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As Companies Face Tougher Audits, Documentation Rules, Practitioners Report Faster Competent Authority Resolutions

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As countries around the world experience the worst economy in decades, many are implementing stricter documentation and audit regimes—and stepping up the enforcement of existing regimes—in an effort to stem the loss of revenue from transfer pricing, practitioners from PricewaterhouseCoopers reported during a global forum in New York March 18.

At the same time, they noted that competent authority proceedings, including advance pricing agreements, are moving faster in several jurisdictions.

Documentation is a primary concern for companies operating in China, with nine new disclosure forms on related-party transactions due in May. Spencer Chong of PwC's office in Shanghai also reported more than 30 pending APAs in that country.

In Australia, the government is seeking to curb the substantial outflow of interest income offshore through stricter limits on intercompany debt even as it works to streamline its APA process, according to Pete Calleja of the firm's Sydney office.

Lorenz Bernhardt of PwC in Düsseldorf said the German government is considering 60 pages of guidelines in support of its controversial position on business restructuring but appears to be resolving competent authority cases more quickly, with one case concluded in five months.

In both the Netherlands and the United Kingdom, practitioners saw a move toward “real time” audits, with the governments seeking to learn about transactions before the company files its returns. They also reported that the Dutch authorities appear open to loss-making comparables in APAs and that the United Kingdom has devoted more resources to its APA program.

Meanwhile, Canada, which is poised to issue guidance on services and guarantee fees and recently required more detailed reporting of financial transactions, has implemented a procedure to allow more years to be considered in a competent authority request.

Americas **Canada**

Saul Plener of PwC's office in Toronto said the Canada Revenue Agency is preparing guidance on both guarantee fees and markups for intercompany service fees. This, he noted, is after the agency in December revised its Form

T106, on which Canadian companies are required to report their intercompany transactions.

The new T106 (available on the CRA Web site at <http://www.cra-arc.gc.ca/E/pbg/tf/t106/README.html>) expanded the information required for financial transactions, Plener said. "Rather than disclosing it on one or two lines, which was the way you had to do it under the old form, you now have about 12 lines" for reporting those transactions, he said.

In addition to the expected guidance on service fee markups and guarantee fees, Plener said Canadian taxpayers are waiting for a paper from the CRA on the treatment of stock options. However, he said this project was likely to take some time.

Plener noted that the country's Income Tax Act specifically prohibits deductions for stock option costs, and also said auditors in Canada are unwilling to allow markups for intercompany services fees "except in very limited circumstances."

Deductions are more likely to be allowed if taxpayers take the indirect approach of calculating an arm's-length charge based on an allocation of the costs behind services, he said. In this type of analysis, "compensation is for the most part the biggest factor that comes into play," Plener said. "The argument we have to focus on is, using compensation, including stock options, gives you a proxy for an arm's-length amount. You're not specifically deducting, or you're not specifically charging, those amounts, so the fact that our Act says you cannot deduct stock options shouldn't be the full consideration."

Asked about the impact of changes to the U.S. rules, which now require charges to subsidiaries in more instances due to a narrowed definition of stewardship, Plener stressed the importance of focusing the analysis on the benefit to the entity receiving the service. "No matter what jurisdiction we're into, that to me is what's critical, and that is where documentation lacks the most," he said. "We focus our attention on how to calculate the allocation to another jurisdiction, and we kind of leave out" the benefit analysis, Plener said.

In addition to stock options and services charges, he said, a recurring issue in Canada is whether royalties should decline over time "as Canada builds up the technology [and] builds up their own trade name by incurring their own marketing expenses."

Plener said the new protocol to the treaty with the United States, which entered into force in December and provides for binding arbitration of double tax disputes, "is very positive news." Because of the arbitration clause, Plener said, CRA officials "realize that the positions have to be coming in a lot more reasonable."

The Canadian Competent Authority also is looking to resolve cases more quickly, he said. "We were able to resolve a competent authority case in three days,"

Plener said. "When we went to competent authority and described the issue and presented it, it was clearly an issue that the auditor should not have reassessed," he said.

In other competent authority developments, Plener noted the December transfer pricing memorandum allowing the resolution of a competent authority case to be applied to subsequent years (17 Transfer Pricing Report 638, 12/18/08).

Under the accelerated competent authority procedure, he said, if a taxpayer has a pending competent authority request for 2004-05 on a royalty issue, "rather than waiting for the auditor to reassess and having to pay your cash up front on that reassessment, you can apply to this program and not only will [the CRA] look at 2004-05, [they'll] look at 2006-07."

Mexico

Mauricio Hurtado de Mendoza of PwC in Mexico City said Mexico's Tax Administration Service (SAT) currently is focused on two issues: documentation and "a very aggressive audit program."

In Mexico, he said, documentation "is not a matter of reducing penalties, it's a requirement for taking deductions."

Hurtado said that in addition to maintaining contemporaneous transfer pricing documentation, Mexican taxpayers must:

- provide information on a segmented basis in their annual tax returns for 2008 according to generally accepted accounting principles; and
- also for 2008, submit a report by an independent accountant confirming all tax obligations.

The auditor's report, he said, must replicate the conclusion of the taxpayer's transfer pricing documentation.

The allocation of expenses is now "a very hot issue" in Mexico, Hurtado said. Like Plener, he stressed the importance of showing the local entity received the benefit of the service. Under Mexican law, he said, "allocation of domestic expenses is rarely considered a deductible item." Thus, whenever a charge is being considered to a Mexican unit, taxpayers must demonstrate that the charge produces a benefit, and further that it is a direct charge under Organization for Economic Cooperation and Development guidelines, Hurtado said.

"Unfortunately, the Mexican legislation does not contain clear guidance on how to demonstrate that direct charge mechanism, so they are of the belief that if you have an allocation on a pro rata basis, it may be considered nondeductible," he said. Hurtado added that the external auditor is required to disclose the fact that the company has taken deductions on a pro rata basis and also must give the

amount of the deduction “in order for the Mexican tax authorities to challenge that item.”

In audits, Hurtado said Mexican authorities are focusing particularly on restructuring transactions and in some cases are challenging their own private rulings through “nullity actions”—a development reported by another practitioner in August (17 Transfer Pricing Report 326, 8/28/08).

Taxpayers may contest a nullity action in court, through the government's tax amnesty program, or through competent authority, Hurtado said. Because going to court is costly and time-consuming, most taxpayers prefer the other options, he said.

Garry Stone with PwC's Chicago office recalled a case in which he and Hurtado had obtained a ruling on a taxpayer's restructuring and “suddenly [the SAT] decided the ruling was not valid anymore.” He said it took five years to work through the economic and legal matters and resolve the case. “I think there are a number of those cases out there,” Stone added.

Brazil

Juan Carlos Ferreiro of PwC's office in Buenos Aires noted that a ruling in Brazil last September made it somewhat easier for taxpayers to challenge the transfer pricing margins imposed by the government. However, he said he could not foresee the country's adoption of OECD-style rules. According to Ferreiro, the tax authority contends that its existing regime—which is based on fixed profit margins rather than the arm's-length standard—“is the only one they can audit.”

Normative Ruling 222, issued Sept. 26, allows companies to demonstrate that the fixed margins are incorrect by using examples of trading operations between themselves and unrelated firms. If they do not have such operations, they may present examples of trading operations similar to theirs but between two other, unrelated firms (17 Transfer Pricing Report 480, 10/23/08).

Ferreiro said the ruling “is perhaps a door open” allowing taxpayers to reduce double taxation resulting from the Brazilian rules. However, he said the tax authorities so far have required the analysis to be conducted on a product-by-product basis, “so we are struggling with them on what we consider an adequate comparable on such an analysis.”

One factor that allows some relief, Ferreiro said, is that the Brazilian rules do not require selection of the tested party based on OECD rules, but allow the taxpayer “to choose the best tested party for their own interests.” The devaluation of the Brazilian currency also has mitigated the effect of double taxation, he reported.

Other Latin American Developments

Ferreiro said that with tax revenues falling across Latin America, countries “see transfer pricing as a means to recover this revenue.”

New rules in Uruguay effective January 2009, published in the Text section of this issue, set forth OECD transfer pricing methods and also contain a list of 33 jurisdictions the government considers tax havens. The rules, issued in a Jan. 26 decree, contain guidance on analyzing and adjusting for comparability and also state that documentation should be filed no later than eight months from the end of the year.

In Argentina, Ferreiro said, recent regulations allow amnesty from penalties “so many companies are being invited to include any transfer pricing adjustment they might have in existing audits in this program.”

Ecuador, meanwhile, is seeing the first tax claims from audits of importers in the pharmaceutical industry, he said.

While transfer pricing is included in Chile's laws, he said, no specific documentation requirements exist.

United States

Horacio Peña of PwC in New York said the United States has seen “an explosion” in the number of Section 6662(e) penalties asserted recently. In addition, he said audit activity in the international area is likely to increase further with the hiring of 700 new Internal Revenue Service personnel to deal with international issues.

IRS officials confirmed that development March 30. (See the related article in this issue.)

In the area of intangibles transactions, Peña said it is not clear how much of the \$210 billion the government intends to collect from international tax enforcement will come from cost sharing. Noting that the IRS currently is insisting on detailed functional analyses that address the economic substance of transactions, he said that development, combined with the new cost sharing rules effective in January, will give taxpayers wishing to transfer intangibles offshore a choice between “living in two worlds.” Those choosing to cost share, he said, will be subject to prescriptive new rules and onerous disclosure, contractual, and record-keeping requirements, while those opting to transfer intangibles under licensing structures will need to satisfy “on a totally different level” that they meet economic and business purpose requirements.

The temporary cost sharing rules, issued Dec. 31, contain specific methods for cost sharing designed to prevent U.S. companies from shifting valuable

intangibles offshore for less-than-adequate consideration and generate buy-in payments that are much larger than those calculated under the previous regime (17 Transfer Pricing Report 579, 1/8/09).

Tax Executives Institute Inc., citing the more detailed and stringent documentation requirements in the new rules, recently asked the IRS to extend deadlines for both amending existing arrangements and submitting cost sharing statements (17 Transfer Pricing Report 838, 3/19/09).

Asia Pacific

Australia

Calleja said the Australian Taxation Office currently is focusing on intercompany debt. The “offshoring” of interest income, according to data published by the ATO, has moved from A\$24 billion to A\$124 billion (US\$16.8 billion to US\$86.7 billion) in the last four years, he said. At the same time, the interest deduction level has stayed roughly the same—between A\$98 billion and A\$100 billion (US\$68.2 billion and US\$69.6 billion), Calleja said.

“The ATO has seen this data and it's been kind of an ‘oh dear’ moment—we have all this interest income going offshore and the deductions are staying local,” he said.

For “many, many years,” Calleja said, the ATO has allowed a three-to-one ratio of debt to equity for purposes of debt deductions. In a recent discussion paper, however, “the tax office has come out and said our arm's-length rules in Division 13 actually trump this debt-equity ratio.” This, he said, “has caused a bit of a tailspin” for some multinational companies.

The discussion paper, released in June 2008, said arm's-length debt should be consistent with an amount that reflects the willingness of third-party lenders to provide debt funding for activities conducted by a subsidiary (17 Transfer Pricing Report 84, 6/5/08).

A more positive development, according to Calleja, is the review the ATO has undertaken of its APA program. A report by independent advisers has been submitted to the tax authority, and a “co-design team” of ATO officials, advisers, and stakeholders is working to redesign the program “to make sure it can manage some of the complexities now in the Australian and the global transfer pricing environment,” he said.

The ATO reported that the review, conducted by PwC, was completed in late 2008 (17 Transfer Pricing Report 597, 12/4/08).

Calleja said a problem with the APA program was that some of the more complex transactions “turned into pretty messy negotiation processes, and in some cases, positive audits.” One reason for this, he said, may have been that the program was designed for “pretty routine inbound distribution transactions, and now we're seeing much more complicated and pretty different arrangements going into it.”

Some likely outcomes of the review, Calleja said, are a streamlined APA for small and medium-sized entities or those with small transactions, and for larger transactions, a “best practice stage and date process.”

The U.S. APA program following IRS hearings in 2005 began requiring taxpayers and APA personnel to agree to target dates for document submission, site visits, and meetings (14 Transfer Pricing Report 225, 7/20/05).

China

Chong said China's State Administration of Taxation, which so far has completed only a handful of APAs, currently has more than 30 bilateral agreements in the pipeline. These, he said, involve six countries: Denmark, Japan, Singapore, South Korea, the United States, and one that Chong declined to name. Japan so far has the most APAs with China, followed by South Korea and then the United States, Chong said.

The Shanghai practitioner also noted that the tax authority has reorganized to focus more on large taxpayers. The SAT in December 2007 selected 45 large enterprises as the first taxpayers to be included in its new Large Enterprise Administration Department, which seeks to centralize the nation's tax audit capabilities (17 Transfer Pricing Report 685, 1/22/09).

Chong said the nine new related-party disclosure forms released in December, due May 15 for Shanghai taxpayers and May 31 for the rest of the country, are “really difficult to understand.” May 31 is also the deadline for transfer pricing documentation, but for 2008 it has been postponed to Dec. 31, 2009, he said. (See the related article in this issue.)

The new disclosure forms, described in Circular 114, evince an increased focus by the tax agency on transactions involving intangible assets. Circular 72, issued Feb. 17, incorporates the forms into China's official software for preparing 2008 corporate income tax returns and explains to auditors how to construct a profile of a taxpayer's related-party transactions (17 Transfer Pricing Report 623, 12/18/08; 17 Transfer Pricing Report 841, 3/19/09).

Chong said that in addition to concentrating on large firms, the SAT has increased its focus on specific industries. Last year, he said, the tax authority conducted training on financial services transactions, inviting practitioners from the Big Four accounting firms as well as taxpayers in the banking industry “to

explain to them how financial services are operating and how they manage their transfer pricing.”

This year, Chong said, “we have heard they are focusing on the pharmaceutical industry.”

Stone said auditors in China have reached a high level of sophistication relatively quickly. “They've gone from zero to 60 in a very rapid period of time,” he said. An advantage to having industry specialists, he said, is that the taxpayer receives a better quality of audit. While adding “that can cut both ways,” Stone said overall he found knowledgeable auditors “easier to deal with than people who just make up adjustments and you can't rationally argue with them.”

South Korea

Henry An of PricewaterhouseCoopers in Seoul cited two recent developments in South Korea: the introduction of a penalty waiver provision for taxpayers maintaining contemporaneous transfer pricing documentation and a moratorium on audits of smaller taxpayers.

The amendments to the penalty provision, proposed in September 2008, waive the penalty for underreporting profits on related-party transactions if documentation is written at the time of the transactions rather than after the fact, and the method used to price related-party transactions is reasonably selected and applied (17 Transfer Pricing Report 486, 10/23/08).

An said the provision, finalized at the end of 2008, allows taxpayers maintaining documentation to receive a waiver on the 10 percent underreporting penalty in the event of a transfer pricing adjustment. The provision applies for adjustments beginning in 2009, which he said “didn't give taxpayers a whole lot of time to prepare.” The definition of “contemporaneous” in Korea, An said, is having the documentation on hand when the company files its returns. Most companies in Korea, he said, have a December year end, which gave them only three months to comply by the March 31 filing deadline.

An also noted that Korea in late October 2008 announced a moratorium on audits of companies with sales and revenue of less KRW 500 billion (US\$360 million) (17 Transfer Pricing Report 558, 11/20/08).

He said the moratorium effectively meant that audits of most companies in Korea ceased over the last five months. “For most taxpayers in Korea, their operations aren't that size,” An said. However, he added, tax audits are likely to begin again in April.

“If you are selected for audit in Korea, brace yourselves,” he said. “I think they've been holding back for five months and they're gearing up to make up for lost time.”

Europe

Germany

Bernhardt said German officials were meeting the week of March 16 to discuss further guidance on business restructuring.

Germany in July 2007 introduced the commensurate-with-income standard, the interquartile range, and the prudent business manager concept into its law along with a provision requiring taxpayers to defend business restructurings (16 Transfer Pricing Report 221, 7/26/07).

Practitioners have said the changes represent a significant departure from both U.S. rules and OECD guidelines in requiring compensation for business opportunity and profit potential when functions are moved to another jurisdiction (17 Transfer Pricing Report 3, 5/8/08).

Bernhardt said the 60-page guideline being considered would represent a third layer of regulation—below both the law changes, which took effect in January 2008, and an ordinance under the statute that has a binding effect on taxpayers. Although the guideline will bind the tax authorities internally, it technically will not bind taxpayers, he said. Still, Bernhardt asserted, it has “much practical importance.”

He added that the guidelines “are heavily disputed and discussed within the German tax administration,” with the federal officials tending to take “outlier” positions and those within Germany's 16 states taking more moderate positions. Bernhardt said the guideline contains “unfortunately not a lot of surprises.”

Among the items PwC rejects, he said, are:

- the concept that the exit charge for a restructuring is merely an interpretation of the arm's-length standard and that the 2008 statute “is nothing new”; and
- an extension of the rules to permanent establishments and partnerships.

Bernhardt said German officials often point out that because the restructuring provisions apply to inbound as well as outbound cases, “it's not only punishing people who go out but also incentivizing people who come in because you can then capitalize the function and get a write-down and therefore deductions in Germany.” However, he said, “there is nothing on inbound [cases] in [the] 60 pages, so I'm not sure how serious they are about incentivizing people to come to Germany.”

Asked about the state of audits in Germany, Bernhardt said government training efforts were creating a difficult situation for taxpayers. “It's easy to talk to

somebody who has no idea at all, or to somebody who is a full expert in the area,” he said. “What we are currently facing in Germany is you have these people in between who have been on a two-week training course and then raise all sorts of unreasonable requests and questions with regard to transfer pricing.”

Further, Bernhardt said, all companies in Germany can expect to be audited every three to five years.

Turning to developments he said were more positive, Bernhardt noted the mandatory arbitration provision in the U.S.-German treaty, which entered into force in December 2007, as well as a memorandum of understanding and guidelines for the arbitration boards released in December 2008 (17 Transfer Pricing Report 628, 12/18/08).

Bernhardt said that while the Germans “have been quite reluctant and negative” about arbitration in prior years, “we are seeing a clear change in their attitude.” This change also applies to competent authority disputes in general, he said, adding that one of his colleagues had settled a mutual agreement procedure case on an informal basis within five months. “I think the attitude toward arbitration procedures and fast settlement of disputes has certainly increased.”

Netherlands

Marc Diepstraten of PwC in Amsterdam said Dutch companies soon are likely to face audits of their current—or even future—transactions. The Dutch authorities, he said, are contacting the heads of the 100 largest companies in the Netherlands and “inviting themselves” in for discussions.

“They want to come to an agreement where in principle, they work in the present,” Diepstraten said. This, he said, “implies, especially for transfer pricing, that they want to be aware of all the major transactions done by the Dutch multinational in advance.” Diepstraten said that in addition to approaching the largest Dutch companies, the tax authorities now are seeking “to have the same type of dealings” with foreign multinationals that have substantial presence in the Netherlands.

While he said the 100 pilot companies “were a bit suspicious at the beginning,” they have agreed to the advance audits, which entail having a transfer pricing control framework in place at the level of the chief executive and chief financial officers. The Dutch also are advocating the approach in the EU Joint Transfer Pricing Forum, he added.

Turning to APAs, Diepstraten said that in the current economic environment, it is more than likely that some companies “cannot commit themselves to the agreements with the Dutch tax authorities two or three years ago.” The tax authority, he said, has invited private practitioners in the next two weeks to

discuss ways to deal with benchmarking and fixed commission fee arrangements during the downturn. The most likely outcome, Diepstraten said, is that tax officials will “look more in depth into the benchmarking studies” and possibly allow loss-making entities into the sample.

United Kingdom

Steve Hasson of PwC in London said that while H.M. Revenue and Customs currently is conducting few transfer pricing audits, that is likely to change given the state of public finances. He also predicted U.K. taxpayers in the next three to five years will be audited under a real-time approach similar to what Diepstraten described in the Netherlands, and further described changes to the U.K. general penalty regime that he said would affect transfer pricing settlements.

“There is a lot of pressure to move much more toward real-time work,” Hasson said in predicting changes to the audit process. “The larger corporates can expect to have a relationship where you need to be discussing what you’re doing in your transactions before you’re filing,” he said.

Hasson said changes to the general penalty contained in Finance Act 2008, which became law July 21 and apply to filings beginning April 1, will have a significant impact on transfer pricing. “Large corporates have been described as being a penalty-free zone in the U.K., and [HMRC] would like to change that,” he said. A significant feature of the change, he said, is that penalties will be charged on adjustments to losses even when no additional tax is payable, with 10 percent of the adjusted loss attracting a penalty.

The new regime covers corporate income, capital gains, value-added, and pay-as-you-earn tax. Negligence and fraud are replaced by the concepts of inaccuracies that are deliberate or result from failure to take reasonable care. Newly introduced statutory penalty “bandings” based on these behaviors remove much of the current discretion of HMRC. Penalties relating to carelessness will be charged up to a statutory maximum of 30 percent of the tax at stake.

Hasson said the new regime was likely to cause delays in case settlements. “I’ve settled hundreds of transfer pricing cases, very often with reducing the amount of losses brought forward,” he said. Because “penalties tend to be career limiting for most tax directors,” Hasson said, if auditors’ discretion to waive them in such cases is taken away, “you can’t settle cases because you’ll be better off arguing them for a few years.”

On the other hand, he said HMRC has been pushing more resources into APAs. “I got one agreed in seven days a few weeks ago,” Hasson said.

Small European Regimes

Isabel Verlinden of PwC in Brussels said that while Belgium “is not the hub of transfer pricing in the universe,” it can be a mistake to ignore it and other smaller European jurisdictions in preparing documentation.

Many smaller countries, she said, feel there has been “over-apportionment over the last couple of years towards those countries with harsh transfer pricing regimes” and are striking back.

In Belgium, she said tax officials have been subjecting companies to “surprise visits.” One of her clients in the enterprise resource planning sector recently received such a visit from seven tax personnel, including two information technology specialists, Verlinden said.

Greece, she noted, recently enacted documentation rules requiring taxpayers to submit a list of related-party transactions for fiscal periods ending after Dec. 18, 2008, to the Greek Ministry of Development. The related-party disclosures must be made within four and a half months of the end of the fiscal year and are to address related-party contracts, the value of the transactions, and related-party deliveries of goods invoiced by third parties (17 Transfer Pricing Report 811, 3/5/09).

Verlinden said the Greek rules incorporate the “masterfile” concept developed by the EU Joint Transfer Pricing Forum. Under that practice, documentation consists of one set of standardized information relevant for all EU group members as well as country-specific data.

“When you look at [the Greek] rules, they are harsh because it's an implementation of the masterfile concept in the most strict sense,” Verlinden contended. “The message here is, for those countries where you think they are not that aggressive in transfer pricing, make sure you have something.”

Middle East

While Stone noted that the Middle East has little in the way of developed transfer pricing rules, he said Egypt is likely to issue regulations in the next year. The country has legislative obstacles to work through, he said, but “they've worked pretty far down the path” and “seem like they're going to fast-track this once they get the legislative authority.”

Once Egypt has rules in place, Stone predicted other countries in the region would follow. Just as Mexico was for Latin America, he said, “Egypt is the linchpin for the Middle East.”

Stone said a motivating factor for countries without transfer pricing rules is that “they're facing transfer pricing issues in other countries [and] they want to have the rules in their own countries to deal with the inbounds.”

Arbitration

Verlinden said that while officials may be more open to having arbitration provisions in treaties than in the past, they are not eager to have cases enter the process under either the European Union Arbitration Convention or recent U.S. treaties with Belgium, Canada, and Germany. Arbitration, she said, is seen as “simply a measure to put additional pressure on getting things done.”

Baseball Arbitration

Verlinden added that officials are likely to be more resistant to the idea of having their cases wind up in the baseball style of arbitration provided for under the U.S. treaties, which requires arbitrators to choose between the two countries' positions without the possibility of crafting their own solution. “There is no possibility of splitting the baby,” Verlinden said. Also, she said, taxpayers may be reluctant to see their cases arbitrated because “it's a complete black box; you don't know what they are doing” or how taxpayer arguments will be processed.

Stone agreed that baseball arbitration was particularly dreaded by tax officials. At a fall meeting of the competent authorities from Australia, Canada, the United Kingdom, and the United States, he said all were “unanimous in saying it would be a problem for them career-wise and for the office of competent authority if they had to end up in baseball arbitration.”

Germany's competent authority, according to Bernhardt, expressed a similar sentiment two months ago. “She clearly said they are so concerned about going into arbitration because they are losing control of the process that they do their best to avoid it, and the likelihood of settlement is much higher than it used to be,” the German practitioner said.

EU Arbitration

Verlinden said that even EU-style arbitration, which does not have the same restrictions as the process set forth in recent U.S. treaties, has not proven popular. Since arbitration became available under the EU convention in 1995, she noted, only two cases have been arbitrated.

One case, which involved French and Italian affiliates of Stockholm-based Electrolux, was concluded in 2003. Little is known about the other case, which involved France and Germany (13 Transfer Pricing Report 473, 9/15/04; 14 Transfer Pricing Report 538, 11/9/05).

According to a survey of 25 country representatives by the EU Joint Transfer Pricing Forum, which has worked to develop a code of conduct for arbitration

cases, very few arbitrations currently are going forward under the EU convention, Verlinden said. Only “one or two panels,” she said, are known to exist.

Triangular Cases

One reason for this, Verlinden said, is that “in a predominant amount of cases, the culprit for the double taxation is not found to be a European country,” but a third jurisdiction. She gave what she called “the classical example” of a U.S. multinational with a distribution center in the Netherlands that sells to a German entity. The goods come into the Netherlands at cost plus five, but the German authority feels the resale minus in its jurisdiction is inadequate. However, “the Dutch are happy with their cost plus five because it's only a distribution center.”

In this case, Verlinden said, “the bad guy is the U.S. multinational because they have set their transfer pricing wrong into Europe.”

The EU forum has created a subgroup to deal with arbitration in these “triangular” cases, she said. One question, she noted, is whether the case should be dealt with under the U.S.-Germany or U.S.-Netherlands treaty.

Following a meeting of the subgroup March 24, Verlinden reported that the members expressed a “strong willingness” to resolve triangular cases on a case-by-case basis, with multilateral APAs containing rollbacks seen as a possible solution. Members, she said, also urged countries to include arbitration clauses similar to those in Article 25 of the OECD Model Tax Convention in their individual treaties.

The subgroup currently is drafting a paper on triangular arbitration, which may be released after its next meeting June 3, Verlinden said.

For a discussion of transfer pricing in Germany and the United Kingdom, see 895 T.M., Transfer Pricing: European Rules and Practice.

For a discussion of transfer pricing in Canada and Mexico, see 897 T.M., Transfer Pricing: Foreign Rules and Practice Outside of Europe.

For a discussion of transfer pricing in Australia, Brazil, and South Korea, see 898 T.M., Transfer Pricing: Foreign Rules and Practice Outside of Europe, Part 2.