

2016-17 Transfer Pricing Survey Series

**Controversy
avoidance and
resolution**

This report is the third in a series about the global 2016-17 Transfer Pricing Survey conducted by EY. To receive other reports in the series, please visit ey.com/tpsurvey or connect with your local EY Tax contact.

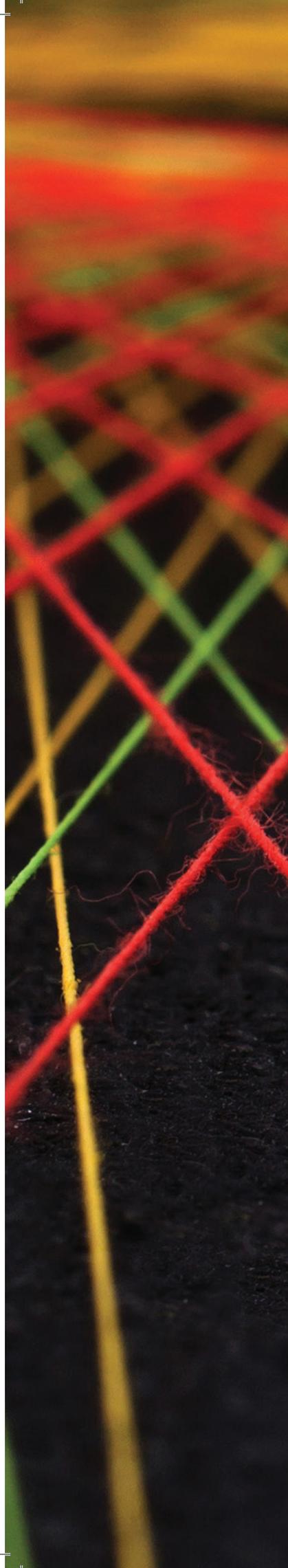
Contents

3

Controversy avoidance and resolution

12

Responding to the challenge



Welcome to our continuing analysis of our 2016-17 *Transfer Pricing Survey*. Our first report, *In the spotlight: a new era of transparency and risk*, gave a high-level overview of the survey findings. The second report, *How anti-BEPS policies are changing transfer pricing*, focused on the impact of measures targeting base erosion and profit shifting (BEPS). This third installment builds on what 623 respondents from 36 jurisdictions across 17 industries have to say in the closely related areas of controversy avoidance and dispute resolution.

In general, it is clear that sweeping new initiatives targeting BEPS, alongside the number of taxing jurisdictions facing budget shortfalls, increases the likelihood of transfer pricing-focused controversy worldwide. This is compounded by tax authorities scaling up their internal resources focused on transfer pricing, along with an increase in the number of countries implementing transfer pricing rules. Indeed, amid so much change and with so much more information in the hands of tax authorities, survey respondents are poised for an era of heightened controversy across multiple defined areas and, especially in emerging markets, where survey respondents indicate they expect a surge of examinations.



Peter Griffin

EY Global and Americas Transfer Pricing Leader



“Thanks to BEPS and other trends leading to greater transparency, tax authorities now have more access to more information than ever before.”

– **Peter Griffin**
*EY Global and Americas
Transfer Pricing Leader*



“What all of this tells us is that, absolutely, fundamental transfer pricing remains the top driver of controversy.”

– **David Canale**
*EY Global and Americas
Transfer Pricing Controversy Leader*

Controversy avoidance and resolution

2016-17 EY Transfer Pricing Survey Series

Controversy: faster, broader and more complex

The survey shows tax professionals are anticipating a sharp rise in transfer pricing-related controversy relative to the recent past. As countries move to implement anti-BEPS recommendations by the Organisation for Economic Co-operation and Development (OECD), 79% of survey respondents believe dispute resolution is becoming more difficult. In fact, overall, EY Global Transfer Pricing Leader Peter Griffin says he believes companies will be experiencing not only more challenging controversies, but also a significant shortening of the transfer pricing life cycle (the period between transfer pricing design/implementation and controversy arising/being resolved). "Thanks to BEPS and other trends leading to greater transparency, tax authorities now have more access to more information than ever before," says Griffin.

Coupled with government budget deficits in so many jurisdictions, Griffin adds, "Authorities have not only greater incentive to move fast but also more tools to do so." Consequently, says Griffin, "companies need to prepare for an era of not only more rapid, but also more intensive transfer pricing scrutiny."

Zeroing in

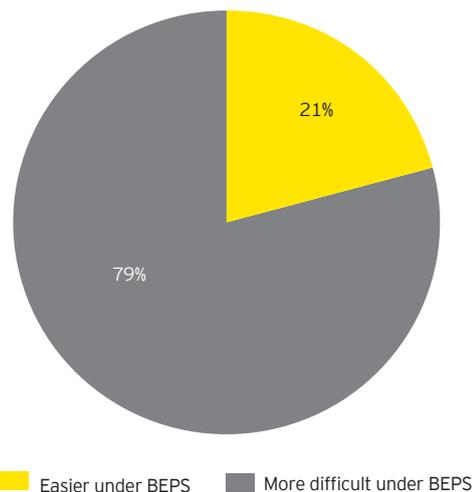
That controversy is accelerating and increasing is clear. But understanding the trouble spots requires a closer and more nuanced look at the sources of disputes.

Overall, the fundamental transfer pricing of goods and services is (and likely always will be) the key driver of disputes between taxpayers and collectors. In this fundamental area, the survey shows virtually no expected increase in the frequency or magnitude of disputes. That is, the percentage of executives reporting that fundamental transfer pricing is a key driver of controversy barely budges from 72% in 2013 to 75% in 2016.

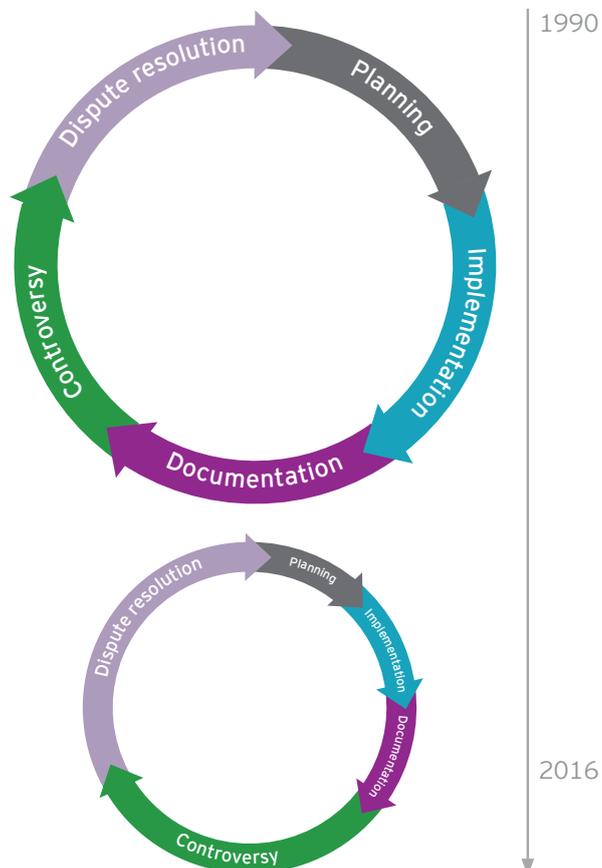
Instead, the sources of the largest increases in expected tax controversy take three key forms: transfer pricing of intangible property; transfer pricing of intra-group financial arrangements and the tax impacts surrounding expanding definitions of the rules for determining permanent establishment (PE).

"What all of this tells us," says EY Global and Americas Transfer Pricing Controversy Leader David Canale, "is that, absolutely, fundamental transfer pricing remains the top driver of controversy." But looking at the areas where concerns are on the rise, Canale adds, "You see that it primarily stems from BEPS actions in these three key areas" (see prior research installment). "And what's particularly troubling is that in each of these cases, the issues are rife with technical complexity and subjectivity." Consequently, says Canale, "controversy in any of these areas is likely to be more difficult to avoid or resolve."

Dispute resolution



A shorter, faster transfer pricing life cycle





“Regardless of prior justifications for cross-border IP charges, BEPS now requires a focus on the location of DEMPE functions: Develop, Enhance, Maintain, Protect and Exploit.”

– **Oliver Wehnert**
EY EMEIA Transfer Pricing Leader

Three key trouble-spots where there is an anticipated rise in controversy stand out:

- ▶ **Intangible property (IP)** – A key focus of BEPS Action 8 is to require greater substance behind cross-border charges for royalties and other intangibles. In the 2013 survey, only 32% of executives indicated such charges as a key source of controversy. However, in the latest survey, the figure surges to 49%.

This is unsurprising, says EY EMEIA Transfer Pricing Leader Oliver Wehnert. “Regardless of prior justifications for cross-border IP charges, BEPS now requires a focus on the location of DEMPE functions: Develop, Enhance, Maintain, Protect and Exploit,” he explains. “IP is an area long suspected by many tax authorities of being a mechanism for shielding income – which is one of the reasons IP attracted its own BEPS Action.” Going forward, “IP will likely be a key focus of examinations which will be taking place using what for many will be a new methodology.” Consequently, says Wehnert, “for any company with significant cross-border IP charges, this is a recipe for increased controversy.”

- ▶ **Permanent establishment** – BEPS Action 7 substantially lowers the threshold under which a company’s presence can create a PE. Three years prior, only 27% cited PE as a significant driver of controversy. But going forward over the next two years, the figure climbs to 44%.

“Challenges as to whether or not in-country operations constitute a taxable presence – or PE – usually arise along the multinational’s ‘plan/design/manufacture/store/market/sell/service’ value chain,” says Zurich-based Ai-Leen Tan, EY Global PE Project Leader. In the past, a company could operate in two or more of these areas (e.g., warehousing and sales) and yet still avoid creating a PE. But BEPS, says Tan, “introduces rules which will allow tax authorities to view the various operations in the same or different locations on a combined basis, such that these will now create a PE.” Because of the new, expanded definition of PE, “undoubtedly, disputes over these issues are going to increase.”

- ▶ **Intra-group financing** – The means by which companies share intra-group interest charges – another key focus of BEPS – is also expected to become a more frequent source of controversy. Specifically, the number of respondents expecting controversy in this rises to 48% for the next two to three years, up from 39% in the 2013 survey.

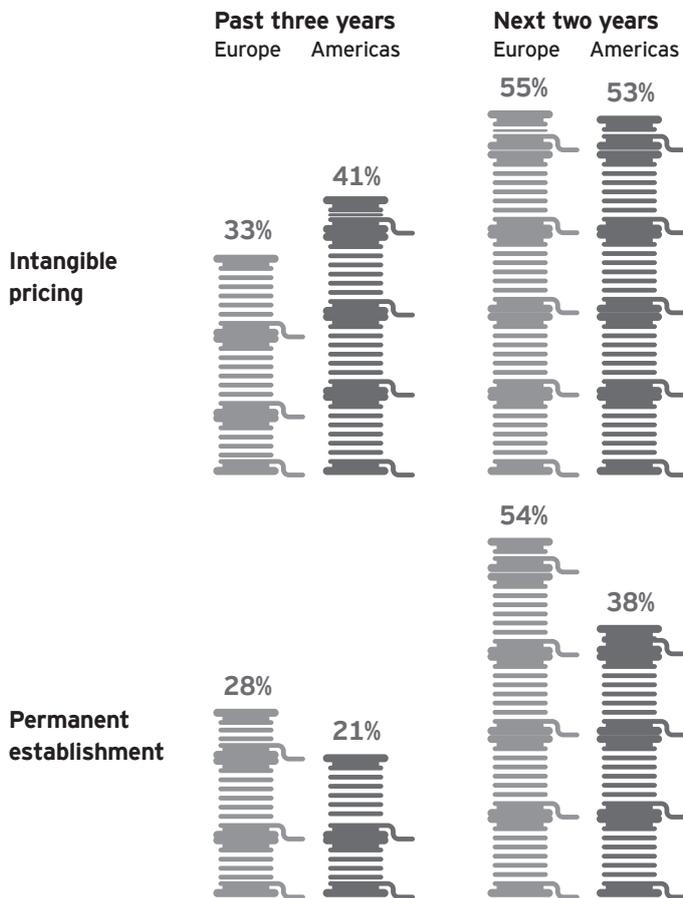
Regional and national variations

The survey points to significant regional and national differences. For example, companies from Europe are significantly more concerned by new PE and intra-group financing guidelines than the rest of the participants overall. Note, in particular, the differences in these two areas between Americas-based and European-based firms.



Europe vs. the Americas

Are these sources of controversy?



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– Ai-Leen Tan
EY Global PE Project Leader, Zurich

Taking an even wider look at the difference between regions, note how intangibles grows in importance to Japanese companies, rising from 39% over the past two years to 63% in the next two years (and, in both cases, well above the overall figures). In a surprising finding, the transfer pricing of goods and services falls from 84% three years ago (well above the overall figure) to 69% in the next two years (well below the overall figure – see color-coded table).

	Overall	Americas	Europe	Japan	Asia (not Japan)	Australia/ New Zealand
Last three years						
Transfer pricing of goods/services	72	68	71	73	84	72
Intangibles	32	41	33	39	27	18
Intra-group financing	39	38	46	9	27	45
PE	27	21	28	33	27	25
Indirect: VAT GST	28	27	33	16	20	24
Indirect: customs	14	11	13	13	25	15
Factors relating to fiscal residence	10					
Transactional taxes	12					
Next two years						
Transfer pricing of goods/services	75	74	75	82	69	73
Intangibles	49	53	55	63	38	25
Intra-group financing	48	50	56	18	35	51
PE	44	38	54	35	33	34
Indirect: VAT GST	25	20	30	13	25	24
Indirect: customs	15	10	16	19	22	12
Factors relating to fiscal residence	15					
Transactional taxes	11					

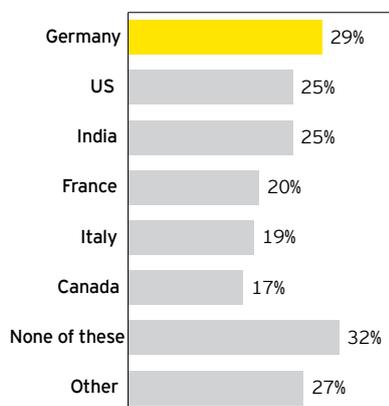
Table note: Red highlights significantly above overall; green significantly below



Differences are also evident country by country. Certain nations, the survey shows, present a relatively higher likelihood of transfer pricing audits. Here, looking back across the past three years shows Germany leading the way, with 29% of companies saying their German operations experienced a transfer pricing audit. German tax authorities are followed closely by those from the developed world, US (25%) – and, notably from the developing world, India (25%).

In which of the following countries was your transfer pricing policy examined in the last three years?

% with examinations in the last three years



Multiple responses allowed

Top six countries by source of respondents

	Australia	Japan	UK	US	Germany
Germany	21%	7%	13%	10%	54%
US	71%	1%	11%	17%	16%
India	64%	10%	12%	11%	20%
France	14%	3%	12%	7%	23%
Italy	14%	4%	6%	8%	27%
Canada	21%	2%	4%	11%	11%

India's rise to such heights is indicative of yet another observation culled from the research: To a large degree, the survey continues to show a paradox between the markets that attract client resources and the ones that actually create controversy. For example, although Germany, the US and India are cited as sources of revenue authority examination with relatively equal frequency, there is an enormous variation in the outcome of such audits. Specifically, respondents reported no adjustments in 64% of US-based inquiries and only 43% for Germany.

By contrast, in India, only slightly more than one in five audits (21%) resulted in the favorable finding of no adjustment. Meanwhile, 38% indicate that their cases from India remain unresolved, indicating procedures in this nation to be more tedious. By comparison, just 19% and 14% of respondents say that their German and US cases were unresolved, respectively – with this comparable to outcomes from France and Italy (although Canada now rivals India for unresolved cases).

One area where multinational corporations say tax authorities from both the US and Germany fall short is in the avoidance of having the same income taxed in two jurisdictions (double taxation). In both Germany and the US, executives say 27% of controversies result in double taxation, topping the list of all nations in terms of frequency.

Also note, although interest, usually moderate, is commonly applied across a wide range of jurisdictions, penalties are significantly less common. However, certain jurisdictions offer a substantially higher likelihood of penalties, such as Italy and India, meaning companies should review their methodologies and resources and adjust accordingly.

Outcome of examinations

	Unresolved	No adjustment	Partial adjustment	Full adjustment
Germany	19%	43%	36%	2%
US	14%	64%	21%	1%
India	38%	21%	36%	5%
France	18%	57%	24%	0%
Italy	17%	25%	54%	3%
Canada	35%	45%	19%	1%

Table note: Red highlights significantly above overall

Knock-on examination results

	Penalties imposed?	Interest?	Resulting in double taxation?
Germany	6%	30%	27%
US	1%	7%	27%
India	33%	31%	19%
France	6%	15%	7%
Italy	28%	29%	21%
Canada	6%	10%	6%

Numbers may not sum due to rounding.

Avoid disputes by becoming more proactive

The prior section shows where companies are experiencing controversy. However, the best way to address disputes “is to avoid them in the first place,” says Canale. Consequently, “companies should do their best to build transfer pricing defense files based on accepted principles – and stand ready. They should also turn increasingly to tools such as advance pricing arrangements (APA), both bilateral and multilateral, and other mechanisms available to achieve greater up-front confidence in their transfer pricing.”

To-date, more than a third of respondents (38%) have used APAs of one form or another as a means of improving certainty and avoiding controversy (see chart to the right). But going forward, Canale expects this number to increase significantly. “Controversy is most definitely on the rise and so the stakes have been raised.”

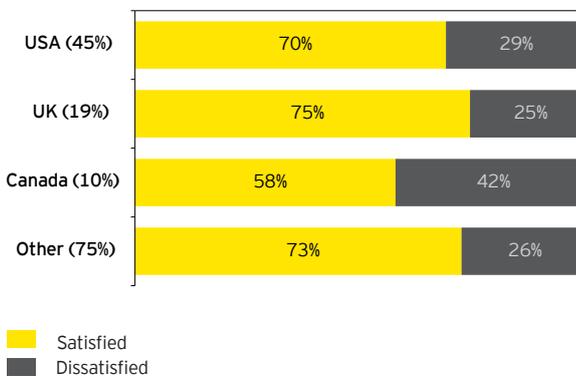
Moreover, “more nations – like India – are announcing/expanding/improving their APA programs, while many jurisdictions are clearly favoring bilateral APAs over unilateral,” Canale says. So amid increasing risks, along with greater accessibility, “we are already seeing heightened interest.” Indeed, the survey findings support this view: 65% of respondents say they will be using more APAs in the future.

Among those who have used APA programs, the results are generally positive. For example, 75% express satisfaction with APAs from UK authorities. Nearly identical numbers (73%) say their experiences have been positive across a wide range of other nation’s APA programs, along with 70% for the US – but falling to 58% for Canada.

Among those expressing dissatisfaction with their APA experience, 69% say the process took too long, 15% experienced what they viewed as a poor or unexpected outcomes, with 6% pointing to onerous compliance requirements.

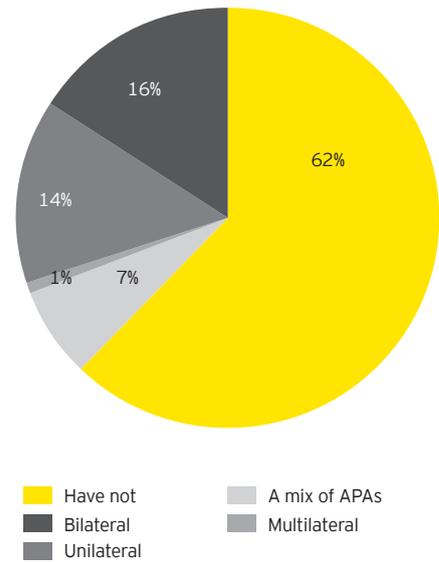
Are you satisfied or dissatisfied with the APA process?

Which countries were involved?

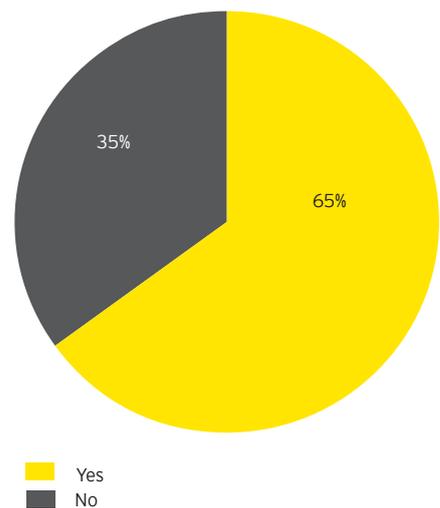


Numbers may not sum due to rounding.

Have you ever used an APA?



Will you be using more APAs going forward more than in the past?





“A key focus of BEPS is on BEPS Action 14, which pledges to improve the effectiveness of MAPs by providing measures to overcome the obstacles that prevent countries from resolving treaty-related disputes under MAP, which includes introducing minimum standards by which host nations are expected to adhere.”

– **Marlies de Ruiter**
EY Global ITS Tax Policy Leader

When all else fails: MAP and litigation

When all else fails, companies are often forced to turn to more drastic dispute resolution measures. Key avenues examined by the survey include mutual agreement procedures (MAP) and litigation.

Experiences with MAP

Three out of four respondents (75%) say they have, in fact, submitted issues to competent authority. Also known as MAP, these are cases where authorities from two nations are engaged to reconcile issues, such as alleged double taxation.

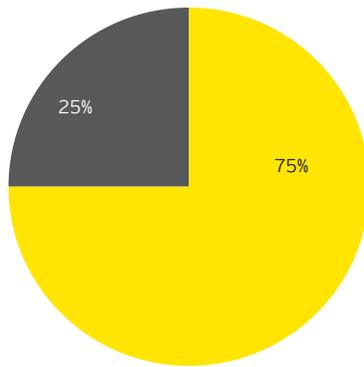
Of those turning to this option, 39% were satisfied with the process and would use it again. But 44% say their issues are as yet unresolved – and 17% say they are dissatisfied. As for those dissatisfied with their MAP basket, the reasons mirror those for APAs: a too long process (44%); a less than desirable outcome (24%) and onerous compliance (4%).

Whatever their current state, going forward, MAP processes are likely to improve significantly. Specifically, says Marlies de Ruiter, EY Global ITS Tax Policy Leader, “a key focus of BEPS is on BEPS Action 14, which pledges to improve the effectiveness of MAPs by providing measures to overcome the obstacles that prevent countries from resolving treaty-related disputes under MAP, which includes introducing minimum standards by which host nations are expected to adhere.” Such standards, de Ruiter says, “address elements such as time to resolution and quality of interaction, with host nations who adopt this measure subject to periodic peer review (by other nations’ tax authorities).”

Today, the Action 14 MAP review process will be applicable to members of the OECD’s Inclusive Framework, which included 90 jurisdictions at the time of this writing. In the years to come, more nations will be expected to participate, which, EY Transfer Pricing Leader for Brazil, Katherine Pinzon, believes is an important next step. “In an era of profound cross-border activity, it is essential that host governments develop more effective processes for settling disputes. “Where there is a major dispute, it tends to be material,” says Pinzon, “which is why it is important that any inefficient, slow moving or arbitrary processes be replaced with something more sophisticated, fair and expedient. This is also particularly important for where disputes involve markets which don’t use or have irregularly or inconsistently used MAP.”

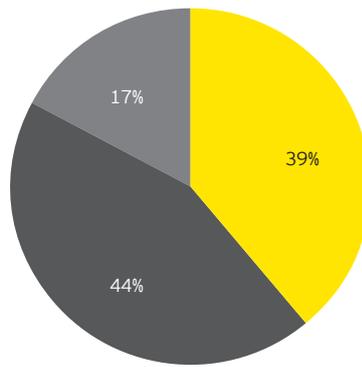
BEPS Action 14, says Pinzon, “is a strong step in the right direction.” Nonetheless, at least initially, “we expect the frequency of controversy will initially rise under BEPS.” Longer term, says Pinzon, “matters regarding resolution should begin to improve, as jurisdictions and taxpayers learn to work with one another and an equilibrium emerges.”

Have you submitted a case to a competent authority (MAP)?



■ Yes
■ No

What is your experience with MAP?



■ Satisfied
■ Unresolved (in progress)
■ Dissatisfied

The litigation route

About one in six companies (17%) have seen controversies so severe their resolution migrated to the courts. Here, 21% express satisfaction with their outcome – and would use litigation again. But 57% say their cases are still unresolved – and 22% are dissatisfied with their outcome. This highlights the long process to take a matter through to litigation, and the variability in outcomes that can arise.

Beyond MAP and the courtroom, companies today may also look to alternative dispute mechanisms, such as obtaining formal or informal domestic agreements – effectively becoming party to joint audits – or seeking binding arbitration.

Conclusion

It is clearly evident that our respondents are anticipating a surge in transfer pricing related controversy, taking into account the perfect storm of:

- ▶ Better resourced tax authorities
- ▶ The additional information that they will be equipped with from the BEPS Action 13 documents regarding Masterfile and local file transfer pricing documentation and country-by-country reporting
- ▶ The continual increase in countries with transfer pricing rules and information sharing protocols

In particular, respondents anticipate controversy to increase in the thorny areas of intangibles and PEs, and to take longer and be more costly to defend.

We recommend that taxpayers equip themselves for this by assessing their structure and risk profile, making adjustments and taking other proactive measures accordingly.

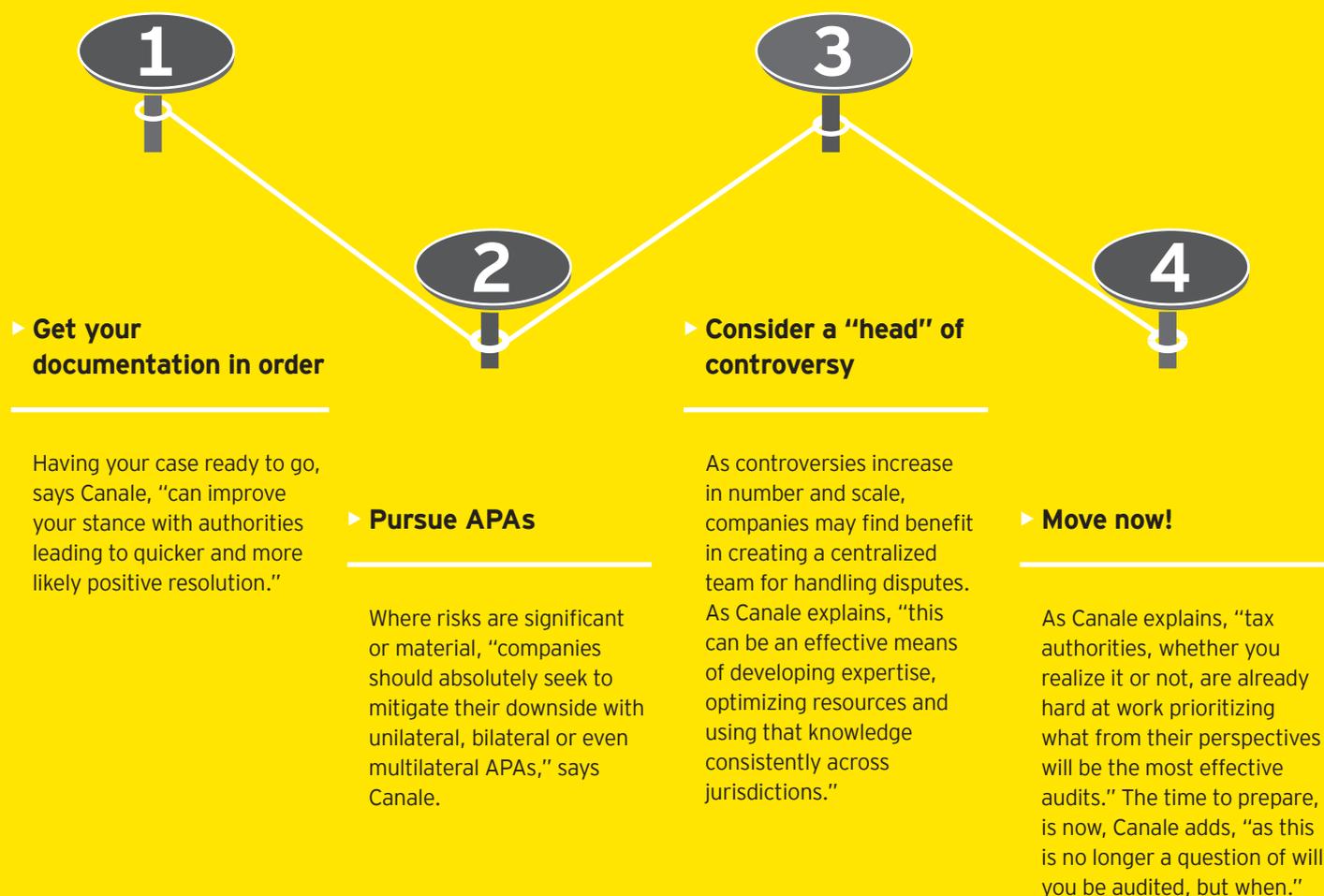


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– Katherine Pinzon
EY Transfer Pricing Leader, Brazil

Responding to the challenge

Survey respondents are expecting a surge in controversy. “But rather than sit back and wait,” says Canale, “companies need to become more proactive.” Here are the next key steps to consider.



EY Transfer Pricing contacts

Peter Griffin

EY Global and Americas Transfer Pricing Leader
+1 612 371 6932
peter.griffin@ey.com

Curt B. Kinsky

EY Asia-Pacific Area Leader – Transfer Pricing
+852 2629 3098
curt.kinsky@hk.ey.com

Oliver Wehnert

EY EMEA Leader – Transfer Pricing
+49 211 9352 10627
oliver.wehnert@de.ey.com

Ichiro Suto

EY Japan Leader – Transfer Pricing
+813 3506 2411
ichiro.suto@jp.ey.com

David Canale

EY Global and Americas Transfer Pricing
Controversy Leader
+1 202 327 7653
david.canale@ey.com

In the spotlight

A new era of transparency
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