

# Transfer pricing perspectives\*

The emerging perfect storm of transfer pricing audits and disputes





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## The emerging “perfect storm”

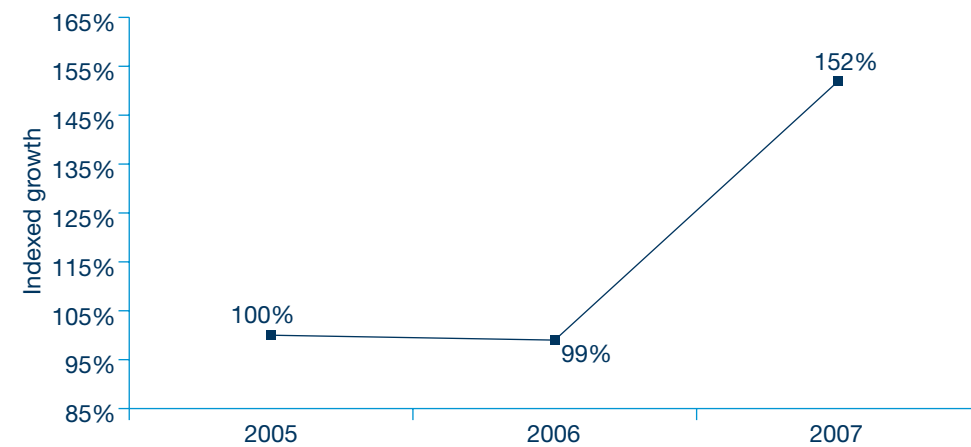
### Global tax audits, controversies, and dispute resolution

Today’s multinational corporations (MNCs) are facing the most challenging tax environment in history because of a combination of four global forces converging to create a “perfect storm.” The unstable environment created by these forces is resulting in a substantial increase in the number and size of transfer pricing audits, adjustments and disputes. This new environment places a premium on audit and dispute avoidance techniques. This paper discusses these four global forces and looks at proactive steps, including resolution techniques, MNCs can take to weather the storm.

The first of these global forces is creating a surge of transfer pricing audits and disputes around the world. Fiscal demands on developed and emerging countries (including infrastructure and entitlement demands) are placing significant pressure on governments to raise revenue and prevent base erosion. At the same time, the Organisation for Economic Cooperation and Development (OECD) has reported that tax revenue in 20 of the largest countries is near all-time highs as a percentage of gross domestic product. These factors are forcing nations to continually pursue revenue enhancement initiatives and enforcement activities to meet increasing fiscal demands. As nations step up their efforts, the number of transfer pricing audits and disputes climbs.

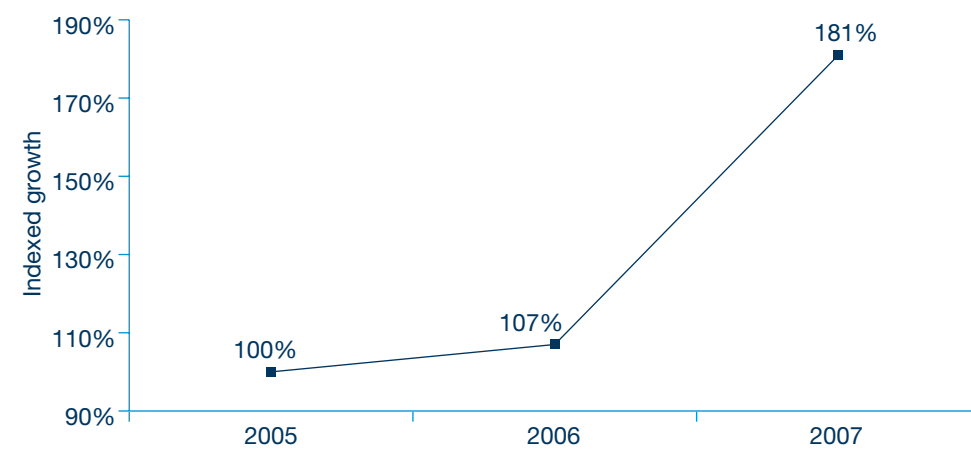
Evidence of this trend can be seen in data obtained during a client engagement by a team of transfer pricing specialists across our global network of firms. The graphs below show the trend lines for (i) transfer pricing dispute engagements, which totals in the hundreds, and (ii) a subcategory of disputes—total transfer pricing audit defense engagements—for the period from 2005-07 (with the index base years set as of 2005). We have broadly defined “disputes” for this analysis to include audits, administrative appeals, competent authority matters, advance pricing agreements (APAs), litigation assistance, and other dispute resolution alternatives.

**Total dispute resolution projects growth  
(Indexed to 2005)**



**Total dispute resolution projects:** Transfer pricing audit defense, administrative appeals, competent authority matters, APAs, other dispute resolution alternatives, and litigation assistance. Source: PricewaterhouseCoopers project tracker

**Audit defense projects growth  
(Indexed to 2005)**



**Audit defense projects:** Transfer pricing audit defense engagements. Source: PricewaterhouseCoopers project tracker

As these graphs indicate, the number of disputes remained relatively stable from 2005-06. However, in 2007 there was a substantial increase in the number of transfer pricing disputes in which PwC was engaged to assist clients, with the most dramatic increase occurring in the area of transfer pricing audit defense. Because tax audits are typically the first phase in a transfer pricing dispute, we can conclude that the other categories of dispute resolution projects also will start to show more rapid growth rates in the near future. We see this upward trend in transfer pricing disputes continuing, based on year-to-date 2008 information submitted to our internal database Project Tracker.

The second global force relates to the constant competitive pressures on MNCs to structure their worldwide business operations effectively and efficiently. These pressures include achieving efficiency expectations in corporate structures and functions; the constant search for low-cost raw materials, labor and suppliers; continuing pressure to meet earnings per share targets; competitor benchmarking; and heightened scrutiny of comparative global effective tax rates. As a result, MNCs are driven to focus on the most efficient global entity structures, operations and transactions while striving to achieve a defensible and competitive effective global tax rate.

Third, governments around the world are cooperating as never before to share taxpayer and industry information, to assist other countries with document and information requests, and to participate in multinational audits (including “simultaneous” examinations). For example, MNCs in the United States are experiencing an increased number of requests from non-US revenue authorities (e.g., Japan’s National Tax Agency) for documents and information held by US-based companies. This is a disturbing trend for many MNCs.

Fourth, MNCs are facing a new era of regulations, penalties, transparency and disclosure around the world. More than 50 nations have enacted transfer pricing documentation regimes, with more on the way (e.g., China). Those countries are increasingly examining transfer pricing transactions and documentation, and they are asserting sizeable adjustments and reassessments in many cases. In addition, with the advent of FIN 48 in the United States, MNCs are required to place greater emphasis on the identification, evaluation, and disclosure of uncertain tax positions. This has led to a transparent environment where uncertain tax positions of MNCs are disclosed to governmental authorities and the public.

These four global forces have coalesced to create an unstable climate for MNCs, resulting in a substantial increase in the number and size of transfer pricing audits, adjustments, and disputes. As part of this process, we are experiencing an unusual “commonality of issues and controversies” around the world, ranging from permanent establishment (PE) audits and controversies in India, Korea and France; to “guarantee fee” cases in Canada, Australia and Japan; to “marketing intangibles” issues in the United States, the United Kingdom and many other countries. Likewise, disputes are increasingly commonplace throughout the world concerning the allocation of management fees and the proper treatment of “equity-based” compensation in cost pools for transfer pricing purposes.

This surge in audits and disputes is placing significant strain on the traditional methods of resolving transfer pricing controversies: audit-level settlements, administrative appeals, mediation, APAs (with rollback features), competent authority negotiations, arbitration, and litigation. In addition, many experts expect that growing pressure from the FIN 48 disclosure requirements may lead a large number of companies to seek the certainty of traditional bilateral advance pricing agreements, thereby increasing the demands on APA and competent authority offices around the globe. Furthermore, the latest statistics show that more than 75 percent of the inventory of the US competent authority office relates to “foreign initiated” adjustments, and this has led to an increased Internal Revenue Service focus on the “exhaustion of remedies” by US taxpayers in non-US jurisdictions, as well as the related foreign tax credit ramifications.

This new environment places a premium on audit and dispute avoidance techniques. Transfer pricing audit and dispute avoidance includes not only the preparation of “quality” transfer pricing documentation, but also the proper structuring of entities, functions and risks; the preparation of appropriate intercompany agreements; and periodic “course of conduct” audits. In the new global tax environment, MNCs must be proactive (not reactive), and they need to adopt holistic approaches (not fragmented responses) to tax audits and controversies. These steps include implementing policies to avoid transfer pricing audits and disputes from the beginning of a project or transaction, including proactive use of APAs.

MNCs need to develop centralized points of contact within the global enterprise, and they need to apply coordinated actions in monitoring and responding to transfer pricing examinations and disputes. Because the resolution of a transfer pricing dispute in one country may have profound ramifications for the same taxpayer in other jurisdictions, MNCs need to revisit their use of one-off approaches to handling audits and disputes in their organizations. The key to achieving successful results will be coordinated global strategic planning, with local tactical implementation. If properly planned and implemented, these steps should assist MNCs in avoiding certain transfer pricing audits and disputes and ultimately achieving the most efficient and favorable results for the company.

In responding to the emerging “perfect storm,” this issue of Transfer Pricing Perspectives focuses on several important global dispute resolution topics, including recent developments involving the taxation of PEs, recommended improvements to APAs and Mutual Agreement Procedures (MAPs) around the world, and “best practices” in the global dispute resolution arena. This edition also will identify the challenges presented by “triangular” transfer pricing cases and consider the possible effect of the new mandatory binding arbitration provisions in several recent international tax treaties. This new era of global tax audits and disputes raises numerous challenges for MNCs and their advisors—are you prepared for the storm?

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## Permanent establishments:

### The definitional background

*By: Joseph Andrus (US) and Richard Stuart Collier (UK)*

Rules defining tax jurisdiction are a foundational element of any system of international taxation. Although domestic tax statutes often assert broad jurisdictional rules, which are constrained primarily by the practical limits of the country's enforcement powers, modern treaty practice has been more restrained. Under treaties, at least those based on the Organisation for Economic Cooperation and Development (OECD) model, the outer limit of a country's jurisdiction to tax the business-related income of nonresident enterprises is defined by reference to the permanent establishment (PE) concept. The fundamental contours of the PE definition are old (at least by the standards of modern taxation), and have been broadly adopted and remarkably stable for many years.

Despite the longstanding nature of these definitions, a thorough rethinking of the treaty rules relating to taxing jurisdiction is underway. This new school of thought is motivated, in part, by technological and other changes in the conduct of international business, such as the growing importance of services and globally integrated service businesses in the international economy; government perception in many quarters that multinational corporations have sometimes engaged in unduly aggressive tax planning and transfer pricing practices; and by a desire of some countries, usually thought of as capital importers or "source" countries, to claim a larger piece of the tax pie. Developments reflecting these pressures include, but are not limited to, the following:

- Various publications of the OECD, including recently released amendments to the model treaty commentary, in connection with OECD's long-running project on the attribution of income to PEs under Article 7 of the model treaty
- The OECD's ongoing business restructurings project, which recently has given rise to a separate project specifically focused on PE definitional issues
- Recent and proposed changes to the OECD model treaty commentary on Article 5 relating to the PE definition in a service business context

It is legitimate to question whether the revolutionary developments in communications technology of the past two decades and the resulting global integration of business models have given rise to a need to rethink fundamental concepts relating to jurisdiction to tax.

- The growing importance in the economy of businesses performing financial intermediary functions that operate on an integrated and virtually borderless basis
- Court decisions including those involving Philip Morris in Italy, National Westminster Bank in the United States, Zimmer in France, and several cases in India that address certain PE issues
- Aggressive and widespread audit activity in many countries involving broad assertions of taxing jurisdiction, particularly assertions of taxing jurisdiction over nonresident affiliates of a sales or manufacturing subsidiary, or a nonresident affiliate of an entity engaging in financial services transactions
- Expansion of the US APA program to cover allocations of income to PEs
- A significant increase in the percentage of pending competent authority matters involving assertions of the existence of a PE, many of which have proved difficult or impossible to resolve.

Because of the variety of these recent developments and because the OECD and government tax authorities have not pursued expansion of the rules relating to taxing jurisdiction in an integrated or holistic fashion, the current PE debate has something of a stealth quality to it. It is legitimate to question whether the revolutionary developments in communications technology of the past two decades and the resulting global integration of business models have given rise to a need to rethink fundamental concepts relating to jurisdiction to tax. However, the OECD and global tax administrators have come to the point of posing these questions in a rather roundabout manner. Therefore, one wonders whether the current exercises at the OECD and elsewhere represent mere fine-tuning of the existing rules to reflect current business conditions, or whether a more fundamental change in the administration of international tax law is underway.

### The PE definition

Under the OECD model treaty, a PE exists, and jurisdiction to tax business income is created when either of two conditions is satisfied. First, if a nonresident enterprise maintains an office or other fixed place of business in a country, it generally will be deemed to have a PE and be subject to tax in that country. Second, if a nonresident enterprise has, in the host country, a “dependent agent” that habitually exercises the power to contractually bind its principal, the enterprise will be deemed to have a PE. Under the OECD model treaty, these are the exclusive jurisdictional tests. Without either a fixed place of doing business in the source country or a dependent agent that possesses the power to contract on behalf of its principal in the source country, the business profits of an enterprise cannot be subjected to the taxing jurisdiction of the source country.

Implicit in the jurisdictional lines drawn in these provisions of the model treaty is the virtually self-evident principle that a variety of business activities, with clear economic consequences inside the borders of the source country, may be undertaken *without* bringing the enterprise inside the jurisdictional tax net of the source country. For example, the sale of products or services from outside the source country to customers inside the source country does not give rise to tax liability of the seller in the customer’s country of residence under the OECD model treaty formulation. This is true regardless of whether the purchaser of the product is related to the seller. Thus, under the traditional reading of the model treaty rules, the activities of a buy-sell distribution subsidiary almost certainly will not create tax jurisdiction over the related supplier. Similarly, the provision of incidental services by employees of an enterprise resident in the source or host country to an affiliate nonresident in the source country ordinarily should not create tax liability for the nonresident entity, provided it has no office or fixed place of business in the source country.

Moreover, the model treaty takes substantial pains to suggest that taxing jurisdictions should not be created in some situations in which the nonresident enterprise actually maintains an office or fixed place of business or a dependent agent in the source country. So-called preparatory and auxiliary activities may be performed through a fixed place of business in the country without bringing the enterprise within that country's tax net. For example, a nonresident enterprise that maintains a supply of goods at a fixed place of business inside the source country from which it fills orders does not thereby become subject to the source country's taxing jurisdiction. Similarly, an enterprise establishing a purchasing office in the source country does not thereby subject itself to the country's taxing jurisdiction. These rules traditionally have served to enhance the free flow of trade in goods and services without creating an undue tax drag.

When controversy has arisen regarding the existence of a PE, often it has been possible to resolve the controversy on transfer pricing grounds. If an allegation is made that a sales subsidiary in a local country acts as the dependent agent of, and therefore constitutes a PE of its supplier, it has been possible to resolve the controversy on transfer pricing grounds by agreeing on the amount of income to be reported by the local sales affiliate. Similarly, in a financial services context, if a broker dealer resident in Country A establishes an affiliate in Country B to originate business and develop client relationships in Country B, it generally has been possible to finesse the question of whether the Country B affiliate constitutes a PE of the Country A broker dealer merely by agreeing to allocate an appropriate share of the enterprise's global income to the Country B affiliate under transfer pricing principles.

None of this is to say that the PE rules are always clear in their application. Essentially, the factual nature of jurisdiction to tax questions has given rise to learned debate and practical controversy. Until recently, however, most such controversy could be resolved on the basis of transfer pricing/income allocation principles.

### **Pressures on the traditional rules and historical practice**

Three distinct sets of pressures have emerged in recent years testing the continuing fidelity of the international tax community to the traditional treaty rules on jurisdiction to tax business income. One of these pressures derives from developing communications technology and the consequences of that technology for the manner in which businesses organize themselves and their cross-border business affairs. Another relates to the prevalent application of tax planning strategies intended to limit taxable income in high tax jurisdictions and enhance taxable income in low tax jurisdictions, to the extent permitted by applicable transfer pricing rules. The third involves the growing economic importance of countries, such as India and South Korea, which have traditionally viewed themselves as capital importers with a strong interest in aggressive assertion of their jurisdiction to tax.

In addition, it has become increasingly obvious at a technical level that there may be stark differences between the income allocation outcome under an intra-entity approach under Article 7 and the result under a pure inter-entity transfer-pricing approach. This is because the PE allocation exercise under Article 7 often will become an all-or-nothing affair. In other words, if a PE is deemed to exist, and if one follows a "people function" approach under Article 7, 100 percent of the profits at issue will often be allocable to that PE and taxed in the location of a provider of services. However, if a transfer pricing solution alone had been applied, a lower level of profit arguably would be attributable to the location of the service provider because risk assumption and business capital would be deemed to reside outside the service provider's jurisdiction. This "all-or-nothing" feature of PE disputes makes the route of alleging a PE a more potent weapon for the tax authorities when compared with a challenge to the transfer pricing arrangements.

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The effect of these practical and technical pressures became evident during the course of OECD work on the attribution of income to PEs under Article 7. In focusing on how income should be allocated among the various branches or PEs of a financial institution, the OECD sought to adopt rules ostensibly consistent with existing transfer pricing principles. In doing so, the OECD thought it important to adopt a system that disregarded potentially artificial or modifiable activities, such as the location where financial assets are booked or financing transactions executed. Instead, it focused on the location of the people undertaking key business activities and making critical business decisions. In particular, the OECD effectively concluded that no weight should be given to arbitrary taxpayer determinations as to where, within the same legal entity, particular financial risks associated with the business were borne.

It was a short step from the adoption of a “functional substance-based” system for allocating income among branches of a single legal entity to the realization that, where separate related legal entities are involved, a similar “substance-based” result could be more difficult for governments to achieve. One of the core building blocks of modern transfer pricing rules under the OECD transfer pricing guidelines and the US transfer pricing regulations is that agreements between related entities regarding the allocation of business risks generally are to be respected by the tax authorities, provided those arrangements have economic substance. Tax administrators increasingly observed that taxpayers sometimes seek to take advantage of this principle to allocate business risks of all kinds (and the income arguably associated with those risk bearing functions) to a “principal” company operating in a lower tax jurisdiction. In some of these situations, taxpayers may seek to separate risk bearing and risk management to achieve transfer pricing results

that would not be possible if the same business operations were conducted in a single legal entity operating under the new OECD Article 7 principles. It became evident to tax jurisdictions that, rather than creating a transfer pricing system of income allocation for real branch operations that ignored “artificial” and “questionable” allocations of risk between separate related entities, a more potent challenge could be made based on a broad reading of PE taxing powers.

Tax administrators in developed markets with higher tax rates have viewed the emergence of principal company structures, involving overt allocations of business risk to lower tax jurisdictions, with increasing alarm. They also have expressed concern over some financial intermediaries that have sought to isolate business risk from operational functions by treating high tax country traders and other key personnel as service providers and allocating risk and associated returns to lower tax jurisdictions. The perception, therefore, grew that assertions of expanded taxing jurisdiction under the PE definition could be used as one tool to attack the tax structures giving rise to these concerns. Further, although the new Article 7 approach, based exclusively on people functions, may be clear in conceptual terms, its application (e.g., at the “field agent” level of discussion) can be vague and uncertain, adding further potential for the PE approach to be pressed into service. That has reflected itself in audits and tax controversies around the world. Inevitably, however, the coalescing pressures leading governments to assert expanded tax jurisdiction have reached the point of bumping up against the limits of the traditional PE definition, giving rise to pressure to reconsider the definitional rules themselves.

### The coming definitional debate

The OECD recently has indicated that it will undertake a separate project related to the Article 5 PE definition in the context of its work on business restructurings. It also recently published alternative treaty language and commentary allowing countries to assert taxing jurisdiction over service entities, even in situations where the entity has no fixed place of business in a jurisdiction. These developments are taking place only a few short years after a thorough OECD review of the challenges to the international tax system presented by electronic commerce concluded that the traditional PE rules were sufficiently robust to resolve the jurisdictional issues raised by changing business models.

It is a curious fact that, even though the PE rules are designed primarily to permit determinations as to when a global business enterprise will become subject to tax in a source jurisdiction, some of the most difficult questions raised under those rules arise in situations where a multinational group of companies has conceded it is subject to tax in the country by establishing a local resident affiliate. For example, particularly difficult issues have included: the determination of whether a local resident sales affiliate or “commissionaire” will be treated as a dependent or an independent agent of a related enterprise; the conditions under which a local sales or manufacturing affiliate will be deemed to contractually bind affiliated suppliers or customers; the conditions under which facilities of a local affiliate or customer are “made available” to the nonresident enterprise; and whether with sufficient regularity and permanence they will become a fixed place of business of that nonresident enterprise.

Also troubling is that a similar theme is emerging in situations that seemingly have nothing to do with the tax authority concerns referred to earlier. For example, where profit-splitting arrangements between related parties conducting an integrated business are in place (perhaps having been

expressly permitted by the tax authorities in relation to the transfer pricing arrangements), one can question whether it is appropriate or sensible to debate questions of the existence of inadvertent PEs.

Because these issues arise in a context where the group has conceded that it is subject to the state’s tax jurisdiction, it should be clear to all involved in the debate that jurisdictional principles are being used as a stalking horse to address more fundamental income allocation concerns. We seem to have come full circle from a situation where more flexible income allocation principles routinely were used to finesse and resolve difficult questions under the PE definition, to a world where expansive jurisdictional arguments are being used to address perceived income allocation abuses. The risk, of course, is that by proceeding in this roundabout way, the jurisdictional restraint reflected in the existing PE definition may be lost.

Expansive claims of jurisdiction to tax can have serious consequences for the system of international tax and trade. Broad, competing jurisdictional claims increase the tax and tax compliance burden on international business. Moreover, the controversies engendered by such broad claims are extraordinarily difficult to resolve. The all-or-nothing nature of a dispute over whether a PE exists makes the compromise of such a dispute in the mutual agreement process hard to achieve. Recent comments by Internal Revenue Service (IRS) officials, suggesting the IRS may become increasingly unwilling to allow foreign tax credits for taxes imposed under jurisdictional claims and other theories of non-US tax administrators with which they disagree, would seem to only heighten this concern.

As the OECD turns overt attention to PE definitional issues, these concerns should be kept firmly in mind. Notwithstanding the path that has brought the debate to the place it currently occupies, it may be a better idea to try to address the income allocation concerns of tax administrators directly, rather than expanding the PE definition to “fix” an income allocation “problem.”

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## Global best practices in avoiding transfer pricing audits and disputes

*By: David Swenson (US), Helen Fazzino (Australia) and Mauricio Hurtado (Mexico)*

“Prevention,” goes the saying, “is better than the cure.” This holds true for global tax disputes. Although it is impossible to avoid every tax dispute or controversy, it is possible—and desirable—to ensure that steps are taken to minimize the chances of an adverse audit and the related possibilities of adjustments and assessments leading to a dispute.

Disputes are protracted and expensive. In addition to the direct costs, significant management time is required by the relevant revenue authorities. Some companies find themselves the subject of recurring audits, with their transfer pricing policies being questioned in numerous jurisdictions. In addition to the significant costs and penalties that may be imposed, recurring audits may be indicative of a deeper malaise within the organization.

In contrast to recurring audits, our experience suggests that some companies can consistently get their approach endorsed by the relevant revenue authorities. Some of these companies simply have not been subject to as much audit activity as others, but in many cases the companies took proactive steps to achieve this favorable position.

It is not possible—or perhaps even desirable—to avoid all risks and disputes. Rather, the approach should be to manage risks so that global commercial objectives can be achieved within the risk tolerances of the local fiscal authorities. This article looks at steps companies should take to ensure they can receive a clean bill of health from—and avoid the costs of disputes with—tax authorities involving their transfer pricing arrangements.

### *Starting at the beginning*

From the outset of any planned development involving the cross-border creation or relocation of related corporate entities, there is a need to perform what often is called a transfer pricing study, or plan. This plan is developed for a variety of business circumstances that may include a specific function, product development or production. In the course of developing a study or plan, it is important to ensure that relevant transfer pricing issues are identified as early as possible. This should include not only a review of various “hot” issues in the specific countries concerned, but also other developments around the world. We live in an increasingly connected global tax environment, and governments are increasingly identifying certain issues and examining those issues in their tax environment. A current example of an issue identified would be matters relating to the taxation of permanent establishments (PEs).

Developing a plan should cover the suggested corporate structure and transaction flows required for the particular business activity and the identification of the appropriate transfer pricing methodologies associated with those corporate structures and transaction flows. This process should address the overall transfer pricing framework and strategy (i.e., how basic transactions are dealt with, how functions are remunerated, and how risks are moved and structured), as well as the transfer pricing modus operandi when executing business strategies and transactions. All material transactions need to be managed by the same process, using the simplest approach possible to deal with standard issues. The process also should recognize that some transactions will have significant effects. For example, issues relating to moving intellectual property from one jurisdiction to another will need to be addressed with greater particularity. Having established the fundamental approach, the strategy process can then engage the right stakeholders at headquarters and in the local jurisdictions.

### *Engaging the right stakeholders*

Depending on the magnitude and complexity of the specific business activity envisaged, the process of creating a plan will draw in a range of stakeholders. The corporate tax department is likely to drive the process of identifying transfer pricing issues, but it is also likely that a tax/transfer pricing /legal team will need to be involved as well as intellectual property specialists, particularly where there are considerable intangible assets at issue. It is essential to assemble a dedicated team of people who represent the different disciplines required and are familiar with the disparate issues involved. This will ensure that no issues are overlooked. Of course, operational functions should be part of the team because it is their business requirements that largely will drive the relevant changes.

### *A common approach*

Although the scale and complexity of projects for which transfer pricing plans are required may vary considerably, the same approach should hold true in all contexts. A meticulous approach to upfront strategy development/ transaction planning should apply as much in comparatively challenging situations—such as where a high value intangible is being transferred to a tax-favored jurisdiction—as it applies to a standard structure—whereby a product is produced in one country and then shipped to another for distribution. The steps discussed here are valid and appropriate for either one. The focus should be on proper planning to comply with local regulations and to avoid disputes.

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It is critical that the transfer pricing documentation is reflective of the economic reality as identified in the prepared corporate documentation.

#### *Building solid foundations*

When a company plans to evaluate the options for restructuring the provision of intercompany services, transfer pricing is an important element of that review. A company may conclude that certain functions should be located in particular countries and identify the transaction flows between certain entities within the corporate group. The corporate tax function must then interact effectively with the appropriate corporate operational officers, the general counsel, the human resources department and others, depending on the size and parameters of the project.

Having completed the planning phase of identifying the appropriate structures, transaction flows and pricing, implementation is the next phase. Here, it is essential that the rigor and details that have applied to the planning are translated into effective implementation “on the ground.”

Establishing the corporate entities and accurately documenting the intercompany agreements are vital. Commercial documentation precedes the establishment of the transfer pricing documents that support the various methodologies chosen for pricing, services rendered, and functions performed. The corporate documents in question should describe in detail the commercial agreements that establish the functions and risks of the respective corporate entities, ensuring the proper debt-equity ratios and intercompany agreements are in place.

Once the corporate phase is complete, the required transfer pricing policies are drafted to support the financial results and the flows of income and costs related to the functions and methodologies that are used. Although this is the phase that generally receives the greatest attention, it is critical that the transfer pricing documentation is reflective of the economic reality as identified in the prepared corporate documentation. We encounter transfer pricing documentation and agreements that do not accurately reflect the underlying corporate structures and relationships or the type of

relationships that unrelated parties would enter into. For example, a mismatch in the allocation of risks between entities creates issues for tax authorities to investigate. Worse, it could provide an entrée for them to question the commerciality of the overall arrangement. A focus on the quality of the transfer pricing documentation should not detract from attention to the quality and detail of the intercompany agreements created at the outset. Investing in that documentation is a key step, but one that can be overlooked in the concern to ensure that transfer pricing documents meet the highest standards. By this stage, completing documentation should be a simple process demonstrating that the dealings and agreements are at arm’s length.

#### *Aligning form and substance*

Matching form with substance in this way is essential. Often intercompany agreements differ considerably from the transactions that take place, and this can create significant problems down the line. To prevent this, manuals detailing standard operating procedures should be adopted, especially in the context of large projects. In one example, a multinational company (MNC) decided to migrate a global brand to a specific, tax-favored jurisdiction. Standard operating procedures were prescribed in detail that laid out what employees needed to do to ensure that substance and form were kept in strict alignment.

Once a structure is established and functionally operational, it is important to implement a periodic review to test the “course of conduct.” This review looks at a suitable time lapse to validate structures, operations and transaction flows after they have been established to ensure the match between substance and form continues to hold. Such a review also can ensure that as business develops, operational activities are not inadvertently creating a mismatch between form and substance. The testing should include an analysis of financial results and the application of the selected transfer pricing methodologies to assess whether the related structures and operations are within the appropriate range.

If a company cannot avoid an audit, taking the steps briefly outlined here will ensure that the company has high-quality, robust and consistent documentation. Today, more and more companies are taking these steps. But many are not necessarily doing so in a complete or structured way, leaving them vulnerable to audits and disputes. Focusing on transfer pricing documentation, regardless of its quality, is not enough. The commercial contracts and agreements underpinning corporate structures must be of an equally high quality to prevent or mitigate any potential dispute.

Of course, sometimes the best planning and implementation will not avoid a dispute because there is a conceptual chasm between the revenue authorities and the taxpayer. For example, this presently is the case in the United States on issues relating to cost sharing. There is a significant philosophical difference between what the revenue authorities believe taxpayers should do and what taxpayers and their advisors believe is necessary and appropriate. In such cases, no amount of careful planning or implementation can bridge the divide between the two parties. But even in these instances, making sure that the steps taken are consistent with best practices should make it possible to defend a position effectively. The steps required to do this may be: first, to identify when this situation exists; then to assess the likely risks; and finally, to ensure that the arrangement, analysis and documentation either maximize the chance of acceptance by the tax authorities or minimize the likelihood of penalties.

#### *The importance of a global transfer pricing dispute strategy*

The issue of cost-sharing identified above is just one example of a number of issues that MNCs are facing from tax authorities around the world. MNCs have operations in more countries than ever before, so there is a greater emphasis on transfer pricing. This leads to a greater probability of exposure to audits and assessments. One company with which we are familiar has 16 audits related to PEs in progress in different countries around the world; another has 30 different kinds of audits in progress worldwide. There is a new global dispute environment, and it is forcing companies to adopt a similarly global response.

In the not-so-distant past, companies tended to handle audits and disputes on a local basis. A local affiliate would handle the audit and report back on the result of a specific case. Today, a number of factors are forcing a change in that approach. Audits are emerging around the world with a commonality of issues, and the implications of settling an audit in one country can have a potentially dramatic effect in other countries. In addition, tax authorities are sharing information through mutual agreement procedures and dispute resolution processes, bilateral and multilateral advance pricing agreements (APAs), tax information exchange agreements, and wider use of tax treaty networks.

Therefore, it is increasingly advisable for a large MNC to take a two-sided and even global perspective of its transfer pricing arrangements and acknowledge that the disputes to which its activities give rise need to be seen from multiple viewpoints. In this environment, companies are realizing a significant premium attributable to global strategic planning. This type of planning typically involves a team dedicated to monitoring audits and the issues that are being raised. Team members identify “hot” issues around the world, such as marketing intangibles and PEs. They also have a centralized point of contact within the company who works with them as well as outside advisors to monitor developments on a global basis.

Some of the largest companies operate with just such an in-house transfer pricing group that uses specific tools and databases to centralize information about transfer pricing documentation for different geographies in addition to other supporting documentation such as contracts and intercompany agreements. Having the right tools and ensuring their availability is a best practice in and of itself.

In addition to collecting information and gathering relevant intelligence, global teams are taking a proactive approach to addressing their global transfer pricing strategy. For example, one company has a cascading APA approach that obtains APAs in certain countries and then appropriately leverages the results of those agreements with other countries. Of course, this approach would not be appropriate for all companies, but it exemplifies the importance of having the ability to develop and implement a strategically proactive global approach.

As global transfer pricing teams understand the specific exposures across their transfer pricing system, they can adjust their arrangements to avoid being penalized for poor arrangements in more than one country. Furthermore, they can adjust their global approaches to intellectual property management and cost-sharing.

#### *Global management of tax obligations*

In addition, teams members need to address tax obligations on a similarly global basis. They need to have an overall view of the company's opportunities to use foreign tax credits, separate country loss utilization, and foreign currency exposures and opportunities. In effect, such a global strategic plan looks at a wide variety of issues to determine where profit and loss can be located and how to resolve disputes in a favorable way. Looking at the tax attributes of a company from a global perspective creates the ability to identify the advantages and disadvantages of resolving particular disputes on the most favorable possible basis. Similarly, where operations in some jurisdictions are experiencing periods of commercial weakness, the global transfer pricing system can be altered to ensure that inadvertent outcomes do not expose the business to transfer pricing risks.

A global team also can help develop a consistent approach to economic facts and theories on a worldwide basis. Inconsistent positions previously could be used and arbitrated from one country to another. Today, however, a number of drivers are making a globally consistent approach vitally important. Governments are communicating more effectively, audits are merging with a commonality of issues and the OECD is taking a more prominent role in guiding tax policies. Consequently, developing a consistent approach around the world is rapidly becoming a necessary capability to avoid disputes with increasingly connected and well-informed tax authorities.

Today, however, a number of drivers are making a globally consistent approach vitally important.



## Mandatory binding arbitration

### A new avenue for dispute resolution or a means to increase the pressure on swift settlement of Mutual Agreement Procedure cases?

*By: Isabel Verlinden (Belgium), David Swenson (US) and Steve Nauheim (US)*

Because of a significant increase in audit, assessment and adjustment activity by tax authorities, the number of tax disputes continues to rise. As a result, the demand likely will escalate for alternative means to achieving resolution of disputes. A number of recent developments have brought the issue of arbitration as a means of resolving international tax disputes—and particularly those involving transfer pricing—into the spotlight. In Europe, the European Union (EU) Arbitration Convention has been heavily discussed. In the United States, two tax treaties (Germany and Belgium) with provisions for mandatory binding arbitration recently passed through the political approval process (a third treaty, with Canada, is pending ratification). But does mandatory arbitration represent a new avenue for resolving international disputes or will its introduction serve as a catalyst for more efficient avenues to achieve resolutions of controversies? This article discusses the background to the issues and considers the extent to which those issues may encourage or deter taxpayers and tax authorities from considering arbitration as a useful addition to the dispute resolution mechanisms used today.

#### *The Apple legacy*

As a means of tax dispute resolution per se, arbitration does not enjoy a particularly favorable reputation in the United States. This may be largely due to the outcome of a 1993 arbitration procedure between Apple Inc. and the Internal Revenue Service (IRS), in which Apple lost the dispute. Deploying the “baseball” approach—whereby the independent arbiter chooses one view that prevails over the other—the arbitration panel’s decision in favor of the IRS in the Apple case sent a chilling effect through the US business community. Although in that instance the arbitration was directed toward the resolution of a tax dispute between the taxpayer and the IRS, the unfavorable outcome for the taxpayer meant that arbitration, in the domestic context, was widely perceived as an unattractive alternative to the other means of resolving tax disputes.

### *A push for swifter resolution*

Fifteen years later, the revenue authorities and the US business community are becoming more critical of what they perceive to be a protracted timetable for the resolution of disputes between countries. They are also more critical of situations in which competent authorities seem unable to reach an agreement. Revenue authorities and businesses, therefore, see the threat of mandatory arbitration as a useful means to apply pressure on tax authorities to resolve disputed cases more quickly. This view was summed up in a letter from the Securities Industry and Financial Markets Association in response to the US Treasury Department's Model Income Tax Convention, which said: "The incorporation of arbitration procedures in U.S. tax treaties will increase the likelihood that a dispute will be resolved in MAP (mutual agreement procedures) because both parties will have the incentive to reach agreement, as neither will be able to delay indefinitely the resolution of a case."

### *Unblocking the dispute logjam*

The mandatory nature of the arbitration clauses in two new US treaties with Belgium and Germany (and the pending treaty with Canada) represents a departure from previous experience in the United States. The first treaty to which the United States was a party that contained an arbitration clause was the US-Germany Double Taxation Treaty in 1989. In that instance, arbitration was voluntary. Perhaps unsurprisingly, no relevant cases were settled through arbitration under the auspices of that treaty. John Harrington, international tax counsel for the US Treasury, outlined in testimony before the Senate Foreign Relations Committee the reasons why he believed the voluntary nature of the arbitration provision in the treaty with Germany had not been effective in seeing disputes move into arbitration. He told the committee: "Although we believe that the presence of these voluntary arbitration provisions may have provided some limited assistance in reaching mutual agreements, it has become clear that the ability to enter into voluntary arbitration does not provide sufficient incentive to resolve problem cases in a timely fashion."

Will the provisions of the new treaties generate different results? Will the availability of mandatory binding arbitration open a new avenue for dispute resolution, or will it put needed pressure on revenue authorities to improve their processes?

### *Frustration with competent authority proceedings*

Before addressing those questions, it is worth looking at the context in which these new treaties have been agreed. When disputes prove insolvable, disputing parties have recourse under existing treaties to competent authority proceedings as part of the MAPs that seek to resolve issues of double taxation between countries, among other measures. But these procedures long have been a source of frustration to taxpayers and their advisors, principally due to the average length of time that it takes to reach a resolution—generally between two and six years. Indeed, the provision in double-taxation treaties for MAPs provides only that competent authorities should "endeavor" to find a solution to double taxation. In certain complex cases, competent authorities may conclude that a solution to the double taxation in question has not been found or that more time is required to find one.

The intention behind the mandatory binding arbitration provisions in the new US agreements with Belgium and Germany may be to pressure competent authorities to reach agreement within a certain period of time. Such agreement would help prevent the need for arbitration, which occurs if competent authorities fail to reach an agreement within a set timeframe. The arbitration process will follow the "baseball" approach, under which one of the positions will prevail, with no compromise available between the competing positions of the competent authorities.

In certain complex cases, competent authorities may conclude that a solution to the double taxation in question has not been found or that more time is required to find one.

A number of indicators suggest that the threat of arbitration, rather than its use, is seen as the main lever for expediting competent authority proceedings.

#### *Taxpayers seek certainty*

Another pressure point for competent authority proceedings is that taxpayers are seeking more certainty in managing their tax risks and potential exposure to risks. One means to achieve this is through advance pricing agreements (APAs). The United States has offered an APA program since 1991, and since then many other countries have followed with their own programs. The APA process also may trigger a competent authority proceeding, which further adds to the inventory caseload for the competent authorities concerned.

So the pressure on competent authorities will continue to increase, not only because of the increase in disputes arising from audits and assessments, but also because more companies are seeking to use the APA process to achieve a measure of certainty to manage their international tax risks more effectively. Because of these pressures, the inventory of competent authority cases likely will increase, which will do little to mitigate taxpayers' concerns regarding the timetable for resolving disputes. What can governments do to expedite the competent authority process?

This is where the concept of mandatory binding arbitration may play a role, and the United States arguably has taken the lead in seeking to include mandatory binding arbitration within bilateral treaties.

#### *Many questions remain*

A number of significant question marks hang over the detail of the envisaged arbitration process and whether taxpayers will seek to make use of the new mechanism to solve their disputes. A number of indicators suggest that the threat of arbitration, rather than its use, is seen as the main lever for expediting competent authority proceedings. This perception was confirmed in the testimony of Harrington before the Senate Foreign Relations Committee on pending income tax agreements when he said: "It is our expectation that these arbitration provisions will be rarely utilized, but that their presence will encourage the competent authorities to take approaches to their negotiations that result in mutually agreeable conclusions."

To date, the progress of the three agreements through the US Senate approval process has been relatively smooth. Although the German and Belgian agreements were held up briefly during the Senate approval process in late 2007, each agreement has been approved, and the Canadian agreement is expected to be approved in late 2008. Previous treaties were rejected or held up in the United States as a direct result of arbitration clauses and some Senators' concerns, including a perceived threat to tax sovereignty that mandatory arbitration provisions may represent.

As the treaties go through the approval process, a number of key questions remain to be addressed. Until they are answered, it will not be possible to assess whether the use of mandatory arbitration is a likely new route to achieve resolution of international tax disputes or whether the threat of mandatory arbitration will be sufficient to expedite competent authority proceedings.

Questions that need to be addressed include:

- **Is mandatory arbitration truly mandatory? Is it truly "binding"?**  
Under the 1989 US-Germany treaty, voluntary arbitration was provided. But no cases were brought under it, suggesting perhaps that, for arbitration to be an effective mechanism, a mandatory element is required. The question involves the extent to which the arbitration procedure is truly "mandatory" and "binding," as taxpayers may decide not to participate in the process, or to reject the results of arbitration.
- **When should arbitration start?**  
If arbitration is to start at a defined point (such as a date based on when information necessary to undertake substantive consideration for a mutual agreement is received by both competent authorities), a key issue is how that date should be determined. Much debate has taken place in Europe in connection with the same issue as it applies to the EU Arbitration Convention. Challenge and debate over when the arbitration process should start has arisen as countries seek to prolong their ability to manage their tax decisions and policies.

- **What issues are eligible?**  
What are considered eligible issues for arbitration? There is some difference as to which issues are eligible for arbitration under the three treaty provisions in the US agreements with Belgium, Germany and Canada. Should all subjects covered by a treaty be eligible for arbitration? If eligibility should have limits, how should these be determined?
- **Should taxpayers participate?**  
What level—if any—of taxpayer participation will be permitted? Taxpayer participation in other forms of dispute resolution, including competent authority proceedings, is seen as a vital element in reaching satisfactory outcomes. Limitations on taxpayer input to arbitration may mean that taxpayers will be unwilling to make use of this potential avenue for resolving transfer pricing disputes. Taxpayers should be allowed to participate in the process in an appropriate and limited fashion.
- **How should arbiters be selected?**  
What standards will be set for selecting the arbiters, and what timetable will be established within which they need to reach a decision? Selecting the appropriate arbitration panel with members who have sufficient knowledge and standing as well as the requisite neutrality to reach a decision may be a challenging prospect. Will the relative scarcity of such individuals impose a limit on the caseload that can be realistically addressed?
- **Baseball arbitration or a negotiated settlement?**  
Deciding the arbitration approach is clearly critical. Whether to use the final offer approach (baseball arbitration), or an independent opinion approach is a significant issue. Would better outcomes be secured if arbiters were encouraged to reach a reasoned decision and opinion in much the same way as a judicial body does, or should the stress on timely resolution mean that arbiters should aim to reach a decision quickly and select one of the two final positions as they do under baseball arbitration?
- **What is the applicable authority?**  
In reaching final arbitral decisions, what should be the appropriate hierarchy of authority running from the treaty provisions to OECD principles to each country's domestic law? What priorities should be accorded to those authorities?
- **Should decisions create precedent?**  
Under the 1989 US-Germany treaty, decisions reached by the arbiters theoretically would be accompanied with a rationale for a decision that could be taken forward as precedent or, at a minimum, be considered in later cases with similar circumstances. This, in effect, would create an additional body of law above the provisions contained in the treaties. If the rationale of the arbiters were not made public, however, arbitration would not create a body of effective guidance. Further, the strict confidentiality applying to arbitration means that it would be challenging to see how a body of effective guidance and precedent could be created without making details of the arbitration public.
- **Should decisions be binding on taxpayers?**  
The decision of the arbitration panel is binding on the governments involved. Should the decisions also be binding on the taxpayers? Taxpayers may still have the ability to refuse to accept the decisions of an arbitration panel and pursue litigation if they are dissatisfied with the outcome.
- **How will effective dates be established?**  
When are the provisions under the treaties effective? How and in what order will they address pending cases? What priorities will be given to cases that have been pending for a number of years? Should those cases have the highest priority or will a "trigger" date for arbitration mean that two more years are required.

The implied threat of removing jurisdiction from the competent authorities in each country has motivated many to resolve cases within the two-year time period.

#### *The EU experience: The Arbitration Convention*

The European experience with arbitration in complex international transfer pricing disputes has a long, detailed history. The EU Arbitration Convention was implemented as a means to force resolution of transfer pricing disputes between EU member states. Conceived as a directive, which is adopted into member states' domestic legislation, the member states perceived it as a threat to their tax sovereignty and objected. As a result, the arbitration directive was withdrawn and replaced by the EU Arbitration Convention. Approval of the EU Arbitration Convention was a tortuous process but was ratified in its present form in 2004. It is extended every five years, provided that no contracting member state objects.

The EU Arbitration Convention requires competent authorities to reach full agreement on double-taxation issues arising from transfer pricing disputes. Disputes must be resolved within two years, or the matter is transferred to an advisory commission that will reach a decision within six months. Competent authorities have one final chance to reach an agreement within that time period. If they fail to do so, the commission's decision is binding on both parties. Though it is unclear how many cases have been settled by such an arbitration process, the implied threat of removing jurisdiction from the competent authorities in each country has motivated many to resolve cases within the two-year time period. Here again, it is the potential for arbitration rather than the process itself that is seen to be effective in expediting cross-border transfer pricing disputes within the European Union.

#### **The role of the EU Joint Transfer Pricing Forum**

##### *The forum's aims*

Making arbitration work in reality is a subject that continually gives rise to raised eyebrows within Europe, both for tax authorities and taxpayers. Consequently, arbitration has become one of the key topics to be addressed by the EU Joint Transfer Pricing Forum. The European Commission established this forum in late 2002. Its aim is to come up with nonlegislative recommendations to help companies operating across the EU manage their transfer pricing challenges in harmony. Besides representatives from the tax administrations of the EU member states, the forum also includes 15 business sector experts, an independent chairman, and observers (such as the OECD). After an initial two-year term, the forum was extended for another two years and was smoothly reinstated again in 2007.

##### *Achievements to date*

The proceedings of the forum have resulted in three communications. The first was a code of conduct on the EU Arbitration Convention, which aimed to enhance the convention's role as an effective tool for resolving economic double taxation within the EU. The second communication presented a code of conduct on transfer pricing documentation compliance in the region. In February 2007, the EU Commission published a third communication on the proceedings of the forum. It invited the EU Council to endorse proposed guidelines on APAs and asked the member states to implement the recommendations included in the guidelines in their national legislation or administrative rules. The purpose was also to put emphasis on dispute avoidance through upfront agreements (APAs) rather than purely focusing on dispute resolution (through arbitration) to mitigate the risk of wasting valuable management time in addressing past transactions.

#### *Where did these initiatives lead to in Europe?*

The role of the forum is to facilitate actions on both the avoidance (through APAs and robust documentation) and resolution of double-taxation issues (through making the EU Arbitration Convention work smoothly). As mentioned above, however, to date there is no convincing evidence on whether arbitration is being called upon swiftly. Even though there are no formal statistics, our experience and research suggest that an increasing number of taxpayers appear to be making requests with their local tax authorities to take their cases to arbitration. But it looks as if those requests are simply used as a means to increase the pressure for a settlement that at least partly addresses the double taxation.

Very few cases have resulted in an actual arbitration, although there have been a number of instances where a panel of arbiters has been set up and has reached a decision to resolve the double taxation, as well as cases in progress for which a panel has been set up. A landmark case involves a dispute in 2003 between France and Italy over the pricing within the Electrolux group between a manufacturing and distribution entity, respectively.

#### *Agenda*

It is clear that the business community has high expectations of the potential for arbitration to become a more easily accessible route among the array of strategic options to avoid double taxation. In this context, it will be interesting to observe the developments relating to the interaction of the EU Arbitration Convention with other procedures. For instance, the resolution of so-called “triangular cases” involving a non-EU taxpayer will be a particularly hard nut to crack. Consequently, a burning issue will be how to marry treaty developments on binding arbitration (such as in the above-mentioned US treaties) with the EU Arbitration Convention. An example of this situation might be a case in which a US manufacturing entity sells products into a Belgian logistics center, which then sells the goods to a German distributor for commercialization in the market. In such a case, even though the Belgian tax authorities might be happy with the intercompany price (perhaps under a cost-plus method for the role of the logistics center as a mere service provider), the German tax authorities might challenge the intercompany price

if the distributor’s margin is perceived as too slim. In such a situation, we reject the idea of allowing countries the free choice to “freeze” the arbitration case until an investigation under competent authority provisions with the United States has taken place. Moreover, at the end of the day, tax authorities might also have less appetite to see the case end up in a binding arbitration as it cannot lead to a “splitting the baby” type of settlement under the rules of baseball arbitration.

#### *The OECD’s plea for binding arbitration*

As set out above, under the current state of play, the MAP according to the treaty can drag on indefinitely as countries are required only to “endeavor to agree.” The OECD has stepped into the breach by urging a clear timeframe and greater certainty in dispute resolution. In 2004, only a week prior to the EU member states completing the ratification procedures to extend indefinitely the EU Arbitration Convention, the OECD released its draft progress report, “Improving the Process for Resolving International Tax Disputes.” That report suggested arbitration as a supplementary mechanism for the settlement of tax treaty disputes.

In February 2007, the OECD released the final report containing a number of proposals to improve the resolution of international tax disputes. The most important in the context of this article is a proposal to add to the OECD Model Tax Treaty a provision that calls for mandatory arbitration. Consequently, the OECD’s Committee on Fiscal Affairs has agreed to modify the basis for most negotiations between countries on tax matters by including the possibility of arbitration in cross-border disputes if they remain unresolved for two years. The business community will welcome this idea, and we sincerely hope that this will become a widespread tool for achieving effective dispute resolution within an acceptable timeframe.

Mandatory binding arbitration of international tax disputes is a new and emerging alternative. It is controversial, and its long-term effect is uncertain. The business community hopes arbitration proves a viable alternative for resolving disputes on a more timely and cost-effective basis.



### Examples of triangular cases

The following examples show some of the circumstances under which triangular cases may arise:

The first (Figure 1: Example 1) shows an instance where research and development (R&D) activities are carried out by an entity in Country A and a license of the technologies is provided to a related entity in Country B, where the manufacturing takes place. The finished products are then transferred to Country C for sales and distribution. Historically, transfer pricing adjustments would involve only one leg of these transactions (i.e., from A to B or from B to C). Increasingly, however, we are seeing situations in which a transfer pricing adjustment is made in one country but has an effect in two other countries.

Fig 1: Example 1

Transfer pricing examples of “triangular cases”  
(all entities are “related parties”)

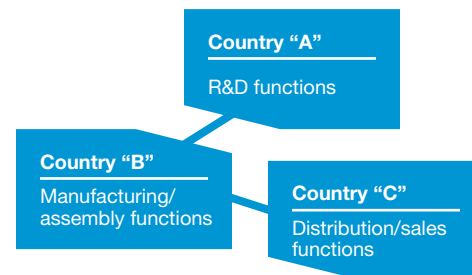
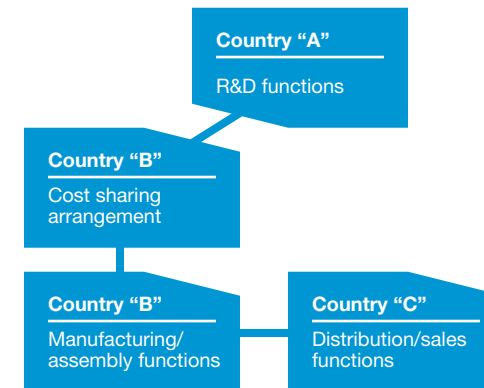


Figure 2: Example 2 shows an entity in Country A that is engaged in R&D activities with a related entity in Country B. Their relationship is structured through a cost-sharing arrangement. Another related entity in Country B manufactures and assembles the final product. The finished goods are then passed to an entity in Country C, which is responsible for sales and distribution. This example shows how two entities in the same country (in this case Country B) can also contribute to the creation of a triangular transfer pricing case.

Fig 2: Example 2

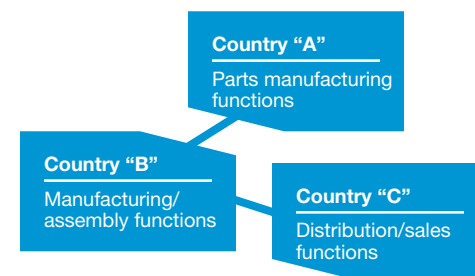
Transfer pricing examples of “triangular cases”  
(all entities are “related parties”)



Many other structures and operating systems may give rise to triangular cases. What triggers a triangular case? A simple instance is shown in Example 3 below. Here, tax authorities in Country C (where the entity responsible for distribution and sales functions is located) conduct an audit and conclude that the price paid by the entity in Country C for the manufactured goods purchased from the entity in Country B is too high. Accordingly, an adjustment is made to that price. That adjustment means that the entity in Country B should reduce the price for the product in Country B, thus reducing its income in Country B. The difficulty arises when Country B decides that, as a result of the adjustment by Country C, Country B also needs to make a transfer pricing adjustment. This effectively suggests that the amount paid to Country A for the parts, or the amount of the cost-sharing or royalty payment to Country A, has been overstated and, therefore, an adjustment is made to the Country B entity to reflect that assessment, potentially triggering a correlative adjustment to the entity in Country A.

**Fig 3: Example three**

**Transfer pricing examples of “triangular cases”**  
(all entities are “related parties”)



The amount of profit in the economic family of the three or more parties is a constant. The question is how the pool should be divided to reflect a fair allocation among all of the affected parties. The allocation of profit is, in effect, a “zero-sum” game. As more countries show interest in transfer pricing issues and audit transactions and raise assessments to maximize their share of global tax revenue, these economic considerations will become more pressing.

Although these situations are rare at present, we believe these types of cases will increase steadily. The emerging world of complex R&D pushes products through multiple countries. As a result, multinational corporations—as well as tax authorities—will be faced with a number of challenges as they address these triangular cases.

*What are the issues?*

The issues raised by trying to address and resolve triangular cases are procedural and substantive.

Is it possible, for example, to create a tripartite mutual agreement procedure (MAP)? Tax treaties generally operate between two countries. Although each country involved may have tax treaties with the other countries, these treaties will not address the relationship among three or more countries. Therefore, the procedural issues include how the resolution of such a case will proceed. Is there a sequential order to be followed? If so, how is it established? In the example described above in Figure 3, would a MAP be instituted between the first two countries (B and C), and then, depending on the result of that process, would a new competent authority matter between the other two countries (B and A) be required? Or, should there be a more creative approach that rolls together the issues from the beginning?

The emerging world of complex R&D pushes products through multiple countries. As a result, multinational corporations—as well as tax authorities—will be faced with a number of challenges as they address these triangular cases.

This approach may offer hope, but it does not satisfactorily resolve the essential problems at the heart of multilateral disputes. It is, undoubtedly, a subject to which the OECD will need to turn its attention.

These questions create considerable uncertainty for taxpayers. Given the time it already takes for competent authorities to reach agreement in some cases, the possibility of consecutive treatment suggests the prospect of a long time lapse between the adjustment and its resolution.

Many of the same challenges apply in the context of binding arbitration. Would arbitration(s) among the parties in the dispute run concurrently or consecutively? Or, should involvement occur simultaneously? What procedures should be adopted if two of the countries are in the European Union (EU), where the Arbitration Convention applies, and the third country is outside the EU? What type of methods should be used in these triangular cases to resolve the substantive transfer pricing issues? Should each country apply its own domestic rules to resolve the dispute, or should a new “integrated method approach” be developed? To date, there have been few cases to address these problems. But relevant indicators suggest that the number will rise, requiring more solutions.

The Organisation for Economic Cooperation and Development (OECD) Convention does not deal directly with triangular cases. However, it may be possible to apply its language and intent to a triangular case. This approach may offer hope, but it does not satisfactorily resolve the essential problems at the heart of multilateral disputes. It is, undoubtedly, a subject to which the OECD will need to turn its attention.

#### *The EU Joint Transfer Pricing Forum*

The EU Joint Transfer Pricing Forum is one of the few international bodies to date that has specifically addressed the issue of triangular cases. The forum looked at triangular cases in the context of the EU Arbitration Convention. The forum’s paper examines the possible effects triangular cases will have on the way the Arbitration Convention works. Specifically, the paper argues that triangular cases should not be allowed to influence the operation of the Arbitration Convention, particularly in light of the perceived benefits the Arbitration Convention has conferred by expediting the resolution of competent authority proceedings.

The paper also argues that a number of pragmatic solutions could prevent the need to alter the Arbitration Convention to accommodate the possibility of triangular cases. These suggested solutions include an additional MAP between the additionally affected countries, extending the workings of existing bilateral treaties to third parties, or even an extension of the Arbitration Convention to a third state.

#### *Practical cooperation required*

It is clear that the challenging issues at the heart of triangular cases are likely to increase as global trade expands and economic pressures mount. Practical and swift resolution of the issues will be needed if multinational taxpayers are to avoid bearing a heavier burden of uncertainty on the development and execution of their tax and business policies. International cooperation and willingness to compromise will be required from tax authorities if those aims are to be realized.



## Advance Pricing Agreements and Mutual Agreement Procedures

### Steps businesses and governments can take to improve the systems

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With fiscal deficits at record levels in major countries, governments face tremendous pressure to enforce tax laws and maximize their tax revenue. Governments are cooperating internationally to exchange information about taxpayers, and multinational corporations (MNCs) are subject to simultaneous tax audits. Tax conflicts relating to the development and use of technology and marketing intangibles also exist between developed and emerging countries. As a result, MNCs are facing a daunting array of rules concerning documentation of transactions, disclosure of financial information, transparency of tax issues, analyses of tax reserves, and reasoned conclusions regarding tax exposures. These global forces are leading to a dramatic increase in tax audits, disputes and tax adjustments around the world. At the same time, there are significant competitive pressures on MNCs to operate efficiently and to produce a competitive global effective tax rate.

The world needs efficient mechanisms to enhance and secure international economic relationships, thereby leading to more certainty in an uncertain environment. The importance of abolishing double taxation is obvious in this context. Advance pricing agreements (APAs), mutual agreement procedures (MAPs) between competent authorities, and arbitration procedures serve this goal.

This article analyzes how taxpayers and governments can improve the use of these international or supra-national procedures to resolve disputes. It describes what conflict theory has to add to the problem of international tax conflicts, and it looks into developments in international institutions and in countries influencing global opinion. Finally, it addresses how taxpayers and governments can enhance the current dispute resolution mechanisms.

### *Improving conflict results*

Conflict theory suggests that basic elements in any dispute are power, rights and interests. When it comes to power as a method for resolving tax disputes, the relationship between a taxpayer and the tax administration is asymmetrical. The former holds most of the information while the latter can avail itself of the wide formal powers it enjoys under tax laws. This imbalance results in different perceptions of respective powers. Determining who is more powerful is an inefficient tool in resolving tax disputes because each side's perception of the power balance may result in investments in unwarranted additional resources.

This leaves rights and interests as elements for solving a dispute between taxpayers and tax administrations. Traditionally, determining who is "right" through a legal dispute has been seen as the preeminent means to resolve tax conflicts. If the tax administration makes a claim that the taxpayer rejects, the dispute may end in court. The advantage of this is that the responsibility for resolving the dispute rests in the hands of a neutral arbiter. But this approach also has a number of weaknesses.

The first weakness involves allocation of resources. Parties to a dispute may disagree on facts and circumstances or on the merits of those facts and circumstances. The court (not having any means to conduct independent investigations) has to decide which facts are correct and determine the merits of the circumstances. Only after considering the merits can the court apply an independent standard, such as tax laws. Moreover, analysis of facts and circumstances requires disputants to dig into the past, which diverts resources away from working to improve the situation for the future.

A second weakness of determining who is "right" is that the tax laws—notably in transfer pricing cases that rely on the arm's-length standard—are rarely

clear. As the Organisation for Economic Cooperation and Development (OECD) reminds us, transfer pricing is not an exact science and requires the exercise of judgment by tax administrations and taxpayers.

A third weakness is the time taken to conclude court disputes. Unlike most tax disputes, a transfer pricing controversy is not a one-off issue but covers many years. As long as the court has not rendered its decision for the financial year in dispute, the controversy will continue into the following financial years. Therefore, the ability of courts to reach a timely decision is a major concern.

A final weakness is that either party to a case, and notably the taxpayer, may be unhappy with the court's decision. Although it relates to prior financial years, the court's decision sets the standard for future years, and the taxpayer's accounting system may be a barrier to meeting this standard.

In addition to power and rights, reconciling interests is the third way to resolve disputes. In this approach, the disputants try to reach an understanding of each other's aims rather than simply adopting intransigent positions. This approach requires disputing parties to share information, views and concerns. The tax director may seek certainty on whether the tax administration will accept the taxpayer's transfer pricing model so he or she can sign off on the company's new accounting system. The tax administration may be instructed by the government to reduce compliance costs for taxpayers and the tax administration alike.

Reconciling interests as a way to resolve tax disputes is gaining momentum at a rapid pace, but it is not without its challenges. Taxpayers may hesitate to share information and possible settlement directions with the tax administration due to concerns that their openness may be used against them. To overcome this barrier when discussing mutual interests to resolve

Reconciling interests as a way to resolve tax disputes is gaining momentum at a rapid pace, but it is not without its challenges.

During the past 15 years, the value of these programs has been accepted, and, increasingly, litigation has been viewed as the option of last resort.

their disputes, taxpayers and tax administrations may use confidentiality agreements that state that options discussed and solutions offered remain strictly between the parties. Confidentiality agreements can help ensure that negotiations will not be shared, even with the court, in the event that parties do not find a mutually acceptable solution and resort to litigation. Confidentiality agreements allow taxpayers and tax administrations to open up and share their interests, so that for the first time in the controversy, they understand the other party's position. Experiences in the Netherlands show that discussing interests in this way is possible. Indeed, tax administrations can exercise restraint when the company offers information or settlement directions in an effort to reconcile interests. These experiences show that this method is beneficial for both parties. It solves transfer pricing disputes from previous years and offers the possibility of reaching an APA.

In conclusion, reconciling interests may be a cost-effective, quick alternative to resolving transfer pricing disputes between taxpayers and tax administrations. APAs and MAPs offer an existing legal framework for this alternative. During the past 15 years, the value of these programs has been accepted, and, increasingly, litigation has been viewed as the option of last resort. Empirical evidence indicates that, despite a substantial increase in transfer pricing audits and controversies, transfer pricing litigation has declined in many countries. The cost of litigation, the lengthy process and the inevitable uncertainty make litigation an undesirable alternative for both taxpayers and governments. In the new environment of financial disclosures related to uncertain tax positions, companies are anxious to avoid many years of uncertainty with respect to material tax risks and exposures. Therefore, APAs and MAPs have become two of the primary alternatives to resolve transfer pricing disputes.

#### *International developments: OECD*

Traditionally, resolving international tax disputes has been based on the MAP of the OECD Model Tax Convention. The MAP is used to solve existing or expected double-taxation cases. The OECD also has published its guidance on APAs in its transfer pricing guidelines.

On its website in 2007, the OECD published guidance on the correct conduct of MAPs. The document, "Manual on Effective Mutual Agreement Procedures (MEMAP)," is intended to be part of broader efforts to improve existing international tax dispute procedures. The basic philosophy of MEMAP is to investigate and identify best practices for MAPs and publish them as guidance. The goal of the MEMAP is to increase awareness of MAPs and how they should function between taxpayers and tax administrations, particularly addressing the key issues of a practical approach and greater consistency of MAPs. Although the status of the MEMAP is fairly low, the power of best practices should not be underestimated. The OECD's goal for the MEMAP is an ongoing development process, and other measures are taken when necessary.

Also in 2007, the OECD adopted a report dealing with tax treaty disputes and their resolution. In this report, the OECD announced that it will amend its Model Tax Convention (in the update due later in 2008) to offer taxpayers the option of bringing unresolved issues to arbitration two years after presenting the case to the competent authorities of the two countries involved. The OECD proposes that both countries appoint one arbiter, and the two collaborate to appoint a chair. The OECD also states that, if appointments are not made, the OECD will appoint the arbiters at the request of the taxpayer.

The proposed arbitration procedure is not an alternative or additional mechanism to a MAP. It has been designed as an extension of a MAP and addresses only issues that have not been solved during regular MAP negotiations.

When designing the proposed arbitration procedure, the OECD acknowledged differences in countries' tax policies and how they organize their tax administrations. Therefore, the proposed amendment will create only a framework for different types of arbitration procedures that countries may include in their tax treaties. In addition, countries that are members of both the European Union (EU) and the OECD have to modify the arbitration procedures to fulfill their obligations under the EU Arbitration Convention. This means that broader adoption of the proposed arbitration procedure depends on the goodwill of the OECD member states. Although it might take several years before arbitration becomes a core part of tax-dispute resolution mechanisms, it is clear that the MEMAP and the proposed arbitration procedure are important milestones in developing the functionality of the OECD's Model Tax Convention.

#### *International developments: EU*

Completed in 2001, the EU's major research project on member states' corporate tax regimes concluded that transfer pricing and double taxation are significant obstacles to the development of a European internal market. Therefore, the EU established the Joint Transfer Pricing Forum to create soft-law tools to be implemented in member states' national legislation.

To date, the forum has launched three reports. The first report is a code of conduct and solves interpretation issues with respect to the EU Arbitration Convention. Its goal is to ensure that the convention operates more efficiently, but delays in implementation by member states have meant that this remains an aspiration rather than a reality. The second report also takes the form of a code of conduct and harmonizes member states' requirements for transfer pricing documentation. This code has been implemented into several national legislations. In its third report, the forum presented its results in the field of dispute avoidance and resolution procedures, as well as guidelines for APAs. Although only recently published, several member states have indicated their willingness to launch national APA programs.

Codes and guidelines are sources of soft law. Codes are political commitments of the member states that will not affect their rights and obligations or lead to division of legislative powers between the member states and the EU. Guidelines have a similar kind of binding effect.

#### *Other international institutions: United Nations and International Chamber of Commerce*

The UN Committee of Experts on International Cooperation in Tax Matters recently has started to discuss dispute resolution. The goal of this committee is to follow and evaluate development of the OECD in the dispute resolution area and possibly include similar provisions into the UN Model Tax Convention. The International Chamber of Commerce is conducting a tax dialogue with other operators in the field of international tax law and in several policy papers has supported taxpayers' rights to arbitration procedures, especially in the area of transfer pricing.

#### *Developments in influential countries*

As tax administrations have increased their focus on transfer pricing, different interpretations of the term "arm's-length principle" have driven disputes. Resolving those disputes has proved to be time-consuming and a strain on taxpayer and tax administration resources. Both taxpayers and tax administrations have recognized a need for change.

The first significant area of change was the introduction of APA programs where taxpayers and tax administrations could agree on transfer pricing methodologies on a prospective basis. Not only do APA programs provide certainty for taxpayers and reduce audit time, but also they slow down the growing number of double-taxation cases that competent authorities have to negotiate under the MAP contained in most tax conventions.

In the late 1980s, several countries, including the United States, Canada and Australia, began discussing the mechanics of adapting APA programs. During 1990 and 1992, Canada entered into a pilot program with the United States on two APAs, but the first APA concluded was between Australia and the United States in 1991.

In 1994, the members of the Pacific Association of Tax Administrators, representing the tax administrations of Australia, Canada, Japan and the United States, developed bilateral advance pricing agreement (BAPA) guidelines, which became an annex—“Guidelines for Mutual Agreement Procedure (MAP) APAs” to the OECD’s Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. The mechanism for tax administrations to communicate with one another was the MAP in the OECD Model Tax Convention.

Other countries began to see the benefits of an APA program, and gradually the number offering an APA program increased, but they took different approaches in their implementation processes. For example, some countries insist on annual reporting requirements as part of the APA that they will review in lieu of an audit. Others omit such stipulations. There are plenty of examples of divergent approaches. For instance, Canada recently announced that it will not consider a “rollback” of the methodology agreed upon in a unilateral APA; whereas countries such as the United States will allow the use of a rollback procedure in certain situations.

Additions to the growing list of tax administrations adopting an APA program include Germany, which released on October 5, 2006, a comprehensive circular on APAs, combined with the creation of a central team of tax officials fully dedicated to dealing with APAs and MAPs; Turkey, which instituted an APA program for taxpayers registered with the Major Taxpayers Tax Office, which became effective January 1, 2008; and Portugal, which plans to introduce an APA regime in 2008.

China, which concluded its first unilateral APA in 1998, recently enhanced the legal status of an APA under the Unified Corporate Income Tax Law (UCIT), effective January 1, 2008. Even though China has completed more than 150 unilateral APAs, there have been only three BAPAs, with two being completed in 2007. It is anticipated that the formalized transfer pricing laws under the UCIT will result in more BAPAs as taxpayers seek certainty from potential double taxation.

The administrations in Sweden, Finland and Denmark are investigating the possibility of adopting formal APA programs. (Denmark is willing to enter into informal APA negotiations with taxpayers.) In the meantime, competent authorities in Sweden and Denmark may accept foreign unilateral APAs that become bilateral based on the MAP included in the relevant tax convention. Although the situation has not arisen, Finland potentially may also accept foreign unilateral APAs. Finland also has a domestic advance tax ruling program available to taxpayers looking for certainty with respect to transfer pricing.

Countries with mature APA programs have implemented changes as enough time has elapsed for both the tax administrators and taxpayers to identify weaknesses and areas for improvement. Tax administrations are facing challenges to balance the desire to make their APA programs more attractive to taxpayers while implementing changes to protect against potential abuse.

Since APA programs began, taxpayers have been concerned about the amount of time required to complete an APA and often perceive the costs to outweigh the benefits. To address these concerns, the United States and Canada have increased staff in an attempt to decrease the time to complete an APA. Furthermore, in 2004, Canada introduced the APA First Step program, which involves the revenue authority visiting large taxpayers not taking advantage of the APA program to promote it.

The introduction of simplified, less onerous programs targeting small taxpayers is a further development. Such programs are aimed at taxpayers whose relatively low levels of transaction complexity and volume mean that they would not otherwise request an APA because of the cost involved. The United States was the first country to release such a program. In 2005, Canada followed suit with a small-taxpayer APA program that offered a unilateral APA with a simplified process that includes the opportunity to have the Canada Revenue Agency (CRA) perform the economic analysis. To date, only about seven taxpayers in Canada have taken advantage of this program. France also recently introduced a simplified program for small and medium-sized enterprises.

Countries also are conducting public forums to discuss improvements to their APA programs. In 2006, Canada held one, where recommendations were made for revisions to the guidelines and for program changes. In November 2007, Australia also sought public input, hosting a forum for taxpayers and tax professionals to discuss, among other transfer pricing issues, the APA program. At this forum, PricewaterhouseCoopers' appointment to conduct an external review of Australia's APA program was announced.

On the other hand, tax administrations have made changes that taxpayers may perceive in a less positive light. On June 25, 2007, Japan's National Tax Agency (NTA) issued expanded guidelines relating to transfer pricing that included the following provisions relating to APAs:

1. The NTA may refuse to process an APA application if certain requested financial information for the Japanese company's foreign related parties, or any other information, is not provided.
2. The NTA may also refuse to process an APA application if it lacks an economic rationale (i.e., a transaction where the agreement between the parties is not supported by the economic substance revealed by a functional analysis).

In addition, the United States introduced a simplified structure that resulted in higher fees. Also, owing to fears that taxpayers may inappropriately use the APA program, there are discussions that a congressional committee may review and approve APAs with large transactions.

Canada now requires a submission within three months of a prefilling meeting because some taxpayers were attending prefilling meetings, delaying submission, and then deciding not to proceed, causing the CRA to lose the ability to audit some prior years. Furthermore, Canada will not accept a taxpayer into the program until after the submission has been reviewed. Other changes implemented by Canada exclude the rollback of agreed methodologies with unilateral APAs and the tightening of the number of years a rollback can be applied in BAPAs.

#### *MAPs and APAs: tax directors' concerns*

MAPs and APAs offer extensive opportunities to optimize the overall tax burden as well as to achieve further benefits such as reducing compliance costs and gaining "certainty" in a risk-adverse climate. Nevertheless, companies often hesitate to initiate these procedures. Why do companies sometimes seem to view the advantages of MAPs and APAs as overshadowed by potential downsides?

Tax directors have expressed their concerns about triggering the attention of the tax administration of the second country when initiating MAPs. This aspect has to be considered particularly when the business model and the transfer pricing documentation do not fully comply with local standards. Companies in this situation often prefer to start unilateral settlement negotiations and sometimes are willing to accept double taxation rather than risk a tax audit in the other country. If companies adopt this position, they are still vulnerable to retrospective transfer pricing audits that will cover the same financial year. There is a good chance that the deadlines for filing an MAP will have expired by then with the result that the company may be hit by transfer pricing adjustments on both sides of the border without any recourse to a MAP.

Tax directors have expressed their concerns about triggering the attention of the tax administration of the second country when initiating MAPs.

Tax directors have expressed the same concerns about APAs. Will an APA trigger a tax audit in either country? This possibility cannot be ruled out, and its likelihood may vary by country. When considering calculating the risks, two aspects need to be considered. First, conducting tax audits at the start of an APA application will be detrimental to the country's APA program. Secondly, almost all tax audits pay detailed attention to transfer pricing issues so that the issues also will be examined outside the MAP/APA arena. Companies may prefer to discuss issues on a contemporaneous basis rather than discuss facts and circumstances of years past. In this context, tax administrations enjoy wide formal powers that they may be tempted to invoke with respect to issues arising from previous financial years with far less respect to current issues.

Tax directors also have expressed concerns about data requests by tax administrations in relation to MAPs or APAs, especially if those data requests exceed what they would normally expect during tax audits. (It should be noted that the OECD calls upon countries not to ask for more information during APAs than during regular tax audits.) It has been suggested that such thorough data requests are driven by the limited experience of local tax auditors in the area of transfer pricing. Our experience suggests that taxpayers can benefit from requesting the support of the more experienced APA team and competent authority of a country in analyzing the company's transfer pricing model rather than trying to solve the issue with the local tax administration of the same country. The application of an MAP or an APA requires a country to bring more experienced people to the table, which helps in finding an efficient solution to the dispute.

Other companies may consider waiting until the subject of an APA is raised in a tax audit. This approach may be driven by a shortage of internal resources to deal with the APA process. However, in view of the increased focus of tax administrations on transfer pricing issues, such an attitude is rarely appropriate. By not taking action on a frequent basis, the company may expose itself to difficult debates with respect to financial accounting, issues of formal tax laws (notably, burden of proof), and deadlines for MAPs. Therefore, a shortage of internal resources may backfire in the long run.

A difficult relationship with the tax administration influences the company's willingness to start MAPs and APAs, especially when prior contacts have damaged trust. Nonetheless, companies are aware that, in the absence of clear standards in transfer pricing, personal opinion plays a decisive role, both within companies and tax administrations. Some parties hide behind formal and legal positions rather than dealing with the economic aspects of their disputes. The best way to respond may be to deal with it contemporaneously rather than taking past experiences into account.

In conclusion, it is fair to say that companies that do not look into using MAPs and APAs are not using all possible means to manage their effective tax rates, to reduce exposures, and to gain certainty.

#### *Improvements to APAs and MAPs*

In the present environment, two of the most frequently used alternatives for resolving transfer pricing disputes are APAs and competent authority MAPs. This section will first discuss basic improvements to the APA programs around the world, followed by a discussion of suggested improvements for competent authority MAPs.

Companies are aware that, in the absence of clear standards in transfer pricing, personal opinion lays a decisive role, both within companies and tax administrations.

### *APA Programs*

Despite the existence of APA programs in more than 20 countries and the wide acceptance of APAs, many improvements are necessary. Of course, APA programs vary from country to country, and many countries have continued to strengthen their APA programs over the years. Nevertheless, virtually all countries can improve their existing programs, and the recommendations below include primary areas that deserve attention. Many other recommendations could be offered, but in our experience the areas discussed below are among the most important.

- 1. Proactive use of prefilling conferences.** Prefiling conferences are extremely important tools for taxpayers and governments. We recommend that all countries use (if not require) these meetings in all but the simplest APA cases. Prefiling conferences should not be limited in number or scope, and taxpayers should be encouraged to use these meetings proactively to facilitate an early understanding of the case. Prefiling conferences usually assist in bringing the parties together to enable an understanding of the key issues and to facilitate the filing of a more complete APA submission. Furthermore, all potentially contentious issues should be identified at the prefilling conference, including those outside the realm of transfer pricing. Taxpayers should be encouraged to provide a complete set of materials and should identify all critical facts. In addition, in BAPAs, tax authorities should encourage taxpayers to engage in similar prefilling conferences with the revenue authorities of the other relevant country. These prefilling conferences should facilitate in filing a more “agreeable” APA submission.
- 2. Comprehensive APA requests and simultaneous filings in BAPA cases.** The two most frequently voiced complaints about the APA process in many countries are that the APA negotiations take too long and the process is too expensive. Much of this is unavoidable and relates to the inherently factual

nature of transfer pricing and the quasi-adversarial positions of the parties in the negotiations. Furthermore, the cost of an APA must be compared with the substantial cost of properly managing an audit of the issue by the revenue authority, responding to any proposed adjustment emerging from the audit, and the pursuit of one or more alternative dispute resolution methods to settle the controversy. One recommendation to address taxpayer complaints concerning the length of time involved is for taxpayers to file a comprehensive and complete APA request from the outset of the process, with all the facts, issues, methods, critical assumptions, economic analyses and other critical data completed and filed from the first day. In addition, in bilateral cases, governments should encourage taxpayers to file the APA applications simultaneously in both countries. This will facilitate each country starting about the same time and from the same point of reference, which should assist in moving the case through the bilateral process as quickly as possible.

- 3. Early agreement to case plans and adherence to deadlines.** It is important to taxpayers and revenue authorities that a number of project management techniques are employed to expedite APAs. In this regard, tax authorities should require the parties to agree to a case plan within the first 30 days of filing the APA application. From a timing perspective, it is extremely important for the government’s APA team leader to propose the draft case plan early in the process and obtain the taxpayer’s agreement. Among other items, the case plan should contain a series of deadlines for milestones in the process. Strict adherence to these deadlines is essential. This process is a two-way street. Any deviations from the case plan should be approved by the APA program leader. In addition, a representative from the competent authority’s office should be part of the government’s APA team from the beginning of the process and should attend all of the substantive meetings.

- 4. Industry specialization.** Many industries operate with unique terminology, governmental approvals, and special regulations. Therefore, possession of relevant industry experience by members of the government's APA team will reduce the time for processing the APA request and should reduce the expense of the process. Ideally, APA team leaders should have strong personal "industry experience" so that they have a better understanding of the case and can be more prepared to expedite the negotiation of the APA. In some countries, it may not be possible to find an experienced team leader. In these cases, other members of the government APA team should have such expertise, and, if an economist is assigned to the case, it is particularly important for the economist to be experienced in the relevant industry.
- 5. Proactive use of subgroups in large APA cases.** Effective APA project management of large cases requires not only the use of pre-filing conferences, strict adherence to case plans and industry specialization, but also the use of specialized subgroups. Using subgroups and smaller working committees should be standard practice in large APAs. These subgroups can be devoted to such areas as comparable company identification and selection, critical assumptions, asset intensity adjustments, economics, accounting methods, and analysis of written agreements. In these large cases, it is not necessary or practical for all members of the APA team to be involved in every issue. In many cases, these subgroups will increase the overall understanding of the facts, reduce conflicts and move the case forward to completion in a timely manner.

- 6. Taxpayer participation.** Taxpayers should fully participate in the APA process. No party to the negotiations is as well informed as the taxpayer and its advisors. As necessary, taxpayers should make factual, legal, industry and economic presentations during the course of the negotiations. In BAPA cases, taxpayers should make such presentations on the critical aspects of the case to the tax authorities of both countries. This does not mean that taxpayers should be "at the table" during the actual competent authority negotiations. Taxpayers, however, can facilitate an understanding of the facts, issues, law and economics that will serve to inform both tax authorities and help draw the countries closer together for settlement.
- 7. Striking a balance between "perfect" transfer pricing and "objective practicality."** The arm's-length principle is easy to state conceptually but extremely difficult to apply in practice. Governments should be encouraged to balance their desire to achieve "perfect" transfer pricing with the need for flexibility and objectivity in reaching practical transfer pricing results. By entering the APA process, the taxpayer has signaled its desire to resolve the transfer pricing issues through negotiations rather than through confrontation and litigation. In turn, the revenue authorities should approach the process with the same desire and should strive to be as flexible as possible in reaching agreement on the transfer pricing issues. This means that in certain difficult cases, creative and flexible approaches may be necessary to reach agreement between the parties.

**8. Use of mediation.** The purpose of an APA is to reach agreement between the taxpayer and the revenue authorities, but that goal is not reached in every case. In situations where the negotiations are protracted or a stalemate is reached, the government and taxpayer should agree to consider nonbinding mediation. Presenting the case to a neutral mediator may serve to draw the parties closer to agreement. Litigation should be the option of last resort, and mediation should be used to avoid further controversy and resolve differences between the parties.

**9. Limitations on the use of certain taxpayer information in subsequent litigation.** Taxpayers should be encouraged to enter the APA process without fear of negative consequences in certain areas. One potential area involves the use of taxpayer information in subsequent litigation if agreement cannot be reached in the APA process. Governments should adopt a clear policy that if agreement cannot be reached, then the tax authority cannot use certain taxpayer information gained in the APA process unless the government obtains the information through normal information-gathering means in the course of the litigation. This policy should encourage taxpayers to enter the APA process without concern that if the negotiations fail, the taxpayer will be placed at a procedural disadvantage if litigation ensues.

**10. Periodic reports on the state of the APA program.** APAs are confidential documents and, therefore, generally not publicly available. As a result, there is a danger of creating a secret body of APA law known only to the revenue authority and certain taxpayers and their advisors. To prevent this situation, governments should periodically issue reports on the state of their country's APA program. Taxpayers and their advisors need to be aware of the positions accepted and the current trends in the countries where an APA will be filed. These reports should contain statistics about the number of APA applications, completed APAs, renewals and withdrawn APA requests. More importantly, they should set forth detailed information concerning the types of transactions covered, the countries involved, the transfer pricing methods accepted, the profit level indicators used and a substantial amount of additional information. The reports also should contain practical guidance on material issues open to different interpretations (e.g., the borderline between "know-how" and "services" or "routine services" and "nonroutine services"). Of course, sensitive taxpayer information such as trade secrets and identifying financial information must be kept confidential. Nevertheless, a great deal of information on critical aspects of the APA program can be published (especially in an aggregate form) without breaching taxpayer confidences. Annual reports will reduce the secret body of APA law and serve to disseminate critical information to taxpayers and the public.

The underlying assumption of entering the APA process is that the parties will negotiate in good faith and reach agreement on the transfer pricing matters covered by the APA. The hope is that disputes and litigation will be avoided. But, the APA process must be practical and efficient. The recommendations set forth above are designed to assist governments in making the process less costly and to enable the parties to reach agreement in a shorter period of time.

#### *MAPs*

MAPs are a product of the tax treaties that have been negotiated by countries on a bilateral basis. They provide the mechanism for taxpayers to avoid double taxation. The competent authorities of each country are designated on behalf of their respective countries to negotiate and eliminate double taxation. The use of MAPs has been evolving as a means of resolving cross-border disputes. Although relief from double taxation long has been available assuming a bilateral tax treaty is in place, taxpayers previously have not relied on or used the process as much as they have in the past several years. The process was viewed as taking too long with little or no input from taxpayers in resolving their disputes. There was also an inconsistent commitment of resources by various tax authorities to provide the necessary resources to resolve cases in a timely fashion. We conducted a survey involving more than 30 countries (EU and non-EU) to identify local governments' trends with regard to MAPs and how they interact with the available domestic legal remedies. The results of the questionnaire are presented on the following page.

Given the developments as a result of globalization, revenue shortages and the need for more timely resolution of cross-border disputes, it is important that governments and taxpayers work to improve MAPs by making them more efficient and responsive to the issues presented.

Below are some proposed actions that governments can take to improve the procedures:

1. Commit the necessary resources to MAPs to handle cases efficiently. At present, it can take more than a year to simply receive the position paper from the government proposing the adjustment.
2. Streamline internal processes. One example of a process that can be adopted is insisting that position papers be developed and exchanged within four months of the date of filing the competent authority request.
3. Develop timelines for case resolution similar to those developed for APAs.
4. Increase the use of technology to resolve cases. Video conferencing is an effective means to increase the number of meetings the government authorities can have to resolve cases. This technology has improved significantly within the past several years so it can be used efficiently. As well as reducing costs, such face-to-face meetings generally are more successful in resolving cases than correspondence.
5. Improve the timeliness and quality of training that competent authority analysts receive to cover not only technical issues but also training in negotiating skills and cultural awareness.
6. Be willing to have taxpayers participate in fact-finding discussions with the governments involved in the particular dispute. It is more efficient, and it ensures that both tax authorities have the same facts.

## Questionnaire

### Mutual agreement procedures

	Yes		No
	EU	Non-EU	EU
<b>Question 1</b> Is there any guidance published on domestic rules and procedures for MAP, both on operational and technical issues?	Germany, Netherlands, United Kingdom, Austria, Spain, France	Australia, China, India, Japan, Singapore, United States, Canada, Korea	Belgium, Czech Republic, Denmark, Poland, Sweden, Italy, Romania
<b>Question 2</b> Is there any information published on the outcome of MAPs (e.g. technical aspects), number of MAPs, type of issues, etc?	Austria	Australia, Japan, United States, Canada	Belgium, Czech Republic, Denmark, Germany, Netherlands, Poland, Spain, Sweden, United Kingdom, Italy, France, Romania
<b>Question 3a</b> Has there been any legislation introduced to enact the 'Code of Conduct for the effective implementation of the EU Arbitration Convention'?	Germany, Austria, France		Belgium, Czech Republic, Netherlands, Poland, Spain, Sweden, United Kingdom, Italy, Denmark, Romania
<b>Question 3b</b> If not, does the country adhere to the Code?	Czech Republic, Netherlands, Spain, Sweden, United Kingdom, Italy, Denmark		Belgium, Romania
<b>Question 4</b> Will the country initiate a MAP if the case has not been presented to a domestic court?	Belgium, Germany, Netherlands, Poland, Spain, Sweden, United Kingdom, Austria, Denmark, France, Romania	Australia, China, India, Japan, Singapore, Mexico, United States, Switzerland, Canada, Norway, Russia, Korea	Italy
<b>Question 5</b> Will the country initiate a MAP if the case is pending a domestic court?	Belgium, Denmark, Germany, Poland, Spain, Austria, Italy, France, Romania	Australia, China, India, Mexico, Russia	Netherlands, Sweden, United Kingdom
<b>Question 6</b> Is it possible to suspend a domestic court procedure pending a MAP?	Denmark, Germany, Netherlands, Sweden, Austria, France, Italy	Australia, India, Japan, United States, Norway, Canada, Russia, Korea	Belgium, Poland, Spain, United Kingdom, Romania
<b>Question 7</b> Will the country initiate MAP/Arbitration procedure after a court decision has been made?	Denmark, Germany, Netherlands, Poland, Sweden, United Kingdom, Austria, France, Romania	Australia, China, India, Singapore, Mexico, United States, Switzerland, Canada, Russia	Belgium
<b>Question 8</b> If not, may the Competent Authorities in the country deviate from a domestic court decision?	Czech Republic, Germany, Netherlands, Poland, United Kingdom, Italy, Denmark, France, Romania	India, Switzerland, Norway, Korea	Belgium

No (continued)	L.P.E. no info N/A		Depends	
	Non-EU	EU	Non-EU	EU
Mexico, Brazil, Switzerland, Turkey, Argentina, Norway, Taiwan, Russia	Luxembourg, Slovenia			
China, India, Singapore, Mexico, Switzerland, Turkey, Argentina, Norway, Taiwan, Russia, Korea	Luxembourg, Slovenia		Brazil	
	Luxembourg, Slovenia		China, Japan, Switzerland, Argentina, Mexico, Australia, India, Singapore, United States, Brazil, Turkey, Canada, Norway, Taiwan, Russia, Korea	
	Luxembourg, Slovenia, Poland		China, Japan, Switzerland, Australia, India, Singapore, United States, Argentina, Mexico, Turkey, Brazil, Canada, Norway, Taiwan, Russia, Korea	
	Luxembourg, Slovenia, Czech Republic		Turkey, Argentina, Brazil, Taiwan	
Singapore, Switzerland, Canada, Korea	Luxembourg, Slovenia, Czech Republic		Brazil, Turkey, Argentina, Japan, Taiwan	Norway, United States
Mexico, Switzerland	Luxembourg, Slovenia, Czech Republic		Brazil, China, Singapore, Turkey, Argentina, Taiwan	
Brazil, Korea	Luxembourg, Slovenia, Czech Republic, Spain		Japan, Turkey, Argentina, Singapore, Taiwan	Italy
Australia, United States, Brazil, Canada, Russia	Luxembourg, Slovenia, Sweden, Austria, Spain		China, Japan, Mexico, Singapore, Turkey, Argentina, Taiwan	

**Mutual agreement procedures**

	Yes		No
	EU	Non-EU	EU
<b>Question 9</b> Do court procedures take less than 2 years in your country?	Austria, Russia	Singapore	Belgium, Denmark, Italy, Netherlands, Spain, Sweden, Germany, France
<b>Question 10</b> In practice, are there thresholds (such as minimum adjustments) imposed by the authorities in the country resulting in denying a MAP?			Belgium, Czech Republic, Denmark, Germany, Netherlands, Poland, Spain, Sweden, United Kingdom, Austria, Italy, France, Romania
<b>Question 11</b> Does the country impose legal fees or administrative charges for entering into a MAP?			Belgium, Czech Republic, Denmark, Germany, Netherlands, Poland, Spain, Sweden, United Kingdom, Austria, Italy, France, Romania
<b>Question 12a</b> In practice, are the tax authorities in the country willing to close a deal/settlement whereby the taxpayer will waive his right to present his case for a MAP?	Belgium, Denmark, Germany, Netherlands, United Kingdom, Austria, Italy, France	Australia, China, Japan, Korea	Czech Republic, Poland, Sweden, Romania
<b>Question 12b</b> Is there a high risk for a tax audit whenever a corresponding adjustment is requested in your country?	Austria, Belgium, Czech Republic, Denmark, Italy, Netherlands, Poland, Sweden, Romania, Germany, United Kingdom	Argentina, China, Mexico, Turkey, Switzerland, Taiwan	Spain, France
<b>Question 13</b> Are joint tax audits feasible from your country perspective?	Austria, Belgium, Czech Republic, Germany, Italy, Netherlands, Poland, France, Romania	Australia, China, India, Singapore, Canada, United States, Korea	United Kingdom
<b>Question 14</b> Will the local tax authorities grant suspension of paying taxes which are disputed under a MAP?	Belgium, Denmark, Netherlands, Sweden, Austria, Italy, France, Romania	Japan, United States, Switzerland, Canada, Norway, Taiwan, Korea	Poland
<b>Question 15</b> Will the local tax authorities grant suspension of paying interest and/or penalties which are disputed under a MAP?	Belgium, Denmark, Netherlands, Sweden, Italy, France, Romania	Japan, United States, Switzerland, Canada, Norway, Taiwan, Korea	Poland, Spain, Austria
<b>Question 16</b> Is there flexibility to use alternative languages other than local languages? (i.e. English only for non-English speaking countries)	Austria, Denmark, Netherlands, Sweden, France	India, Switzerland, Canada, Norway, Korea	Czech Republic, Poland, Germany, Italy, Spain

No (continued)	L.P.E. no info N/A		Depends		
	Non-EU	EU	Non-EU	EU	Non-EU
Australia, India, Japan, Brazil, United States, Argentina, Canada, Norway, Taiwan, Korea	Luxembourg, Slovenia, Czech Republic		China	Poland, United Kingdom, Romania	Mexico, Switzerland, Turkey
Australia, China, India, Japan, Singapore, Mexico, United States, Switzerland, Turkey, Argentina, Canada, Norway, Russia, Korea	Luxembourg, Slovenia		Brazil, Taiwan		
Australia, China, India, Japan, Singapore, Mexico, United States, Switzerland, Turkey, Canada, Norway, Russia, Korea	Luxembourg, Slovenia		Brazil, Argentina, Taiwan		
India, Singapore, Mexico, United States, Switzerland, Canada, Norway, Russia	Luxembourg, Slovenia		Turkey, Argentina, Brazil, Taiwan	Spain	
Australia, India, Singapore, United States, Canada, Norway, Korea	Luxembourg, Slovenia		Japan, Brazil, Russia		
Japan, Switzerland, Turkey	Luxembourg, Slovenia, Spain		Taiwan, Russia	Denmark, Sweden	Argentina, Brazil, Mexico, Norway
Mexico, Russia	Luxembourg, Slovenia		Brazil, Turkey, Argentina	Czech Republic, Germany, United Kingdom	Australia, China, India, Singapore
Mexico, Russia	Luxembourg, Slovenia		Turkey, Argentina, Brazil	Czech Republic, Germany, United Kingdom	Australia, China, India, Singapore
Argentina, China, Japan, Mexico, Taiwan, Russia, Singapore	Luxembourg, Slovenia, United Kingdom		Brazil, Turkey, United States, Australia	Belgium, Romania	

Similarly, below are suggestions of actions that taxpayers can take to improve the process.

1. Taxpayers and their representatives must be prepared to be actively involved in the process. This means carrying out additional fact-gathering for the governments that are negotiating their case. It also can mean participating in meetings with the tax authorities to be sure that the nature of the business and the transactions in question are understood.
2. Taxpayers and their representatives have to be prepared for a negotiated settlement. This means developing, if necessary, a strategy for resolving the dispute, including considering the “go forward” implications of a competent authority settlement.
3. Taxpayers must improve the quality of documentation available to the tax authorities to support their transfer pricing transactions.

Are there consequences to taxpayers and governments if steps are not taken to strengthen the MAP? Unequivocally, the answer is yes. Taxpayers will not have the timely certainty that they need in their dealings with various tax jurisdictions, and governments will not have the appropriate revenue due them on a timely basis. Arbitration will have to be invoked, which could be costly and further delay outcomes of tax disputes. MAPs need to be strengthened so the outcomes for which they are designed can be achieved more effectively, efficiently, and in a timely manner.

#### *Tearing down barriers*

Reconciling the interests of taxpayers and governments is an effective and timely approach to resolving transfer pricing disputes. In many cases, it may be preferred over litigation because double taxation is an almost unavoidable result of court cases on transfer pricing. APAs and MAPs offer excellent opportunities for taxpayers and governments to cooperate in finding a mutually acceptable solution. Therefore, the immense effort by international institutions to improve APAs and MAPs should be welcomed and supported.

Companies increasingly are interested in APAs and MAPs. Their key concerns include the progress of the contacts between competent authorities, the length of time to resolution and the feeling of being left out during the process. After all, they have created the object of the negotiations (i.e., the value and the tax), and the outcome of the negotiations between the competent authorities also will influence the design and organization of their financial systems. Governments addressing these issues can take steps to tear down barriers to prosperity.

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