Picking through the minefield: Dispute prevention and conflict resolution in transfer pricing

Advanced Pricing Agreements (APAs) are helping to alleviate the risk of double taxation. In turn, Mutual Agreement Procedures (MAPs) may offer a smoother path to conflict resolution. But neither is a panacea.

With cash-strapped exchequers fixing their sights on transfer pricing and globalisation adding to the already complex web of intra-company and inter-government arrangements, corporations still need to mount a strong and proactive defence against potential disputes. This includes making sure their transfer pricing policy justifications and associated documentation can stand up to intense scrutiny and challenge. Policies will also need to be pragmatic in balancing the trade-off between certainty, risk and tax optimisation.

So what does recent experience tell us about how to pick through the transfer pricing minefield?

Transfer pricing has always been one of the most fraught areas of tax management. An EU study in 2001 described transfer pricing as one of biggest obstacles to the single market.

The OECD guidelines have helped to formalise certain aspects of transfer pricing, but the OECD recognises that this is 'not an exact science', with considerable room for interpretation and variation around the world.

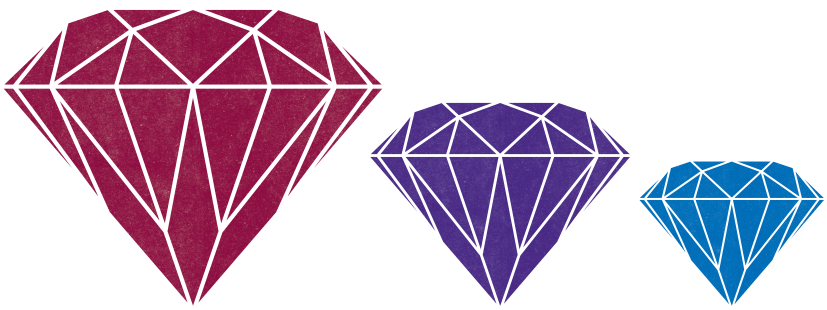
The arm's length principle of what an unrelated company would pay is often arbitrary as there may be limited empirical evidence upon which to base a transfer price. No two commercial situations are exactly the same, leading to a range of different outcomes. As almost every corporation has found to their cost, this uncertainty opens up considerable risk of adjustment and double taxation.

The impact on tax liabilities is only part of the expense. Corporations also need to consider the drain on time and resources created by disputes that can run for several years and even then may not come to a lasting or satisfactory resolution. The challenge of finding a solution is compounded by the presence of at least three potentially conflicting parties – a tax payer and two tax authorities.

Escalating risk

Fiscal deficits have sharpened the focus on transfer pricing. Many tax authorities believe that directing resources to transfer pricing yields the best returns, which is leading to an increase in the frequency and depth of investigations.

Globalisation is increasing the variety of intra-company transactions and the number of countries that need to be considered in transaction pricing strategies. Our work with a number of emerging market tax authorities highlights the different priorities and perspectives in play. Some emerging market tax authorities are taking increasingly outlying positions, even if this leads to prolonged conflicts over revenue. Cases in point include how to allocate the location savings from large new markets or supplies of offshore services for Information Technology (IT) and other services.



APA: unilateral or bilateral

APAs have emerged as a proactive strategy as corporations look to deliver greater certainty and avoid disputes (Figure 1 outlines the steps in the APA process and Figure 2 highlights the potential benefits).

Figure 1: OECD guidelines Annex to Chapter IV: Steps in the APA process

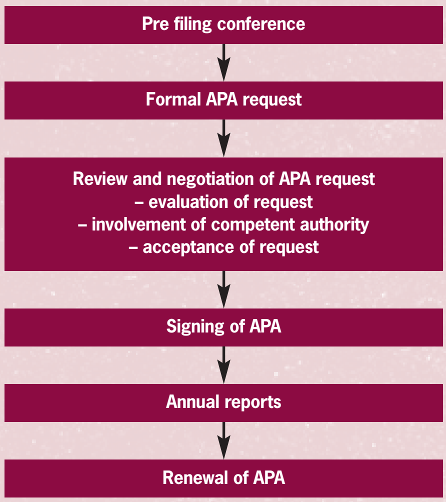
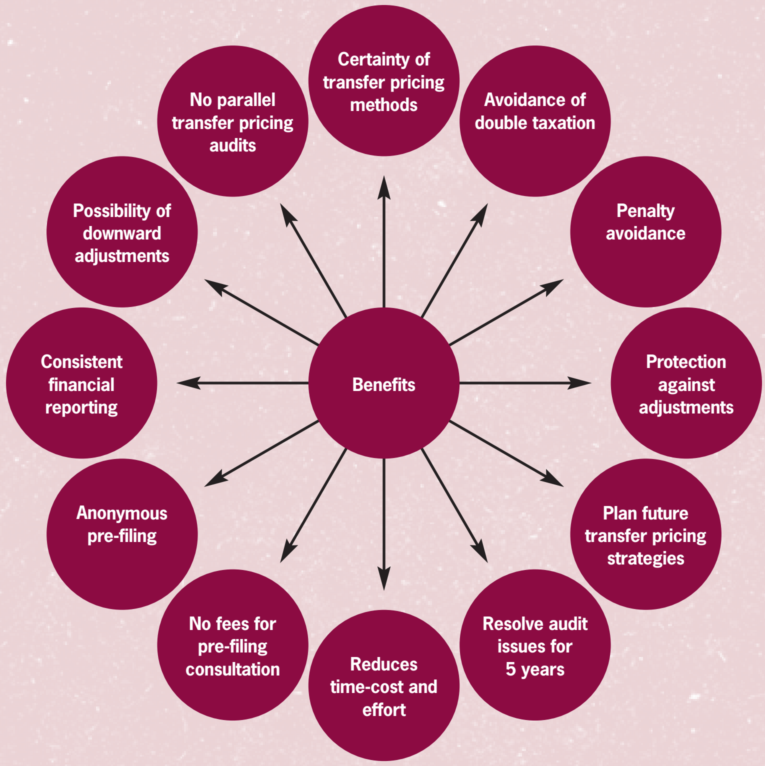


Figure 2: APA benefits



Corporations can directly present their case to one tax authority and negotiate terms for a unilateral APA. Some corporations are also seeking bilateral and multilateral APAs, which provide additional protection.

Seeking a bilateral agreement can increase the time and complexity of preparation, evaluation and negotiation. But they are generally seen as better than unilateral agreements as they can provide a safeguard against the risk of double taxation. They also offer a true arm’s length range based on negotiations at both ends, rather than negotiating a single agreement, which could be lopsided.

Nonetheless, some tax authorities are more accommodating than others. When dealing with a relatively aggressive regime like India, a unilateral agreement would have the advantage of avoiding the rigorous annual audit and heightened potential for litigation.

The nature of the agreements in particular countries is a factor. In Japan, for example, unilateral agreements are very similar to transfer pricing audits and therefore quite rare.

The choice between unilateral and bilateral agreement would also depend on the quality of the relationship between the ‘competent authorities’ in each jurisdiction. The competent authorities are experts in the tax authority delegated to act on behalf of the government. Some are more likely to see eye to eye than others, which might be reflected in the relative number of agreements in place between counterparts from particular countries.

Time is a further consideration, especially if seeking a bilateral agreement. The OECD guidelines suggest that cases should be settled ‘promptly and efficiently’. The amount of resources tax authorities can dedicate to APAs varies, which can lead to delays.

If seeking an APA, it is important to consider whether a transaction may be excluded because it is subject to an ongoing audit case.

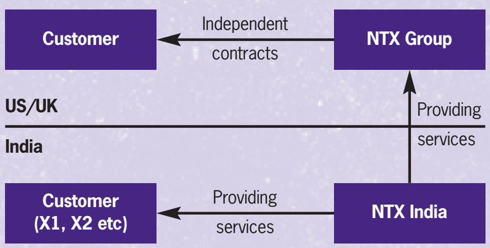
Therefore while APAs can deliver certainty, it is important to factor timings, the approach of the countries involved and relationship between the parties into choices, preparations and negotiations.

Case study: IT services

Some details of this case study have been changed and simplified for this article.

The NTX Group is an IT services and solutions provider headquartered in the UK, with offices in India as well as other locations. The Group procures the business from their clients in the respective local markets and sub-contracts it in full or in part to NTX India, which in turn develops the software offshore for the Group. NTX India directly provides IT services to the clients of the other NTX Group members. NTX India not only delivers the outsourced work for NTX UK and other NTX group members but also provides IT services to its independent third party clients (see Figure 3).

Figure 3: Service delivery model



The projects entered into by NTX India could be either time-and-material (T&M) or fixed price projects. However, the contracts with NTX Group members are always T&M. In case of T&M contracts the development effort is billed based on the pre-negotiated and mutually agreed hourly rate. However, in the case of fixed price contracts, the project fees are determined on the basis of negotiations and mutual agreement with the client, factoring in the project scope and complexity.

Current transfer pricing policy

NTX India provides IT services to NTX UK. NTX India also provides similar IT services to independent third parties i.e. X1, X2 etc. The services provided by NTX India to NTX UK are similar to the services provided to the independent third parties. As internal comparables are available (T&M contracts of NTX India with independent third parties), the Comparable Uncontrolled Price (CUP) method was implemented.

The issue

Going forward there is a possibility of all independent third party contracts being converted into fixed price contracts. In such situations, the adoption of the internal CUP method as the 'most appropriate method' may not be viable as an hourly rate would not be available and sufficient comparability under OECD guidelines not exhibited. Thus NTX proposes to adopt the Cost Plus Method (CPM) for intercompany services going forward. The CPM has previously been used to corroborate the application of the CUP method.

At present, no adjustments have been made by HMRC in the previous several years under audit, however, NTX India annual audits have always contested the idea of CUP being the most suitable model and this caused duplication of time, resources and effort, and costs year on year. The APA is being sought to resolve whether to continue to apply the internal CUP and/or move to CPM as and when CUPs are no longer available.

The group has decided to apply for a bilateral APA to seek agreement from the two tax authorities as to the correct method and, where the CPM is adopted, the mark up rates to be applied. This should give certainty going forward and save management time and effort in resolving any differences between the UK and Indian perspectives.

Uncertain resolution

If transfer pricing adjustments emerge, arbitration procedures exist within the EU. Many non-EU jurisdictions also have arbitration through their double tax treaties. Some older agreements may not have scope for formal arbitration.

MAPs allow competent authorities to negotiate a bi-partisan agreement over conflicts or areas that sit outside the tax conventions. They are an important option in dispute resolution, but the results can be mixed.

While the tax payer can present its case to the competent authority, and a clear and persuasive case will certainly be welcomed, they cannot directly participate in the negotiations.

Moreover, most competent authorities have a long backlog of cases, so the MAP is unlikely to provide a swift resolution. Even with time, the two sides may only reach a partial agreement that still includes some double taxation or indeed fail to reach an agreement altogether. Delays and difficulties with resolution are common especially where the competent authorities have different perspectives.

Another important factor to bear in mind is the time limitations. Treaties may include time limits for filing MAP claims. Local tax authorities may also include their own restrictions.

Case study: MAP on interest due

A UK company buys goods and services from its US parent, which it trades around the EU. The amount due to the US parent was left in an intercompany account, spurring the IRS to insist that the balance should be subject to interest charges. After lengthy negotiations, a settlement was agreed in which the US parent recorded the interest due in its profit and loss account for tax purposes and its UK arm recorded this as a charge in its P&L.

Her Majesty's Revenue and Customs (HMRC) in the UK subsequently rejected the charge as it argued that the UK company had no obligation to pay interest to its US parent. It also argued that any such adjustment would require an MAP. An MAP was subsequently submitted, which sanctioned the arrangement between the UK company and its parent. As the interest had been paid, no further adjustment was deemed necessary.

The MAP did thus resolve the issue, but the process took around nine months, most of which was taken up in waiting for the competent authorities to get round to the case. A more proactive approach would have saved a lot of time and expense by assessing the interest charge issue as part of the up-front transfer price strategy and managing the subsequent risk of challenge from HMRC on the agreement in the US.

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On the front foot

So how can corporations get the right balance between uncertainty and optimisation and how can they make the most of the APA and MAP procedures?

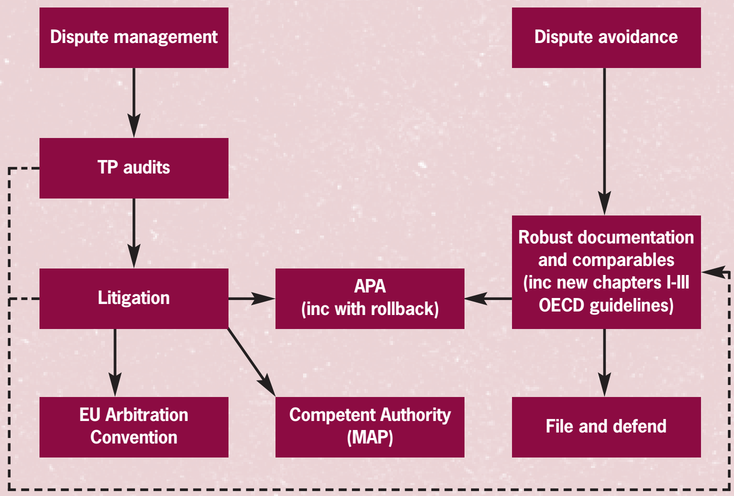
The first and most important consideration is that the onus is on the corporation itself to provide a watertight justification for its policy and the corroboration and documentation to support this – there is no room for 'chancing your arm' or 'making it up as you go'. This includes ensuring that the intra-company arrangements are in line with the economic substance of the transaction. It also includes assessing any potential vulnerabilities or areas not covered that could be open to challenge (the case study on page four cited interest on balances as an example). As Figure 4 highlights, these solid foundations provide the basis for effective dispute avoidance and management.

Preparing an APA case is a lengthy, complex and costly process and sufficient resources need to be made available. Presentations also need to be clear. It is particularly important to test the validity of critical assumptions, which if breached will mean the whole agreement needs to be revisited and may be set aside.

Corporations will naturally seek to optimise the terms of their APAs. But there is a risk that what looks good now may not be advantageous in the future as the business environment and strategies change and economic returns fluctuate.

It is important to be flexible to take account of changes in strategy and returns. Preparations should include scenario analysis to evaluate the impact of changes. Flexibility also includes not over-engineering proposals. Start with an initial meeting (which can be on a no names basis), ascertain an acceptable transfer pricing policy and work from there.

Figure 4: Considering the trade-off between tax certainty, risk and optimisation – Dispute management v Dispute avoidance



It is also important to lay all the cards on the table to secure buy-in from tax authorities. There may be particular suspicion if a corporation seeks an APA in one area (eg royalties), but not another (eg supply of goods).

In seeking a multilateral APA, a useful strategy is to tackle a 'difficult' tax authority first ('soft precedent') so that others may be reluctant to go against this for fear of being seen as outliers.

The need for a justifiable policy and the corroboration to support this is equally important if a MAP becomes required. A good foundation will make it easier for the competent authority to argue the case on the tax payer's behalf.

Conclusion

Transfer pricing policies have always been a trade-off between certainty, risk and tax optimisation, with how to ensure effective dispute avoidance and dispute resolution at the heart of the balance. APAs could provide greater up front certainty, but challenges remain in a fragmented global tax environment. Similarly, while the MAP can help to overcome disputes, there is no certainty that it will be taken up by the competent authorities or guarantee a solution.

Policies therefore need to be clear, flexible and pragmatic, taking into consideration the need for a persuasive case. They also need to factor in unfolding scenarios and changes in circumstances, the different perspectives of each tax authority and how to make life easier for overstretched competent authorities.

It is impossible to take the risk entirely out of transfer pricing, especially as overly cautious approaches could lead to damagingly high tax bills. But well-prepared corporations can eliminate any unnecessary risk and aggravation.

If you would like any further information on any of the issues raised in this article please contact the authors or your usual Grant Thornton contact.

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