Day 3, Session 1

Transfer Pricing Audits

WIRTSCHAFTS UNIVERSITÄT WIEN VIENNA UNIVERSITY OF ECONOMICS AND BUSINESS

Ágata Uceda

Partner, KPMG Meijburg & Co

KPMG Meijburg & Co Belastingadviseurs

Agenda

I. Lessons learned

II. Selection of TP audits / summaries

   a. Margins and prices
   b. DEMPE
   c. Characterization of tested party
   d. Profit level indicators
   e. CBCR requests
   f. Other audits

Lessons learned

I. Lessons learned:
   I. Audits are becoming more complex
   II. Tax authorities learning from each other (exchange of information, OECD, fiscalis trainings) and from public cases (state aid, news papers)
   III. Exhaustive information requests
   IV. Trend towards less principles based and more reading the law literally
   V. Subjective criteria in the law "DEMPE", synergies, group effects, examples of extreme situations in the OECD guidelines
   VI. Perception of agressive tax planning as starting point
   VII. Large adjustments to try to settle in the middle

TP Cases in the last decade (2013-2023)

TP Cases with a single topic	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	Total	%
Arm's Length Principle			2	5		4			3	2	3	**19**	**14,0%**
Benchmark, Range and Median									1	2	3	**6**	**4,4%**
Business Restructuring	1		1		1		1	1	1			**6**	**4,4%**
Financial Transactions	6	2	2	3	4	5	4	1	7	3	9	**46**	**33,8%**
Royalty and License Payments	2	1		2	2		1	2	3		3	**16**	**11,8%**
Transfer Pricing Documentation	2	2				1	2	3	1	1	1	**13**	**9,6%**
Transfer Pricing Methods	2	1	5	1	2	2	3	1	1		2	**20**	**14,7%**
Other				3	1		2	3	1			**10**	**7.4%**
Total	**13**	**6**	**10**	**14**	**10**	**12**	**13**	**11**	**18**	**8**	**21**	**136**	**100%**

Section I.a

Selection of TP audits and lessons learned

Margins and prices

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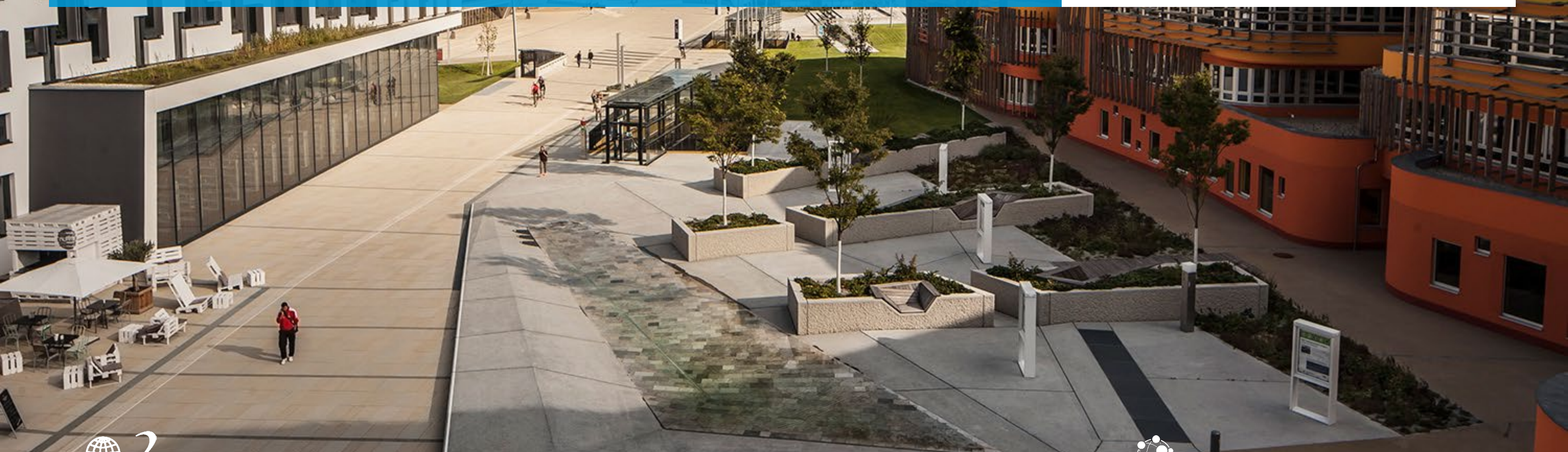

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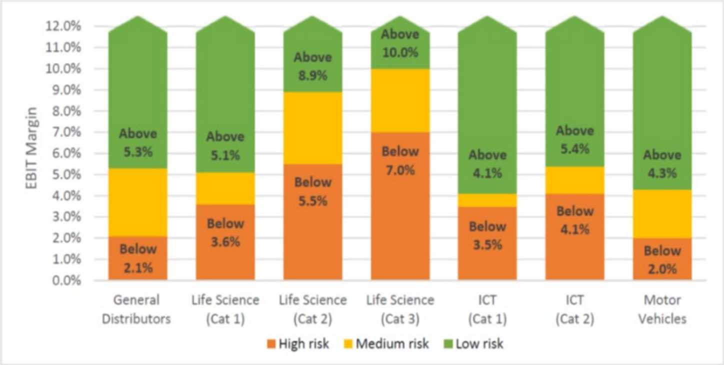
Australia: Inbound distributors – expected returns

- In 2019, the Australian Taxation Office (ATO) released guidance (PCG 2019/1) outlining its expected returns for inbound distributors in Australia. This guidance places the returns of distributors in the three categories of Low/Medium/
High risk across the following industry-based clusters:
  - ***(i) General;***
  - ***(ii) Life Sciences*** (LS) (including Pharmaceutical and Medical Device)*;
  - ***(iii) Information and Communication Technology*** (ICT)*; and
  - ***(iv) Motor Vehicles***.

  *The LS and ICT industries are further divided into three and two categories, respectively, driven by various functional intensity factors.



- While PCG2019/1 states that the guidance doesn't necessarily reflect the Commissioner's views on arm's-length outcomes (which would be determined on a case-by-case basis), we have seen the ATO benchmarking and expected EBITs matching the published ranges in ATO position papers emerging from recent audits and taxpayer settlements.

- The ATO indicated that based on the functional intensity factors, it expected returns at the median of the range across the full portfolio.

- As an example, a Cat. 3 Australian pharmaceutical products distributor recently received an ATO's position paper outlining an interquartile range of 5.5 percent to 12.8 percent with a **median of 9.4 percent**. Previously, the taxpayer reported distributor returns of 5.5%, with some years above/below the average. The taxpayer distributed over-the-counter and prescription medicines (including vaccines and rare disease medicines), both branded and generic and vaccines.

Australia: Royalty transactions

- Concerns an Australian subsidiary of an Italian fashion accessories and brand owner.

- Australia pays a royalty of 6 percent net sales for use of valuable brands.
- Italy **reimburses** Australia for certain **brand-related marketing expenses, approximately 3 percent of local revenue**.
- The ATO challenged the royalty rate, arguing that it should be adjusted down to 1 percent of net sales.
- The proposed adjustment would have resulted in the **brand owner receiving net income of approximately negative 2 percent** of the Australian company's revenue (when taking the adjusted royalty and reimbursement together).

- The ATO argued that because the Australian company was generating low profits and losses, it should have renegotiated the 6 percent royalty down.

- By way of evidence, KPMG's arguments included the following.
  - The low profits were temporary and due to heightened competition (introduction of a new competitor which effectively became the market leader within three years of entering Australia), the longer-term returns to the Australian company were very strong, and the use of the brands were ever more valuable at that time of heavy competition.
  - Given the inherent relationship between the sale of trademarks, the royalty rates, and the marketing reimbursement, all three arrangements should be considered together when applying the arm's-length principle.
  - The arm's-length principle should also be considered from all perspectives, including whether the arrangement at such a reduced royalty rate was realistic for the brand owner (given the overall negative outcome to the brand owner).

- **The case was settled with a royalty of 3.1 percent**
- The ATO refunded all royalty WHT associated with the royalty adjustment and penalties were reduced to nil.
- The tax payer was also able to defer payment of tax during the period of negotiation (in contrast to the usual 50/50 payment/ full up-front payment) based on the strength of the arguments being relied upon.

Italy: Royalty rate challenges

- The Italian Tax Authority (ITA) recently challenged a 1 percent royalty paid for brand licensing in the business-to-business (B2B) sector.
- The royalty represented the lowest point of the interquartile range of a set of external cuts.
- The tax audit involved companies operating in B2B sectors dealing with public and/or government contracts or tenders.
- The ITA claimed that because contracts are awarded based on the most competitive offer, the Group's branding had little to no relevance in securing the contracts. Therefore, no royalty should be paid by the local company for the use of the Group brand.
- KPMG was successful in arguing that a royalty was still required by highlighting the important reputational aspects of a Group's brand. Specifically, the brand works as a strong sign of recognition, which increases the reliability and trust in the relationship with all stakeholders (public counterparty, suppliers, and potential consumers of the final goods and services).
- Reputational value is evidenced by the significant investments in marketing, advertising, and brand development by these companies to increase their perceived strength in these areas.
- Consequently, the brand represents a factor of great importance for success regarding public tenders.
- As a result, the ITA did not pursue any adjustments to the 1 percent royalty rate.

TP audit NL

- A company headquartered in Europe has several manufacturing plants in Europe, including the Netherlands.
- The 2022-2023 audit covers years 2018 & 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 "business" 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 DTA can go back indefinitely to investigate possible reasons for the loss.
- The business transferred (2006) was acquired from a third party for a total value of (number disguised) Euro 20M just before the intercompany transfer.
- The DTA argues that the "business" transferred should have been sold for Euro 25M, that is, Euro 5M more than the group paid the third party, then there would be no loss at liquidation (2019). The rational is that "the group" knew they 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) where 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 Euro 15M. That is, the purchase price of Euro 20M minus working capital, minus fixed assets.
- Even thought the transaction took place 17 years ago, the group has the purchase price allocation from the third party acquisition which explains clearly the Euro 20M paid for the full business (customer list, working capital, very limited fixed assets (one production line 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 + associated revenue) that took place in 2015.
- Finally, the group charges a royalty rate (less than 0.5% 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.

Use of Databases

Benchmarking royalties?

- Intangibles are per definition unique assets
- How relevant are commercial databases to benchmark royalties?

Section I.b

Selection of TP audits and lessons learned

DEMPE

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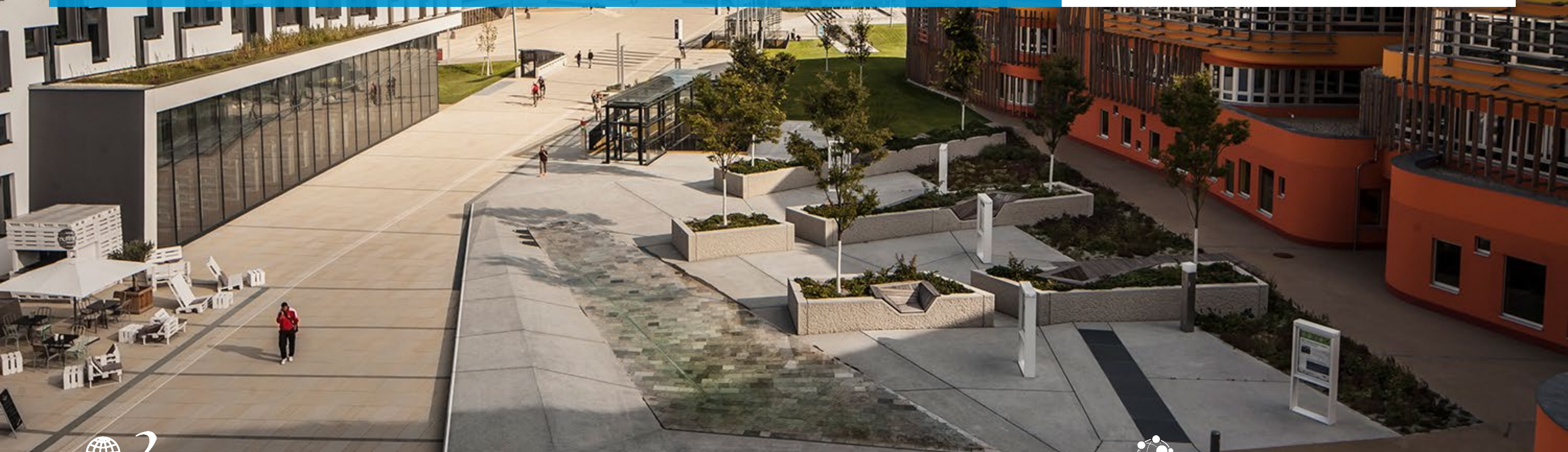

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Sweden: DEMPE Case #1

Gaming company audit – Part I

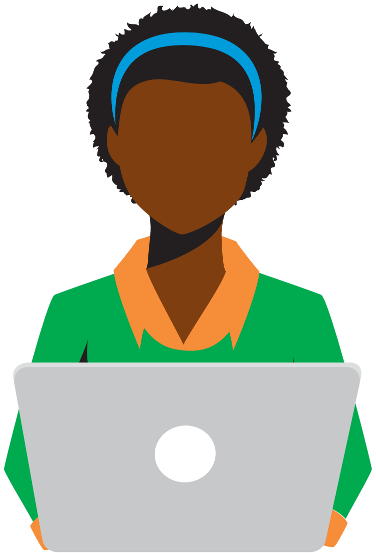
- An initial Swedish audit of a Malta-based gaming company for tax years 2013–2015 was concluded in December 2016:
  - The company had a profit split between its operating entities in Sweden and the U.K. and its parent company in Malta. No activities took place in Malta except board meetings.
  - The Swedish Tax Agency (STA) focused its audit on the company's executive officers, all of whom were employed by the Swedish and U.K. entities.
  - The STA concluded that the Maltese entity should only receive a cost plus return and that the profit split should be between the Swedish and U.K. entities.
  - The audit resulted in an adjustment of approximately USD 200 million, and approximately USD 13 million of penalties were levied.

Sweden: DEMPE Case #1 (Continued)

Gaming company audit – Part II

- A Swedish gaming company was acquired by a U.S. group in 2016.
- The STA argued that as a result of the acquisition by the US entity, control over the intangibles had been transferred to the US and as a result, the Swedish entity had lost control of the decision-making (i.e., performed fewer DEMPE functions).
- The STA's position was that the reduction in Swedish DEMPE functions constituted an outbound transfer of intangibles which required compensation. It made an adjustment of about USD 2 billion (representing the Swedish entity's share of the value of the group, 50 percent, times the acquisition price paid by the new U.S. parent).
- On the question of exit charge, the STA agreed with the taxpayer that no transfer of IP rights to the U.S. group occurred as part of the acquisition. However, the STA proposed an assessment of USD 140 million to account for the economic returns from the intangibles that should have been allocated to the Swedish entity.

  The gaming company was successful in demonstrating that the Swedish company remained in charge of the IP even after it was acquired by the U.S. group through a platform contribution analysis. As a result, the U.S. group was entitled to 20 percent of the Group's profits based on their contributions, with the residual profits (after the acquisition) split between Sweden and the U.K.



DEMPE (Denmark)

Danish audit

- A Danish company conducting R&D decided to switch to a U.S.-headquartered model.
  - The CEO and several senior personnel moved from Denmark to the U.S. around the end of 2011.

- In June 2018, the Danish tax authorities (SKAT) audited the company's 2012 tax year and determined that this move of personnel, by reducing DEMPE functions in Denmark, had effected an IP transfer of approximately USD130 million from Denmark to the U.S., which required an exit charge.
  - With interest, this resulted in additional Danish tax of approximately USD30 million.

- This represents a retroactive application of DEMPE, as the BEPS initiative was not even announced until 2013.

DEMPE (Germany)

German audit

- A U.S.-headquartered multinational has a German subsidiary that operates as a sales subsidiary for the European market. In FY 2014/2015, the sales entity was stripped down from a buy/sell entity to an agent.
  - Following the conversion, no exit payment was required, as the multinational argued that the German subsidiary had performed limited functions and was only entitled to a small indemnification for the early termination of its distribution contract.

- In the current tax audit, the German tax authorities are arguing that, before the conversion, the German subsidiary had a function and risk profile that went beyond the regular activities of a buy/sell entity.
  - This is partially based on the fact that, in addition to distribution personnel, the German entity had one employee with a senior role in the multinational’s R&D operations.

- Based on the presence of this individual, the German tax authority is asserting that the German entity was performing DEMPE functions, which implies that (1) the German entity performed nonroutine functions in the past and (2) is, therefore, the co-owner of certain market intangibles. As a result, they are arguing that an exit charge is required.

DEMPE (IRS APMA)

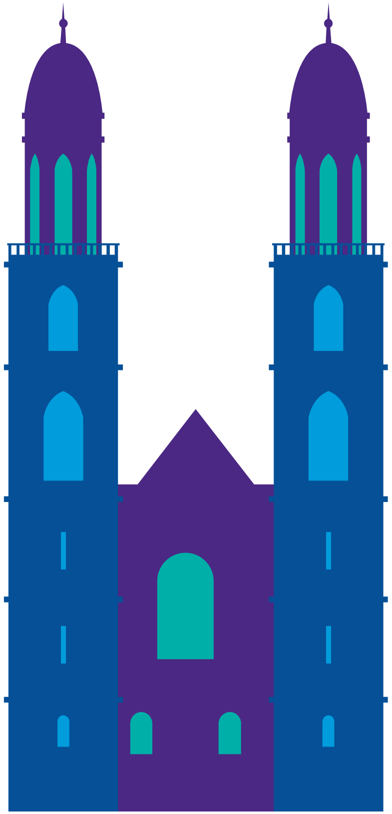
U.S.-Switzerland bilateral APA

- A multinational technology firm has engaged KPMG to pursue a bilateral APA between the U.S. and Switzerland.

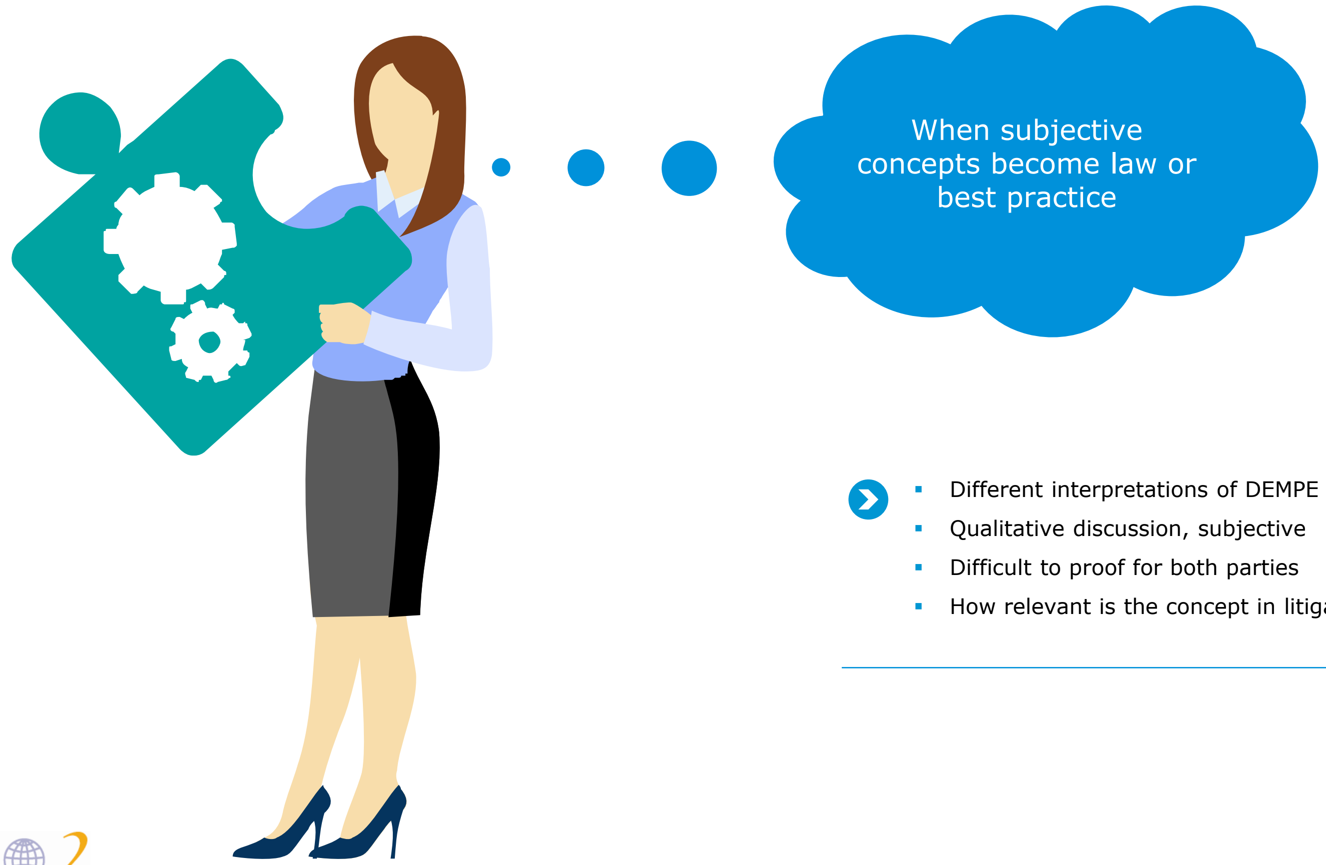
- The purpose of the APA is to inbound IP into the U.S. and to transition from a Swiss principal structure to a U.S. principal structure.
  - The client is motivated by BEPS and DEMPE exposures in the current structure due to a lack of significant DEMPE in Switzerland.
  - They have about 20 people in Switzerland who perform legal and marketing functions. In DEMPE terms, only protection is performed in Switzerland.

- In prefiling discussions, APMA has been focused on DEMPE issues with the current structure, even though the IRS previously agreed that Switzerland owned the IP.

- APMA may be getting prepared to argue that the U.S. should not make a payment or should make a reduced payment to Switzerland for the IP because most of the DEMPE was always in the U.S.



DEMPE



- Different interpretations of DEMPE under tax audit
- Qualitative discussion, subjective
- Difficult to proof for both parties
- How relevant is the concept in litigation?

Section I.c

Selection of TP audits and lessons learned

Characterization of tested party

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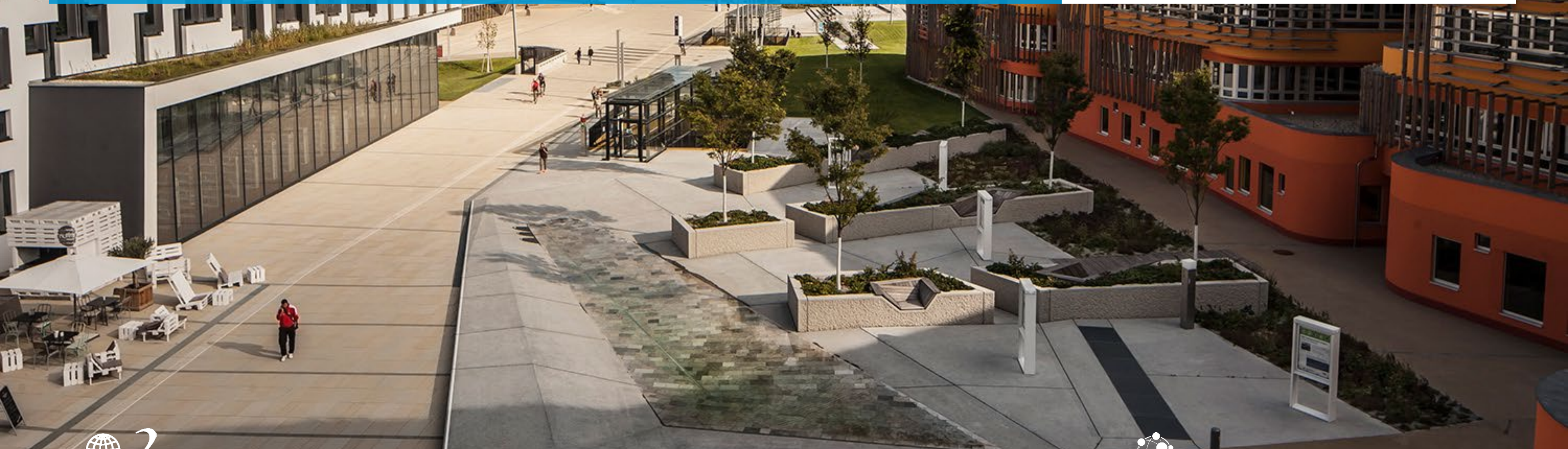

Poland: Distributor reclassified to a limited-risk distributor

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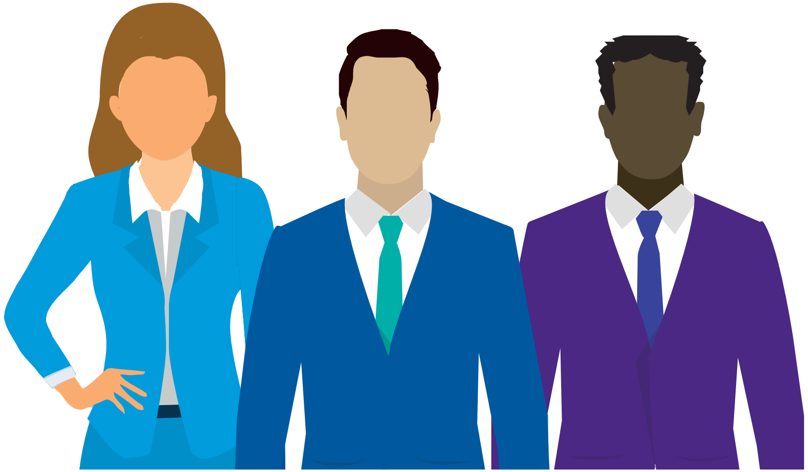
- A Polish subsidiary of a multinational group under audit operates as a retail distributor of apparel goods in Poland under a well-recognized brand. In 2011, the Polish subsidiary procured goods from third-party suppliers; however, the supply contracts were negotiated on group level (i.e., Polish subsidiary had no influence on purchase price.
- For the 2011 tax year, the Polish subsidiary was in a loss position.
- The Polish tax authority claimed the Polish subsidiary was a limited-risk distributor as almost all strategic decisions were completed by related parties abroad, including:
  - Procurement process: designing goods being sold, choice of third-party suppliers, and negotiations with such suppliers
  - Setting pricing policy
  - Determining general marketing strategy.
- The Polish tax authority concluded that the Polish subsidiary should receive a guaranteed operating profit despite the fact that they had no intercompany tangible good transactions. The Polish tax authority performed a benchmarking analysis (using the TNMM) to determine an IQ range of 0.9 percent to 6.36 percent and made an adjustment based on negotiated level between a lower quartile and a median—1.5 percent.
- Polish tax authorities rejected the following arguments:
  - According to explicit Polish tax provisions, TP tax assessments should be connected with related-party transactions; whereas in the analyzed case, the Polish subsidiary procured goods from third parties. Other IC transactions of the Polish subsidiary were not challenged by Polish tax authority.
  - Polish company losses were caused by business (not TP) reasons (i.e., there was no profit shifting/tax base erosion).
  - The Polish subsidiary profile did not match the LRD profile based on the functions performed locally.
  - In years preceding the audited tax year, the Polish company was profitable, and profits exceeded typical LRD remuneration. In those years, profits weren't transferred abroad and were subject to corporate income tax in Poland.

  Company settled FY 2011 by agreeing to support payment of 1.5 percent.

Poland: Distributor reclassified to a limited-risk distributor (continued)

- In mid 2012, the company created centralized procurement in a related party and began routing the third-party tangible goods through the centralized procurement center.
- In 2012 and 2013, the company continued to have losses.
- The Polish tax authority has opened an investigation for 2012 and 2013.
  While the company did not pursue competent authority in 2011, they are revisiting the issue for the 2012 and 2013 tax years.



Zambia: Distributor reclassified to a limited-risk distributor

- The Zambia Revenue Authority (ZRA) completed an audit of a Zambian company's (Taxpayer) trading operations for the period 2010 to 2014, resulting in adjustments to the company's profits (ZMW 56 million or USD 3.8 million) and a gross tax of ZMW 13 million (approximately USD 1 million). Taxpayer lodged an appeal with the Tax Appeals Tribunal (TAT).

  Taxpayer's transactions included purchase of finished products, payment of royalties, payment for management services and shared services, and payment for intercompany loans.

- The ZRA argued that Taxpayer was a limited risk distributor (LRD) and thus could not operate as a loss-making entity. In support, the ZRA argued that:
  - Taxpayer's Zimbabwe affiliate had significant control over the Taxpayer's operations in Zambia
  - Foreign related parties were responsible for key sourcing and invoicing activities, assumed some of the inventory risk, and provided critical services that were essential for the business to thrive
  - The level of investment and skilled staff based in Zambia was low, indicating that most of the risks were not assumed by the Taxpayer.

- While the ZRA agreed with some of the arguments raised by the Taxpayer, including the misapplication of the gross tax, the ZRA and TAT ultimately agreed that the Taxpayer operated as an LRD and should not report losses

- Key takeaways from TAT's judgment
  - The functional and risk profile of an entity should be in line with its characterisation. For a full-risk distributor, local personnel would be expected to be highly skilled and conversant with the business operations.
  - Aggregation of transactions that are not closely linked or continuous produce inaccurate results for the arm's length principle.
  - A loss position can be an appropriate audit trigger; however, it cannot serve as the sole basis for an adjustment.
  - Benchmarking studies should be closely reviewed and analyzed for purposes of comparability. Note that the comparables from Western Europe were rejected in the Taxpayer's case.

Section I.d

Selection of TP audits and lessons learned

Profit level indicators

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Mexico: Berry ratio disallowance

- A multi-national enterprise (MNE) distributor in Mexico involved in reselling auto parts to third-party original equipment manufacturers in Mexico used the Berry ratio to establish intercompany transfer prices.
- Operating under a maquiladora regime, the goods were distributed by the Mexican distributor via flash-title to the foreign principal, who assumed the material risks associated with the goods and performed negotiations with third-party clients.
- Under audit, the Mexican Tax Administration (SAT) disallowed the Berry ratio approach, arguing that the Berry ratio was not a profit level indicator *per-se*, but rather a measure to assess if an entity's gross profit was sufficient to cover its operating expenses. As a result, the transaction pricing was not arm's-length.
- The SAT has also argued that such indicator did not accurately evaluate all the functions performed by the distributor from an economical standpoint.
- After extensive negotiations, a settlement was reached that used an operating margin (OM) obtained from a comparable company's set instead of using the Berry ratio. The margins were significantly adjusted to reflect the nonroutine functions performed by the comparables, but not effectively performed by the tested party (which was the Mexican flash-title distributor).
- Using the Berry ratio approach, the Mexican flash-title distributor showed a 0.3 percent OM, which was then adjusted to 1.5 percent as a result of the negotiation (the comparable companies nonadjusted OM was around 6 percent).

Germany: Challenges to cost plus return for sales and marketing services

A German subsidiary of a multinational group under audit operates as a sales and marketing services provider to its foreign parent.

Foreign parent sells directly to German customers, and remunerates the German subsidiary at cost plus a 4 percent mark-up.

For fiscal years (FY) 2013–2015, the German tax authorities claimed that despite the contractual terms (which characterized Germany as a service provider), the German subsidiary's functions were more aligned with that of a buy/sell distributor.

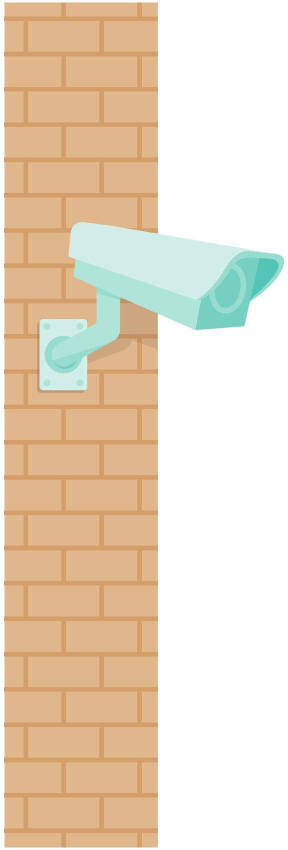
In particular, authorities based their position on the fact that German salespeople earned a commission rate on sales "mediated" for the foreign parent, and thus the entity itself should be entitled to a return on sales.

The German tax authorities concluded that the German subsidiary should receive an assured taxable profit equal to a percentage of foreign parent's German-sourced revenues. Taxpayer and authorities discussed an initial settlement, which would involve adjusting the years under audit (FY13–FY15) and adjacent years 2016–2019 to reflect a 0.25 percent return on sales, with a commitment to increase the return to 2.5 percent of sales from 2020 onward.

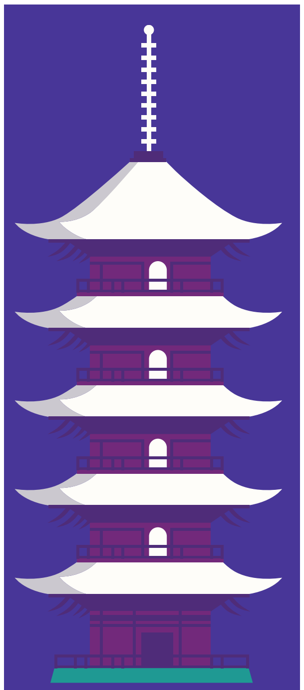
Taxpayer successfully advanced the following arguments in its counter-proposal:

- In years 2013 – 2019, the Group profitability as a whole was relatively low (4–5 percent), indicating limited profit to assign to sales and marketing/distribution functions.
- Revenue growth and product mix for the German business mirrors the Group's worldwide business.

Company ultimately settled by agreeing to a 0.30 percent return on sales for FY13–FY19, with a favourably low 1 percent go-forward return for 2020 onward.



Japan: Cost plus versus profit split



- A Japanese subsidiary of a U.S. multinational investment company was primarily engaged in research of the Japanese financial market based on detailed instructions from its U.S. headquarters (HQ).
- The Japanese subsidiary received cost plus 10 percent markup for services rendered to the U.S. HQ.
- The U.S. HQ provided stock options to some of the researchers employed by the Japanese subsidiary.
- The Japanese tax authority (NTA) concluded that the Japanese subsidiary performed an entrepreneur role in the investment business, and therefore, a cost plus approach is not appropriate.
- The NTA claimed that the Japanese subsidiary should be compensated based on a profit split method using salaries and depreciations as split factors.
- Regardless of the fact that the unexercised stock options were provided to some of the Japanese employees directly by the U.S. HQ, the Japanese tax authority counted the stock options as one of the contribution factors of the Japanese subsidiary.
- The NTA claimed that the Japanese subsidiary performed an entrepreneur role based mainly on the following arguments:
  - Most investments were related to the Japanese market.
  - Research conducted by the Japanese subsidiary was crucial to the business.
  - The Japanese subsidiary was involved in the decision-making processes for the business.
  - No written detailed instructions were provided by the U.S. HQ.
  - Japanese employees must have played major roles for the business since they received stock options.
- Using the profit split method, the NTA assessment resulted in the Japanese subsidiary receiving cost plus markup of
28.1 percent.
- The case was taken to Mutual Agreement Procedure (MAP).
  - The Japanese and U.S. governments discussed, and methodology was changed to transactional net margin method (TNMM).
  - Though the Japanese government had to pay some refund, it won a certain increase of profits left in Japan.

The Netherlands

- Global services company using a profit split method
- Audit is focusing on the implementation of the PSM
- Exceptions to the policy (interest expenses, FX results, US GAAP versus local accounting)
- After 2 years under audit tax authorities find something they were not looking for and we were not aware about
- Audit takes a 180 degrees turn and focuses on that and only that point
- Deadline to issue final assessment approaches and DTA decides to be conservative and issue assessment for all subjects under discussion and a few more that were not even discussed

Choice of tested party and PLIs

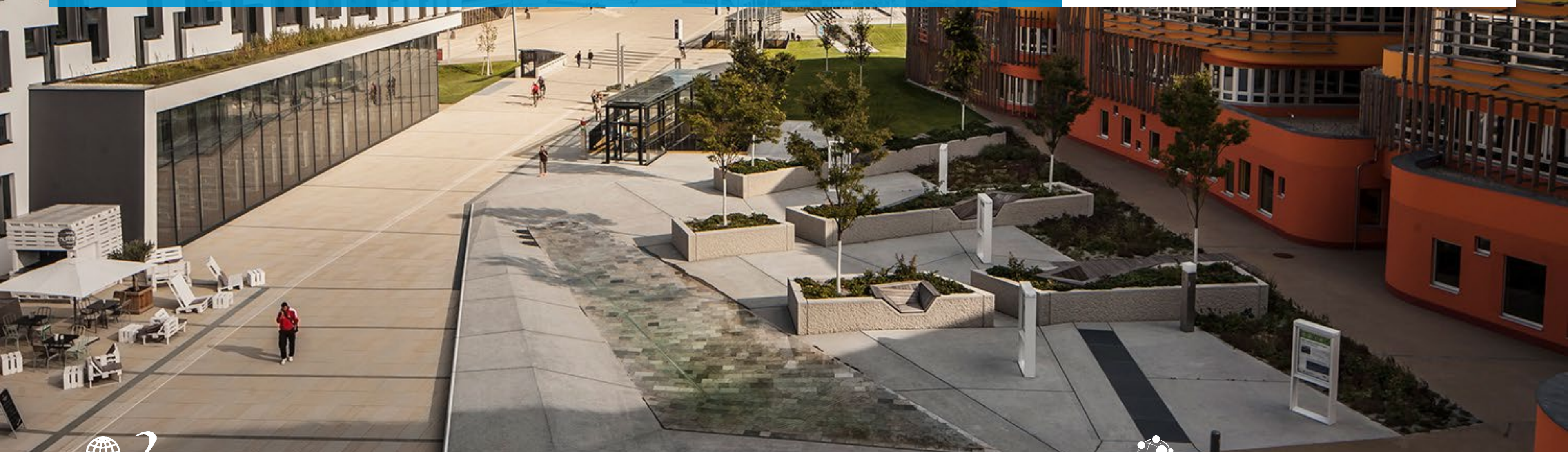
Be careful with labels in the TP documentation (routine/non routine, principal/entrepreneur) and broad simplifications

- Disputes about choice of tested party
- Characterization of tested party
- Profit level indicator
- Implementation of the TP policy (below the line)
- From LRD to something else and back to LRD

Section I.e

Selection of TP audits and lessons learned

CBCR requests

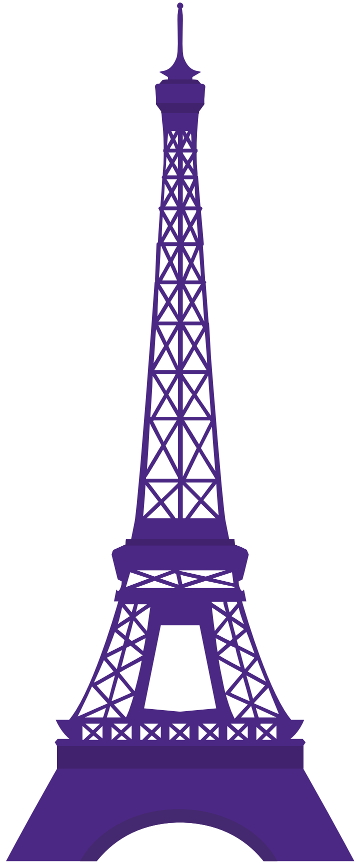


CbyC audit in Austria

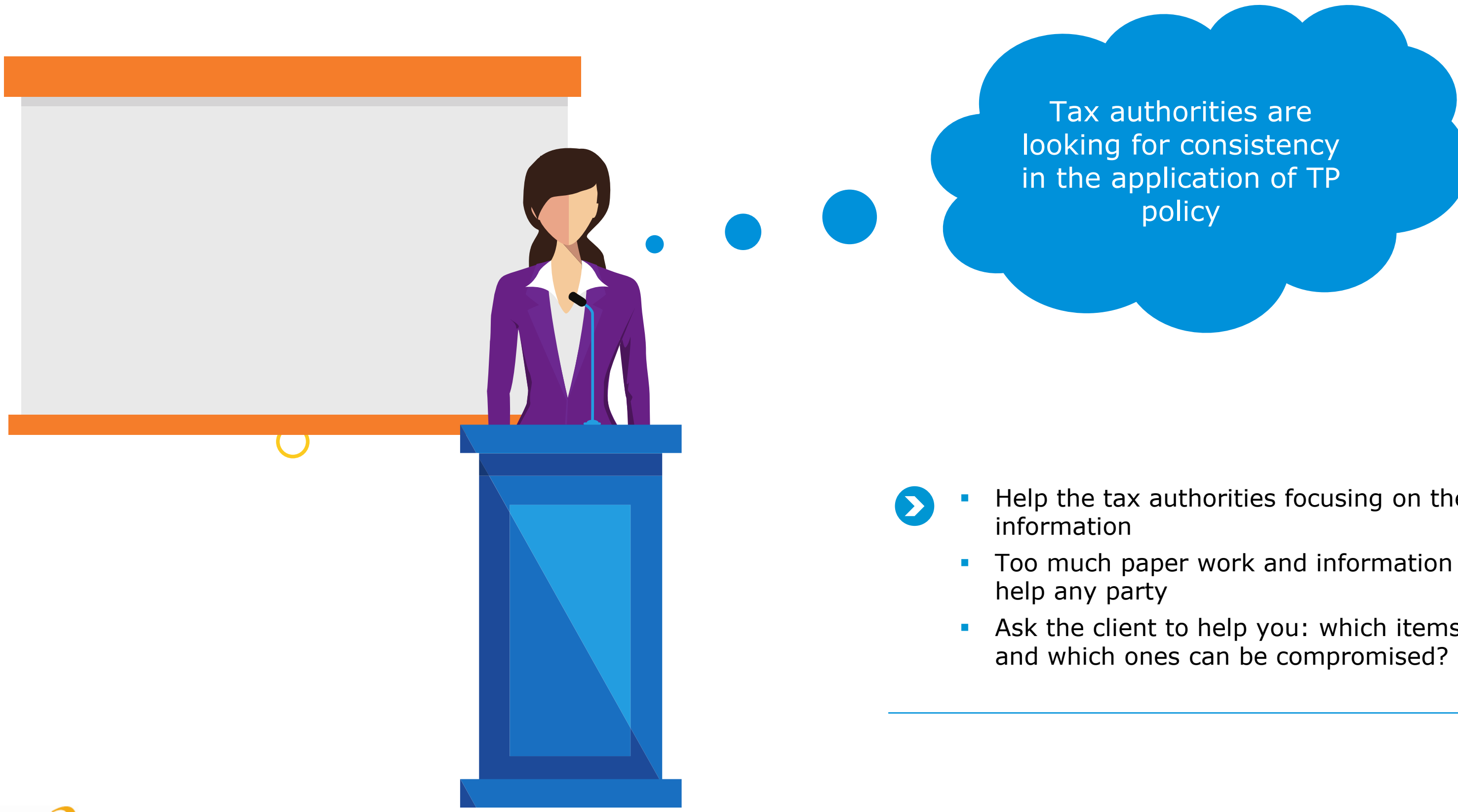
- A Swiss company’s Austrian subsidiary is under examination in what appears to be an audit triggered by the CbyC report.
- The Austrian subsidiary had contract manufacturing, contract R&D, and certain management functions, all working under a cost plus transfer pricing model for the Swiss principal.
- The Austrian tax authority used the CbyC report, information from LinkedIn, travel records, and other information to argue that the Swiss principal did not have enough DEMPE function and that the real DEMPE was in Austria.
- The Austrian tax authority proposed a profit split based on the relative headcount taken from the CbyC report, the important drivers of the business profits of the group taken from the MF and their understanding of the allocation of the DEMPE function.
- KPMG contacted the Austrian tax authority and stated that, under the September 2017 OECD guidance, such an adjustment is not appropriate. KPMG was able to effectively demonstrate that the Swiss principal had substance. The case was settled with a small increase in the cost plus for the Austrian functions.

CbyC audit in France

- A European multinational is now under examination in France (2015–2017) in what appears to be a CbyC-triggered audit.
- KPMG in the U.K. is helping the U.K. subsidiary respond to a detailed IDR that was sent by the FTA to HMRC and then served on the U.K. subsidiary.
- The IDR asks for detailed P&Ls for four broad categories of branded products as well as details of the distribution activity in the U.K.
- We understand that a similar IDR was sent to 80 countries, presumably the 80 countries listed on the CbyC report.
- Some of the key areas the IDR focuses on include:
  - P&L broken out by product including marketing spend, staff dedicated to each product, operating income, etc.
  - Evidence of marketing activities performed by the local U.K. entity
  - Copies of agreements (presumably third party and intercompany)
  - Response due within 45 days.



Too much information everywhere



- Help the tax authorities focusing on the relevant information
- Too much paper work and information sharing does not help any party
- Ask the client to help you: which items are really important and which ones can be compromised?

Contact details

Ágata Uceda
Partner
KPMG Meijburg & Co

Uceda.Agata@kpmg.com
+31 8890 91420
+ 31 652005906