as the above report from KPMG's German member firm indicates.

Being proactive

In the current transfer-pricing enforcement environment, therefore, it is imperative for taxpayers in loss situations to prepare documentation explaining that the losses result from factors outside of transfer pricing, if this is, in fact, the case. Examples of such factors include start-up costs, an unexpectedly weak market, increasing competitive pressures throughout the taxpayer's industry, a competitor's unanticipated introduction of a next-generation product, high overhead expenses resulting from an extraordinary event, or one-time restructuring expenses. In such instances, the taxpayer's position generally is strongest when comparable uncontrolled prices (CUPs) exist that support its intercompany prices.

To sound a cautionary note, taxpayers should realize that there are potential limitations to the use of a CUP approach when in a loss situation. For example, in the German Supreme Tax Court Case No. I *R 22/04*, BFH/NV 2005 at 1719 (April 6 2005), the German court rejected a loss-making taxpayer's CUP evidence that demonstrated that its prices were consistent with arm's-length prices, ruling that the taxpayer's CUPs did not reflect commercial reality. In the absence of CUPs or other transaction-based methods for support, a taxpayer's leading defence may be to prepare arguments to explain its losses and present those arguments in an affirmative, thorough documentation study.

Year-to-year volatility in profit is another unexpected potential transfer-pricing examination trigger. Taxpayers facing this situation may believe that the volatility results from market forces that should be obvious to a tax authority and thus may not expect challenge. Other taxpayers may believe that, because the volatility resulted from an international restructuring that also generated profit shifts in other jurisdictions, the transfer-pricing planning studies and tax-planning documents supporting the restructuring should suffice under

Japan

Japan's National Tax Agency (NTA) tends to look at system profits and the division of such profits among affiliates. This approach nearly always takes the form of a "back-of-the-envelope" profit split to gauge whether the Japanese entity is earning a fair profit, as opposed to examining the testing method presented in any formal documentation. Japan's regional tax bureaus such as those in Tokyo (TRTB) and Osaka (ORTB) play a significant role both in local examinations and in Japan's advance pricing agreement (APA) programme.

examination. Unfortunately, neither view is entirely correct. In our experience, examiners closely scrutinize large annual profit swings, especially in cases involving large decreases compared with previous years' profits. In addition, because tax examiners view the functional and risk profile as the key determinant of a company's expected profitability, many may reject the assertion that market forces drive volatility in annual profits. For example, tax examiners typically assume that a captive wholesale distributor purchasing goods from its parent would assume a relatively low level of risk, and thus should earn positive profits each year. In such cases, the examiner generally would seek to attribute the risks associated with market volatility to the parent company.

Most tax examiners carefully scrutinize cases involving volatility in profits that result from international restructuring or tax planning. Examiners generally seek evidence that the new structure is legitimate (and not a tax shelter), and that the post-restructuring functions and risks that the company asserts now characterize the affiliate under examination are accurate and differ materially from its previous functions and risks.

A common misperception among taxpayers is that having similar tax rates across their countries of operation mitigates the need to prepare transfer-pricing documentation because there is little or no incentive to shift profits from one jurisdiction to another. This is a misperception because, in practice, companies can and have used transfer pricing to shift income back, tax-free, to their parent companies. Clearly, the incentive to do so might be greater if the parent resides in a low-tax jurisdiction, but even small differences in tax rates between jurisdictions provide incentives for shifting profits. Even if tax planning plays no role in setting transfer prices, each tax jurisdiction has an incentive to protect its income base from inadvertent errors in transfer pricing that may erode that base. Moreover, tax authorities are often concerned that if they have less vigorous enforcement regimes compared to other countries, taxpayers will have an incentive to leave more profits in those countries with relatively more aggressive tax regimes. Therefore, having a parent company incorporated in another taxing jurisdiction, even a high-tax jurisdiction, is another unexpected transfer-pricing examination trigger in the subsidiary's location.

Biography

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Management fees are yet another unexpected potential transfer-pricing examination trigger. Tax examiners frequently question whether the payor actually received services that provided benefits to its operations. If the payor successfully demonstrates that it received benefits from the services two issues frequently remain at the centre of such tax authority challenges. The first issue is whether a mark-up over the provider's costs is warranted. The second issue is the determination of the provider's cost base for the application of the mark-up. In many countries, the latter is of equal or greater focus than the former, and can lead to time-consuming, data-intensive examinations. Therefore, it is critical for companies engaging in management-services transactions to prepare adequate documentation to support such charges.

Where do we go from here?

Unquestionably, tax authorities are continuing to increase their level of scrutiny of companies' transfer pricing. All signs point to the continuation of this trend into the future, as transfer-pricing enforcement regimes and the levying of penalties continue to expand worldwide, both in countries with long-established transfer-pricing rules as well as in countries that are relative newcomers to the transfer-pricing arena. Indeed, even countries that have not traditionally focused on

China

While the Chinese government is a relative latecomer to transfer-pricing regulation, as it is currently drafting its documentation regulations, annual filing requirements have existed in China for some time. He Lian Tang, a senior official from China's State Administration of Taxation (SAT), stated in a speech at a recent KPMG-sponsored conference in New York city, that more than half of non-Chinese companies do not report earning any profits in China. As a result, the SAT suspects that transfer pricing is the culprit. To combat these perceived transfer-pricing issues, the SAT has created its own unique list of 10 "high-risk transfer-pricing examination triggers":

- Persistent losses
- Sudden drop in profits after tax holiday expiration
- Growing sales/investment accompanied by losses
- Inconsistent pattern of profits and losses
- Transactions with entities in tax havens
- Profit rate lower than affiliates
- Profit margin lower than industry average
- Payment of various fees to affiliates
- Substantial related-party transactions
- Decision-making controlled by affiliates.

Another aspect of China's transfer-pricing regime is the tax authority's continued use of secret comparables to benchmark taxpayers' results. As a result of the tax authority's use of secret comparables, taxpayers may be surprised to find that their results are lower than those of peers or the industry average, an important transfer-pricing examination trigger in China.

transfer-pricing are increasing their scrutiny of transfer-pricing issues in tax audits. China provides a good example of this trend, as KPMG's member firm in China reports above.

As this discussion illustrates, the factors that tend to trigger transfer-pricing challenges vary substantially across countries and in relative importance within countries as well. In this environment, in which companies must constantly adapt to changing market and regulatory conditions, it is even more important to be aware of, and react to, the potential triggers described in this discussion to manage transfer-pricing exposure.

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