

Managing transfer pricing controversies and dispute resolution in a post-BEPS world

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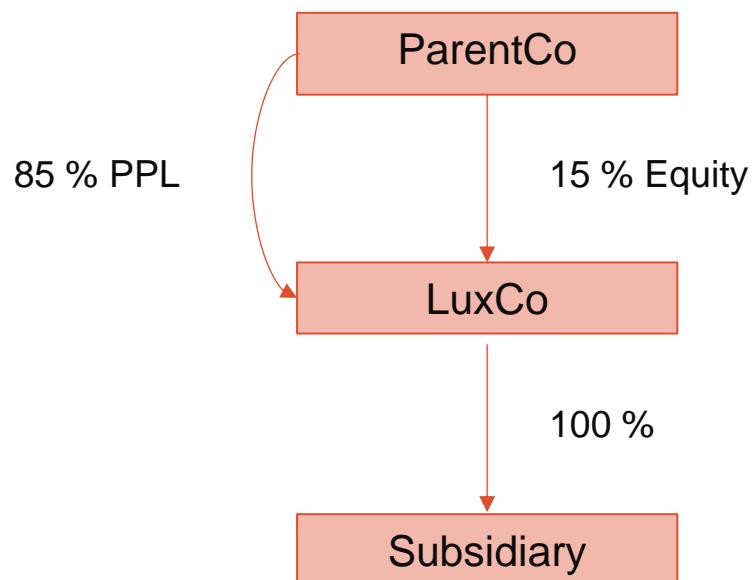
Of Counsel

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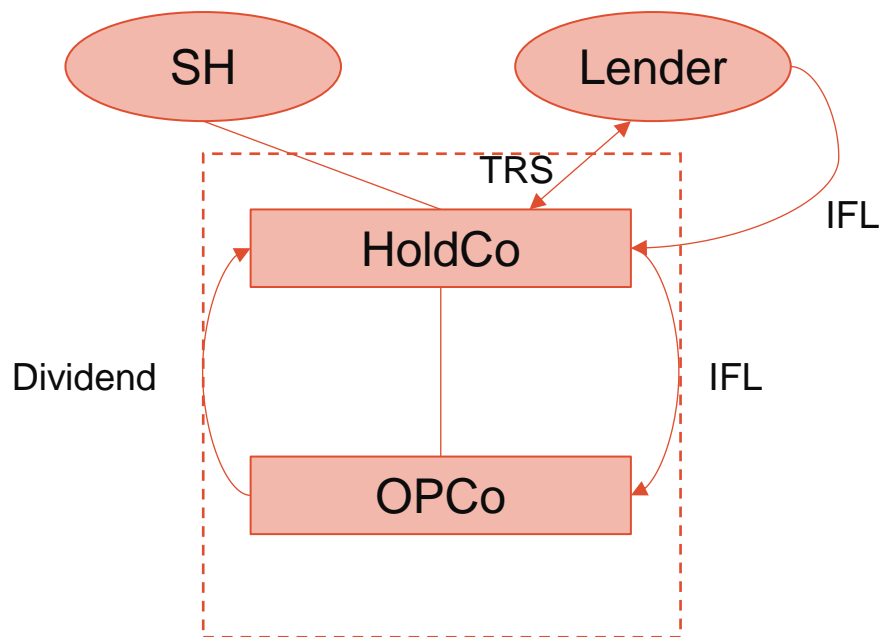
What is the Luxembourg Tax Administration auditing and which challenges do they make?

I. Interest Rate / PPL



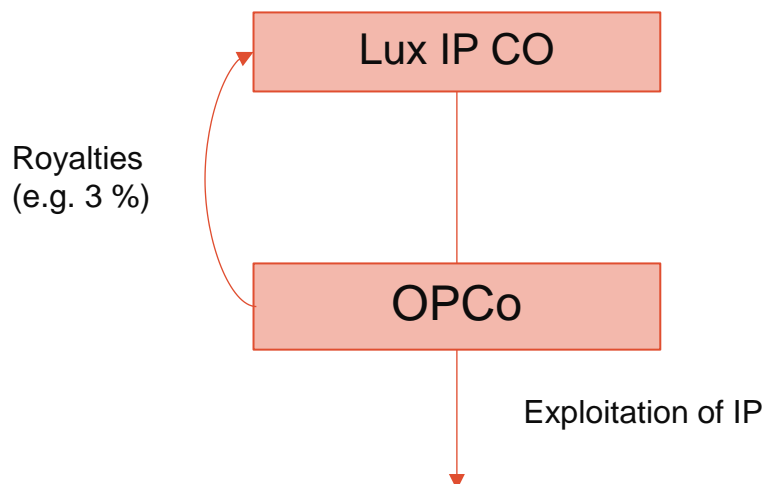
- In 2013, LuxCo financed a shareholding held in a subsidiary by 15 % equity and 85 % debt (PPL) carrying a fixed and variable interest corresponding to the “adjusted net profits” i.e. profits – fixed interest – margin
- ATC issued under the condition that it will be terminated if i.a. *“the total amount of the yield (fixed and variable) on the financing instrument(s) exceeds the arm’s length remuneration on an accrual basis”*
- LTA requalified the variable yield exceeding 85 % of the profits as non arm’s length / hidden profit distribution → 15 % WHT + non deductible
- Taxpayer: yield on the PPL is lower than the amount accruing on an arm’s length fixed interest bearing loan over the same period i.e. average median of 8,47 % for 2013 – 2017 (9,81% for 2013 - 2015) – hence arm’s length
- Taxation office: IBL and PPL are not comparable because of the retroactive effect of the PPL (cumulating yield vs. taxation on an annual basis) - hence no arm’s length pricing may be determined
- Complaint: PPL not arm’s length because of shareholder’s dividend expectation

II. IFL / TRS



- HoldCo and OPCo opted for the fiscal unity
- OPCo realises commercial profits
- OPCo's operating costs financed by IFL
- HoldCo financed through IFL + concluded a TRS with the lender / TRS "exchanges" 85 % of the consolidated profits vs. a fixed nominal amount (opex)
- TP study documenting that HoldCo's remuneration of the remaining 15 % of the profits is arm's length
- Tax authorities: abuse of law under § 6 Tax Adaptation Law because no commercial rationale of TRS
- Payments under the TRS → hidden profit distribution
- Complaint: hidden profit distribution confirmed

III. IP Box / Royalties



- Former IP Box regime (art. 50bis ITL)
 - 80 % exemption on income derived from qualifying IP (patents, trademarks, copyright software, domain names...)
 - 100 % exemption from NWT of the qualifying IP
- Systematic challenge by the tax authorities
 - Arm's length rate of the royalties
 - § 6 Tax Adaptation Law: abusive structuring + absence of commercial rationale (in particular absent any royalty payments before the IP Box regime was available)

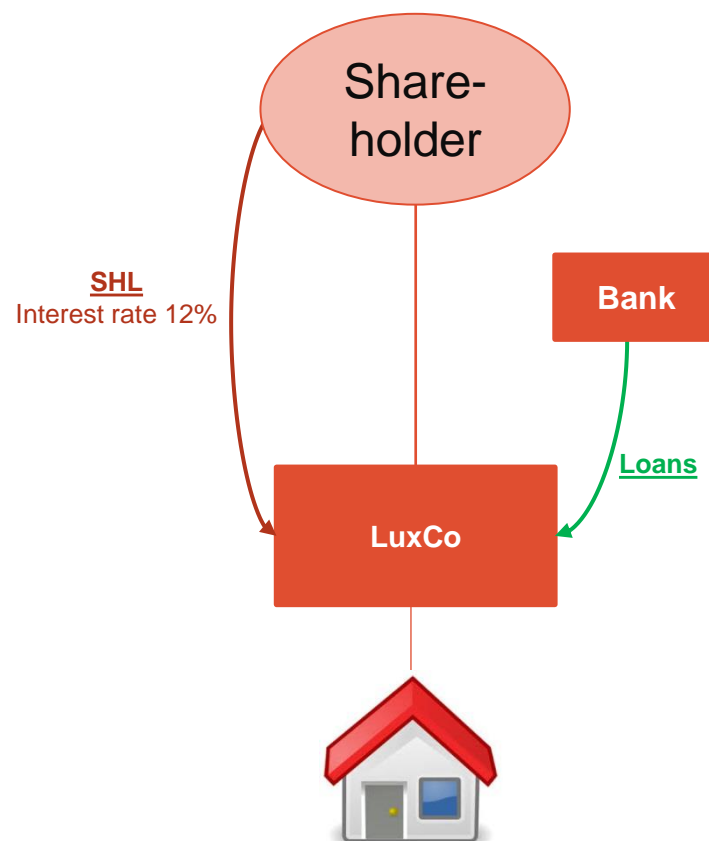
What has happened when these cases have come to court?

I. TA 22 October 2018 / N° 40348

- LuxCo financed a real estate property in France in 2008 by i) an external financing (bank loan) and ii) a subordinated SHL with an interest rate of 12 %
- The LTA considered that the interest rate of 12 % was not at arm's length (i.e. no valid economic reason to apply such high rate compared to the market rates i.e. 2,52% 2011 and 3,57% 2012)

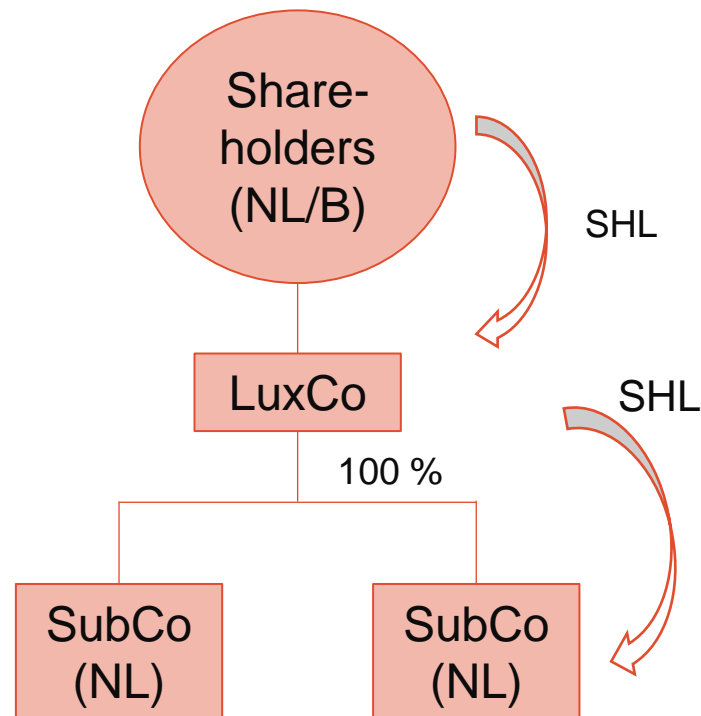
➡ *Requalification of excessive interest into a hidden dividend distribution*

- LuxCo provided a transfer pricing study with a range between 321 bps (lower quartile) and 788 bps (upper quartile)
- LuxCo provided a second TP study with a range between 9,95 % and 19,61 %
- LuxCo referred to a 5% interest provided by the Circular 164/1 LIR 23 March 1998
- TA: accepts ex post TP studies but rejects LuxCo's arguments - pricing not justified
- CA: rejects LuxCo's arguments – no relevant comparables



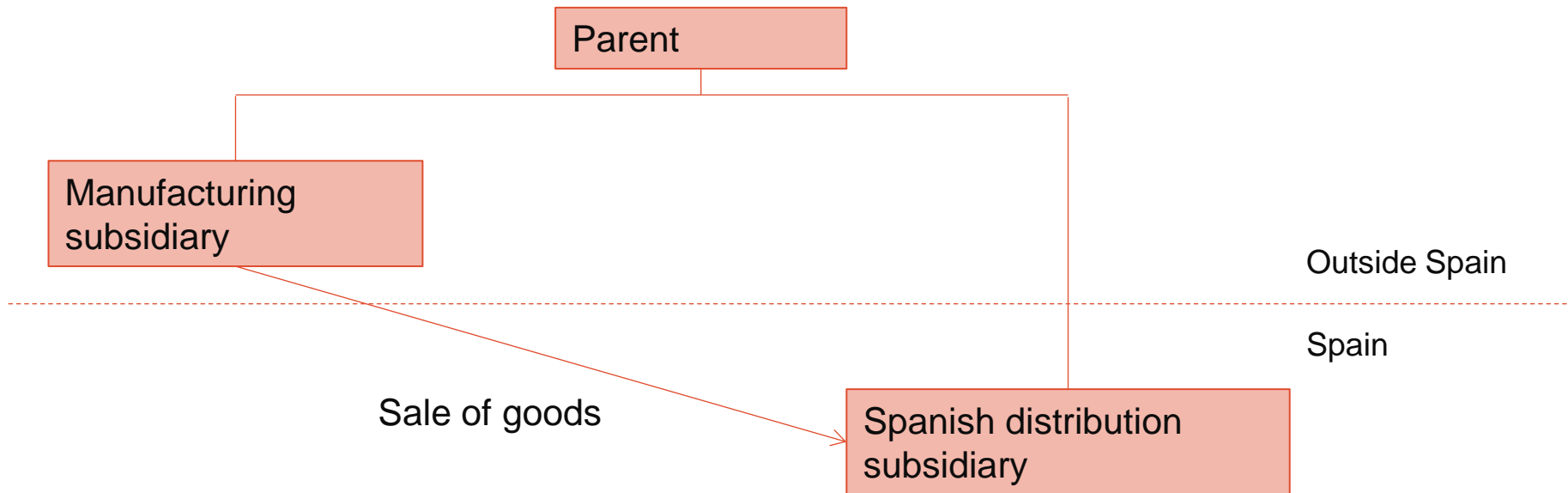
II. TA 7 January 2019 / N° 40251

- LuxCo purchased shares + provided loans in NL start-ups before waiving the loans + depreciation of the shareholding
- LTA: depreciation / waiver \neq arm's length but hidden profit distribution (non-deductible + 15 % WHT) - shareholders at the same time managers of all the companies and the depreciation + waiver only for their benefit without commercial rationale for LuxCo
- LuxCo: (i) no benefit to the shareholders (hidden profit distribution can only benefit shareholders not subsidiaries) and (ii) no transfer of profits and (iii) waiver economically justified
- TA: confirms LTA
- CA: Taxpayer provided sufficient evidence that the subsidiaries are without activity and financially distressed – sufficient to waive the appearance of the unusual character of the operations and hence no hidden profit distribution



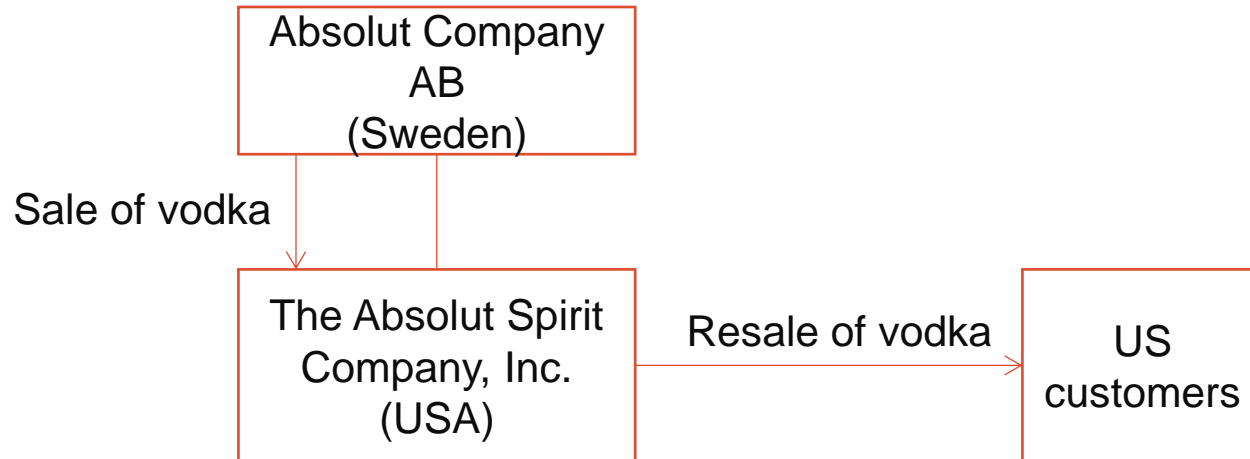
Which future challenges could be expected given recent high profile international cases and changes to the international tax conventions?

Goods distribution: IKEA Distribution Services, National Appellate Court of Spain, 6 March 2019



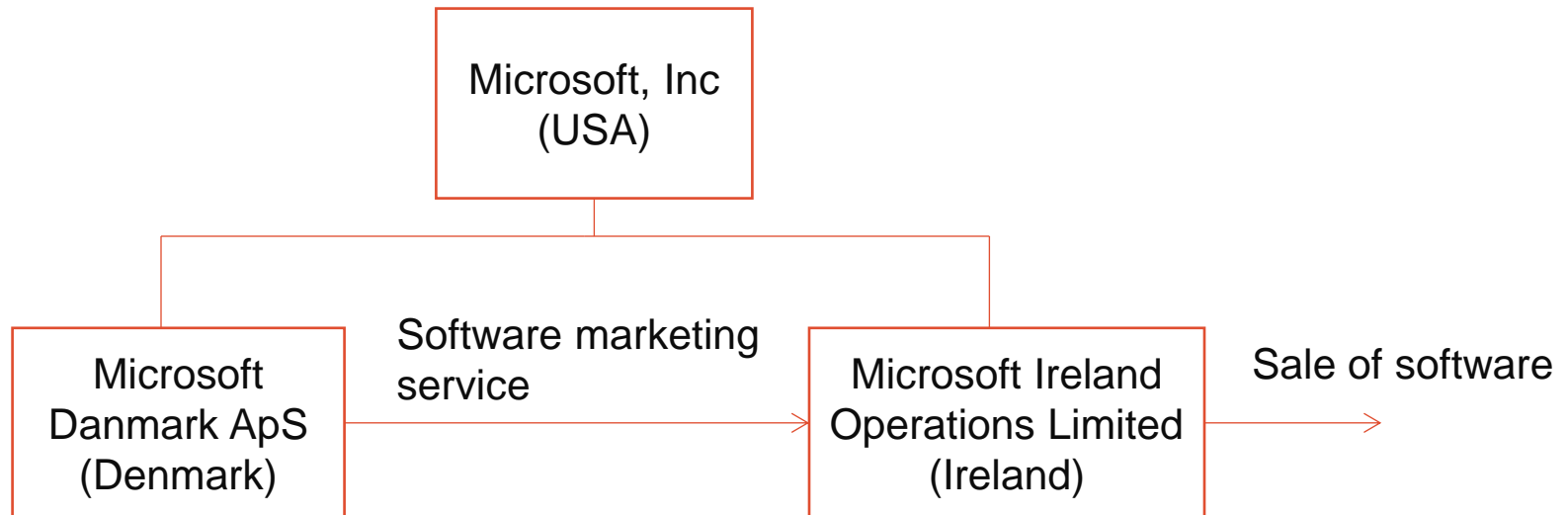
- Distributor margin inside ALR on average but not in year of assessment
- Decision: a multi-year ALR is acceptable, but the margin must be in this ALR in every year
- However, it cannot be adjusted up to the median unless there are comparability defects in the benchmarking, and different sales volumes is not a sufficient defect

Goods distribution: Absolut Company AB, Swedish Supreme Administrative Court, 19 June 2019



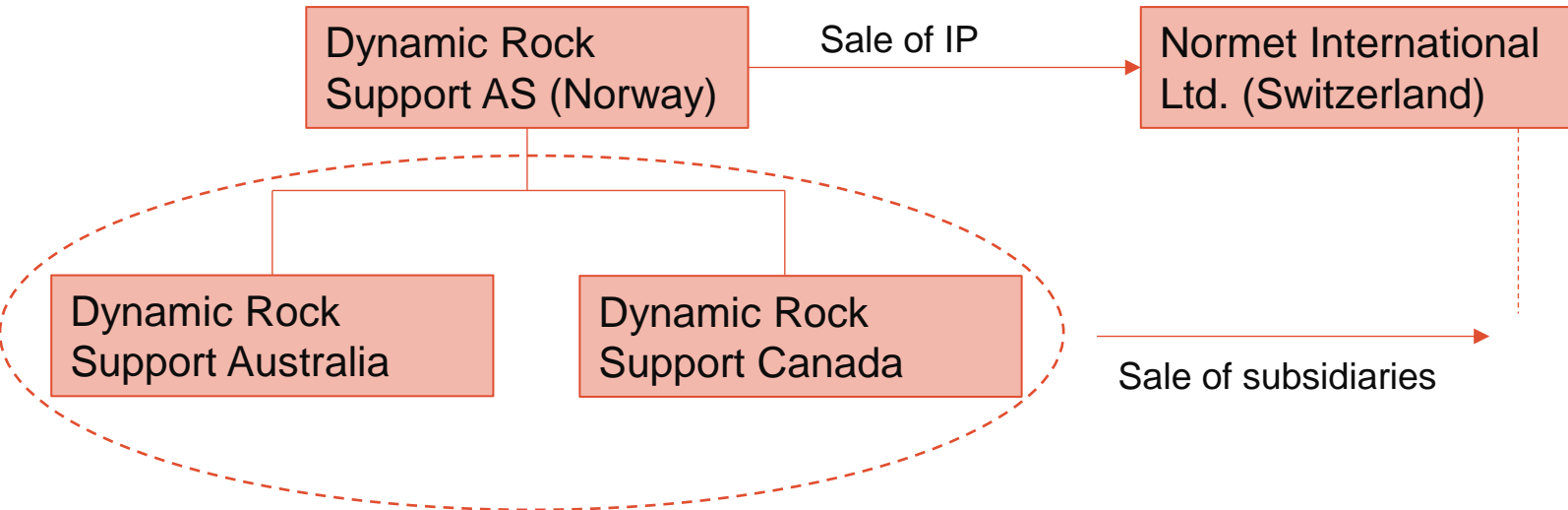
- Alleged undercharging to its US distributor
- Sub's US local file showed that it earned above the arm's length range of operating margins in 2007, justifying the transfer pricing for US purposes
- Taxpayer explained that this was because of outside events (takeover announcement) and the gross margin was reduced in 2008 to bring the US average operating margin back down
- Decision: multi-year analysis of tested party margins (2007-2008) accepted in this economic situation

Marketing service: Microsoft Danmark ApS, Danish Supreme Court, 31 January 2019



- Taxpayer earned a commission on sales of Microsoft software in Denmark made by Microsoft Ireland
- Tax administration argued that it should also receive a commission on sales of computers with pre-loaded Microsoft software because marketing the software had the effect of encouraging more purchases of computers containing the software
- Decision: impact on computer sales was incidental; also marketing of computers with Microsoft software loaded could have encouraged separate *software* sales

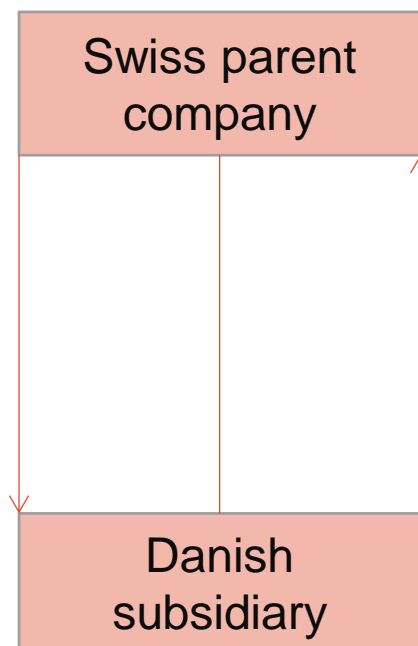
IP transfers: Dynamic Rock Support AS, Borgarting Court of Appeal (Norway), 19 March 2019



- Sale of the company was split into a (taxable) IP sale and a (non-taxable) subsidiaries sale
- Alleged misallocation of sale proceeds in favour of high value placed on subsidiaries
- Alleged incorrect to use a royalty present value method to value the IP, instead of valuing the distributor subsidiaries
- Court agreed that it was correct to consider both sales together and hence the allocation of the total sale proceeds
- Also that the IP value should be the (large) residual after deducting the value of the subsidiaries

Royalties: Anon, Danish Eastern High Court, 4 July 2019

Licence for use of marketing intangibles, know-how and access to group network



- IP owner

Royalties of 2% of turnover, increased to 2% and 4% because of new IP-focused business model

- Local opco

Anon, Danish Eastern High Court, 4 July 2019 (continued)

- Tax administration challenges:
 - No evidence of economic reasons for the continued losses of the taxpayer – turnover of the subsidiary consistently high
 - Danish subsidiary therefore only kept going to service the group's global clients
 - Also no evidence that Danish market conditions had been taken into account in setting the royalty rates
 - Danish subsidiary's high marketing expenditure indicated low or zero benefit from the trademark
 - No evidence of benefit from access to the global network because the Danish market appeared to be separate and price- not brand-driven (according to the TP documentation)
 - Swiss parent's intangible development expenditure actually fell after the business change
- Decision – tax assessment upheld by the court because of insufficient evidence from the taxpayer to counter the challenges

OECD developments: revision of the transfer pricing guidelines

Financial transactions (new chapter)

- Will include guidelines on recharacterisation of debt as equity, but will allow different approaches by each jurisdiction
- Will emphasise importance of borrower's credit rating
- Implicit group support adjustments to credit ratings will be optional
- May include some suggested safe harbours
- However, the issues are very controversial and disagreements are certain to continue

EU developments: Joint Transfer Pricing Forum

'The Application of the Profit Split Method Within the EU', March 2019

Results of a survey of the use of the PSM – not often used, and then only for APAs.

Probably because it is subjective and hence open to *challenges* – for example:

- Key people – who are they?
- Remuneration of key people – adjust for local purchasing power?
- Assets – revalue at the transfer pricing value? How often?
- Costs – latest year or a run of years, and if so how weighted?

Makes the following recommendations:

- Only use the PSM where one of the necessary conditions apply, i.e.:
 - ☐ Valuable contributions from each party and they cannot be benchmarked, or
 - ☐ High level of integration of activities (e.g. joint production process), or
 - ☐ Sharing of significant risks, or bearing of similar significant risks
- Use the *residual* profit split method
- Use figures from the *financial statements*

Which options are available to taxpayers to resolve transfer pricing controversies?

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- Informal discussions with tax administrations (but not in Luxembourg)
- Rollbacks in APAs (but not in Luxembourg)
- Domestic courts (Appeals Tribunal, Appeals Court)
- Local mediation (but used rarely because not very effective)
- MAP (with and without the MLI mandatory binding arbitration clause), per Circular
- European Arbitration Convention - possibility to invoke mandatory arbitration following vote on draft law no. 7431 in Parliament on 11 December 2019)
- Use of more than one option (in sequence or simultaneously)

What can taxpayers do to avoid transfer pricing controversies in the first place?

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- Good economic analysis of roles, contributions and risks
- Ensure adequate substance
- Two-sided benchmarking/consideration of next best alternatives for both parties, especially in valuations
- APAs – unilateral, bilateral, multilateral
- Supportable basis for tax rulings and APAs
- Responsibilities and payments set out clearly in good related party agreements
- Operation of agreements in an arm's length way

Summary of conclusions

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Current/imminent transfer pricing risks:

- Rulings/APAs which are expiring
- Use of profit split method
- IP transfers – valuations and ongoing royalties
- Conventional approaches to financial transfer pricing

Recommendations for TP risk management:

- Good economic analysis of roles, contributions and risks
- Ensure adequate substance
- Two-sided benchmarking/consideration of next best alternatives for both parties, especially in valuations and restructurings
- Supportable basis for tax rulings and APAs
- Responsibilities and payments set out clearly in good related party agreements
- Operation of agreements in an arm's length way
- Reference to industry experts and benchmarks in litigation, even if not very similar (but beware conflicting benchmarks)
- Base arguments on financial statements and tax returns
- Explaining unusual profits by temporary economic factors can be successful
- Evidence of normal industry practice can be decisive

Thank you for your attention !

Do you have questions?

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