International Tax Review – 2020 Tax Controversy Leaders Guide

Vision 2020 - Tax Audits and Controversy in an Age of Conflicting Objectives

***David Swenson**, Global Tax Controversy and Dispute Resolution leader in the Washington DC office of **PwC**, discusses the global tax audit and controversy landscape in today's unprecedented environment and the complexities it raises for regimes and companies alike.*

Prior to the COVID-19 pandemic, multinational enterprises (MNEs) were facing the most challenging tax environment in history. It is now unquestionable that the magnitude of the pandemic will further heighten this challenging environment, resulting in a substantial increase in the number and size of tax audits, assessments and disputes with revenue authorities worldwide. Virtually no area of tax enforcement will be immune, including direct and indirect taxes, state aid disputes, and tariffs and trade matters. In this context, transfer pricing will remain an area of increased focus by tax administrations, particularly as a result of modifications made to operating models and intercompany pricing to increase cash flow in a turbulent environment where many MNEs are incurring significant losses around the world.

In the midst of the pandemic, the Organization for Economic Cooperation and Development (OECD), the European Commission and individual countries in the European region continue to propose new policies for taxing the digital economy, with the aim to better align taxable income with value creation. The OECD is pressured to find a solution in the near future, given that unilateral measures to tax the digital economy will increase the risk of double taxation and potential trade wars. MNEs are closely monitoring these developments and the promulgation of new international tax rules in the digital space in the United States and other countries, with an eye towards understanding how these potential new rules will impact business operations, including supply chain operations, in the current environment. The specter of double taxation looms over the increased uncertainty that has been created in the current environment.

Profit split approaches are being refined and relied upon more frequently. Defining 'value creation' to determine the proper allocation of profits, however, can be subjective in nature. Moreover, it is difficult to reach consensus on a standardized approach, or even the common elements in a suggested methodology. Consequently, there are significant questions as to whether tax administrations are likely to accept allocations of profits based on methods with variable elements, thereby creating uncertainty and the risk of double taxation as an increase in audits unfolds in the coming years.

Taxpayers, tax professionals, and tax administrations are closely following a number of prominent cases in both national and international courts, given the impact that landmark decisions may have on future audits and the regulatory environment. Although litigation is generally an option of last resort, many stakeholders predict an increasing number of matters reaching the purview of judicial review with the use of expert testimony to help resolve often complex matters where significant tax revenue is at stake.

This dynamic environment places a premium on audit and dispute prevention techniques. MNEs need to develop coordinated approaches to audits and disputes around the globe, adopt preventive measures (such as pre-filing rulings and enhanced relationships with revenue authorities), and leverage both traditional and new alternative dispute resolution techniques to achieve the best possible outcomes.

The impact of COVID-19

The COVID-19 pandemic has forced the world to break from the past and deal with a changed world. The entire globe has been impacted, with no government or taxpayer being completely immune from the economic chaos. In the wake of COVID-19, MNEs are experiencing economic *extremis* and disruption to supply chains and other aspects of business operations. The OECD Transfer Pricing Guidelines and local country transfer pricing regimes were not designed to address the financial impact of a global pandemic. The financial impact is even more significant for structures where local subsidiaries operate as limited risk entities earning a guaranteed return, but where overall system profit is reduced or eliminated. In such cases, the MNE will need to consider whether and how to support affiliated entities to maintain business continuity. In the short-to-medium term, liquidity and free cash flow are paramount for taxpayers that elect to delay payments (e.g. waiving royalties or reducing margins for limited risk entities), notwithstanding the overall functional and risk profile as evidenced in intercompany agreements. In the medium-to-longer term, MNEs may consolidate or rationalize to address changes to their markets or supply chains.

Past economic downturns (e.g. the Dot-Com recession and the 2008 Financial Crisis) did not reduce the IRS's or other taxing authorities' review of transfer pricing modifications, business restructurings, or loss transactions — even though substantive in nature and undertaken in the presence of economic duress. Indeed, following the 2008 Financial Crisis, taxing authorities raised — and vigorously pursued — debt-equity issues in the context of refinancings involving third-party banks. Therefore, it is reasonable to assume that the next round of audits by the taxing authorities will be robust when they commence examinations of COVID-19-impacted tax years. In this regard contemporaneous documentation will be critical. At a macro level, such documentation should demonstrate how COVID-19 changed the commercial landscape and disrupted supply chains throughout the world. At a specific company level, the documentation should further establish that losses or downward economic adjustments were related to the extraordinary circumstances of the COVID-19 pandemic rather than the intercompany pricing.

Notably, the reality of unexpected losses has prompted questions to both local tax regulators and the OECD as to how MNEs should address transfer pricing policies in 2020 and the following years. More generally, in the US, the IRS published a Frequently Asked Questions (FAQ) guide on Transfer Pricing Documentation Best Practices, which clearly demonstrates that contemporaneous transfer pricing documentation is going to be extremely important to demonstrate the arm's-length nature of business results. Core themes of the FAQ guide included changing business circumstances in light of economic downturns and the requirement that transfer pricing documentation appropriately explain the associated impacts on profit realization. The OECD will be issuing transfer pricing specific COVID-19 guidance and has invited various stakeholders to submit information on issues to be addressed. Specific advice would help both taxpayers and tax administrations to mitigate the onset of COVID-19 related tax controversy.

In the interim, however, tax administrations in many countries may be less likely to pursue new audit activity and ongoing audits and litigation may be deferred or delayed, with priority focused on criminal activity and tax avoidance as a result of the crisis. Taxpayers with advance pricing agreements (APAs) may see critical assumptions violated due to economic conditions. Certain competent authorities have stated that they will assist taxpayers in addressing the impact of the crisis on both pending and existing APAs. In the US, for example, APMA is actively discussing various substantive and procedural issues with treaty partners, including the application of transfer pricing methods in periods of economic distress and the impact of current economic conditions on specific industries, types of taxpayers and different regions, among other factors.

MNEs will continue to grapple with economic conditions caused by COVID-19 for the foreseeable future, while at the same time, continue to monitor the progress of the OECD BEPS 2.0 project, which is top of mind for all interested parties.

BEPS 2.0 – the Digitalization Project

Not surprisingly, governments have been immersed in addressing the economic chaos resulting from the pandemic, thereby creating a stumbling block to revamping the global tax system. The OECD, is however, increasingly pressured to deliver on its BEPS 2.0 (or the "digitalization") project. The digitalization project refers to the OECD's efforts to develop a multilateral set of rules related to the jurisdiction to tax and the allocation of profits in the digital world. Led by the Inclusive Framework, those jurisdictions involved in the project, a number of policy notes and reports have been issued over the last couple of years.

Most recently, the Inclusive Framework issued a package of documents that updated the work on tax challenges arising from the digitalization of the economy. Specifically, the Inclusive Framework settled on an initial approach based on two pillars. Pillar One proposed a three-part profit allocation mechanism that partially departs from the arm's length principle and, at the same time, creates a new taxing right that is not based on physical presence. Pillar Two features both an income inclusion rule (a minimum tax standard) and denial of deductions for base-eroding payments, as well as other supporting rules. For the first time, the Inclusive Framework supported the Pillar One

“unified approach” as the basis for further negotiations on revising taxing rights. It is worth highlighting that a key goal of Pillar One is to increase tax certainty through effective dispute prevention and resolution features. Subject to consensus, mandatory binding dispute resolution tools will also be developed.

The Inclusive Framework continues to double down on its ambitious timeline to achieve a consensus solution by the end of 2020. In the interim, the Inclusive Framework has continued to emphasize that if a comprehensive consensus-based solution is not reached within the agreed G20 timeframe, there is substantial risk that jurisdictions will increasingly adopt uncoordinated unilateral tax measures that are bound to increase the risk of double taxation. Achieving a consensus solution may become more problematic as countries will be keen to protect their own tax base as part of the efforts to rebuild from the economic deterioration caused by the COVID-19 pandemic. Moreover, government stimulus packages and other measures will need to be financed and governments will be incentivized to find additional sources of taxable revenue. The digital services economy is now under heightened scrutiny as a source of potential tax revenue, particularly focused on the major digital companies in the US. Governments will, therefore, be keen to attempt to tax digital companies in an effort to recover from the global recession. Accordingly, certain stakeholders are of the view that the digital tax project is now more relevant than ever.

One area of concern for many stakeholders is how to ensure the resolution of disputes between countries and companies with respect to how much tax is owed in a jurisdiction under the developing new rules. In this regard, the OECD publicly announced the development of a two-phased process that would use a two-panel approach. The first panel would make an initial determination and a second panel would make a decision that would be considered binding, if the first panel is unable to reach a resolution. That said, binding dispute resolution continues to be a difficult and politically contentious matter.

However, the road to a global agreement on changes to the international tax framework has become more uncertain following the US Treasury Department’s decision to “pause” participation in certain OECD negotiations so that all stakeholders could focus on responding to economic issues resulting from the COVID-19 pandemic. The US Trade Representative (USTR) has also made it clear that countries should not pursue discriminatory unilateral actions while the Inclusive Framework agreement is pending negotiations, warning that the US will pursue sanctions against countries that move forward with such unilateral actions. In response to the USTR, various governments as well as the European Union have indicated an unwillingness to stop considering or implementing actions, despite retaliatory steps taken by the United States. To the extent that countries start enacting their own measures targeting digital activities, trade tensions will inevitably increase and may result in significant retaliatory tariffs.

Is a trade war on the horizon?

Indeed, many stakeholders are predicting a trade war is on the horizon due to political unrest with respect to digital taxes (along with food, gas, and cars). In 2019, the US completed an investigation of France's digital tax under Section 301 of the 1974 Trade Act, concluding the tax constitutes discrimination against US technology companies, which nearly prompted a trade war between the two countries. In response to France's digital tax, the USTR had announced new tariffs on French wine and other French goods, but the two countries reached a detente and France delayed the collection of levies. However, the USTR recently issued a notice of action in the Section 301 investigations and a retaliation schedule to begin in January 2021, which would place an additional 25% tariff on a range of products made in France.

The US has also announced investigations into unilateral measures in the UK, Italy, Brazil, and other countries, which may likely lead to new punitive tariffs and heightened trade tensions. The concern is that trading partners are adopting tax schemes designed to unfairly target US-based companies, and the USTR has indicated that the US will be prepared to take action to defend US businesses and employees against discrimination. Many stakeholders are concerned that the imposition of tariffs could further strain a global economy that is facing the worst downturn in more than a century.

Moreover, the OECD tax chief has commented that the progression and resolution of global talks on digital services taxes may depend on the outcome of the US elections in November 2020. In the interim, the OECD will present what has been termed "blueprints" by October 2020, which will provide the technical details of the unified approach for Pillar One and Two. That said, there is continued caution that reaching a consensus by year end may not be realistic given the number of issues that are pending, and a lack of consensus would prolong already delayed talks to secure a deal on taxing the digital economy. In the interim, a number of stakeholders predict a clear and significant risk of trade wars over the digital services tax.

Tax reform

The international tax provisions in the US Tax Cuts and Jobs Act (TCJA) – coupled with an interconnected, complex and challenging global tax environment relating to BEPS 2.0 and the impact of COVID-19 pandemic on the global economy – will further complicate MNEs' supply chains and other decisions on where to locate business functions, assets and risks.

In today's distressed economic environment, MNE tax departments are being forced to re-prioritize their tax agendas. Pre-pandemic the focus was on tax reform and compliance, while the focus now (and in a post-pandemic era will be) on addressing liquidity needs, modifying transfer pricing arrangements to free up cash flow, restructuring operations and meeting compliance burdens. Nevertheless, tax reform implications need to be contemplated in parallel with modifications to transfer pricing arrangements and/or business restructurings that are implemented to mitigate the COVID-19 pandemic impact. MNEs will be particularly well-advised to consider transfer pricing risk with respect to the Base Erosion Anti-Abuse Tax (BEAT), the Global Intangible Low-Taxed Income (GILTI) tax, and the Foreign-Derived Intangible Income

(FDII) deduction. The interactions between these three provisions must be closely evaluated because the tax consequences of one provision may significantly impact the tax consequences of another.

As MNEs consider different supply chain structures and locations within their global operations, they must also consider the risk of transfer pricing audits and examinations and develop and implement appropriate strategies and best practices.

Profit splits

The use of profit split approaches has become increasingly common in the issuance of new guidelines and local legislation, as well as in audits and in applying alternative methodologies. A core issue in numerous transfer pricing controversies surrounds the source of value creation and questions regarding where to attribute profit to value creation. These disputes tend to be complex, therefore audits and negotiated settlements are often contentious and protracted.

Action 10 of the OECD's BEPS Action Plan relates to the development of rules or measures that clarify the application of profit split approaches in the context of global value chains. In June of 2018, the OECD released its final report titled *Revised Guidance on the Application of the Transactional Profit Split Method*. This report provided that a profit split approach may be appropriate when the contributions of the parties cannot be reliably evaluated in isolation because the relevant business operations are highly integrated, or where the parties share the assumption of economically significant or closely related risks. Furthermore, the UN's Twentieth Session of the Committee of Experts on International Cooperation in Tax Matters revealed that the next version of the UN Practical Manual on Transfer Pricing for Developing Countries, which is due by 2021, will include additional updates on profit split methodologies. These actions demonstrate a trend toward the promulgation of guidance that embraces the use of profit split approaches.

In the context of alternative dispute resolution options, in March 2019 the US APMA program released a Functional Cost Diagnostic (FCD) Model - the FCD workbook is an Excel-based tool for collecting and analyzing taxpayer financial data in cases where APMA believes that two or more parties may be making significant value-added contributions to the relevant business operations, regardless of industry or whether the proposed covered transaction is inbound or outbound to the United States. In the latter part of 2019, the Director of the APMA program announced the impending release of an enhanced FCD workbook that will include new features, including a requirement that taxpayers identify and provide certain information with respect to entities and transactions within the related-party group and supply chain that may impact the profitability of US operations. Although certain taxpayers may be requested to complete an FCD Model in the process of filing an APA request, APMA stressed that this does not evidence APMA's conclusion regarding the selection of a best method in given cases. The FCD Model reflects APMA's view that a diagnostic evaluation of taxpayer data under a residual profit split method model may be appropriate in certain cases. Recently, APMA's Director publicly stated that the introduction of the FCD tool did not substantially impact the number of APA applications filed in 2019. In addition, we

understand that APMA has recently honored the requests of taxpayers to submit APA applications without an accompanying FCD model in certain instances.

The new reality is that profit split approaches will continue to gain popularity from a local regulatory perspective as well as in transfer pricing disputes. MNEs will be encouraged to proactively consider whether tax authorities are inclined to apply a profit split to their particular intercompany arrangements, considering the functional profile of the relevant entities within the overall value chain.

International tax litigation and state aid

There are noteworthy transfer pricing and related disputes taking place around the world where tax administrations are focused on a variety of issues. Many of these disputes have reached national and international courts, notwithstanding the OECD's BEPS efforts to improve the international tax framework and develop effective and efficient dispute resolution options. Recently, there have been several landmark decisions that serve as guidance for taxpayers, tax advisers, and tax administrations. The core trends in these cases include, but are not limited to: the definition of intangibles assets, recharacterization of transactions, inclusion of stock option costs in cost sharing arrangements, attribution of profit to permanent establishments, use of adjustments to comparable uncontrolled prices, aggregation of transactions, etc.

In the US in particular, we witnessed notable decisions within recent months.

On June 22, 2020, the US Supreme Court refused to grant the writ of certiorari in the high-profile case *Altera Corp. v. Commissioner*. The *Altera* case involved the validity of a Treasury regulation (Treas. Reg. sec. 1.482-7A(d)(2)) that required stock-based compensation (SBC) to be included in the cost pools of intangible development costs (IDCs) associated with cost sharing arrangements (CSAs). Although the *Altera* saga has ended in the Ninth Circuit, the core issue regarding the validity of Treas. Reg. sec. 1.482-7A(d)(2) can be litigated in other circuits. The wake of *Altera* could potentially motivate the IRS to scrutinize stock-based compensation costs more proactively. Accordingly, taxpayers whose intercompany CSA agreements contain clauses referencing SBC and the validity of Treas. Reg. sec. 1.482-7A(d)(2) must assess the impact of the *Altera* litigation on their contractual and tax obligations.

In *Whirlpool v. Commissioner*, the Tax Court dealt with the question of whether income earned by a Luxembourg based Controlled Foreign Corporation (CFC) via the sale of appliances produced by a disregarded Mexican entity constituted foreign-based company sales income (FBCSI) under IRC section 954(d)(2) (the branch rule). The Tax Court held that the Luxembourg CFC was subject to the branch rule by passing title and selling inventory (via its participation in intercompany sales agreements and its recording of sales income), and that the sales income was FBCSI because Whirlpool's Mexican branch was treated as a subsidiary of the Luxembourg CFC. Thus, the sales income generated by the Luxembourg CFC constituted FBCSI. The *Whirlpool* case requires companies with maquiladora regimes to reassess their positions for purposes of financial accounting.

In the European Union (EU), the hallmark state aid controversy between the European Commission and Apple, Inc. over a $14.9 billion tax bill was recently decided in favor of

Apple by the EU General Court (EGC). The EGC ruling found that the European Commission failed to meet the requisite legal standard that Ireland's tax deal obstructed state-aid law by providing Apple an unfair advantage. Accordingly, although the case may be subject to appeal, it appears Apple will not be required to repay $14.9 billion in state aid benefits the European Commission claimed it had received from Ireland. This case has been part of the EU Commission's five-year crusade to eliminate allegedly unfair tax deals that MNEs have received from EU governments. This decision will likely not hinder the EU's continued review of tax planning measures under state aid rules. The EGC decision will, however, set important precedent in tax law for a number of state aid disputes over Irish tax structures.

Audit readiness and dispute resolution options – global strategies

Historically, taxpayers have handled transfer pricing audits on a case-by-case (or ad-hoc) basis, with the assistance of global and local country resources. The COVID-19 pandemic and corresponding impact on the global economy will force taxpayers to revisit risk mitigation procedures and deploy global strategies to assess risk and develop a coordinated, centralized approach to transfer pricing arrangements, particularly when the prospect of disputes involving the 2020 year and subsequent years are subject to audit. These tax audits will take place many years after the close of the relevant taxable years – and this time gap allows memories to fade, employees with the institutional knowledge to leave, and supporting data and analyses to become lost. Recessionary times often enhance these challenges due to higher workloads and generally increased employee turnover.

To combat these challenges, MNEs are well advised to prepare a contemporaneous "audit-ready" defense file. Defense files can mean different things depending on the eye of the beholder (and, of course, depending on the MNEs needs). At a minimum, and using a transfer pricing issue as an example, the defense file should at least contain the relevant contemporaneous documentation requirements necessary to avoid an assertion of related penalties. The defense file, however, should contain a number of additional materials that, in the aggregate, will achieve at least two key objectives. The first objective is the need to develop and support the "theory of the case" (i.e. the factual underpinnings, business purpose and legal basis for the tax position). The second objective is the need to serve as a resource that thoroughly identifies applicable risks and exposures and appropriate responses. The global tax department will also need to have an understanding of the important nuances in audit processes on a country-by-country basis. In that connection, the dispute resolution process, including the right to administrative appeals, competent authority procedures, arbitration and litigation, varies across jurisdictions, requiring enhanced awareness of procedural options and requirements.

Assessing audit readiness is also prudent in the context of planning opportunities by addressing uncertainty upfront and developing a proactive approach to assess the risk of current and potential positions through the lens of the future tax landscape while considering proposed and finalized guidance and legislation. This has become increasingly important as a result of BEPS 2.0 and local tax reform initiatives to implement digital services taxes.

Effective dispute resolution capabilities have become more critical, with tax departments increasingly considering alternative dispute resolution options, including mutual agreement procedures (MAPs), as well as APAs and other pre-filing rulings. Such options, however, must be evaluated on an issue-by-issue and country-by-county basis to determine whether the dispute resolution option under consideration will be most effective and efficient under the circumstances of each case.

Takeaways

The global tax community expects increased tax audits and disputes and heightened uncertainty and complexity in this new decade marked by unpresented events and extremely difficult economic challenges. Without a doubt, MNE steps to preserve liquidity and free up cash flows as well as allocate losses, will be subject to close review by tax administrations throughout the world. Profit split approaches may be used more frequently in situations where a particular tax administration deems such an approach necessary to achieve its fair share of income and tax. Governments will now attempt to enhance revenue collections to help fund COVID-19 costs and restart economies. Until consensus is reached on the digital services tax, individual countries are likely to continue to move forward with unilateral steps in taxing the digital economy. As a result, the risk of double taxation of MNEs may substantially increase and the threat of trade wars is on the horizon. In this unprecedented environment, MNEs will be forced to struggle with a new level of uncertainty and with tax models that present new challenges in multinational taxation. Accordingly, it is of paramount importance that MNEs develop strategies to prevent and manage audits on a local country and global scale.

David Swenson
PwC
Global Leader, Tax Controversy and Dispute Resolution Network
david.swenson@pwc.com

The author would like to acknowledge and thank Crystal Thorpe, PwC, Director – Global Structuring, and Ryan Trombley, PwC, Experienced Associate - Global Structuring, for their contributions to this article.


This article was previously published in International Tax Review's August 2020 Tax Controversy Leaders Guide