Tax audit insights

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Transfer pricing audit insights

Austria: Audit on cash pooling

- An Austrian entity, which is a member of a cash pool and made consistently high deposits in the cash pool over many years (up to EUR 200 million per year), came under scrutiny during a tax audit in 2018. The audit covered the period 2012–2014, and the Austrian tax authorities questioned whether the interest rate for the cash pool deposits was at arm's length, suggesting that a third party would have requested higher interest rates for the deposits.
- The tax authorities determined the deposit interest rate based on the cash pool master's rating, resulting in a rate of three-month Euribor + 150 bp–75 bp, with the 75 bp remunerating the cash pool master. This increased interest rate would have led to an additional corporate tax burden of more than EUR 1 million for the tax audit period. The Austrian company filed an appeal with the Federal Fiscal Court challenging the tax audit adjustment.
- Court decisions on transfer pricing are infrequent in Austria, especially regarding cash pooling, making the outcome uncertain. The company faced the risk of having the constant deposit in the cash pool reclassified as an intercompany loan, which would lead to higher interest rates. Additionally, the cash pool master's substance might be questioned, potentially negatively influencing the decision.
- In 2015, the Federal Fiscal Court ruled in a non-officially published decision that a six-month Euribor (flat) represents an arm's-length interest rate for cash pool deposits (six-month represented the average of one year, which is a usually considered as short term in a cash pool). In the court's opinion, there was insufficient information regarding the cash pool master (e.g., functions, risks, revenue, and liquidity situation) to determine the interest rate based on the rating of the cash pool master.
- Ultimately, the Austrian tax authorities agreed to an interest rate for cash pool deposits of six-month Euribor + 2.2 bp for the tax audit period. This led to a 50 percent decrease in the profit adjustment for the tax audit period. For later years (approximately until mid-2022), this led to a de facto zero interest rate for deposits due to the negative six-month Euribor rate at the time, marking a significantly improved outcome for the company.

Belgium: Permanent establishment (1 of 2)

Background

- A company headquartered in the Netherlands sells its products via physical retail stores located in the Netherlands and Belgium as well as online.
- As the Belgian stores are operated by a Dutch company, this Dutch company has had a permanent establishment (PE) in Belgium for corporate income tax purposes since 2007.
- Thus far, the Belgian PE has been treated as an entrepreneur for commercial as well as tax purposes, meaning that the profits and losses relating to the operation of the Belgian stores have been allocated to the Belgian PE. The Belgian PE experienced historical losses.
- The majority of the functions in relation to the Belgian operations are performed from the Netherlands, including strategic management, procurement strategy/product portfolio, marketing and pricing, innovation, and warehousing/distribution/transport.
- The activities of the Belgian PE are limited to (1) management of local stores/sale of products/discounts, (2) aligning group strategy with the Belgian market, and (3) limited stock (in store).

Position of the Belgian tax authorities

- Considering the functionality of the Belgian PE, the Belgian tax authorities take the position that:
  - The Belgian PE can be qualified as a limited risk distributor (LRD).
  - The TP method applied is not in line with the arm's-length principle.
  - The application of the TNMM with return on sales as profit-level indicator seems to be more correct.
- The Belgian tax authorities made the following proposed adjustments:
  - Correction of the EBIT of the Belgian PE for financial year 2020 (and further) to a positive EBIT based on a benchmarking study to be performed by the taxpayer
  - Strikeout of tax losses incurred during financial years prior to 2020. The taxable profit of the Belgian PE for the financial years 2007–2019 was thus effectively adjusted to zero.

Belgium: Permanent establishment (2 of 2)

Position of the Dutch tax authorities

- Based on the division of functions and the management of risks with respect to the Belgian stores, the Dutch tax authorities follow the reasoning and position of the Belgian Tax Administration that the Belgian PE can be considered an LRD.
- The Dutch tax authorities seem willing to accept a unilateral correction, provided that they receive sufficient written substantiation, including a benchmark report, functional analysis, and (updated) master files and local files for the relevant years.
- Generally, a request for an ex officio reduction can be filed with the Dutch tax authorities within five years after the end of the financial year.
- When making a corresponding adjustment, however, the Dutch tax authorities may grant an ex officio reduction regardless of the 5-year period, in case certain conditions are met. This thus provides an opening for granting a corresponding correction also for earlier years—in this case back to 2007, effectively over 13 years.

Belgium: Recharge of restructuring costs from Russia to Belgium

- The Russian subsidiary of a Belgian-headquartered group that engages in the manufacturing and distribution of products adjusted its operations due to the social, economic, and political conditions in Russia during 2022. Specifically, in 2022, the group decided to scale back its distribution functions in Russia and suspended the construction of a manufacturing plant. As a result, the Russian subsidiary incurred restructuring costs, such as electricity expenses and ongoing construction costs, as well as severance payments for employees previously involved in the distribution business. These restructuring costs, particularly those related to the dismissal of employees, were financed by the Belgian headquarters (HQ), and a write-off was taken on the outstanding receivable.

- The Belgian Tax Authority (BTA) questioned the deductibility of the write-off that the Belgian headquarters took on the outstanding receivable.

- Several arguments were presented to the BTA in support of the write-off taken in Belgium:
  - A policy of joint responsibility and joint efforts to support group entities in a situation similar to the Russian subsidiary exists, which allows for deviations from the arm's-length principle. Therefore, there may be commercial justifications for diverging from what an independent party would do, particularly if this would be the best available option from a group perspective.
  - Secondly, the group is committed to maintaining a presence in the Russian market, despite the costs, due to potential growth opportunities. The restructuring costs could be categorized as “shareholder expenses,” as these costs were incurred for the benefit of the group as a whole rather than solely for the benefit of the Russian subsidiary.
  - There are expected future benefits from the arrangement between the Belgian HQ and the Russian subsidiary if the Russian operations continue. Specifically, the Belgian HQ would continue to receive royalties, dividends, and management fees from the Russian subsidiary.
  - Options realistically available include allowing the Belgian HQ to take the write-off to prevent the Russian subsidiary from facing a liquidation situation or reducing/eliminating future losses and application of the force majeure clause.

- Ultimately, it was agreed that no write-off would be taken. Instead, a conditional waiver on the receivable would be granted to the Russian subsidiary.

Belgium: Reduced royalty rates/exemption from management fee and royalty fee for five years

A Belgian headquartered group is engaged in the manufacturing and distribution of products. Belgian parent (UPE) charges royalties to the group's principal entities for the use of trademarks. In addition, the UPE also recharges management fees to the principal entities for the provision of central management support services. Both fees have been benchmarked.

The group lowered the royalty rate to the minimum rate supported by the benchmarking study for the principal entities located outside of Belgium. Additionally, the principal entity located in Eastern Europe was granted a five-year exemption from both management and royalty fees.

The BTA questioned the rationale behind the reduced royalty rates and the exemption granted to the East-Europe start-up principal entities within the group.

The following arguments were presented to the BTA:

- The reduced royalty rate for foreign group entities, as compared to domestic companies, aligns with established case law (Hyatt).
- Paragraph 6.78 of the OECD Guidelines, which is also followed by the Belgian administration, states that a distributor may perform functions, utilize assets, or assume risks that exceed those of an independent distributor with similar rights. Such a distributor would typically require additional remuneration from the owner of the trademark or other intangibles. This remuneration could take the form of higher distribution profits (resulting from a decrease in the purchase price of the product), a reduction in royalty rate, or a share of the profits associated with the enhanced value of the trademark or other marketing intangibles. As such, a reduced royalty rate is reasonable.
- The passing on of marketing costs (via the management fee) accounts for the lower royalty rate.
- The international market is less brand sensitive, which justifies the reduced royalty rate.
- Lower cost-plus margins for start-up companies have been agreed in Belgian rulings. OECD Guidelines state that deviations can be justified based on the business strategies pursued.

The case was closed without requiring adjustments.

Cambodia: Transfer pricing adjustment on rental income

Background

- A company (Company A) in a multinational group has an existing business in Cambodia, requiring it to establish presence in several locations (e.g., cities and provinces) all throughout Cambodia. However, the land ownership law in Cambodia requires that at least 51 percent of a company is owned by a Cambodian citizen. This is a problem because Company A is wholly owned by a foreign entity.
- To obtain land ownership, the group established a land-holding company (i.e., Company B, which is a shell company with no operations) that is 51 percent owned by Cambodian citizen, with the intention to purely hold the land, which is used in the business operations of Company A.
- Company A provided a loan to Company B, at 0 percent interest, and correspondingly, Company B charges minimal rental income to Company A (i.e., based on the certain percentage of the income earned by Company A). There's no proper TP benchmarking analysis or TP documentation prepared by Company A or B to support this related-party transaction.
- Over the past years (i.e., due to COVID-19), the income of Company A decreased, resulting in a decrease in rental income earned by Company B.
- The tax authority in Cambodia conducted the tax audit in Company B and then issued a TP adjustment issue to Company B on the premise that the rental income charge is not at arm's length. In the assessment, the tax authority challenged that had the parties applied the "market rate" of rental, Company B would have recognized a higher rental income. Furthermore, the tax authority has challenged the basis of the rental based purely on variable component (i.e., percentage of sales). Accordingly, at the very least, rental arrangements should have at least fixed component (i.e., fixed fee) and, if necessary, an additional component to account for any variable factors in the business.

Outcome

- The case was resolved where the tax authority and Company B discussed and agreed on a fair market value (FMV), which was based on the tax authority's "database" and research of FMV of similar properties in the respective locations, which the client proposed to discount 10 percent to take into account the market escalation rate for rental.

Takeaways:

- The tax authority has been more aggressive in issuing TP adjustment issues. One key challenge identified in this case is whether the "market rate" applied by the tax authority in its TP adjustment issue is reflective of the arm's length rate, considering all factors. However, due to the lack of proper benchmarking study of documentation on the part of the company, it became difficult for it to challenge this type of assessment, highlighting the importance of keeping proper TP documentation.
- Pricing arrangements involving related parties must be studied carefully to ensure that all other relevant factors are taken into account (e.g., basis for the fees charged, circumstance, rates, currency applied, risks assumed, etc.). Note that the TP regulations have been introduced for a number of years, but the actual implementation and enforcement are still relatively new in practice.

Czech Republic: Depreciation of the valuation difference

- Taxpayer is a contract manufacturing provider (assembly plant) operating in the welding technology sector. Its main activity is the production and subsequent sale of welding consumables for the group's related parties. Taxpayer develops, manufactures, and distributes equipment used for cutting, joining, and automatic welding of steel, aluminum, and other metals and metal alloys. Welding consumables are then resold to a related party in the group.
- Taxpayer manufactures for a related party under a Manufacturing Agreement. This agreement was also linked to a margin letter, which set the taxpayer's target profit margin for 2014 and 2015 at between 2.5 percent and 3.5 percent. The profitability achieved was regularly reviewed by the taxpayer to ensure that it was within a specified range.
- The Czech Tax Authority (CTA) performed a benchmarking analysis for the 2014 and 2015 tax years. The tax authority disagreed with the exclusion of yearly depreciation related to a "valuation difference" arising from the company's legal transformation via spin-off from the cost base for calculation for the year-end transfer pricing adjustment. According to the CTA, the valuation difference is related to an economic activity of the company and should be included in the cost base.
- Because the taxpayer failed to achieve the profitability calculated on full operating costs (i.e., including amortization of valuation difference) in comparison to the result of the CTA's benchmarking analysis, the CTA assessed additional tax for the 2014 and 2015 taxable period.
- There is currently a court case pending at the level of the Supreme Administrative Court (SAC), as the Regional Court agreed with the CTA's approach. Taxpayer continues to assert that the "valuation difference" is only a fictional accounting item, which does not represent a real cost (i.e., cash-out) and which does not influence the production costs of products. In addition, taxpayer argues that CTA's approach results unjustifiably in two different prices for the same product depending on whether a company undertakes a tax-neutral business restructuring or not.
- Taxpayer further argues that, because the comparable entities in the benchmarking analysis do not record a valuation difference, it is therefore appropriate for the taxpayer's cost base to be adjusted to exclude the valuation difference.
- Moreover, the taxpayer views the valuation difference as an extraordinary item that must be excluded from transfer pricing calculations under the OECD Guidelines.

Czech Republic: Secondary TP adjustment

- Taxpayer is an assembly plant operating in the electronics industry and providing contract manufacturing and assembly services. Its main activity is the assembly of servers and other IT products for the group's end customers, which are nonrelated parties. Taxpayer assembles individual components into the final products according to the prescribed specification and procedures determined by the customer. This final product is then delivered and invoiced to that customer.
- All business aspects (e.g., new engagements, prices, and production volumes) are negotiated and agreed directly between taxpayer and final customers. The Group's involvement is rather limited. However, multilateral "umbrella" agreements formally defining general aspects of cooperation on the group level are concluded with customers.
- The Czech tax authority (CTA) determined that, under the umbrella agreements, taxpayer is classified as a limited risk contract manufacturer. CTA performed a benchmarking analysis of independent comparable manufacturers. As a result, CTA decreased the incurred loss by an amount equal to the difference between Taxpayer's operational results and the CTA benchmarking results. CTA asserts that the "missing" revenue should have been compensated by the parent company.
- Furthermore, CTA characterized the compensation that should have been paid by the parent company as dividend payments from taxpayer to its parent company, i.e., a secondary transfer pricing adjustment. Consequently, the deemed dividend resulting from the increased compensation is subject to withholding tax.
- The tax proceedings are currently ongoing; however, all indications suggest that CTA is firmly convinced of its evaluation of the case, thus withholding tax had been assessed.
- Despite the secondary transfer pricing adjustment being a widely recognized method for resolving discrepancies resulting from primary and corresponding adjustments, CTA has failed to address specific critical aspects in this particular case that are essential for an accurate assessment. Specifically:
  - The primary adjustment decision explicitly states that it is not relevant which entity from the group should have compensated the loss. Nevertheless, CTA automatically assumes that it should have been the ultimate parent entity.
  - CTA does not address the precise timing of when the difference between the agreed price and the market price was ascertained, despite its crucial importance in assessing whether the compensation should be considered as actual dividend payments subject to withholding tax or not.

Denmark: Business restructuring – Deemed transfer of intangibles

- A group with a Danish parent company with activities within the digital economy was acquired several years ago by a large international group with an ultimate parent company in the USA.
- The purchase price of the shares was mainly allocated to intangible assets and inflated due to expectations of significant benefits from integrating the activities into the bigger group. The expectations for earnings 10 years later have been far from fulfilled as the activity as a whole has been loss-making.
- Business restructuring – Over the course of three to five years after the acquisition, the number of employees in the Danish company was reduced by approximately 80 percent. After the acquisition, the earnings in the Danish company are positive but small and, as indicated, far below the expectations that were the basis for determining the purchase price of the shares.
- The Danish Tax Authorities (DTA) initiated an audit and claimed that the Danish company's intangible assets can be considered for tax purposes to have been transferred to the American parent company, which has taken over DEMPE function and control of the activity and risks related to the company´s intangible assets. The sale price is in principle set to be the value for which the shares were originally sold.
- The company´s transfer pricing documentation did not give a clear indication of when a business restructuring had taken place. Without documented support, the Tax Authorities looked to the acquisition price.
- The case will most likely be presented for initiation of treaty-based MAP, and the company´s right to litigation will be ensured.
- Key takeaways: Overall, the case highlights the challenges faced with business restructuring as a result of implementing acquisitions into the larger group's existing organization and business model. In the absence of documentation of the actual control of relevant risks and in the absence of better evidence, the Tax Authorities will emphasize the acquisition price of the shares.

Denmark: Profit split method

- Before being acquired by a large US multinational enterprise (MNE) in the 2010s, a Denmark-headquartered group with various business segments had a growth and diversification strategy that involved a highly decentralized business model. Generally, product intangibles (patents) were centralized at the Danish company, i.e., product intangibles were economically owned by the Danish company. A royalty model ensured that group entities, including former owners of the patents, pay for the use of IP.

- Following several loss-making years, the Danish Tax Authority (DTA) determined that the royalty payments to the Danish company were not at arm's length. In addition, DTA observed that licensees were highly profitable in almost all of the group's business segments.

- Upon request from the DTA, the Danish company agreed to test the allocation of profits in the group with a corroborative method. The Danish company provided data and calculations for a profit split method (PSM) analysis. The results indicated that the Danish company was not sufficiently compensated. In response, the DTA disregarded the applied transfer pricing policies and increased the taxable income. The DTA claimed that the PSM is the most appropriate method. The DTA also changed the weighting of the applied allocation keys without explanation, increasing the allocation of profits to the Danish company by more than 10 percentage points.

- This dispute has resulted in several MAP cases, both treaty-based MAP as well as MAP as provided for by the EC Convention. The MAP cases are still in process. There have been challenges in agreeing on factual matters, especially regarding functions and control of risks linked to intangible assets. One case is currently progressing toward EU arbitration for further resolution.

  Following the audit process, the taxpayer increased royalty rates for the following years, substantiating these alterations with the previously submitted PSM calculations. Although the taxpayer accepted the outcome of the PSM method, it aims to retain the existing royalty model for future application, deeming continual reliance on PSM burdensome.

- This case highlights the challenges that may be faced in managing a decentralized structure, the need for alignment with transfer pricing policies, and the role of robust transfer pricing documentation.

- Furthermore, this case underscores the profound implications of data sharing with tax authorities, emphasizing the critical importance of discerning what information to disclose and what might be strategically withheld, particularly in initial phases of a case. Such considerations are crucial in navigating regulatory interactions with foresight and strategic insight.

France: Examiner sends exchange of information request for invoices related to French HQ companies

Background

- A French company engages in distribution activities in which it sells goods produced by and purchased from a foreign related party.
- The company underwent a transfer pricing exam by the French authorities. The French examiner noted the company has French customers in other regions where revenue is being booked. As a result, the French examiner sent an exchange of information request to the United States, Switzerland, and Singapore requesting invoices related to France-headquartered companies.
  - In the United States, a simplistic request was received asking for transaction data with French headquartered companies.
  - In Switzerland and Singapore, the requests were more involved and included functional interview questions, among others.

Takeaways

- Taxpayers should remain aware of exchange of information requests and be ready to respond in a timely matter.
- KPMG has observed similar exchange of information requests in other French examinations, so companies with French headquartered businesses should remain aware of the possibility of these requests.
- Taxpayers may expect a rise in the number of requests as tax authorities leverage their foreign counterparts.
- With the rise of country-by-country reporting initiatives, taxpayers should also consider that their intercompany transactions will come under further scrutiny from tax authorities across the globe.

Germany: Tax authorities assert German R&D subsidiary should have received sales-based remuneration for distribution activities

Background

A US-owned manufacturing company owns several German entities that primarily perform research and development activities that are compensated on a cost-plus basis. One German entity also performs distribution activities, for which it was also compensated on a cost-plus basis. Various intercompany loans exist related to financing working capital needs and historic cash repatriation activities.

Tax authority's position

The German tax authorities asserted that the German subsidiaries of the US company were involved in distribution activities to the extent that an additional sales-based renumeration was required in Germany. Other transfer pricing adjustments were also identified on audit.

Outcome

The German tax authorities have tentatively reached an agreement with the German subsidiaries. The agreement tentatively resolves all the transfer pricing issues with a single adjustment that is not directly attributable to any one entity or a particular activity or asset. No reference is made in the agreement to a change in the basis upon which the distribution company's activities are remunerated. This agreement was reached after the US company provided the German tax authorities with evidence that shows the German entities performs primarily contract R&D activities and only limited sales-related activities.

Key takeaways

It is important to carefully monitor the overall margins of routine-type entities and consider financial transactions and one-time effects in order to be able to demonstrate an overall appropriate remuneration. In addition, it is notable that the company was able to reach a settlement which did not require it to commit to a change in transfer pricing methodology (namely, to a sales-based remuneration) for its distribution activities.

Germany: German tax authorities question company's decision to deduct restructuring costs on German tax return instead of US tax return

Background

- A US-based manufacturing company owns several German entities that perform manufacturing, sales, and marketing activities. Recently, the US parent company acquired another multinational group that included German operations. Following this acquisition transaction, the company undertook a restructuring project to (i) integrate the acquired entities within its existing structure and (ii) simplify its German operations via legal entity rationalization.
- The company deducted on its German tax return the costs associated with this restructuring. As explained by the company to the German tax authorities, the restructuring costs incurred were necessary because such restructuring enables the company to stay competitive with its industry peers. The company also notes that the restructuring resulted in a stable positive profit over the multiyear average in line with its functional and risk profile.

Tax authority's position

The German tax authority questioned whether the restructuring costs should be deducted on the US parent company's US tax return (instead of the German tax return). The German tax authority requested additional information regarding the restructuring in order to better understand the decision-making process relevant to the restructuring and related contractual arrangements and activities.

Outcome

This case is ongoing.

Key takeaways

It is common practice to seek a tax deduction for costs associated with postacquisition integration and legal entity restructuring projects. For cross-border restructurings of this type, it is very important for companies to maintain an internal memorandum that documents the involvement and control of risks over the costs of the restructured entity. Having an internal memo that contains this information will be useful later if deductions for such costs are challenged at some point. It is also important to be able to demonstrate that the overall margin of the restructured routine entity is on a weighted average basis considered to be at arm's length.

Japan: Despite extraordinary issues, US-Japan APA reaches resolution

Background

- A Japanese company is engaged in the manufacture of automotive components. The Japanese company has subsidiaries in the US engaged in the manufacture and distribution of automotive components.
- Taxpayer filed a bilateral US-Japan APA request in 2019. Covered transactions were broken down by business segment and included purchases of components from related parties for further manufacturing and sale to third parties, purchase of finished goods for resale to third parties, royalty payments for use of IP, contract R&D services, and sales/technical support services.
- For the manufacturing and distribution transactions, the US entities were the tested parties. Factors unrelated to transfer pricing such as Section 203 and Section 301 tariffs, the COVID-19 pandemic, large asset impairments, and plant closures negatively impacted the results of the US entities and left the entities in a loss position or low level of profit in recent years.
- Despite these extraordinary issues, the competent authorities were ultimately able to reach a resolution.

Outcome

- Following negotiations between the competent authorities, it is understood that the competent authorities had agreed to a CPM range for the distribution and manufacturing transactions.
- However, per the mutual agreement, no transfer pricing method was specified for the covered transactions. The factors listed above, however, were taken into account in resolving the APA.
- A compensating adjustment was only made to limit the amount of the royalty transactions to increase the taxable income of the US entities.

Mexico: Audit of a company in the manufacturing of food products

- A multinational company in the food industry was audited by the Mexican Tax Administration (SAT) for several tax years. The company's business consists of the manufacturing and distribution of processed food.

- For FY 2016, SAT argued that the intragroup administrative services and exchange losses were not deductible since it considered that the company did not provide enough supporting evidence to prove that the services were effectively rendered by foreign related parties to the company.

  Also, SAT argued that, regarding the transactions carried out with related parties in connection with the reimbursement of expenses and interests paid abroad, the Company did not comply with the TP rules, including the application of the TP method (comparable uncontrolled price) and the interest rate determination, respectively.

- For the reimbursement of expenses, SAT pointed out that the company did not provide sufficient supporting evidence to validate the prices applied in the transactions carried out by its related party with third parties (possible internal comparables), which would prove that a reimbursement should be applied by the company.

  For the interests paid abroad, SAT determined that, through the Z score model, the company's credit rating was "D," thus, concluding that no entity (related or unrelated) would grant any loan to the company. In this case, the total amount of the interest deduction was rejected.

- The company decided to enter a mediation procedure through the Mexican Tax Ombudsman (PRODECON) to negotiate and resolve both tax and TP issues through a conclusive agreement.

- Through PRODECON, new elements and documents were provided to support the viability of the deduction. In order to reach an agreement with SAT, the company proposed a TP adjustment considering the lower limit of the market range obtained from comparable companies.

  Since the procedure in PRODECON is limited to a 12-month negotiation period and this procedure could not be extended any further, it was terminated and no agreement at this stage was reached.

- Following the failure to negotiate through a conclusive agreement, currently, a negotiation is being carried out directly with SAT outside the mediation mechanism and before the tax credit may be released; whereas as part of this phase, additional information and supporting evidence are being rendered to the tax authorities to reduce the tax contingency.

Mexico: TP approach for full-fledged distributors

- The company is a multinational enterprise involved in the electronic and home appliances devices business with a distribution entity in Mexico. The company priced the goods purchased from the distribution entity's foreign related parties to be distributed in Mexico using a gross margin approach.
- The activities performed by the Mexican distributor included marketing and sales effort functions. One of the most relevant risks assumed by the Mexican distributor was the price relief/rebates provided to third-party clients (retailers) in cases of obsolescence or slow inventory movements.
- The Mexican Tax Administration (SAT) started an audit and disallowed the gross margin approach because, from the revenue authority's perspective, the intercompany price estimated based on the tested party's gross margin (in this case, the Mexican distributor) did not take into account the marketing and sales effort functions performed by the Mexican entity. Deductions were also disallowed—not due to transfer pricing but from an income tax perspective—because SAT argued they lacked economic substance/supporting evidence.
- The company reached a settlement with SAT through a conclusive agreement procedure with the Tax Ombudsman office. The agreement contemplated an adjustment based on an operating margin approach, which was estimated by contemplating not just regular accounts payable, inventory, and accounts receivable adjustments but also a country risk premium. The transfer pricing method was changed from the resale price method to the transactional net margin method.
- The company initially filed a negative operating margin result, which was then adjusted to a 1.78 percent return on sales as a result of the negotiation handled through the conclusive agreement procedure. This adjustment is not eligible to pursue Competent Authority assistance (for double tax relief), given the regulatory framework of the settlement carried out through the Tax Ombudsman office.

Netherlands: TP audit focused on “business” transfer 17 years ago

- A company headquartered in Europe has several manufacturing plants in Europe, including in the Netherlands.
- The 2022–2023 audit covers years 2018 and 2019 and a business transfer that took place in 2006 (17 years ago!).
- The business was not transferred from the Netherlands but from a subsidiary of the Netherlands to another group company. The 2006 transfer is under audit because the company in the Netherlands holding the shares of the business seller was recently liquidated resulting in a liquidation loss for the Netherlands. In case of liquidation loss, the Dutch Tax Authority (DTA) can go back indefinitely to investigate possible reasons for the loss.
- The business transferred in 2006 was acquired from a third party for a total value of approximately EUR20 million just before the intercompany transfer.
- The DTA argues that the business transferred should have been sold for approximately EUR25 million, that is, EUR5 million more than the group paid the third party, then there would be no loss at liquidation (2019). The rationale is that
“the group” knew it would have to restructure.
- The business was transferred to another EU country. The buyer is also a manufacturing plant.
- The business transferred was mostly a customer list. Other assets (some working capital, some fixed assets, and some employees) were left behind, and the business seller shut down in 2008. The business seller could not be liquidated until 2019 because of some environmental liabilities.
- The business was transferred for approximately EUR15 million. That is, the purchase price of EUR20 million minus working capital and minus fixed assets.
- The group has the purchase price allocation (PPA) from the original third-party acquisition, which clearly explains the EUR20 million paid for the full business (customer list, working capital, very limited fixed assets (one production line is a bit obsolete)) and some employees. The group also has all the related documentation: intercompany asset purchase agreement, due diligence of the business, business case for the acquisition from the third party, etc.
- The DTA argues that the business transfer/customer list was not at arm’s length even though it deviates only slightly from the PPA.
- The DTA also challenges the valuation of a different business transfer (production line plus associated revenue) that took place in 2015.
- Finally, the group charges a royalty rate (less than 0.5 percent of sales) for the use of the group’s brand. The DTA argues brands in a business-to-business context do not add value, and the royalty is not deductible.

KPMG

Romania: Royalty payments scrutinized in Romania

- The taxpayer is a Romanian entity operating in the distribution of dairy and milk products. Several years ago, the group planned for the Romanian entity to become a manufacturer of the dairy and milk products, but its activity remained limited to the exclusive distribution of the dairy and milk products in Romania. The products are manufactured in Germany by a group affiliate with a long history of production, then acquired by the taxpayer.

  Any related intellectual property was owned by a Dutch affiliate. For that reason, the taxpayer needed to separately compensate the Dutch affiliate via a royalty.

- The taxpayer had low profitability in recent years and was in a loss during the 2019–2022 period. Taxpayer paid a 5 percent royalty on the sales made in Romania. The relevant intercompany contract states that the royalty payments are due for production rights, know-how, exclusive distribution on the Romanian territory, etc. Taxpayer performed a benchmarking study that supports the royalty payment of 5 percent as within the interquartile range of a comparable set of royalty arrangements.

- The Romanian tax authorities denied in full the royalty payment of 5 percent of sales made on the Romanian territory. The adjustment fully denied the deductibility of the expense, denying the existence and need of a royalty payment for a distributor, even if there are comparable contracts for distribution activity.

  The Taxpayer asserts that denial of deductions for royalty payments related to distribution does not accord with the OECD Guidelines.

- Royalty payments represent a well-known concept in the world of international taxation, and the legitimacy of these royalty payments is evidenced in the OECD Model Tax Convention and in the Conventions for Avoidance of Double Taxation concluded between states. However, in Romania, expenses with royalty payments are heavily denied by the Romanian tax authorities.

United Kingdom: Transfer pricing settlement agreed

Background

A UK subsidiary within a life sciences MNE group underwent a Profit Diversion Compliance Facility (PDCF) process after being nudged to do so by HMRC focusing on the extent and location of historical regional management activities in EMEA. The UK entities received a cost-plus return for their role in the regional management with a principal for the region located in another European jurisdiction with a lower tax rate.

With the passage of time and evolutions in the business, evidence of the people functions and governance activities in the region was incomplete presenting a real practical challenge. Additionally, the implementation of the cost-plus policy was inconsistent.

Outcome

Extensive work undertaking functional interviews of employees still in the business, and collation of other evidence and sanity checks around the global value chain led HMRC to accept that the cost-plus characterization was appropriate for the UK entities contribution to regional management. However, HMRC asserted that the markups given were insufficient and challenged the comparability of the benchmarking sets. HMRC argued that any point in the interquartile range (IQR) was at arm's length but then undertook its own benchmarking exercise to identify its own comparables and IQR, which the taxpayer decided to pragmatically accept despite significant weaknesses in the HMRC analysis.

Key takeaways

Being audit ready by contemporaneously documenting, and collating underlying evidence for, key people functions, decision-making, and governance would have given the taxpayer a stronger negotiating position and saved considerable time and disruption.

HMRC's approach here is reflective of its general approach to very critically look at the comparability of benchmarking sets in audits and PDCF processes after testing the functional analysis and evidence. This includes undertaking its own benchmarking, focusing on asserted quality rather than quantity of comparable companies.

United States: Company receives IRS nudge letter following period of several years with sustained losses

Background

A US company involved in distribution activities in which it sells goods produced by and purchased from foreign-related parties incurred repeated losses over period of several years. As a result, the entity received a nudge letter from the Internal Revenue Service (the “Service”).

Tax authority’s position

The Service, by way of a nudge letter, inquired as to the substance of the controlled transactions the entity is engaged in. The Service cited the entity’s involvement as a distributor of goods obtained from a foreign entity and its reporting of losses or low margins on tax returns as the basis for issuing a nudge letter. The Service requested the company investigate its transfer pricing policies, applicable intercompany agreements, financial results, and tax filings to ascertain whether compliance with transfer pricing rules is satisfactory and to correct any noncompliance. The Service also required evidence of such compliance. The nudge letter explicitly stated that it neither constituted an audit or an examination.

Taxpayer’s position

KPMG teamed with the entity to address the inquiries posed by the Service and addressed each request in the nudge letter to demonstrate compliance with transfer pricing rules and regulations. The company affirmed its compliance and provided the Service a detailed description of its intercompany pricing activity. The company also provided an explanation of its key functions as well as those of relevant suppliers. The entity explained relevant risks associated with its activities and emphasized that its risks and functions are comparable to related parties in the market. The company detailed why the pricing methods it utilized are reliable and consistent with similarly situated parties in the market and why its transfer pricing policy is well established and consistent. Lastly, the company explained that its losses were not the result of noncompliance with transfer pricing rules, but rather due to greater than anticipated operational expenses, expansion costs, the COVID-19 pandemic, and the appreciation of relevant foreign currencies relative to the American dollar.

Outcome

The controversy in this matter is ongoing. In early 2024, the company timely replied to the Service’s nudge letter. The company awaits the Service’s reply to its responsive filing.

United States: IRS proposes comparable set based on operating asset intensity for distribution activities

Background:

- A US company engages in distribution activities in which it sells goods produced by and purchased from a foreign related party. In 2022, the company filed a renewal APA application regarding the distribution transaction using the transactional net margin method (TNMM) and operating margin (OM).
- Taxpayer proposed a comparable set based on similar standard industrial classification (SIC) codes to the distributor with comparable functions, assets, and risks. As part of the APA negotiations, the Service approached KPMG with a comparable set drawn from an internal database based on operating asset intensity (operating assets to sales) and other financial ratios similar to taxpayer. The Service proposed set included distributors across a wide range of industries including construction materials, food products, and software. Only one comparable appeared in both sets of searches.
- KPMG analyzed the sets from a quantitative perspective, relying upon the guidance in the OECD's Public Consultation Document Pillar One – Amount B relating to OAS Intensity, and a qualitative perspective. KPMG proposed a combined set that eliminated comparables outside of taxpayer's factor intensity grouping and building materials companies due to the impact of the pandemic on the industry.

Tax authority's position

- Ultimately, the Service's position paper relied upon the taxpayer's proposed set with adjustments to some of the comparables; however, the Service relied upon the set based on operating asset intensity and Amount B principles to support its position and corroborate the range it proposed.

Outcome

- The competent authorities ultimately agreed to an OM range of 2.00 percent to 4.93 percent.

United States: Understanding IRS Letter 6607

Background:

- The IRS is intensifying its scrutiny on US subsidiaries of international corporations that engage in domestic distribution but neglect to pay the adequate tax on the revenue generated from their US operations. These entities consistently declare losses or minimal profit margins annually, exploiting transfer pricing to understate their US income. To counteract this tactic, the IRS is issuing compliance notifications to an estimated 150 subsidiaries of sizable foreign conglomerates to underscore their US tax obligations and incentivize self-correction

KPMG experience

- Although Letter 6607 appears to be primarily intended for US companies involved in the purchase and resale of tangible goods from foreign-related parties, KPMG has noted that companies engaged in both distribution and manufacturing activities within the US have also received this letter from the IRS. Currently, KPMG has observed companies from various industries receiving this letter from the IRS, including companies from the automotive, chemical, and construction materials industries.
- Letter 6607 is a voluntary compliance document that provides three options. Option 1 indicates that the taxpayer is fully compliant with IRC Section 482. Option 2 provides for the taxpayer to amend all noncompliant returns to reflect increased taxable income. Option 3 allows the taxpayer to request an additional 30 days to respond.
- If Option 1 is selected, the taxpayer must attach a detailed description that includes, but is not limited to, the pricing, function and risk analyses, transfer pricing methodology, and economic analysis in order to demonstrate compliance with IRC Section 482. The attachment should also describe any losses or low margins for the years mentioned in Letter 6607.
- If the taxpayer is not a simple distributor, highlighting this in its response could be beneficial in helping the IRS correctly assess the taxpayer’s facts. KPMG has observed companies receiving this letter even when their distribution segment was at arm's length, but other factors, such as their manufacturing segment, pushed them into losses.

Key takeaway

- Any taxpayer in the US, which is a subsidiary of a foreignheadquartered company, should be careful when they are in a loss position, as they can expect further scrutiny from the IRS.

Vietnam: Defending TP position during COVID-19 period

Background:

Taxpayer is a contract manufacturer of jewelry and related fashion accessories in Vietnam. It incurred losses in FY 2020 and FY 2021 due to significant drop in global demand for “nonessential” goods caused by the global COVID-19 pandemic. There were temporary closure of operations and restrictions on number of workers allowed to be on-site mandated by the local government to combat the spread of COVID-19. This meant that full wages and benefits were paid to workers despite these restrictions during the lock down periods.

The local files presented the economic adjustments to show impact of the idle capacity, extraordinary costs incurred, etc., resulting in the COVID-19 pandemic. The analysis demonstrated that the company would have achieved an arm’s-length return in light of the impact of the pandemic

Tax authority’s position

Tax authority rejected the economic adjustments because similar adjustments were not made to the comparables, which were not possible due to limitation of data.

Tax authority simply used the benchmarking result contained in the taxpayer’s local file to impose profit adjustments for 2020 and 2021. While the benchmarking results were relatively low compared to pre-COVID-19 years, the proposed adjustment still led to an enormous tax assessment.

- ## Company’s defense

- Emphasized that the group/related party (counterparts) incurred losses to a greater extent for 2020 and 2021.
- Conducted benchmarking analyses of (1) manufacturers of nonessential products in the same province/region (South Vietnam), (2) manufacturers located in the same industrial park as the company, and (3) manufacturers of jewelry/accessories located in Vietnam.
- Based on the analyses above, the benchmarking observations showed that the losses were significantly greater compared to the taxpayer without considering any economic adjustments.

Outcome

- Tax authority agreed with the taxpayer’s explanation and did not make profit adjustments.

Key takeaways

- Economic adjustments are often challenged by the tax authority. Losses incurred by a taxpayer during 2020 and 2021 (COVID-19) are highly contentious in Vietnam. Having a pragmatic strategy and being able to clearly convey the arguments to the tax authority are critical in defending our position and/or mitigating TP risks.

International tax audit insights

Cambodia: Denying priority periods tax incentive

Background

The company's principal business activity is to manufacture and supply aluminum cans and ends for sales in Cambodia and for export abroad. Per the investment application form to the Cambodian Investment Committee of the Council for Development of Cambodia, which clearly shows a share capital of approximately US$5 million and investment capital of approximately US$45.7 million (included building, machinery and equipment, and other expense), the company is entitled to tax incentives in accordance with the 2003 Law on Amendment of the Law on Investment, which includes an exemption from income tax. The exemption period comprises a trigger period plus three years plus the priority period. The priority period is determined in accordance with the law on financial management, which depends on the amount of actual uses of the investment capital. Referring to the actual investment capital of the company, it has exceeded US$20 million, and hence, the company is entitled to a two-year priority period for tax on income exemption purposes.

Tax authority's position

The tax authority denied the company's two-year priority period for the exemption of the tax on income on the basis of the "share capital" of the company of US$5 million in determining the condition for eligibility of the priority period—that meant there should be no priority period. The tax authority reassessed 20 percent tax on income on the taxable income for the years instead of exempted as claimed by the company.

Outcome

The 20 percent tax on income reassessment had been withdrawn by the tax authority after the company filed the official protest letter and attended meetings to explain the case and applicable regulations, in particular to differentiate between share capital and investment capital.

Key takeaways

The tax authority accepted the interpretation of the law on investment and what is considered as share capital and investment capital.

India: Depreciation claim on goodwill

- An Indian group undertook an intragroup restructuring, resulting in a tax-free merger of two Indian companies into another company. Excess of merger consideration over the net assets acquired of the two companies was accounted for as goodwill in the books of accounts of the resulting company. The resulting company recognized goodwill of US$12.5 million and claimed tax depreciation on the goodwill, resulting in significant tax benefit.
- Under Indian jurisprudence, there is a long-standing controversy on allowability of depreciation on goodwill arising on corporate restructuring. Further, due to an amendment in tax laws, there is a specific bar on allowability of depreciation on goodwill.
- KPMG assisted the company in obtaining a purchase price allocation of the goodwill, which involved identification of various intangibles acquired (customer contracts, customer relationships, assembled workforce, processes, systems and certifications, synergy benefits, etc.) and undertaking valuation of the identified intangible assets.
- In tax audit proceedings, the field officer raised questions on the goodwill depreciation claim and sought to deny the claim in both of the scenarios—preamendment years and postamendment years. The company filed detailed submissions in support of the goodwill depreciation claim, emphasizing that amount classified as goodwill comprised various underlying intangible assets acquired by the resulting company. Reliance was placed on the purchase price allocation report and various judicial precedents.
- Based on the detailed submissions, the field officer allowed goodwill depreciation claim in both the scenarios—preamendment years and postamendment years, resulting in significant tax benefit for the company, without any extensive tax litigation.

Key takeaways:

- It was held that goodwill arising from corporate restructuring comprising underlying intangible assets is eligible for tax depreciation.

India: Income from sale of shares artificially split into capital gains and "other sources income"

- A German company sold unlisted shares in an Indian company at a negotiated price to another Indian resident. The German company and the Indian purchaser both held shares in the unlisted Indian company but were not related to each other. In order to arrive at the negotiated price for sale of shares, the German company performed two valuations.
- First, for the purpose of compliance with domestic tax laws, the valuation prescribed a floor price below which shares must not be sold. The second valuation was undertaken for the purpose of compliance with exchange control regulations, which prescribed a ceiling price beyond which the shares must not be sold.
- The negotiated price was above the floor price prescribed as per domestic tax laws and below the ceiling price prescribed as per exchange control regulations, so as to ensure compliance with both domestic tax laws and exchange control regulations.
- The field-level tax authorities held that shares of a company cannot have two separate valuations on the same date. The field officer redetermined the sales consideration by restricting it to a floor price prescribed as per domestic tax laws and taxed the balance sales consideration as other sources income, taxable at a higher rate of 43.68 percent. As a result, significant tax demand was raised on the German company.
- On appeal, the first appellate authority upheld the action of the field level tax authorities and held that sales consideration received in excess of floor price prescribed under domestic tax laws is in the nature of gift, taxable as other source income at 43.68 percent.
- On filing an appeal before the second appellate authority, it was held that domestic tax law provision only prescribes a minimum price below which an unlisted share must not be sold. In case the negotiated sale price is more than the floor price prescribed under the relevant provision, it was sufficient compliance with domestic tax laws, and the field officer was not empowered to artificially split the sales consideration into capital gains and other sources income

Key takeaways:

- Where shares of a closely held Indian company are sold, if the sales consideration is higher than the fair market value of such shares, then such sales consideration shall be taxable as capital gains income and not other sources income.

Korea: Ireland company's royalty withholding tax

- An Ireland-based company (Company A) that engages in the acquisition, development, and management of a patent portfolio business entered into a settlement and license agreement with a Korean company (Company B) regarding patents owned by Company A. Pursuant to this agreement, Company A received royalty income in 2021 related to the patent portfolio held by Company A without withholding tax in Korea in accordance with the tax treaty between Korea and Ireland.

- In 2023, the Korean tax authorities conducted a regular tax audit on Company B and challenged the beneficial ownership issue against the royalty payment made to Company A. The tax auditors tried to impose the taxes on Company B, the withholding agent, by arguing that Company A was a conduit company without substance in Ireland and used for a tax avoidance purposes. The Korean tax authorities concluded that Company A could not be considered as the beneficial owner, and accordingly, the Korea-Ireland tax treaty benefits would not be applicable in this case.

- Company A supported the beneficial ownership over the royalty income by asserting that Company A was established in Ireland not for tax avoidance purposes but for proper business reasons such as attractive business location, geographical advantages, and good infrastructure, altogether creating a business-friendly environment.

- Also, Company A asserted, with various supporting documents and an explanation letter, that Company A and its related parties have a substantive presence in Ireland. Specifically, Company A has economic substance in Ireland as it derives business profits from its activities and pays taxes in Ireland. In addition, Company A does not have any legal or contractual obligation to pass on the royalty income to another person.

- After reviewing the explanation letter and all the supporting documents, the tax auditors dropped the proposed tax imposition and closed the tax audit on Company B without tax imposition for the royalty payment to Company A.

United States: BEAT examination of an inbound bank

- Taxpayer, a multinational foreign-owned bank, was selected for examination of its 2018 BEAT calculations pursuant to Section 59A and the applicable regulations.
- The multiple IDRs issued during the examination requested detailed information about various components of the taxpayer's base erosion payments and base erosion tax benefits reported on Form 8991.
- In general, the BEAT regulations provide that payments designated as base erosion payments are reported as gross amounts rather than on a net basis. However, exceptions to the "no netting" principle apply to certain mark-to-market securities, where items of gains and losses are netted to arrive at a single amount. The IRS requested written confirmations of the amounts of base erosion payments, which were reported as gross amounts and the amounts that were netted, including the code/regulations supporting the netting position.
- The base erosion percentage calculation distinguishes between derivative contracts that are entered into with related parties as opposed to unrelated parties. The former are excluded from both the numerator and the denominator of the base erosion percentage and the latter are only included in the denominator (which, in effect, reduces the percentage). The IRS requested evidence as to how the related- and unrelated-party derivatives were identified.
- In general, payments made to related parties that qualify for the service cost method (SCM) under the transfer pricing regulations are excluded from both the numerator and the denominator of the base erosion percentage calculation. The IRS requested information about how the taxpayer conducted the SCM analysis in this regard.
- The BEAT calculations are performed at the aggregate group level pursuant to Section 59A(e)(3). The IRS requested support on how the taxpayer applied the aggregation rules in this context.
- The IRS ultimately closed the examination without proposing any adjustments.

KPMG

Trade and customs audit insights

Indonesia: Free trade agreement tariff adjustment on indirect shipment

Facts

- An Indonesia heavy equipment company (the Company) imports various products from its headquarters in Japan.
- The Company may obtain a lower rate on customs duties under a free trade agreement between Indonesia and Japan, subject to certain conditions and documentary requirements. If the requirements are not fulfilled, the Company would be subject to import duty underpayment due to a higher tariff plus additional taxes related to importation (income tax and VAT on importation).
- The Company claimed that it satisfied the requirements and should receive the benefits of the free trade agreement to its imports.
- During an audit, the Indonesia customs authority stipulated that for the free trade agreement to apply, the Certificate of Origin must be accompanied by a certificate from the shipping line. This certificate must confirm that the goods were directly shipped to Indonesia with no other activities performed other than loading and unloading, or that there was no loading/unloading process during transit. As a result, the Company was required to provide proof, typically in the form of a certificate from the shipping line.

Issue

- The Company was able to provide the required certificate for direct shipments. However, for several shipments where no direct vessels were available from Japan to Indonesia, the goods had to be transshipped to a second vessel before arriving in Indonesia. As a result, the client could not provide the certificate from the shipping line confirming that the goods were directly shipped without any activities other than loading and unloading.

Response

- KPMG assisted the client in providing a statement letter from the shipping line confirming that the container seal remained unchanged throughout the journey from the Japan port to the Jakarta port.

Result

- Upon completion of the customs audit and closing conference, the Indonesia customs auditor accepted the arguments and supporting evidence for both direct and indirect shipments. The findings were canceled, and potential underpayment, including negative profiling, was avoided.

VAT audit insights

France: Proof of exempt intracommunity supplies and exports

Facts

- Following a tax audit, the tax authorities sustained a French company's (the Company) liability to pay EUR1.6 million VAT.
- The tax authorities considered that the intra-EU sales and exports carried out by the Company should have been subject to French VAT, as it was unable to justify the dispatch of the goods outside France.
- The Company challenged the tax authority's position by providing consignment notes for some of the intra-EU deliveries carried out but could not obtain all the documentation from the transport companies.
- Regarding the exports, the Company highlighted that the amounts reassessed correspond to a transfer pricing adjustment (invoice sent to a group company) but not to an actual export.

Response

- The Company produced several detailed documents describing all the flows carried out by the Company based on the available documents proving the shipment of goods outside France (invoices, logistics documents, packing lists, and consignment notes).
- Subsequently, it was possible to connect the transactions carried out to the supporting documents using different reference numbers (invoice numbers, order numbers …).
- As a result, the tax authorities have partially canceled the VAT reassessment for exports and maintain the VAT adjustment for some intra-EU sales, based on the level of evidence provided.
- The case is still pending, but this sheds light on the importance of gathering sufficient evidence when goods are sent outside of France and building a reliable invoicing audit trail documentation to support the VAT treatment of the activity.

KPMG

France: Regularization of distance sales flows in several member states

Facts

- A French company (the Company) operates in the sale of household electrical equipment from France to various member states of the European Union.
- Under French legislation, an intra-EU distance sale of goods is defined as the dispatch or transport of goods within the European Union to a final consumer.
- Such sales are taxable in the member state where the consumer is established if the seller carries out distance sales above EUR10,000 EU-wide in a 12-month period effective July 1, 2021 (before July 1, 2021, member states applied a domestic threshold of either EUR35,000 or EUR100,000).
- Following several tax audits in several member states, the local authorities have requested the Company to regularize its situation for the years 2020, 2021, and 2023.

Response

- The Company has partially regularized its situation by registering through the One-Stop Shop (OSS), which allows taxpayers to comply with their VAT obligations relating to distance sales through a single filing.
- In addition, the Company engaged in negotiations with the French tax authorities for the dual purpose of:
- Obtaining the right to regularize the sums due before the reform via the OSS
- Obtaining a reduction in the penalties applicable to it.

Result

- The Company is still waiting on the final response from the French tax authorities.

France: VAT liability and fixed establishment

Facts

- A German parent company (German Parent) registered for VAT in France conducts its activities in France through its French subsidiary.
- The German Parent charges French VAT on sales of goods that are "domestic" sales of goods (points of departure and arrivals of goods are in France).
- For sales performed by a nonestablished company, French VAT law requires local business customers to self-assess VAT under the reverse charge mechanism rather than requiring the nonestablished company to collect and remit VAT.

Key issues

- The French subsidiary is legally and economically dependent on the German Parent.
- The activities of the German Parent in France are largely carried out through the intermediary of its subsidiary.
- Consequently, the subsidiary is deemed to be a "fixed establishment" of the German Parent for purposes of determining VAT liability.
- Because the German Parent was deemed to have a fixed establishment in France, the VAT reverse charge mechanism was not applicable. Therefore, the German Parent had to charge French VAT on its "domestic" supplies of goods.

Response

- The French tax authorities agreed with the taxpayer's position on condition that the German Parent demonstrates that it can dispose of the human and material resources of its subsidiary as if it were its own.
- This provision of human and material resources can be proven, for instance, through the existence of service contracts signed between the companies.
- The French tax authorities are increasingly scrutinizing the notion of a fixed establishment. Therefore, it is highly recommended that foreign companies review their position in France to avoid a recharacterization as a fixed establishment in the context of a VAT audit.

India: GST on secondment arrangements

Facts

- As part of its operations in India, an Indian company (the Company) executed employee secondment agreements between its Indian subsidiaries and the overseas parent company.
- Previously, under Indian goods and services tax (GST) law, services provided by an employee to an employer were exempt from GST.
- However, a recent Supreme Court ruling determined that if the employees had not fully terminated their employment with the overseas company, the secondment of employees from an overseas group to an Indian subsidiary would constitute a taxable service.
- This ruling has classified such secondment arrangements as manpower services provision, subjecting them to GST, with the imposition of additional interest and penalties.

Response

When the case facts could be distinguished from the Supreme Court ruling:

- The Company prepared responses to the notices issued by the tax authorities.
- The responses defended against interest and penalty charges by highlighting the factual differences and asserting that the Company actually employed the secondees.

When the case facts mirrored the Supreme Court ruling:

- The Company agreed to pay the tax liability while contesting interest and penalty charge.
- The Company maintained that there was no attempt to evade tax; instead, the Company merely followed prevailing jurisprudence that largely favored the taxpayer.

Result

- The cases are currently pending resolution.

Key takeaway

- The applicability of GST on the secondment of employees among group companies must be determined based on the unique circumstances/facts of each case. It is crucial to carefully examine this issue, ensuring that the tax position aligns comprehensively with income tax law and other applicable regulations.

Indonesia: VAT joint liability in case of sales to public bodies

Facts

- An Indonesia company (the Company) operates in the elevator lift, escalator, and moving walkway industry serving various customers in Indonesia.
- Under Indonesian VAT law, such entities are categorized as VAT collectors (Wajib Pungut or WAPU). Contrary to the general VAT mechanism where the seller remits the VAT to the Indonesian State Treasury, under the WAPU mechanism, the customer with WAPU status assumes responsibility for collecting and remitting the VAT.
- In transactions involving a WAPU, the seller issues a VAT invoice with the specific "030" code. The WAPU would then pay the invoice amount, excluding the VAT, and directly remit and report the VAT. It should also provide the seller with evidence of VAT remittance.
- For some transactions, the Company did not receive remittance evidence from the WAPU, leaving it unaware of the unpaid and unreported VAT.

Issue

- During an audit, the Indonesia Tax Authority (ITA) held the Company responsible for VAT amounts that were not remitted and reported by the WAPU. As a result, the ITA adjusted the VAT base leading to an underpayment and a balance that was subject to a 100 percent penalty (now reduced to 75 percent under current law).
- The Company had payment documentation from WAPU customers that showed that the payment it received excluded VAT.

Response

- During audit, the Company highlighted the payment evidence and argued that the ITA correction, which imposed joint liability on the Company for the unpaid VAT due to the customer's noncompliance as a WAPU, lacked a legal basis. Despite this, the ITA only approved transactions confirmed in its system, where the customer had remitted and reported VAT. The ITA maintained unpaid VAT transactions and assessed them through tax assessment letters.

Result

- After the audit, the Company submitted an objection to a regional tax office. The objection officer agreed with the Company's position and granted the objection. The auditor's tax assessment letter was subsequently canceled, and the Company was able to obtain a refund.

Italy: Refund of VAT after partial rejection of a VAT refund claim in presence of double precaution for the Italian tax authorities

Facts

- An Italian branch of a UK company (the Company) claimed a significant VAT credit accrued during 2020 in Italy.
- The Italian tax authorities requested the Company to issue a bank guarantee for the entire VAT credit sought for refund.
- Subsequently, the tax authorities partially suspended the refund, alleging the presence of tax debts in the Company’s tax register.

Response

- The Company appealed the suspension deed before the first-level Italian Tax Court.
- The appeal was based on the argument that the tax authorities, by requesting the bank guarantee and suspending the refund, exercised a double precaution against the Company’s VAT credit.
- According to a recent ruling by the Italian Supreme Court, such double precaution is invalid and contrary to the principles of neutrality and proportionality of the VAT as outlined by European jurisprudence.

Result

- The first-level Italian Tax Court upheld the client's appeal, confirming the right to the VAT reimbursement given that the Company issued an appropriate bank guarantee even in the presence of tax debts of a different nature in the Company’s tax register.
- The court ordered the removal of the suspension served by the tax authorities.

Italy: Tax authorities failing to reconcile VAT due with the subsequent self-disclosure carried out by the company

Facts

- A nonresident company in Italy (the Company) self-disclosed several violations to the tax authorities concerning the correct registration of invoices for VAT purposes.
- The Company proceeded to pay the VAT due and relevant penalties through the target system, an alternative compliance mechanism to ordinary tax payments that contains fewer details.
- The Italian tax authorities' automated controls failed to reconcile the Company’s self-disclosure and VAT payment with the VAT due, resulting in the Company receiving a payment request for the same amounts.

Response

- The Company engaged in discussions with the tax authorities, which included a reconciliation of the VAT due with the late VAT payments.

Result

- The Company was successful in securing an administrative annulment of the payment request, thus, preventing the initiation of a litigation before the Italian tax court.

Italy: VAT payments carried out by a nonresident company via the "target system"

Facts

- A Swiss company operating in Italy (the Company) through a VAT representative executed VAT payments utilizing the "target payment" method, a system designated for nonresident companies.
- The target system is an alternative compliance mechanism to the ordinary tax payments, which contains fewer details.
- The Italian tax authorities issued a payment request to the Company, alleging omitted VAT payments that it did not identify in its systems.

Response

- KPMG supported the Company in appealing against the payment requests. It was determined that the tax authorities' contestation originated from a technical issue in the automated controls related to the target payment system. As a result, the Company was successful in obtaining an administrative annulment of the payment request.

Result

- Ultimately, the Company was successful in obtaining an administrative annulment of the payment request.

Mexico: VAT not paid on offset of accounts

Facts

- A Mexican company (the Company) received information requests from the Mexican tax authorities concerning its past transactions and compliance with a recent Mexican Supreme Court decision on the VAT treatment of VAT offsets.
- The decision clarified that VAT is not considered paid when two Mexican entities offset accounts receivable/accounts payable without any cash flow.
- For example, if two parties indebted to each other offset the owed amounts to extinguish the obligation, the associated VAT on the offset fee is not considered paid and is therefore not creditable. Despite the denial of the buyer's VAT credit, the vendor's VAT payment obligation remains.
- The Mexican tax authority is currently auditing and challenging the past five years of refunds and VAT returns, imposing interest and surcharges when the VAT was "paid" through an offset.

Response

- The Company is currently preparing its response, which involves (i) analyzing transactions over the past five years to quantify the impact of the VAT offsets,
  (ii) preparing a technical memo to evaluate different alternatives and solutions to avoid the offset based on the client's business model going forward, and
  (iii) responding to additional tax authorities' requests.

Result

- The tax authorities have not yet concluded their analysis.

Sri Lanka: Navigation to regain access to seized bank accounts

Facts

- A general insurance company in Sri Lanka (the Company) received a bank seizure notice from the Sri Lankan Inland Revenue Department for three taxable quarters in 2016 and 2017.
- The seizure was due to the client claiming deductible VAT but not attaching the relevant schedule for the VAT return.
- The Company did not respond to follow-up submissions to appeal the assessment because it did not receive them resulting in the disallowance of the deductible VAT and subsequent seizure of its bank accounts.
- As a result, the Company was forced to halt operations.

Response

- In the Company's response to the Sri Lanka tax authority, it highlighted the following facts:
- There was no revenue loss to the missing schedules.
- The law requiring schedule attachment might not be mandatory on the basis of legal ambiguity.
- The Company was unaware of the issued assessments until it received tax default notices, which was a violation of natural justice.

Result

- Through these efforts, the Company was successful in achieving a reversal of the bank seizure while securing the deductible VAT claim.

Taiwan: Refund of overpaid VAT upon business dissolution

Facts

- A furniture manufacturing company (the Company) applied to dissolve its Taiwanese branch in 2023 and sought a refund for overpaid VAT under Taiwan's "refund-first, verification-later" mechanism. Under the mechanism, a business entity that has overpaid VAT and has undergone a merger, business transfer, dissolution, or cessation of business may apply for a refund of the overpaid VAT before verification if the criteria are met. This ensures an early tax refund and a favorable cash flow position.
- During the refund application process, the Taiwan tax authority questioned the eligibility of the deductible VAT claimed, particularly concerning expenses for passenger cars and office interior decoration. The tax authority contended that the cars were used for personal purposes and not for business, and that the office decoration might have a salvage value, potentially generating taxable sales in the future, making the relevant deductible VAT ineligible for refund upon dissolution.

Response

- The Company responded to the Taiwan tax authority by:
- Providing a historical review of client's tax status
- Developing a defense strategy and negotiating with the tax authorities on the eligibility of the input VAT in question
- Effectively coordinating with the tax authorities, resulting in the successful refund of the overpaid VAT upon the entity's dissolution.

Result

- The Company was successful in applying for the refund-first, verification-later mechanism and secured a refund of approximately 90 percent of the overpaid VAT.

Thank you

Contact information

For any questions, please reach out to Cameron Taheri (head of Global TP Dispute Resolution Services).

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Background

Cameron is a principal in the KPMG Washington National Tax – Tax Controversy & Dispute Resolution group and the head of our Global TP Dispute Resolution Services team. He specializes in resolving transfer pricing disputes on behalf of multinational corporations, including advance pricing agreements, competent authority settlements, and examination and appeals. Previously, Cameron was a team leader in the Advance Pricing and Mutual Agreement Program (APMA) at the Internal Revenue Service.

Professional experience

- Prepares and develops advance pricing agreements and competent authority settlements between multinational corporations, the IRS, and foreign governments
- Analyzes US income tax treaties to provide clients with double tax relief on nontransfer pricing issues including permanent establishment, income sourcing and characterization, foreign tax credits, and shipping and transportation income
- Assists clients in navigating IRS examination and appeals including responding to information document requests and preparing protest letters

Education, licenses & certifications

- BA degree, economics, University of Texas at Austin
- JD degree, Northeastern University School of Law

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