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Transfer Pricing Litigation: A Comparative Study of Fourteen Countries

During the PwC global transfer pricing conference in Budapest in October 2010, PwC practitioners debated with the tax directors of international companies on litigation as a possible way of settling disputes with tax authorities. This article considers the many differences among the countries represented, and notes that some of these differences were indeed unexpected.

1. Introduction

It has been explained many times why companies can expect to face more challenges to their transfer pricing models in all the countries in which they operate. When such disputes arise, they can be dealt with in various ways, including negotiate and settle; litigate; or apply for a mutual agreement procedure or arbitration under international treaties. Each of these ways has its own advantages and disadvantages. During the PwC global transfer pricing conference in Budapest in October 2010, PwC practitioners debated with the tax directors of international companies on litigation as a possible way of settling disputes with tax authorities. It soon appeared that there are quite some differences among the countries represented, and that some of these differences were unexpected.

This article summarizes what a tax director should know about litigating a transfer pricing case in a foreign country, including new issues which the tax director will have to consider in addition to the issues already familiar from litigation in the tax director's home country. This country review includes 14 countries from all trading continents: Australia, Belgium, Brazil, Canada, France, Germany, India, Japan, Korea (Rep.), Malaysia, Mexico, the Netherlands, Poland and the United States.

2. Administrative Appeal

As a first step, a multinational corporation may have to file for administrative appeal against the transfer pricing adjustment with the local tax authorities. The authors found that, if the company wants to litigate its case in court, this step is mandatory in some countries but not in all countries, as indicated in Table 1.

Table 1	
administrative appeal is a mandatory step for litigation	Belgium, Canada, France, Germany, India, Japan, Korea, Malaysia, Netherlands, Poland
administrative appeal is not a mandatory step for litigation	Australia, Brazil, Mexico, United States

In India, which has more complex rules in this area, the taxpayer can choose to start the administrative appeal at two different institutes of the government, namely the Dispute Resolution Panel or the Commissioner for Appeals. The existence of two options requires the foreign tax director to develop a strategy enabling the foreign tax director to make the best choice for his or her case. All countries where an administrative appeal is a mandatory step prior to litigation, reported that they have rules allowing the taxpayer to go to court if the government fails to take a decision on the administrative appeal within a certain time period.

All countries have a system in place in which the administrative appeal is handled by a different person than the one who has issued the tax assessment with the transfer pricing adjustment. The purpose of this procedure is to ensure that the issue is reviewed within the tax authority by an independent tax inspector with a fresh view. In Poland and the United States, the administrative appeal is even handled by a separate part of the government. In most countries, however, the administrative appeal is handled by a different individual within the same tax office. As transfer pricing adjustments in practice are decisions by a team within a tax authority, the tax director may be concerned how fresh the view in administrative appeal is in reality, as the internal reviewer may already know of the case and the sentiments surrounding the case, e.g. within the framework of internal technical meetings.

With these issues in mind, the question arises as to why taxpayers would bother to file an administrative appeal in those countries where it is not a mandatory step prior to litigation. The answer is that, despite the said issues, a large number of disputes are resolved on administrative appeal in favour of the taxpayer, especially in the United States. In addition, it is less costly and less time consuming than litigation. Finally, none of the countries requires that the administrative appeal be filed by a lawyer who is admitted to the bar.

3. Reputational Aspects of Tax Litigation

Most multinational corporations consider corporate responsibility as a cornerstone of their reputational strategy. Corporate responsibility is about corporate self-regulation, support to law enforcement and ethical standards. It is about the deliberate inclusion of the public interest into corporate decision making. The question therefore arises

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as to how tax litigation relates to the company's corporate responsibility strategy and to its reputation, especially if the issue may be described in a newspaper article as "aggressive tax planning". As an anecdote, it is recalled in this context that, when GlaxoSmithKline settled its US transfer pricing dispute with the IRS in 2006, a reputable newspaper commented that "the IRS accused GSK of transfer pricing". Apparently, misunderstandings easily arise. Some companies have a strict policy not to litigate their tax issues because the government is also an important customer of the group. The company therefore may want to balance possible benefits of litigation against the possible impact of litigation on its reputation with financial markets and customers. Table 2 shows in which countries it can become public knowledge that a multinational corporation has serious tax issues.

Table 2	
taxpayers named in litigation	Australia (but petition for anonymity), Belgium, Brazil, Canada, France, India, Japan, Korea, Malaysia, Mexico, Poland, United States
taxpayers not named in litigation	Germany, Netherlands

4. Cash Is King

An important consideration for the group will be whether it has to pay the disputed tax upfront, especially in view of the long time frame of litigation. All countries reported that the full cycle of litigation lasts between five and ten years. India is the exception to this rule, where litigation is anticipated to take more than ten years.

The authors found quite some variations in the answer to the question of whether the disputed tax must be paid upfront. In the United States, the answer depends on the tax tribunal at which the taxpayer litigates the transfer pricing adjustment. In India, the payment of disputed tax is subject to negotiation, but both UK and US multinational corporations may invoke certain arrangements based on their tax treaties with India. In Brazil, taxpayers can choose to bring their case before an administrative court or directly before a judicial court. Disputed tax is suspended while the litigation is in the administrative court. Before the judicial court, taxpayers must proceed with a deposit of the disputed tax or offer assets in guarantee. Alternatively, they can plead for a preliminary injunction in order to suspend the disputed tax, although such preliminary injunction is unlikely to be granted. In Canada, 50% of the disputed tax must be paid upfront or be guaranteed. In some cases, it may be possible to ask the court for a suspension of the entire amount of the disputed tax. Table 3 indicates whether tax must be paid upfront in the countries considered in this survey.

Table 3	
upfront payment	Canada (50%), Japan, Korea, Malaysia, Poland, United States (federal district court; court of federal claims)
guarantee	Brazil (judicial court), Canada, France (but not in MAP), Japan (only in MAP), Mexico
suspended	Belgium, Brazil (administrative court), Netherlands, United States (tax court)
subject to negotiation	Australia, Germany, India

5. How Strong Is the Case in Court?

When considering litigating a transfer pricing dispute, the director may want to evaluate how strong the case would be in court. Not only does such evaluation require an analysis of the economic rationale of the transfer pricing system, but it also requires additional analyses such as of the division of the burden of proof and the strength of the available transfer pricing documentation. Table 4 considers the burden of proof in transfer pricing cases in the countries analysed in this comparative survey.

Table 4	
burden of proof typically with tax authorities, provided that taxpayer has adequate documentation	Belgium, Canada, France, Germany, Japan, Korea, Netherlands, Poland
burden of proof typically with taxpayer	Australia, Brazil, India, Malaysia, Mexico, United States
court may shift burden of proof to most appropriate party	Canada, India, Mexico, Netherlands

Quite often multinational corporations are convinced of the robustness of their transfer pricing documentation. An often overlooked question is, however, whether the documentation would convince a foreign court, i.e. outsiders trained in legal analysis and not in economics or business administration. Important questions for litigation include whether the documentation has been reviewed against local laws, including the possible requirement that it be prepared in the local language. When it comes to the strength of the transfer pricing documentation, the company may want to consider preparing additional documentation to remedy possible deficiencies.

6. The Experience of the Foreign Judicial System

A multinational corporation may also want to consider the experience of the foreign judicial system in transfer pricing cases. In all countries, the number of transfer pricing cases is very low. India is the exception, and accounts for more than half of the total number of transfer pricing cases around the world. In addition, although most countries provide for a system of expert witnesses, it appears that they are called upon only in Australia, Canada, Mexico and the United States on a frequent basis. Finally, in many countries, practitioners on both sides have developed a common, economic approach to transfer pricing issues, and the question arises as to whether a court will follow this common approach or whether it will apply a totally different approach. These issues require careful consideration by the multinational corporation.

7. In Court

Most countries have a judicial system that follows a generic model of a district court, a court of appeal and a supreme court. However, the authors found some interesting variations on the generic model. When considering litigating a case in one of the EU Member States, the tax director should be aware that the local supreme court is obliged to refer the case to the European Court of Justice if the interpretation of EU law in respect of the transfer pricing legislation in the concrete case is unclear. Also, EU taxpayers may lodge a complaint with the European Commission if the local transfer pricing legislation, administrative guidelines or conduct of the tax authorities runs counter to EU law. In Brazil, the taxpayer can choose to bring its case directly before a judicial court or before an administrative court. Taxpayers generally prefer the administrative court as a first step, as there is an equal number of representatives from the administration and from taxpayer organizations. In India, it appears that taxpayers have been quite successful in litigating transfer pricing adjustments. In the Netherlands, the court can invite the taxpayer and the tax authorities to restart settlement negotiations, but now under the guidance of an independent mediator. In the United States, the taxpayer can choose to commence its litigation before one of three different tax tribunals, each having its own rules for appeal, upfront payment of tax, relevance of earlier case law, etc.

As to what kind of ruling to expect from the judicial system, the authors also found some unexpected differences. In almost all countries included in this review, the lower courts may either decide in favour of a particular party or may decide anything in between the positions of the two parties, while the supreme court only considers whether the decision of the lower courts is lawful. In Brazil, Korea and Norway, however, the situation in the lower courts resembles final-offering arbitration. The lower courts in these countries have very little authority (if any at all) to develop an independent view on whether the transfer pricing adjustment can differ from the adjustment proposed by the tax authorities or from the zero adjustment defended by the taxpayer.

Finally, the authors found quite some different answers to the question whether litigation requires the services of a lawyer admitted to the bar, as indicated in Table 5. It is interesting to note that in some countries like Germany and the Netherlands it is considered that the litigation system has been designed in such a way that the taxpayer can represent himself.

Table 5	
lawyer not required	Australia, Brazil, Germany, Mexico, Poland
lawyer required only for specific actions such as oral pleading in Supreme Court	France, India, Netherlands
lawyer required	Belgium, Canada, Japan, Korea, Malaysia, United States

8. Conclusion

The foreign tax director is often faced with the decision to accept the final settlement offer of the local tax authorities or to litigate the transfer pricing adjustment. From earlier disputes in the foreign tax director's home country, he or she is familiar with the hazards of litigation. This article has summarized additional topics to be taken into account when considering transfer pricing litigation in a foreign country.

In the preparation for PwC's global transfer pricing conference, the authors found a number of significant procedural differences between countries that require tax directors to develop a country-specific strategy before bringing their cases to a foreign court.

Moreover, in the discussions between tax directors and PwC practitioners during the conference, attention was drawn to important aspects of other dispute resolution mechanisms. All debaters expressed concerns that litigation may hinder company-driven change to the transfer pricing system, as it may be seen as a sign of weakness during litigation. A multinational corporation may therefore be locked into its current transfer pricing system as long as the litigation lasts.

In Australia and the Netherlands, the tax authorities recognize that if there is a contentious issue in the audit period, it is likely to also exist in later years. Therefore, in these countries, settlement negotiations offer the opportunity to resolve the issue also for more recent years in addition to the years under audit. It may be a great advantage over litigation to the tax director to resolve all disputes in one effort through negotiations.

Belgium, Mexico and the Netherlands reported that if a company is willing to consider a change of its transfer pricing system for future years, such behaviour is highly appreciated by tax authorities and may help in reaching a settlement for the years under dispute in a more amicable way.

Germany, the Netherlands and the United Kingdom offer enhanced relations programmes, and consideration must be given to how litigation fits into these programmes.

Also, when considering how to resolve a dispute, it is important to bear in mind that differences also exist as to how effective mutual agreement procedures may be. Brazil, for example does not have any system for mutual agreement procedures in place. In France, on the other hand, a mutual agreement procedure will result in the payment of the disputed tax being suspended without guarantees, while such guarantees are required during litigation. Likewise in Japan, payment of tax may also be suspended during a

mutual agreement procedure, subject to a guarantee being provided (although no such suspension is possible for litigation). Japan and Germany have over 350 and 500 pending mutual agreement procedures, respectively, with some 100 being resolved each year for both countries. The Netherlands claims to resolve more than 90% of its mutual agreement procedures within two years.

The conclusion from the debate was that the decision of a tax director to settle, to litigate or to start a mutual agreement or arbitration procedure for a transfer pricing dispute in a foreign country must take into account many factors that differ from one country to another, and even from one industry to another. Thus, it is important for tax directors to keep an open mind to all possibilities and options when such a situation arises.