Audit readiness in transfer pricing

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This article deals with some of the most common threats to taxpayers in transfer pricing audits.

Are you ready for an audit of your company in key jurisdictions? Will this result in double taxation, interest, and penalties? This article deals with some of the most common threats to taxpayers in transfer pricing audits.

International taxation issues have been a top priority in the political agenda in recent years. The integration of economies and national markets has increased substantially, threatening the tax systems of countries. Several governments have agreed to a comprehensive package of measures that require coordinated implementation through domestic legislation and international treaties, and these will be enhanced by selective monitoring and increased transparency. Many of the traditional strategies that enable double non-taxation will be restricted if widespread adoption of such measures is achieved, particularly the alignment of national standards with best practice guidelines.

In order to initiate a tax audit procedure, tax administrations are planning and programming their reviews by considering the types of transactions companies engage in, including intercompany transactions, level of revenues, treaty shopping indicators, restructurings, recurring losses, and types and quantity of assets, among others. During such reviews, tax administrations request information and documentation to support that income has been properly recognised and that deductions comply with the requirements established by the relevant provisions.

Frequent challenges by tax authorities

An important aspect to consider among multinational enterprises (MNEs) from a transfer pricing perspective is business reorganisations and restructurings within a corporate group. The reviews are based on different angles, including exit tax, existence of permanent establishments, and substance. From a tax administration perspective, the reallocation of significant risks of a business derived from a restructuring between associate enterprises without supported economic substance, will be challenged. Based on the above, taxpayers must consider that a restructuring cannot not be supported solely by contractual terms, but must also be consistent with the conduct of such enterprises as concerns the allocations of risks, which must comply with the arm’s length principle. In that sense, a company’s business restructuring must be planned and monitored not only from an economic and accounting approach, but also from a legal, tax, and transfer pricing perspective.

Audit readiness in transfer pricing

In addition, certain payments among related parties such as interest and royalties, back-to-back loans and expense allocations, including for research and development (R&D), will be closely scrutinised. For such activities, MNEs must consider not only the generation of a possible source of wealth and withholding tax rules in a specific country, but also the specific rules and requirements of each tax jurisdiction that allow the deduction of the expense. If these rules are not considered, such disallowance could result in economic double taxation, interest and penalties.

Some of the issues observed by tax administrations regarding passive income include the thin capitalisation rules, back-to-back loans, and interest rates that comply with the arm's length principle, along with maintaining documentation that proves a loan is necessary for the business and that the entity can obtain the necessary cash flow to pay the loan balance in accordance with its contractual obligations. Similarly, purported ownership or migration of intangibles to low tax jurisdictions involving ongoing local expenses to advertise and promote brands and trademarks are closely reviewed, as well as allocated expenses (including R&D), payments for technical assistance versus know-how, and royalty-free agreements, among others.

Another aspect to be considered by MNEs involves intercompany management fees, which are challenged by tax administration on the basis that the taxpayer has not demonstrated in supporting documentation (contracts, deliverables, and appropriate allocation of expenses in the case of allocation agreements, among others) that such services have been effectively rendered and a benefit obtained. Further, in some countries, including Mexico, allocated expenses are routinely disallowed.

Finally, the process of assessing the consistency of a taxpayer's risk allocation with the arm's length principle can be burdensome and costly. However, it is a good practice for taxpayers to implement a process to establish, monitor, and review their transfer prices, taking into account the size and complexity of their transactions, the level of risk involved, and whether they are performed in a stable or changing environment. Where an MNE detects a possible risk through a review of its transfer prices, it is preferable that a voluntary self-correction be made by the enterprise before a tax audit is initiated.

Preventive measures – defence files

Many times, audits are conducted long after transactions take place, and several factors can affect the availability and reliability of information, as well as the defence of tax positions, when evidence is not prepared prior to or contemporaneous with the transactions. The main objectives of a defence file should be to reduce the risk of disputes and defence costs and to strengthen tax positions, considering that in almost all cases tax authorities challenge the tax treatment of a specific item derived from a transaction based on the following: lack of supporting documentation and information; absence of economic substance of the transaction; failure to comply with the formal requirements stated in the tax provisions; and lack of compliance with the arm's length principle for related parties transactions.

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Audit readiness in transfer pricing

One of the most important aspects that the taxpayer must contemplate is the management of information in case of an exchange.

As mentioned, among different tax jurisdictions, one issue to consider from a taxpayer perspective is supporting documentation and evidence for each transaction carried out by the MNEs. For transfer pricing purposes, a solid functional analysis is fundamental because it provides the basis for performing transfer pricing analyses of comparability with transactions with or among independent parties, and must consider the economically significant activities and responsibilities undertaken, assets used, and risks assumed by the parties to the transactions.

A complete functional analysis should identify key value drivers, the appropriate transfer pricing method, as well as other opportunities that may be relevant for the company. For example, it may be necessary in an audit defence to give special attention to preparing an analysis from the perspectives of different tax jurisdictions and being responsive to examiner requests, or strategic positioning and communication. Nearly all subsequent components of a transfer pricing study depend heavily on the reliability and thoroughness of the functional analysis.

A crucial point to consider is that a transfer pricing analysis requires the collection of reliable information not only to complete the study, but also to have the most suitable picture of the economic substance of each transaction and compliance with each country's transfer pricing guidelines and rules. Furthermore, the more complete and reliable the information, the more prepared it will be upon audit.

It is also worth noting that various documentation (such as invoices, contracts, deliverables of services rendered, policies, invoices, accounting records, and certificates of residence for the fiscal year that a treaty benefit has been applied, among others) should be kept by the taxpayer considering the statute of limitations in each jurisdiction involved in the transaction, as well as local requirements (e.g. formal agreements, translation to local languages, apostils and notarisations), to be valid and suitable as evidence of the tax treatment given to each item. For example, if services were rendered to a Mexican entity (five-year statute of limitations) by a foreign related party in the United States (three-year statute of limitations), the Mexican tax administration could request the deliverables issued by the US entity five years later in order to evidence the services carried out.

On the other hand, private letter rulings, legal and tax opinions by an expert, no-name basis approaches with tax authorities, as well as advance pricing agreements from the transfer pricing unit of each tax administration are resources that are worth considering in order to have a stronger position in case of a tax audit.

Procedural aspects to consider on multijurisdictional audits

Considering that nowadays the exchange of information between tax administrations of different jurisdictions is a fact, and countries have been engaging in joint tax audits in order to review a taxpayer simultaneously, each in its own territory,

Audit readiness in transfer pricing

MNEs must carry out the necessary actions that allow them to deal with these types of procedures.

One of the most important aspects that the taxpayer must contemplate is the management of information in case of an exchange. The parties involved in the review process must be prepared with consistent information and documentation in case each tax jurisdiction requests evidence locally pursuant to an exchange of information procedure.

Also, an important resource to consider on international issues, is the advisability of filing a protective claim when a right to initiate a mutual agreement procedures or a bilateral advance pricing agreement is contingent on future events and may not be determinable until after the statute of limitations expires.

Finally, MNEs must define transfer pricing global policies regarding their intercompany transactions, assets, risks, and quality of the information kept and provided to transfer pricing specialists and tax authorities. These policies must not only be defined at a worldwide level, but must also be as flexible as possible so that they may be adjusted to comply with the regulations of each jurisdiction.

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