Insights: Transfer Pricing

CRA Charles River Associates

January 2021

2020 was a year like none other as the global economy and governments across the world were impacted by the COVID-19 pandemic. In this edition of *Insights: Transfer Pricing*, we highlight the work of CRA's Transfer Pricing Practice in 2020. Additionally, we provide a recap of the 2020 transfer pricing landscape and focus on hot topics: the implications of the pandemic on transfer pricing, the taxation of the digital economy, and what lies ahead in 2021.

Our consulting work: The year in review

Our consultants help clients navigate every phase of implementing and supporting international tax structures including: intellectual property (IP) and acquisition planning, documentation, and audit defense. We also provide support and expert testimony services in tax and transfer pricing litigation. We highlight some of our 2020 projects below.

Planning

Tax authorities continue to scrutinize tax structures among multinational companies. In 2020, we conducted IP restructuring work for our clients in various jurisdictions including those onshoring their IP to Ireland due to changes in Irish tax law. Specifically, our engagements involved the valuation of complex IP for clients in a variety of industries. For clients that had IP registered in Germany, we helped them review their exposure to potential withholding taxes. The methodologies our transfer pricing consultants used were tailored to each respective client, the industry issues they faced, and the specific facts and circumstances of each transaction. We continue to stay on top of current transfer pricing matters to assist clients with their planning needs.

Documentation

We keep apprised of global regulatory requirements and provide documentation recommendations to clients tailored to their operations. We advised clients on their global transfer pricing documentation obligations and stayed apprised of documentation requirements and assisted clients with Country-by-Country Reporting (CbCR) compliance, Local File and Master File development, as well as regional form submissions.

Audit defense

CRA's transfer pricing consultants successfully defended IP valuations, IP migrations, and international tax structures under audit by the Internal Revenue Service (IRS) and tax authorities around the world. In 2020, we assisted clients with transfer pricing audits for cases in Denmark, Germany, Hong Kong, and the United States.

Litigation consulting

CRA consultants assisted counsel and their clients involved in an international arbitration and those facing litigation involving tax and transfer pricing disputes. Our 2020 work on high profile cases involved understanding complex industries and complicated issues related to tax reporting, cost sharing, IP valuations, and other transfer pricing matters.

A recap of regulations/guidance and litigation

At the beginning of 2020, the Organisation for Economic Co-operation and Development (OECD) was focused on BEPS 2.0 however, as the impact of COVID-19 intensified, the OECD and other tax authorities pivoted to address COVID-19-related issues. Many countries announced extended deadlines on tax and transfer pricing filings and proposed general guidance on the way forward in light of COVID-19. 2020 also saw continued discussions and developments related to the taxation of the digital economy from the OECD, while governments implemented their own digital taxation policies. CRA's up-to-date reference guide of global TP regulations can be found at: **https://www.crai.com/insights-events/publications/road-map-post-beps-transfer-pricing-world/**

Key IRS news and regulation

US - IRS	
April 2020	IRS releases FAQs on best practices for transfer pricing documentation.
May 2020	Competent authority filing modifications and APMA APA consultations.
June 2020	US seeks "pause" in OECD Pillar 1 discussions of digital economy to focus on COVID-19. Supreme Court upholds cost-sharing regulations as valid in *Altera Corp. v. Commissioner.*
August 2020	North Carolina announces voluntary corporate transfer pricing resolution initiative. Swiss-US competent authority arrangement regarding treaty arbitration clause.
November 2020	US Tax Court rules in favor of IRS in *The Coca-Cola Co. v. Commissioner* regarding transfer pricing adjustments.

Key OECD projects/transfer pricing guidelines

OECD	
February 2020	OECD releases Transfer Pricing Guidance on Financial Transactions.
July 2020	OECD and Brazil's federal revenue authority (Receita Federal) invite taxpayer input on transfer pricing issues relating to the design of safe-harbor provisions and other comparability considerations. OECD releases global tax reporting framework for digital platforms in the sharing and gig economy.
October 2020	OECD releases Pillar One and Pillar Two Blueprints and tax challenges of digital economy.
December 2020	OECD publishes information on the state of implementation of the hard-to-value intangibles approach by members of the Inclusive Framework on BEPS. OECD releases "Guidance on the transfer pricing implications of the COVID-19 pandemic."

Litigation

Transfer pricing litigation in 2020 involved typical issues such as selection of comparables, but also included the characterization of transfer pricing arrangements, deductible expenses, intercompany financing, and state aid, among other things. We highlight notable cases below.

North America

Case	Issue	Status
United States		
Whirlpool (US Tax Court)	Whirlpool set up a tax structure in which its Luxembourg-related party used a maquiladora structure and sold products to its US-related party. The IRS ruled that sales to the US-related party are foreign base company sales income (FBCSI) under Section 954(d) and increased taxable income.	On May 5, 2020, US Tax Court ruled in favor of the IRS.
Altera Corp. (US Supreme Court)	Altera excluded stock-based compensation expenses in the costs shared under its cost sharing arrangement (CSA). In 2019, the Court of Appeals ruled that stock option compensation costs should be shared under a CSA.	On June 22, 2020, the US Supreme Court denied Altera's petition for certiorari.
Coca-Cola (US Tax Court)	Coca-Cola's US-related party received royalties from its related-party affiliates that the IRS deemed were not arm's length. The IRS used the comparable profits method (CPM) and adjusted the US income upward by $1.8 billion.	On November 18, 2020, the US Tax Court ruled in favor of the IRS.
Canada		
Loblaw Financial Holdings Inc. (Federal Court of Appeal)	Loblaw had a related party in Barbados, which it claimed qualified for a foreign bank exclusion as it met the "investment business" definition, and thus, was not taxable. The Tax Court of Canada (TCC) ruled that the entity did not meet the definition criteria.	On April 23, 2020, the Federal Court of Appeal (FCA) overturned the TCC decision, noting that the Barbados entity qualified for the foreign bank exclusion.
Cameco Corp. (Federal Court of Appeal)	Cameco reorganized its operations in which its Swiss-related party distributed uranium and earned windfall profits when uranium prices rose. The Canada Revenue Agency argued the transaction was a "sham" and would not have been entered into at arm's length, but the TCC ruled in favor of Cameco noting that uranium prices were not predictable.	On June 26, 2020, the FCA dismissed the Canadian Revenue Agency's appeal that attempted to reconstruct transactions by eliminating intercompany sales.
AgraCity Ltd. and Saskatchewan Ltd. (Tax Court)	AgraCity's Canadian entity engaged its Barbados-related party to sell products to Canadian customers. The Canada Revenue Agency argued that the Barbados entity did not add value and income should go to the Canadian entity.	On August 27, 2020, the Tax Court of Canada ruled in favor of AgraCity.

Europe

Case	Issue	Status
Europe		
Dutch Zinc Smelter (Court of Appeal)	A Dutch zinc smelter converted its Swiss-related party into a principal. The Dutch tax authority argued that both the conversion payment and cost plus remuneration post restructuring were too low. The Court upheld the taxpayer's position as the tax inspector did not meet the burden of proof requirement and the Dutch tax authority appealed the decision.	On April 3, 2020, the taxpayer settled by using a profit split, indicating that the Dutch parent did not convert from an entrepreneur to toll manufacturer, but also that the Swiss principal performed valued-added functions.
A/S Norske Shell (Norwegian Supreme Court)	A/S Norske Shell, a party in the Shell group, was part of a cost contribution arrangement. A/S Norske charged local R&D costs to unrelated parties, but did not charge those to other related-party affiliates. The Petroleum Tax Appeals Board argued such costs should be shared by the related parties.	On May 28, 2020, the Norwegian Supreme Court ruled in favor of A/S Norske Shell stating that such payments would not have been shared at arm's length.
Adecco A/S (Danish Supreme Court)	At issue were licensing payments from Adecco's Danish entity to its Swiss parent. Skatteforvaltningen (the Danish tax authority) argued the payments were not deductible, the royalty rate was inappropriate, and that documentation was insufficient.	On June 25, 2020, the Danish Supreme Court ruled in favor of Adecco asserting that the royalty payments were deductible and arm's length, and that documentation was sufficient.
Danish Software Company (Danish Tax Court)	Following a restructuring, a Danish entity was converted from a full-fledged distributor to a commissionaire. The Danish entity transferred its IP to Switzerland. Since no documentation existed for the transaction, Skatteforvaltningen issued a discretionary assessment on the IP.	On July 2, 2020, the Tax Court ruled that sufficient functional analysis was conducted but adjusted the life of the IP.
Apple (General Court of the European Union)	In 2016, the European Commission ruled that Apple owed back taxes to Ireland related to its operations prior to a 2014 restructuring.	On July 15, 2020, the EU General Court ruled that Apple was not subject to back taxes.
General Electric (High Court)	HM Revenue & Customs (HMRC) accused General Electric (GE) of fraud related to interest tax deductions, claiming that GE double-claimed tax relief in Australia and the UK on interest for a loan to avoid tax.	The case is ongoing and confidential.
BlackRock (UK First-tier Tribunal)	BlackRock used a Delaware holding company that was tax resident in the UK to acquire a company. The US parent funded the acquisition by issuing loan notes to the holding company. HMRC denied the interest deduction, arguing that the transaction would not have occurred between third parties and the loans were entered into for unallowable tax avoidance.	On November 3, 2020, the First-tier Tribunal ruled in favor of BlackRock's appeal for deducting interest payments on loans, as there was evidence that the holding company acquired the target for commercial purposes and that a lender would loan a third party for the acquisition.

Asia Pacific

Case	Issue	Status
Oceania		
BHP Billiton Limited (High Court of Australia)	The High Court of Australia sided with the Australian Taxation Office (ATO) that BHP Australia is taxable on its share of the marketing hub's profits from sales of commodities acquired from Australian subsidiaries of BHP UK and those acquired from Australian subsidiaries of BHP Australia. This is because BHP Australia and BHP UK are associates of each other and the marketing hub.	On March 10, 2020, the High Court of Australia dismissed BHP Billiton's appeal.
Glencore (Full Federal Court of Australia)	The ATO argued that the price charged by Glencore Australia to its Swiss parent for copper concentrate was too low. The Full Federal Court of Australia sided with Glencore in 2019.	On November 7, 2020, the Full Federal Court of Australia dismissed the ATO's appeal.

Middle East and Africa

Case	Issue	Status
Middle East and Africa		
Mopani Copper Mines Plc. (Supreme Court of Zambia)	The Zambian Revenue Authority found that Mopani, a Zambian-related party of Glencore, sold copper to its Swiss parent, Glencore, at prices lower than at arm's length. Mopani appealed the decision to the Tax Appeal Tribunal and then to the Supreme Court.	On May 20, 2020, the Supreme Court of Zambia dismissed Mopani's appeal.

Hot topics in transfer pricing

Transfer pricing in the wake of COVID-19

The OECD issued its guidance on the implications of COVID-19 on transfer pricing in December 2020. This guidance reasserted the use of the arm's length principle, outlined in the OECD 2017 Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, when determining transfer pricing between related parties. The guidance clearly indicates that companies should fully document how their businesses and transfer pricing policies have been impacted by the pandemic and the need to assess the comparables used in determining arm's length pricing, among other things. A comprehensive review of this guidance and key issues are found in **this article** by Anna Soubbotina and Robin Hart.

Transfer pricing in the digital economy and beyond

The COVID-19 pandemic has spurred on the digitalization of many sectors. Research indicates that we have vaulted five years forward in consumer and business digital adoption in April and May of 2020, alone. Equally important, there's a shift in consumer behavior to using digital services, 75% of new users say they will continue to use digital services after things return to normal. Given all of this, it's important for all corporate taxpayers, regardless of where their global presence is and how they generate sales today, to pay attention to the recent tax regulations and guidance.

Unilateral measures

Several countries have taken unilateral measures to tax the digital economy. About half of the European OECD members have either announced, proposed, or implemented a tax on certain gross revenue streams of large digital companies. Digital service taxes range from 2% in the UK to 7.5% in Hungary and Turkey. The revenue base being taxed varies from online advertising revenue to a broader revenue base that includes the provision of a digital interface, targeted advertising, and the transmission of user data for advertising purposes.

India introduced an equalization levy of 6% on advertising and related services earned by foreign entities. This was expanded to cover non-resident e-commerce operators and suppliers. The Chinese tax authority has postponed the implementation of a new VAT regime for online sales and is investigating how to tax the digital economy.

Multilateral measures

Multilateral measures include proposals by the United Nations (UN) and the OECD. The UN proposal, Article 12B to the UN model tax treaty, provides two options. A tax rate of 3-4% with the final rate to be decided by each respective country on gross sales. A second option available to multinationals is to be taxed on a net basis. This would be determined by computing the global profit rate of MNEs' in-scope activities, applying it to the company's local sales, and attributing 30% of it to the market jurisdiction where customers are located.

In October 2020 the OECD issued its Pillar One and Pillar Two Blueprints on taxing the digital economy. While this is referred to as the taxation of the digital economy, it is in fact the first step in forming tax policy for the 21st Century, and if implemented, it will be the most significant taxation change since the 1920s. Pillar One effectively reallocates the ability to tax profits, so some countries will be giving up their jurisdiction to tax profits while other countries will gain that right. This is, of course, a highly political issue. Pillar Two effectively implements a global minimum corporate tax which, in theory, should generate more tax revenue for countries, and so is less controversial, and may be implemented first.

- Pillar One redefines the existing nexus concept, i.e., taxation occurs when a multinational enterprise (MNE) has a physical presence in a tax jurisdiction. The new nexus rule focuses on the location of the sales to the end customer rather than if a company has a physical presence in a jurisdiction. New profit allocation rules extend beyond the arm's length principle and would allow jurisdictions to apply formulas where the arm's length principle does not work. Importantly, the scope of Pillar One has expanded beyond the digital economy to include other consumer-facing businesses.

- Pillar Two, also referred to as the Global Anti-Base Erosion Proposal (GloBE), focuses on developing a minimum global tax "where other jurisdictions have not exercised their primary taxing rights or the payment is otherwise subject to low levels of effective taxation."[1] The OECD aims to reduce the risk of unilateral measures by proposing four rules that would amend tax treaties to prevent double taxation.

[1] OECD, "OECD secretariat invites public input on the Global Anti-Base Erosion (GloBE) Proposal under Pillar Two," https://www.oecd.org/tax/oecd-secretariat-invites-public-input-on-the-global-anti-base-erosion-proposal-pillar-two.htm.

According to the OECD, Pillar One and Pillar Two could increase global corporate income tax revenue by $50-80 billion per year. If you also take into account the US GILTI regime, the total effect could be $60-100 billion per year.

In the mid-January 2021 OECD consultation meetings, corporate taxpayers flagged issues with the OECD Pillar One and Pillar Two Blueprints that include:

- How a corporate taxpayer calculates profits since often there is a timing difference between when costs are incurred and revenues are generated. For example, in R&D intensive industries, such as the pharmaceutical industry, significant costs are incurred first and revenues may not be generated for a number of years.
- The level of cross-border coordination required to implement Pillar Two, a global minimum tax.

The EU has maintained that if a global consensus on the OECD's digital taxation policy is not achieved by mid-2021, the EU will establish its own digital tax policy creating a unified approach for its member countries. Currently, the EU's digital tax policy consists of three possible approaches: (i) an additional corporate income tax on digital companies, (ii) a tax on revenues generated by digital companies, or (iii) a tax on business-to-business digital transactions.

What lies ahead in 2021

Tax authorities will continue to scrutinize documentation reports. The IRS issued best practices on transfer pricing documentation. Other countries, such as Denmark, are also focusing on the quality of the transfer pricing documentation they have received and questioning whether the information/reports are sufficient. We recommend that taxpayers:

- Continue to adhere to transfer pricing regulations and guidance to prepare and maintain clear records and documentation detailing how their intercompany transactions meet pertinent regulations and guidance. Specifically, we advise preparing comprehensive transfer pricing documentation that provides evidentiary support for assertions, such as the impact of COVID-19 on your business, particularly in light of the OECD's guidance. Given that tax authorities will review a taxpayer's transfer prices and the accompanying supporting ranges and will then propose adjustments, taxpayers should ensure that their selected transfer prices are robust and defendable.

The OECD will be focused on achieving a multilateral approach to taxing the digital economy by implementing its Pillar One and Pillar Two Blueprints. Given the backdrop of the pandemic, it is debatable if consensus will be achieved in 2021 although the G20 countries remain committed to making further progress. While it is not yet certain what will be implemented, it is important for taxpayers to:

- Understand the implications of Pillar One and Pillar Two on their business models and financials.
- Be active in the OECD's consultation process with taxpayers.
- Be aware of the current unilateral digital taxation policies that are in place and the impact of those policies on business models and financials.

In 2021, ongoing transfer pricing cases to watch include:

- *Medtronic Inc. et al. v. Commissioner of Internal Revenue*, in which the IRS has argued the use of a CPM versus the comparable uncontrolled transaction (CUT) approach employed by Medtronic.
- *Facebook Inc. and Subsidiaries v. Commissioner of Internal Revenue*, involving the valuation of IP licensed by a US entity to an Irish entity.
- *3M Co. et al. v. Commissioner of Internal Revenue*, a dispute involving the royalty payments paid by a Brazilian entity to a US entity.

Recent transfer pricing litigation indicates that:

- Financial transactions continue to be scrutinized. Companies should check that the interest rates on their intercompany loans are supported by substantial analysis and documentation.
- The valuation of IP is a critical issue and courts will scrutinize all the elements of an IP valuation.
- Companies should be aware of the courts' preference for the comparable uncontrolled price (CUP) method (even with adjustments) over other transfer pricing methods in certain situations.

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